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Financial Innovation: Reducing Fintech Regulatory Uncertainty

Many companies are developing innovative financial technology—or *fintech*. Broadly, fintech aspires to provide financial products using technological advances. Given that most of the federal financial regulatory framework was created prior to these technologies, fintech companies often face uncertainty over how—or whether—existing federal laws and regulations may apply to them or their products. Thus, policymakers may consider ways to reduce regulatory uncertainty and integrate fintech into the regulatory framework. This often involves balancing efforts to encourage innovation while protecting consumers and the financial system from excessive risk. This In Focus examines regulatory uncertainty related to fintech and analyzes possible policy approaches and recent regulatory initiatives that may reduce it.

Fintech and Regulatory Uncertainty

Fintech is an inclusive term that can encompass many technologies providing an array of financial services or products (see **Table 1** for examples). The existing regulatory structure, however, may not always have clear rules for new types of fintech. In addition, companies and regulators may have difficulty determining the risks a new technology may create before it is launched. This regulatory uncertainty can negatively affect many different stakeholders.

Table 1. Examples of “Fintech”

Innovation	Financial Product or Service Affected
Online Marketplace Lending	Commercial lending
Crowdfunding	Equity issuance
Blockchain Ledgers	Payment and settlement
Robo-Advising	Wealth management
Algorithmic High-Speed Trading	Securities trading
“RegTech”	Regulatory compliance
“Big Data”	Credit bureau agencies

Source: CRS. **Note:** This is a non-exhaustive, illustrative list.

Companies and Investors. Companies must attract investment in order to develop and introduce innovative technologies. Investors generally consider whether a technology will comply with applicable regulations in determining the profitability of these investments. Yet, there may be no clear precedents for which regulations apply to a new financial technology. In addition, certain fintech firm principals’ and investors’ expertise may lie in technological fields—e.g., software engineering or computer programming—rather than in the financial

industry, increasing their uncertainty as to how financial regulation may or may not apply to their product.

Regulators. Absent a track record of performance, regulators may lack a complete understanding of what outcomes a new technology or product may generate, the risks it presents, and the appropriate regulatory treatment. Consequently, they may (at least initially) apply regulation in an ineffective or inefficient way to a technology with which they are unfamiliar.

Consumers. When accessing an unfamiliar financial product, consumers may lack a complete understanding of the product’s terms or the risks they face. This could be especially problematic if it is not clear what consumer protections apply to that product.

Potential Regulatory Approaches

Many still-evolving terms are used to describe different programs regulators have implemented or proposed to address fintech uncertainty, including “sandbox,” “greenhouse,” and “single point of entry.” Generally, such programs use at least one of the following approaches.

Increased Regulator Outreach. Communication between fintech firms and regulators can help these firms better understand how regulators view a developing technology and potential regulatory concerns. Communication also helps make regulators aware of new fintech innovations when developing new or interpreting existing regulations. As discussed below, certain regulators have established offices within their organizations to conduct outreach to fintechs—including maintaining outreach websites, participating in fintech conferences, and organizing office hours with fintech firms.

Regulator Information Gathering and Study. Some regulators have announced research collaborations with fintech firms to improve their understanding of new products and technologies. Such initiatives could include jointly designing a research trial or fintech firms sharing data about their product performance with regulators.

Tailored Regulation or Limiting Enforcement Actions. If policymakers determine that particular regulations are unnecessarily burdensome or otherwise ill-suited to a particular technology, they might exempt companies or products that meet certain criteria from such regulations. Similarly, a regulator could issue a *No Action letter*—an official communication stating a regulator does not expect to take enforcement actions in certain situations. Regulators will often only provide such special regulatory treatment to companies that first demonstrate that consumers will not be

exposed to undue harm or meet other conditions, like agreeing to share data with regulators for research purposes.

Offer-Specific Regulatory Regime. Regulatory uncertainty can be resolved if regulators offer or require certain fintech firms to enter a regulatory regime with well-defined permissions, restrictions, and responsibilities. For example, a regulator could offer or require a specific charter or license for certain firms.

The regulatory approaches described above could be supported or opposed by various stakeholders depending on how they are designed and implemented and which firms or products are affected. For example, while fintech firms may want to reduce regulatory uncertainty and operate under one set of rules nationally (rather than different rules in each state), they may also oppose new or additional data reporting requirements. Incumbent financial institutions may argue that regulatory tailoring for fintech firms would put incumbents at a competitive disadvantage. State regulators and consumer advocates may oppose any federal charter that would preempt state consumer-protection laws.

Implementation Considerations

Regulators may consider the following when determining their particular regulatory approach:

Institution- or Product-Based Application. Policymakers choosing to tailor regulation for fintechs could apply a different regulatory treatment either to companies or to products. If the goal is to provide new, inexperienced firms an opportunity to learn how they and their products would be regulated, institution-based regulation for firms meeting criteria associated with start-up companies may be the better option. But if the goal is to integrate a new technology regardless of the size or sophistication of the firm offering it, the differentiated regulatory treatment could apply to the product rather than the firm.

Rule-based or Regulator Discretion. Policymakers could also choose to tailor regulation for fintechs meeting certain objective criteria. Alternatively, regulators could use discretion in determining which fintech companies or products would qualify for such tailoring, potentially based on authorities or directions enacted in legislation.

Duration. Policymakers may also consider how long to apply a particular regulatory treatment to a fintech company or product. For example, a specific charter could last indefinitely, while an exemption or No Action letter might last only a finite period.

U.S. Examples and Proposals

CFPB Office of Innovation. Originally launched in 2012 as “Project Catalyst,” this office within the Consumer Financial Protection Bureau (CFPB) was revamped and renamed in 2018. The office’s mission is to promote innovation, competition, and consumer access within financial services through regulatory relief, engagement with the fintech community, and collaboration with other regulators. The office allows fintech firms to apply for research pilot projects, issues No Action letters, and has proposed granting regulatory safe harbors and exemptions

in the future. The CFPB also has the statutory authority to waive consumer disclosure requirements for companies that apply to test and improve consumer disclosures. Lastly, the office coordinates with other consumer regulators abroad.

SEC FinHub and LabCFTC. Securities and commodities regulators have also established outreach programs. The Securities and Exchange Commission (SEC) created FinHub and the Commodity Futures Trading Commission (CFTC) established LabCFTC. These portals are the agencies’ efforts to engage with the fintech industry, consolidate and clarify communications, and inform policy. Since their inception in 2018 and 2017, respectively, neither FinHub nor LabCFTC have announced new fintech rules.

OCC Fintech Charter. In 2018, the Office of the Comptroller of the Currency (OCC) announced that it would consider “applications for special purpose bank charters from [fintech] companies that are engaged in the business of banking but do not take deposits.” Companies with this charter would be explicitly subject to all laws, regulations, and federal preemptions applicable to national banks. To date, no such charter has been granted.

State-level Programs. A number of states have passed laws or created new licenses to tailor regulation for certain types of fintech firms. For example, Arizona passed a law that exempted firms meeting certain requirements from having to obtain licenses they otherwise would need for the first two to three years of operation. Similarly, Wyoming enacted a law that allows regulators to exempt innovative financial products from certain regulations for two to three years provided the products meet certain conditions. New York now requires that cryptocurrency exchanges and certain other cryptocurrency-related businesses obtain a special license to operate in the state or serve New York residents or businesses.

Selected Legislation: 116th Congress

The FINTECH Act of 2019 (H.R. 1491) aims to create a regulatory “single point of entry” for fintech start-up firms. The bill would establish a FinTech Council within the Department of the Treasury. The council would designate a regulator with authority to bring enforcement actions against each fintech firm that meets certain criteria. Qualifying firms would have safe harbor from enforcement actions by nondesignated regulators. In addition, the act would create an Office of Financial Innovation within each federal financial regulatory agency that would serve as a point of contact for fintech firms.

The U.S. Virtual Currency Market and Regulatory Competitiveness Act of 2019 (H.R. 923) would require the CFTC and other relevant regulators to provide recommendations for creating an alternative regulatory structure for virtual currency exchanges.

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