AN UNSAFE SANDBOX: FINTECH INNOVATION AT THE EXPENSE OF CONSUMER PROTECTION?

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INTRODUCTION

One risks sounding like a Luddite when expressing concern with technological progress. Yet managing any technological advancement requires making tradeoffs between fostering innovation, regulation, and protecting consumers.[1] These aims might not be mutually exclusive, but they are also not perfectly harmonious. And with the financial crisis looming in the rearview mirror, the present regulatory challenges are more pronounced.[2] Too-big-to-fail still resonates with the political class—a moniker with expanded meaning that now applies to large technology companies as well.[3] It is against this backdrop that the Consumer Financial Protection Bureau ("CFPB") proposed its Compliance Assistance Sandbox ("Sandbox"), allowing Fintech products and services to avoid the regulatory burdens that accompany innovation.

This Essay argues that the Sandbox is not the best way to achieve the dual goals of innovation and consumer protection. Part I offers background into the policy and commentary from industry leaders, policymakers, and trade groups. Part II argues that the policy satisfies none of the stakeholders: consumers, financial services firms, and regulators. With no clear direction or ends in mind, the CFPB's Sandbox could have negative repercussions both for the Fintech industry and its consumers.

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1. Chris Brummer & Yesha Yadav, *Fintech and the Innovation Trilemma*, 107 GEO. L.J. 235, 248 (2019).
2. Nathan Cortez, *Regulating Disruptive Innovation*, 29 BERKELEY TECH. L.J. 175, 199 (2014).
3. Nizan Geslevich Packin, *Too-Big-to-Fail 2.0? Digital Service Providers as Cyber-Social Systems*, 93 IND. L.J. 1211, 1215–16 (2018).

I. CFPB COMPLIANCE ASSISTANCE SANDBOX POLICY

Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act defines the CFPB's powers.[4] The purpose of the Bureau is to administer "consumer financial law consistently" so that consumers "have access to markets" that are "fair, transparent, and competitive."[5] To facilitate these goals, the CFPB may leverage rules, orders, guidance, and interpretation.[6]

President Donald Trump signed an Executive order on July 31, 2018 to review the current financial regulatory landscape.[7] Per this dictate, the U.S. Department of the Treasury ("Treasury") produced several reports targeting areas for reform, including nonbanks and Fintech firms.[8] One proposed solution was a "regulatory sandbox"—a safe space to allow financial services firms to innovate without liability.[9] Simply put, "the sandbox creates an environment for businesses to test products with less risk of being 'punished' by the regulator for non-compliance. In return, regulators require applicants to incorporate appropriate safeguards to insulate the market from risks of their innovative business."[10] The goal of a sandbox is to "[p]romote the adopting and growth of innovation and technological transformation in financial services."[11] The report goes on to highlight two case studies in Singapore and the United Kingdom; though it is short on specifics.[12]

The aims of the CFPB's new Sandbox mirror the Treasury's report. The policy was proposed on December 13, 2018 and allowed for a comment period.[13] The Sandbox utilizes three types of relief to protect Fintech firms. It includes no-action letters, which are specific exceptions for products.[14] It also incorporates "statutory safe harbor provisions" and "exemptions by order."[15] To participate and gain access to these forms of relief, Fintech firms would need to file an application and receive the CFPB's blessing.[16] This approval includes "a statement, subject to good faith compliance with specified terms and conditions, the Bureau approves the recipient's . . . offering or providing the described aspects of the

4. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

5. 12 U.S.C. § 5511(a) (2018).

6. *Id.* at § 5492(a).

7. Press Release, U.S. Dep't of the Treasury, Treasury Releases Report on Nonbank Financials, Fintech, and Innovation (July 31, 2018), https://home.treasury.gov/news/press-releases/sm447.

8. U.S. DEP'T OF TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES (2018) [hereinafter TREASURY REPORT], https://home.treasury.gov/sites/default/files/2018-07/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financi....pdf.

9. *Id.* at 168.

10. Dirk A. Zetzsche et. al., *Regulating A Revolution: From Regulatory Sandboxes to Smart Regulation*, 23 FORDHAM J. CORP. & FIN. L. 31, 64 (2017).

11. TREASURY REPORT, *supra* note 8, at 168.

12. *Id.* at 170.

13. 83 Fed. Reg. 64036.

14. *Id.*

15. *Id.* at 64037.

16. *Id.* at 64041.

product or service" and "rational basis for the Bureau's issuance of the approval."[17] The CFPB protects these firms from statutory or regulatory interference by ensuring, "the recipient(s) would be immune from enforcement actions by any [f]ederal or [s]tate authorities, as well as from lawsuits brought by private parties."[18]

The application to participate would require a "description of the consumer financial product or service to be offered . . . including (a) how the product or service functions, and the terms on which it will be offered; and (b) the manner in which it is offered or provided to consumers, including any consumer disclosures."[19] With the desired time for experimentation, firms must provide an "explanation of the potential consumer benefits of the product or service" and the "potential consumer risks posed."[20] The onus is also on the firm to identify "the statutory and regulatory provisions from which the applicant(s) seeks relief," as well as the other regulators from which the applicant desires relief.[21] These features are what the CFPB will evaluate to determine admission.[22]

The CFPB invited comments, receiving a total of twenty-nine letters. Reviews were mixed. One group of state attorneys general emphasized that "sandbox programs benefit consumers by encouraging entrepreneurial investment and innovation without compromising well-established consumer protection laws . . . ."[23] Highlighting governmental failure to encourage entrepreneurship, Arizona claimed that its own sandbox experienced success, but it still necessitates federal regulation.[24] Specifically, it notes that "sandboxes offer a way to lower the regulatory burdens associated with successfully navigating this patchwork system, while maintaining necessary consumer protections."[25] Likewise, the American Bankers Association ("ABA")—primary trade association for banks—argued that the policy "ensure[s] consumers have access to the innovative financial products, services, and delivery mechanisms they expect."[26]

The comments, however, were not all supportive. Another group of state attorneys general wrote that while technology can offer consumers access to vital financial services, "irresponsible banking practices and lax regulation pose significant risks not only to consumers, but to the entire U.S. financial system."[27] The group feared that the sandbox would "permit the CFPB to exempt—in some

17. *Id.* at 64041–42.

18. *Id.* at 64042.

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.* at 64043.

23. Office of the Arizona Attorney General, Comment Letter on Proposed CFPB CAS Policy at 2 (Feb. 12, 2019), https://www.regulations.gov/document?D=CFPB-2018-0042-0030.

24. *Id.* at 3.

25. *Id.* at 5.

26. Am. Bankers Ass'n, Comment Letter on Proposed CFPB CAS Policy at 1 (Feb. 11, 2019) [hereinafter ABA Comment], https://www.regulations.gov/document?D=CFPB-2018-0042-0016.

27. New York State Attorney General's Office, Comment Letter on CFPB CAS Policy at 1 (Feb. 12, 2019), https://www.regulations.gov/document?D=CFPB-2018-0042-0031.

cases indefinitely—companies and even entire industries from certain consumer protection laws and regulations through a process designed to value speed over careful decision-making."[28] Aside from claims of CFPB overstep in erasing private liability and other agency regulation, the letter's primary focus was on consumer protection.[29] Following New York's lead, consumer groups argued that thoroughly evaluating these applications would tax CFPB resources, and without full assessment, the regulatory check amounts to a "rubber-stamp that violates the Bureau's duties."[30] Paradoxically, the consumer groups further argued that such an onerous and uncertain process might lead to inconsistencies that may later amplify the risks of liability and litigation.[31]

II. THE IMPLICATIONS OF THE CFPB FINTECH SANDBOX

Solving regulatory problems in a space as dynamic as financial technology is no small task,[32] but the CFPB Sandbox might not be the answer. Part II addresses potential issues with the policy. This Part is divided into three sections. Each discusses the implications for different stakeholders—consumers, industry, and regulators—and concludes that the Sandbox might not be the ideal approach.

A. The Sandbox Does Not Protect the Primary Fintech Consumer.

The CFPB's overarching goal is to protect consumers, but creating a liability-free space for Fintech firms to operate appears to fall short of this end. The first question we need to answer is: who is the typical Fintech consumer? An Ernst & Young report found that nearly half of twenty-five to thirty-four-year-olds (*i.e.*, millennials) leveraged financial technology products and services, with the age segments slightly older and younger utilizing services at comparable rates.[33] Those forty-five and older were significantly less likely to consume these products.[34] Not surprisingly, Fintech users were also voracious users of other new technology from social media to streaming services.[35]

The problem with millennials as the target market is that research shows that they do not always make the best financial decisions. For instance, less than

28. *Id.* at 2.

29. *Id.*

30. Nat'l Consumer L. Ctr., Comment Letter on CFPB CAS Policy at 30 (Feb. 12, 2019), https://www.regulations.gov/document?D=CFPB-2018-0042-0029.

31. *Id.* at 32.

32. William Magnuson, *Regulating Fintech*, 71 VAND. L. REV. 1167, 1171–72 (2018) ("Fintech presents a particularly acute problem from the perspective of systemic risk for three reasons. First, fintech firms, because of their size and business model, are more vulnerable to adverse economic shocks than large financial institutions, and those shocks are more likely to spread to other firms in the industry. Second, fintech firms are more difficult to monitor and constrain than typical financial institutions because regulators lack reliable information about the structure and operations of fintech markets. Third, fintech markets suffer from collective action problems that inhibit cooperation among market actors.").

33. ERNST & YOUNG, EY FINTECH ADOPTION INDEX 2017 at 16 (2017), https://www.ey.com/Publication/vwLUAssets/ey-fintech-adoption-index-2017/$FILE/ey-fintech-adoption-index-2017.pdf.

34. *Id.* at 16.

35. *Id.* at 19.

one-third of millennials construct long-term financial plans.[36] This is perhaps a product of deficient financial literacy programs at younger ages.[37] Another example, from 2012 to 2018 credit card use among college students increased from twenty-eight to forty-six percent, and of that population, thirty-six percent already have over one thousand dollars in debt.[38] This is an increase of about ten percent in six years.[39] Though the student loan crisis has garnered most of the attention from millennials, increases in credit card debt should begin drawing the ire of policymakers.

Apps like Robinhood have introduced a new generation of investors to the market, but without much in the way of additional education.[40] This might result in millennials purchasing risky tech portfolios or cryptocurrencies—potentially lucrative investments, but ones that do not teach a younger generation how to properly invest and save. Finally, millennials tend to make questionable decisions when it comes to retirement.[41] Between not saving enough or taking advantage of company benefits and matching programs,[42] many millennials commit the mortal sin of needlessly withdrawing money from a 401(k) for discretionary purposes.[43] Troubling research from the TIAA Institute further illustrates that the biggest financial education gap among younger generations is "comprehending risk."[44]

This begs the question: are millennials vulnerable to an unregulated Fintech market? The CFPB's goal is consumer protection, and the primary consumers of Fintech services tend to be millennials. When the CFPB Sandbox begins, as designed, it will allow Fintech firms to operate with fewer regulatory guardrails, and consumers will not know the difference between a test product and one subject to the existing statutory environment. This leaves consumers, especially young consumers lacking financial literacy, susceptible to abuse, predatory behavior, or even negligence. Now exposed, these consumers are then left with no modes of recourse.

36. EVERFI, MONEY MATTERS ON CAMPUS 2 (2019), https://everfi.com/wp-content/uploads/2019/05/MoneyMatters-2019.pdf.

37. *Id.*

38. *Id.* at 10.

39. *Id.* at 10.

40. *See* Anne Sraders, *Is Robinhood Safe? What to Know About the Investment App in 2019*, THESTREET (Apr. 28, 2019), https://www.thestreet.com/technology/is-robinhood-safe-14933475 (arguing that it leads to questionable investing strategies).

41. JENNIFER ERIN BROWN, NAT'L INSTITUTE ON RETIREMENT SECURITY, MILLENNIALS AND RETIREMENT (2018), https://www.nirsonline.org/wp-content/uploads/2018/02/Millennials-Report-1.pdf (arguing that two-thirds of millennials have nothing saved for retirement).

42. *Id.* at 1.

43. A survey from ETrade revealed that 57% of 18 to 34-year-olds already withdraw from their 401(k) plans. *ETrade Study Reveals Early Retirement Account Withdrawals Are on the Rise Among Young Investors*, BUSINESSWIRE (Aug. 21, 2018), https://www.businesswire.com/news/home/20180821005671/en/E*TRADE-Study-Reveals-Early-Retirement-Account-Withdrawals.

44. PAUL J. YAKOBOSKI, TIAA, MILLENNIAL FINANCIAL LITERACY AND FIN-TECH USE (2018), https://www.tiaainstitute.org/sites/default/files/presentations/2018-09/TIAA%20Institute-GFLEC_Millennial%20P-Fin%20Index_September%202018.pdf.

Now, this is not to suggest that financial technology developments are somehow bad; actually, most are quite good. In fact, plenty of new products and services specifically address some of the deficiencies listed above. The California-based Affirm operates as an alternative to credit cards.[45] Wally uses artificial intelligence to improve spending habits.[46] And Betterment provides millennials with a holistic financial picture to help them save.[47] Each was designed to tackle discrete problems that traditional financial institutions neglected. Regulators must encourage and cultivate these ideas, while providing a safe environment for similar firms to develop.

The CFPB should not promote technological growth at the expense of consumers. Still, it could remedy this problem to ensure that the target Fintech consumer base is adequately protected. For instance, the CFPB could require clear disclosures that a particular product or service is only in a testing phase, and no liability could result from any issues or problems with its use. Or the Bureau could mandate that certain educational offerings accompany the release of test products. Plenty of noninvasive solutions exist to better protect young consumers so that they can safely try and test these innovative products.

B. The Sandbox May Have Unintended Consequences for Financial Services Companies.

A backlash from consumer groups and support from industry trade associations is predictable with most deregulatory measures. Case in point: the ABA began its comment letter stating, "As the history of banking amply demonstrates, innovation promotes financial inclusion, expands access to credit, and improves access to information, which in turn, supports informed decision-making and financial well-being."[48] But financial services firms should feel some unease.

The overarching concern should be consistency. If everyone were allowed to play in the Sandbox, then perhaps the above tropes would apply. But this has not been the case. This program is modeled after other international regulatory pilots.[49] And in some instances, regulators accept less than one-third of applications.[50] This process inevitably allows the government to choose which firms get to innovate risk-free and which firms remain constrained by existing regulation.

45. *A Group of Fintech Firms are Changing the way Consumers Borrow*, ECONOMIST (Oct. 10, 2019), https://www.economist.com/finance-and-economics/2019/10/10/a-group-of-fintech-firms-are-changing-the-way-consumers-borrow.

46. Michael Ansaldo, *Wally+ Review: It's Actually Enjoyable to Track your Spending with this App*, PCWORLD (Aug. 6, 2018, 6:57 PM), https://www.pcworld.com/article/3286808/wally-review-its-actually-enjoyable-to-track-your-spending-with-this-app.html.

47. Sarah Max, *A Robo-Advisor Takes a New Approach to Active Investing*, BARRON'S (Oct. 11, 2019, 6:09 PM), https://www.barrons.com/articles/robo-advisor-betterment-dimensional-fund-advisors-51570831638.

48. ABA Comment, *supra* note 26, at 2.

49. *See* TREASURY REPORT, *supra* note 8, at 170.

50. In the UK for example, the FCA has accepted about thirty-two percent of applications to its Fintech sandbox. *See* Mekebeb Tesfaye, *The FCA's Fintech Sandbox is Already Delivering Value*, BUS. INSIDER (Oct. 11, 2018, 7:12 AM), https://www.businessinsider.com/fca-fintech-sandbox-delivers-value-2018-10.

The CFPB listed the generic criteria to gain acceptance into the Sandbox, but it lacks specifics.[51] This should create pause. In recent memory, the government has shown preference for certain companies over others.[52] And in the past few years, large technology firms like Facebook and Amazon have come under increasing scrutiny.[53] Would banks be able to catch up in a technological foot race if nimbler technology companies were denied applications? Participation "lends a certain regulatory imprimatur to a participating firm . . . .This is certainly one of the key benefits of the regulatory sandbox for startup firms, but it raises reputational issues for the regulatory body in selecting participating firms."[54] Additionally, the CFPB includes no size criteria for applicants. Sandboxes have historically targeted early stage technological development—that is, smaller enterprises. But would the CFPB show a preference for larger firms with more technological expertise, resources, and lobbying arms? Or would early stage start-ups have opportunities to participate?

There are innumerable open questions about the application process, both technical and political, that the CFPB has not answered. As such, the potential procedural inconsistencies should be enough to sound the alarm for industry players. Less regulation might sound nice at first blush, but Fintech leaders are not following the policy to its logical conclusion. The purpose of rules-based regulation is that it attempts to treat all companies—big, small, established, new—fairly. They all must operate within the same constraints and guardrails, without others receiving special treatment. But a system that allows the CFPB to pick and choose which financial services providers get a regulatory advantage should raise red flags.

C. CFPB Emphasizes Industry Innovation at the Expense of Regulatory Learning.

Finally, the Sandbox policy seems counterintuitive to the CFPB's call to regulate on behalf of consumers. A sandbox is a pilot program. It should teach firms what they can and cannot accomplish. But it should also provide regulators reciprocal lessons so they can build long-lasting policies. A sandbox should yield findings the CFPB can use to write new regulations or report to Congress.

Yet the CFPB is more concerned with opening the door to unrestrained financial innovation. Even the ABA urged the CFPB "to account for experience with or evidence gathered through the NAL and Sandbox process to, when ap-

51. *See* 83 Fed. Reg. 64042.

52. *See* Steven Overly & Josh Gerstein, *Trump Administration Sues to Block AT&T-Time Warner Merger*, POLITICO (Nov. 20, 2017, 8:59 PM), https://www.politico.com/story/2017/11/20/trump-lawsuit-att-time-warner-merger-250956.

53. David McLaughlin et al., *Trump DOJ Escalates Big Tech Scrutiny with New Antitrust Probe*, BLOOMBERG (July 24, 2019, 7:19 AM), https://www.bloomberg.com/news/articles/2019-07-23/u-s-opens-probe-of-online-platforms-over-competition-harm (discussing potential antitrust implications of BigTech).

54. Hilary J. Allen, *Regulatory Sandboxes*, 87 GEO. WASH. L. REV. 579, 625 (2019).

propriate, amend certain regulations or provide guidance clarifying an interpretation of a rule or statute."[55] A sandbox ought to "serve as a practice ground for other politically challenged reforms."[56] That is, in the way that firms dynamically learn and grow from the freedom of a liability-free pilot, regulators themselves should learn from their experiences monitoring these innovative financial products.

The CFPB also has definitional problems. Fintech refers to "the slew of internet- and smartphone-enabled financial innovations" in the last decade.[57] This is quite broad,[58] and can implicate retirement products, to banking, to brokerage services. The fractured financial regulatory apparatus in the United States is already clunky; though Dodd-Frank and other post-recession developments sought to encourage more cooperation and coordination among regulators. Given the disparate nature of Fintech products and services, significant inconsistencies could develop, as these firms implicate a variety of different laws and regulations beyond the CFPB.

Without addressing these concerns, what the Sandbox policy accomplishes is shifting the burden from young companies self-identifying risks to regulators predicting issues for products and services in their infancy. While many complain that regulators tend to be reactive as opposed to proactive, and especially with technology they tend to insufficiently apply old administrative artifices to new and dynamic problems. But to open the door to regulation-free innovation, with the CFPB rubber-stamping any and all new innovations is the wrong approach.

CONCLUSION

The circumstances that led to the Great Recession are unlikely to repeat themselves; as such, the financial services industry will continue to innovate.[59] Yet Fintech has a democratizing element that can relieve the pressure of too-big-to-fail banks and offer consumers access to better products and services. But smarter as opposed to unchecked innovation is the answer. The solutions require more exploration, but hopefully this Essay provides a worthwhile starting point to design and offer a new regulatory framework that better optimizes the dual goals of fostering financial innovation and protecting consumers.

55. ABA Comment, *supra* note 26, at 9.

56. Allen, *supra* note 54, at 643.

57. *Id.* at 585.

58. Professor Iris H-Y Chiu offers an overview of Fintech landscape. *See generally* Iris H-Y Chiu, *Fintech and Disruptive Business Models in Financial Products, Intermediation and Markets-Policy Implications for Financial Regulators*, 21 J. TECH. L. & POL'Y 55, 56 (2016).

59. Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 STAN. L. REV. 657, 721 (2012).