



RESPONSE TO BUREAU OF CONSUMER FINANCIAL PROTECTION REQUEST FOR INFORMATION RELATING TO BUREAU SUPERVISION PROCESSES

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We appreciate the opportunity to respond to the Bureau of Consumer Financial Protection's (Bureau) request for information on its supervision activities.¹ The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment, therefore, does not represent the views of any particular affected party or special interest group but is designed to assist the Bureau as it considers whether it should modify its enforcement activities. Specifically, we wish to address how to ensure that the Bureau supports financial innovation that can benefit consumers by supporting regulatory sandboxes and using regulatory contracting to provide regulatory certainty to market participants. More generally, this comment seeks to assist the Bureau in embracing a regulatory approach that benefits consumers by allowing for competition and innovation while providing necessary consumer protections.

Innovation can be a powerful tool in helping provide consumers with better financial services and a more competitive financial services market.² A regulatory environment that provides a space for

¹ Request for Information Regarding the Bureau's Supervision Program, 83 Fed. Reg. 7166 (Feb. 20, 2018).

² For example, recent studies indicate that innovative nonbank lenders are able to provide some customers with better rates than traditional financial services. See Julapa Jagtiani & Catharine Lemieux, *Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information* 19–22, 26 (Fed. Reserve Bank of Phila., Working Paper No. 17-17, 2017). See also Yuliya Demyanyk & Daniel Kolliner, *Peer-to-Peer Lending Is Poised to Grow*, ECONOMIC TRENDS, Aug. 14, 2014; U.S. DEP'T OF THE TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING 21 (2016) [hereinafter TREASURY REPORT]. There is also evidence

firms to experiment while still providing appropriate consumer protection, and provides market participants with regulatory certainty, will help to encourage this positive innovation. One tool that regulators can use to further this goal is a “regulatory sandbox,” which has been used by foreign regulators and is beginning to be adopted in the United States, with the state of Arizona being the first government to do so. Another related tool would be to implement new regulatory contracts to help give regulated entities clarity and confidence as to their regulatory obligations. The Bureau could use these two tools independently but could also use them together to powerful effect.

THE POTENTIAL FOR A REGULATORY SANDBOX

One supervision tool the Bureau has expressed interest in, either on its own accord or with an eye toward facilitating state regulators’ use of it, is the “regulatory sandbox.”

What Is a Regulatory Sandbox?

A regulatory sandbox is a fairly recent development in financial regulation. The United Kingdom’s Financial Conduct Authority (FCA) is generally regarded as implementing the first sandbox in 2015,³ with numerous countries following suit or announcing their plans to do so.⁴

While regulatory sandboxes vary in their constitution, their general purpose is to provide an environment where companies can try a new product or service on a small number of customers to determine if the product or service works with limited regulatory exposure while ensuring that the customers testing the service are protected. In exchange for participating in the sandbox, companies frequently agree to provide the regulator with data and allow continuing oversight.

Firms seeking to use a regulatory sandbox are highly unlikely to be bad actors seeking to take advantage of consumers. Instead, these are firms looking to engage with regulators and experiment with new products for which there is some regulatory uncertainty. While sandboxes should require that the companies compensate customers harmed by the product or service being tested if the harm is caused by a violation of consumer protection law, fines and penalties meant to punish or deter bad acts are not appropriate.

In some cases, like that of the FCA sandbox, a major form of regulatory relief is a relaxation of the licensing requirements for a financial services firm. A company that would need a license to offer a service can test the service in the sandbox without getting the full license, and if the service works

that innovative lenders are able to provide credit to customers in markets that banks have exited. See Usman Ahmed et al., *Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises*, 10 INNOVATIONS 35, 35–36 (2015) (finding PayPal Working Capital loans disproportionately disbursed to areas with relatively high declines in the number of banks and to traditionally underserved populations); see also Jagtiani and Lemieux, *supra*. Likewise, there is evidence that innovative lenders engage in less discrimination than traditional lenders. See Robert P. Bartlett et al., *Consumer Lending Discrimination in the Fintech Era*, UC BERKELEY PUB. LAW RESEARCH PAPER, Dec. 7, 2017, at 18–22.

³ SCHAN DUFF, ASPEN INSTITUTE, MODERNIZING DIGITAL FINANCIAL REGULATION: THE EVOLVING ROLE OF REGLABS IN THE REGULATORY STACK 3 (2017); Financial Conduct Authority, *Regulatory Sandbox* (Feb. 14, 2018), <https://www.fca.org.uk/firms/regulatory-sandbox>.

⁴ DUFF, *supra* note 3, at 3.

the company can proceed to obtain the license.⁵ Other powers provided by a sandbox can include the waiver or modification of rules, informal guidance, and no-action relief.⁶

While federal regulators, including the Bureau, utilize some of these tools already, there is no formal regulatory sandbox at the federal level. However, there is movement among the states to create sandboxes. Arizona is the first US state to establish a regulatory sandbox, and other states are expected to follow suit.⁷

The Role of the Bureau in Supporting the States

Advances in technology have the potential to improve the quality of financial services, but innovations may also pose risks or generate uncertainty for regulators. States are well suited to experiment with different regulatory methods of encouraging innovation on a small scale, allowing for experimentation and education that can be shared while limiting the scope of mistakes. Therefore, it is in the best interests of consumers that the states be able to function as true “laboratories of democracy” and be able to conduct meaningful experiments with financial services. The Bureau, as the primary federal consumer protection regulator for financial services, is uniquely positioned to help or hinder the use of state regulatory sandboxes. The Bureau should take steps to avoid discouraging the use of state sandboxes or of frustrating the purpose of state sandboxes, and it should assist states where appropriate.

One risk facing state sandboxes is the possibility of inconsistent overlapping federal regulation. Even if a firm and its customers are based in the same state, the Bureau and other federal regulators likely retain jurisdiction. Firms considering whether to enter a state sandbox therefore need to worry that any regulatory relief or forbearance they receive from state regulators will be negated by the federal government. Not only would this deprive the firm of the benefits of a state sandbox, but it would also deprive the state and consumers of the benefits of innovation provided by the sandbox.

To avoid this risk the Bureau should, in a credible and binding way, make it clear that it will defer to the state regulator regarding firms operating within and consistent with the requirements of the state regulatory sandbox. Further, the Bureau should consider exempting firms operating within a state regulatory sandbox from Title X of Dodd-Frank via rulemaking for conduct done within the sandbox.⁸ Such an exemption would promote consumer protection because the consumers in question would be protected by the terms of the state regulatory sandbox. The experimentation conducted in the sandbox would promote consumer protection generally by encouraging innovation and competition in financial services.

In addition to using rulemaking, the Bureau could also utilize regulatory contracts (discussed in a later section of this comment) to give firms certainty that they would not face regulatory risk beyond the risk stipulated by the terms of the regulatory sandbox. Using contracts to limit the

⁵ Financial Conduct Authority, *Sandbox Tools* (Feb. 15, 2017), <https://www.fca.org.uk/firms/regulatory-sandbox/sandbox-tools>.

⁶ See, e.g., *id.*

⁷ H.B. 2434, 53rd Leg., 2d Reg. Sess. (Ariz. 2018).

⁸ 12 U.S.C. § 5512(b)(3)(A) (2010).

Bureau's action and use of data will allow firms to avoid regulatory uncertainty and encourage the use of state regulatory sandboxes.

A second risk facing state sandboxes is that the states may lack the necessary analytical capacity to maximize the value of the experiments run in the sandbox. This isn't to say that states per se lack the capability to do analysis, but the Bureau possesses significant resources, including a large staff of researchers who possess relevant expertise and should be interested in the results. The Bureau can and should assist the states in their analysis (if they request assistance), while remembering that the state regulators are in control. This would include placing strict limits on how the Bureau will use data obtained in the sandbox so that the use is not in conflict with the aims of the state sandbox or the reasonable expectations of the firms engaged in the sandbox.

While the Bureau should be humble with regard to state sandboxes, this does not mean it must abdicate its role. As a condition of the Bureau deferring to the state sandbox, the Bureau could require that the sandbox meet certain criteria reasonably related to consumer protection while still allowing the states wide latitude to develop programs that meet their needs. These criteria could include the following:

- The sandbox provides a reasonable basis to believe that only residents of a sandbox state, or another state where there is a reciprocity agreement, are customers for the product or service.
- There is a reasonable basis to believe that the product or service will not cause harm to parties outside a state participating in the sandbox.
- The sandbox places reasonable limits on the duration of the test and the number of customers who can participate.
- The sandbox has credible requirements for consumer protection and compensation for losses a consumer sustains as a result of the product or service violating consumer protection law.
- The sandbox provides reasonable oversight of participating firms.
- The criteria for entering and exiting a sandbox are applied fairly and do not serve as an inappropriate advantage for some firms over others.
- The sandbox reports its findings broadly (with reasonable exceptions for information related to trade secrets, law enforcement, and other sensitive topics) so that the public and firms outside the sandbox can assess the sandbox's activities and findings.

These criteria will help ensure consumer protection. However, the Bureau should give deference to the states as they develop their sandboxes. The states have every incentive to protect their customers, both directly and by encouraging innovation. This is also true in the case of state sandboxes that have reciprocal arrangements with other states or countries that operate a comparable sandbox.⁹ So long as every state sandbox conforms to the state's consumer protection laws, the Bureau should defer to the states' enforcement decisions with regard to participating firms.

⁹ Arizona's sandbox is one example. See ARIZ. REV. STAT. § 41-5611(F) (2018).

The Possibility of a Federal Sandbox

As mentioned above, various federal regulators, including the Bureau, have some of the powers typically found in a regulatory sandbox. Given the fragmented nature of federal financial regulation,¹⁰ it may be hard for any one agency to create a sandbox that provides truly sufficient coverage and certainty. However, that does not mean that the Bureau should not consider whether a meaningful federal sandbox could be developed.

To pursue the creation of a meaningful federal sandbox, the Bureau should assess whether the powers it currently possesses are adequate to create one, either by itself or in conjunction with other federal regulators. If the Bureau (and other regulators as relevant) does possess sufficient power, the Bureau should develop such a program. In particular, the Bureau should focus on ways to limit firms' regulatory exposure in a credible and binding way (such as with regulatory contracts). As discussed earlier, the firms seeking to participate in a regulatory sandbox are unlikely to be bad actors for which punishment would be appropriate, and the Bureau should not want to discourage other Bureau-regulated firms from seeking engagement, so deterrence is unnecessary. Therefore, limiting potential liability to whatever is necessary to restore customers harmed by an inadvertent violation of consumer protection law is appropriate.

The Bureau should also consider how to best communicate information obtained during a sandbox experiment to the public and other market participants. Given resource limitations, it is unlikely that every firm that wishes to participate in a sandbox will be able to. The Bureau should avoid letting sandbox participation provide an excessive competitive advantage. One way to do this is to broadly communicate findings (with appropriate exceptions for uniquely sensitive information). This will allow other market participants to benefit from the existence of the sandbox even if they are not participants, and it will allow the public to learn from and assess the sandbox's activities.

To the extent that the Bureau determines that current law impedes the creation of a useful regulatory sandbox, the Bureau, in conjunction with other federal regulators, should provide Congress with suggestions for how to reform the law to support the creation of a meaningful regulatory sandbox. This information will benefit Congress as it assesses what legislative reforms it can undertake to encourage financial innovation and competition that will benefit consumers and the broader economy.

REGULATORY CONTRACTS AS A MEANS TO RESTORE PREDICTABILITY IN AGENCY INTERPRETATION

Acting Director Mulvaney has committed the Bureau to undertake a new regulatory philosophy committed to the rule of law and the predictable application of the Bureau's statutory authority.¹¹ The Bureau's internal mission statement has been amended to add the language bolded in the following quote: "The Consumer Financial Protection Bureau is a 21st century agency that helps consumer finance markets work **by regularly identifying and addressing outdated, unnecessary, or unduly burdensome regulations**, by making rules more effective, by

¹⁰ See generally GOVERNMENT ACCOUNTABILITY OFFICE, COMPLEX AND FRAGMENTED STRUCTURE COULD BE STREAMLINED TO IMPROVE EFFECTIVENESS (Feb. 2016).

¹¹ See Mick Mulvaney, *The CFPB Has Pushed Its Last Envelope*, WALL ST. J., Jan. 23, 2018, <https://www.wsj.com/articles/the-cfpb-has-pushed-its-last-envelope-1516743561>.

consistently enforcing federal consumer financial law, and by empowering consumers to take more control over their economic lives.”¹²

This commitment to the rule of law is commendable. One challenge to consider in implementing this new approach is the Bureau’s unique culture and relative youth as an agency coupled with the fact that a subsequent director will have substantial discretion to significantly shift policy.

While there have been notable exceptions, such as the recent “Operation Chokepoint” controversy in which banking regulators discouraged banks from interacting with legitimate but politically disfavored businesses, the regulatory approaches of the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the nation’s bank regulatory agencies (the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, etc.) have traditionally followed the predictable, rule-of-law approach described by Acting Director Mulvaney. This has included the use of publicly adopted rules, which are subsequently honed through “no-action” letters and interpretive letters that seek to accommodate reasonable business developments unanticipated by prior rulemakings.

The only reason that “no-action” letters and interpretive letters can provide assurance that the agency will not subsequently switch directions in regulatory interpretations is that a professional culture among lawyers at the agencies, and former agency lawyers representing clients before the agency, has developed over substantial spans of time. The Federal Reserve is over 100 years old; the SEC is over 80 years old. At just six years old, the Bureau has not had sufficient time to cement such a professional culture in its approach to regulatory interpretation.

One reform that could help cement a rule-of-law culture would be a “regulatory contract” approach, which we explore in the remainder of this comment. The general idea will be for the Bureau to provide regulated entities, where appropriate, with binding regulatory contractual agreements to interpret regulations in specific ways going forward. Within the bounds of the law, and under binding contractual principles, the Bureau could provide contractual assurance to regulated parties that they could rely on the Bureau’s stated interpretation of the law and that the Bureau would not abuse its power in the future through erroneous interpretations of law or instances of “pushing the envelope.” This comment describes how the Bureau could provide binding regulatory contracts with regulated parties describing, for example, how the Bureau will interpret otherwise unclear or vague provisions contained in its authority to prevent unfair, deceptive, or abusive acts or practices (UDAAP) or to enforce the Equal Credit Opportunity Act (ECOA).

In *U.S. v. Winstar*, the United States Supreme Court found that a regulatory contract can bind a federal agency and provide for financial damages in the event of a subsequent change in regulatory approach, even if that change comes about as a result of a change in statute. That case provides a ready-made solution to mitigate the risk that a subsequent Bureau will reverse itself after regulated parties took actions in good faith and reasonable reliance on the Bureau’s representation.

¹² See Mark Huffman, *Is the Consumer Financial Protection Bureau Mission Changing?*, CONSUMERAFFAIRS, Jan. 5, 2018, <https://www.consumeraffairs.com/news/is-the-consumer-financial-protection-bureau-mission-changing-010518.html>.

U.S. v. Winstar

During the savings and loan crisis of the late 1980s and early 1990s, many federal financial regulators including the Office of Thrift Supervision (OTS) rushed to encourage healthy thrifts to purchase insolvent thrifts in order to preserve government deposit insurance funds. As part of that effort, some thrifts were promised a favorable exception to capital accounting rules to make it easier for them to earn a profit by taking over the failing thrift. In *U.S. v. Winstar*, thrifts were induced into a contract to take over other insolvent thrifts in part by a promise by OTS to provide favorable accounting treatment (although doing so is disfavored by the accounting profession) to help the acquiring thrifts meet their capital funding requirements.¹³

A change in federal statute specifically forbidding the regulatory capital approach OTS committed to under its contract was later passed into law, and OTS immediately acted to reverse its regulatory accounting treatment for goodwill for the thrifts previously permitted to account for goodwill in that way via regulatory agreements.¹⁴

In *Winstar*, this contractual commitment by the OTS was held as binding on the government and resulted in a damages award to the plaintiff, even though the violation of the regulatory agreement was a result of subsequent change in federal statute.¹⁵

What Would Regulatory Contracts by the Bureau Require to be Valid?

Winstar was a Tucker Act suit, a statute that makes the government liable for claims in tort and contract.¹⁶ Under the Tucker Act, the general requirements for determination of an actionable contract typically include offer, acceptance, consideration, and authority vested in a government actor to enter into the contract.¹⁷

The court in *Winstar* did not directly rule on whether the contracts were valid when executed, as the parties in the appellate action had stipulated to that fact.¹⁸ Much of the analysis in *Winstar* focused on whether the government's commitment was clear enough in the agreement (i.e., whether there was clear offer and acceptance of a binding contractual commitment).¹⁹

The two central arguments taken seriously by the court in *Winstar*, though ultimately unavailing for the government, were the unmistakability doctrine and the sovereign acts doctrine. If the regulatory contract is clear on its face about what contractual commitments the Bureau undertakes, then the unmistakability doctrine will not apply to undermine the regulatory agreement.

If the regulatory agreement further provides only for monetary damages in the event of breach, the sovereign acts doctrine will not operate to undermine the contract either (and a separate concurrence from Justice Scalia suggested in *Winstar* that for contracts involving regulatory power over commercial contract regulation, which is what the Bureau does, the sovereign acts

¹³ *United States v. Winstar Corp.*, 518 U.S. 839, 849 (1996).

¹⁴ *Winstar*, 518 U.S. at 857.

¹⁵ *Id.* at 843.

¹⁶ *Id.* at 886.

¹⁷ *Commercial Federal Corp. v. United States*, 55 Fed. Cl. 595, 615 (Fed. Cl. 2003).

¹⁸ *Winstar*, 518 U.S. at 860.

¹⁹ *Id.* at 863.

doctrine wouldn't apply even if subsequent government action were restricted beyond mere monetary damages).²⁰

Any enduring risk from the unmistakability doctrine could be mitigated through careful drafting of language in any regulatory contract to make clear that the Bureau seeks to undertake a binding contractual commitment. The language should further directly reference the holding in *U.S. v. Winstar* to show the Bureau's intent that *Winstar* damages will apply to any future violation by the government of the contractual agreement.

Regulatory contracts accomplish a very different set of goals than government acquisition contracts, and they are subject to different laws. For example, the federal government's acquisition contracts typically include "termination for convenience" clauses, which grant the government much flexibility to terminate contracts later deemed onerous to the government, and indeed federal acquisition regulations often require that federal procurement contracts include such provisions.²¹ Regulatory agreements have not typically included such a provision, and they would be worth little to contractual counterparties if they did.

One post-*Winstar* case at the Court of Federal Claims notes that "it is not the province of courts to determine whether a deal is good or bad; rather, it is to determine what the terms of the deal were at the time it was entered into by the contracting parties."²² The Claims Court then noted a concern that otherwise "no contract would be safe from post hoc judicial tinkering."²³ Thus the Claims Court is unlikely to revisit the terms of a regulatory agreement struck with the Bureau to determine whether it thinks the consideration the Bureau receives is sufficient.

Courts have further not typically required regulatory agreements to include consideration. In *Groos Nat'l Bank v. Comptroller of Currency*, the United States Court of Appeals for the Fifth Circuit found, "Nor is there any reason to import the common law of consideration, proper to private contractual relations, into the relationships between a regulatory agency and the entity it regulates. . . . If the Comptroller does enter such an agreement by way of attaining voluntary compliance, we will not introduce the trappings of common-law contractual consideration to question that agreement. To do so would deeply intrude upon the regulatory agency's legitimate efforts to substitute voluntary agreement for formal cease and desist proceedings."²⁴

The Fifth Circuit's ruling in *Groos* seems fairly clear that consideration is not an essential element for a regulatory contract. In the event that that changes, or simply to ensure against a circuit split in the future, the Bureau could include some form of consideration in regulatory contracts. Some types of consideration that private parties could provide to the Bureau as part of their contractual commitments could include a promise to provide the Bureau with information about the performance of the company's product or service, work with the Bureau regarding its financial literacy efforts, or share information about market conditions with the Bureau.

²⁰ *Id.* at 923.

²¹ Roni Adil Radi Elias, *How Good Must the Government's Good Faith Be? Defining the Boundaries of the Contractual Duty of Good Faith and Fair Dealing in Public Contracts*, 10 CHARLESTON L. REV. 105, 143-44 (2016).

²² *Home Savings of America v. United States*, 50 Fed. Cl. 427, 434-435 (Fed. Cl. 2001).

²³ *Home Savings*, 50 Fed. Cl. at 435.

²⁴ *Groos National Bank v. OCC*, 573 F.2d 889, 896 (5th Cir. 1978).

There is no indication from the existing case law that regulatory contracts would necessarily need to go through any Administrative Procedures Act review to be valid. The court in *Winstar* did not appear bothered by the fact that the regulatory accounting treatment promised to the OTS's contractual counterparties represented a departure from existing regulatory accounting practices.²⁵

Critics of this approach may argue that agencies are only permitted to regulate via established “notice and comment” channels. In *Winstar*, the Supreme Court disagreed with that perspective. The court in *Winstar* specifically addressed arguments that “regulatory capacity” and “nonregulatory capacity” contracts should be treated differently, and swiftly rejected that argument as nonsensical, noting “the Government’s ‘regulatory’ and ‘nonregulatory’ capacities were fused in the instances under consideration, and we suspect that such fusion will be so common in the modern regulatory state as to leave a criterion of ‘regulation’ without much use in defining the scope of the sovereign acts doctrine.”²⁶ In a concurrence, Justice Scalia rejected outright that regulation of commercial contracts would ever amount to the type of police power intended in the reserved powers doctrine.²⁷

To the regulatory transparency traditionalist, this would appear at first blush to be a suboptimal approach to regulation. That perspective suggests the primacy of the Administrative Procedures Act approach to regulation, with attendant notice and comment, deliberation by the agency, and the prospect of subsequent judicial review.

And yet the Bureau is a unique agency. Its very design in the form of a single director at a self-funded agency limits the deliberation that would typically flow from a commission structure. This has informed the Bureau’s own approach to regulation.

Ideally agencies would put clear rules through a transparent notice-and-comment process. They should conduct objective benefit-cost analysis of those rules to ensure that new rules do not diminish consumer access to credit. They shouldn’t bring enforcement actions based on erroneous interpretations of law. The Bureau has been subject to critiques for failure to meet all of those standards from both Republicans and Democrats since its inception.²⁸

Under future leadership, the Bureau may commit the same infractions, given the design of the agency. Thus, given the excesses of the prior Bureau director, it may prove difficult to maintain an emphasis on strict APA compliance, as such compliance may not endure under a future Bureau director if the agency’s structure isn’t changed.²⁹

The court in *Winstar* expressly recognized the legitimacy of government regulators achieving regulatory goals through contracts.³⁰ The Supreme Court’s comfort with this change in regulation

²⁵ *Winstar*, 518 U.S. at 854.

²⁶ *Id.* at 894.

²⁷ *Id.* at 923.

²⁸ See HOUSE FINANCIAL SERVICES COMMITTEE, UNSAFE AT ANY BUREAUCRACY: CFPB JUNK SCIENCE AND INDIRECT AUTO LENDING (Nov. 24, 2015).

²⁹ For further discussion on this issue, see J.W. Verret, Op-Ed., *Regulatory Contracts Needed to Hold CFPB Accountable*, THE HILL, Mar. 28, 2018, <http://thehill.com/opinion/finance/380528-regulatory-contracts-needed-to-hold-consumer-financial-bureau-accountable>.

³⁰ *Winstar*, 518 U.S. at 886.

through private contract was evident despite the court's recognition that prior congressional intent disfavored the regulatory accounting treatment provided pursuant to the contract.³¹

Tucker Act contractual claims also require that a government entity have statutory authorization to enter into the contract. Section 1012(a)(2) of the Dodd-Frank Act provides the Bureau with authority to enter into binding contracts. The Bureau's authorizing statute expressly references its power to enter into contracts.

That power is not limited to contracts to employ workers or procure supplies, and it is included in a sequence of powers that references regulatory authority. There's nothing in the Bureau's authorizing legislation that suggests that the list of powers it is authorized to exercise should not be read as interactive, and thus the Bureau's regulatory authority should be seen as legitimately exercised via contract.

To the extent that a regulatory contract involves an exemption from a prior rule, the terms of that commitment could be included in both an exemption going through notice and comment as well as a binding regulatory commitment from the Bureau. Alternatively, a regulatory contract could include a promise to undertake a regulatory exemption via notice and comment.

Regulatory contracts would not be permitted to allow parties to blatantly violate federal law. For example, a regulatory contract could not permit parties to commit intentional discrimination or violate terms of the Qualified Mortgage rule specified in statute. Regulatory contracts could, however, constitute a contractual commitment by the Bureau with respect to its use of discretionary authority authorized by statute.

Despite the preceding paragraph, one post-*Winstar* action involved a promise by a bank regulatory agency to permit a bank with branching rights in direct contravention to existing regulations prohibiting that type of branching.³² Thus, perhaps the Bureau would in fact be able to agree to rescind the application of regulations it had previously adopted for particular counterparties to regulatory agreements.

The Court of Federal Claims has gone to great lengths to preserve the integrity of contracts with the government, to the extent that even contracts subsequently deemed illegal as violations of law can still result in a remedy for the plaintiff.³³ If the illegality is not "plain" to the government's contractual counterparty at the time the agreement is entered into, the counterparty will still receive a remedy.³⁴ The theory behind that approach is that the government is better able to determine whether it is complying with laws governing government contracts than private counterparties, which lack the means to force the government to comply with those requirements.³⁵

It's not clear whether there are any restrictions on the type of regulation the Bureau would be allowed to conduct via regulatory contract. The court in *Winstar* found that some acts of sovereign power may not be contracted away.³⁶ For example, the government may not surrender through

³¹ *Id.* at 854–855.

³² *Washington Mutual v. United States*, No. C06–1550, 2008 WL 8422136, at *2 (W.D. Wa. Aug. 12, 2008).

³³ Michael T. Janik & Margaret C. Rhodes, *Gould Inc. v. United States: Contractor Claims For Relief Under Illegal Contracts with the Government*, 45 AM. U. L. REV. 1949, 1957 (1996).

³⁴ *Id.* at 1957.

³⁵ *Id.* at 1977.

³⁶ *Winstar*, 518 U.S. at 874.

contract its eminent domain power or the power to impose generally applicable taxes.³⁷ However, the court nonetheless maintained that regulatory agreements designed to shift the financial risk of such changes in use of sovereign power would remain valid.³⁸

This review of the *Winstar* line of cases, coupled with the Bureau's statutory authority, makes clear that the Bureau has wide discretion to enter into regulatory contracts.

What Could Regulatory Contracts at the Bureau Accomplish?

One of the policy arguments in favor of regulatory contracting is that it can provide incentives for regulated entities to share information with regulators about their internal cost of compliance, which can thereby help to make regulatory processes more cost effective on both sides of the contract.³⁹ One commenter observed that regulatory contracts could have the advantage of making regulatory agencies more nimble.⁴⁰

The Environmental Protection Agency initiated a program similar to the regulatory contracting approach suggested in this article when it introduced Project XL, a contract-based approach to compliance that emphasized allowing industry to determine in part the most cost-effective means of compliance.⁴¹ Some other types of regulatory contracts that the federal government typically engages in, which combine the government's role as a contractual counterparty with its role as a regulator, include contracts involving the provision of water rights, use of federal lands, student loans, and housing provision.⁴²

The principal argument in favor of regulatory contracting at the Bureau would be the advent of regulatory certainty for regulated entities, particularly for startups innovating new methods of consumer financing arrangements that currently operate within a zone of unclear regulatory expectations. Regulatory contracts could substantially enhance the value of regulatory sandboxes that have previously been utilized in the United Kingdom and explored both above and in other work by the Mercatus Center.

Indeed, the Bureau previously attempted a form of regulatory sandbox in Project Catalyst, but that project is largely seen as not achieving its potential. One reason for this is that startups and regulated entities do not trust that the regulatory discretion at the Bureau wouldn't be abused and shared information used against them after entering into a relationship with the Bureau through Project Catalyst. Regulatory contracts stand to resolve this problem by providing an avenue for regulatory certainty in the design and operation of Project Catalyst.

Regulatory contracts could bind the Bureau against taking aggressive legal interpretations of statutes, which are not well held in legal precedent, during efforts to extract future settlements. Furthermore, regulatory contracts could insure parties against a subsequent change in statute or a change in Bureau policy that works to vitiate the benefits of their regulatory contract.

³⁷ *Id.* at 874–877.

³⁸ *Id.* at 880–882.

³⁹ William F. Pederson, *Contracting with the Regulated for Better Regulations*, 53 ADMIN. L. REV. 1067, 1099 (2001).

⁴⁰ *Id.* at 1072.

⁴¹ *Id.* at 1071.

⁴² Michael W. Graf, *The Determination of Property Rights in Public Contracts after Winstar v. U.S.: Where Has the Supreme Court Left Us?*, 38 NAT. RESOURCES J. 217–218 (1998).

Indeed, any attempt by a future Bureau director to subvert the terms of the contract would likely be looked on unfavorably by a court, as the Court of Federal Claims has observed that the duty of good faith and fair dealing requires that the “Government-as-contractor cannot exercise the power of its twin, the Government-as-sovereign, for the purpose of altering, modifying, obstructing or violating the particular contracts into which it had entered with private parties.”⁴³

This suggests that any attempt by the Bureau to subvert its contractual obligations, or any attempt to get around its contractual commitments, will not receive the same *Chevron* deference usually granted to Bureau actions in judicial review. The Court of Federal Claims has held that one of the commitments the government makes as part of its implied covenant of good faith and fair dealing is that legislative change will not seek to vitiate the benefits that the government’s contractual counterparties obtain under a contract with the government.⁴⁴

Thus, not only does a regulatory contract protect a party from subsequent legislative change that would incidentally eliminate the benefits of its regulatory contract with the government, but a regulatory contract would also protect a party from legislation seeking to directly vitiate the regulatory contracts themselves. Thus, even if Congress later sought to prohibit regulatory agreements granted by the Bureau, it could not do so in a way that vitiated prior regulatory agreements without violating the government’s obligation of good faith and fair dealing.

The remedy for a breach of a regulatory agreement will be the damages awarded as compensation for harm caused to the company as a result of the change in regulation. If, for example, the entity was insolvent before obtaining the regulatory agreement, as was the case for some thrifts obtaining regulatory agreements similar to the one granted in the *Winstar* case, damages would be unlikely since the entity was likely to become insolvent anyway.⁴⁵ If the regulatory agreement was, however, with a fintech startup with reasonable prospects for future growth at the time the Bureau attempted to rescind the regulatory contract, damages may be calculated as the expected present value of future profits the fintech startup would have enjoyed but for the regulatory agreement being rescinded or impeded by the Bureau.

There is an open question as to whether the Bureau could provide for stipulated damages in regulatory contracts. Since the standard damages for violation of a regulatory contract would come from the general US Treasury fund through a damages award by the Court of Federal Claims, the Bureau may be limited in how far it could obligate the government through stipulated damages provisions in regulatory contracts under federal appropriations law.

Specification in regulatory contracts of the types of damages permitted may more likely be upheld to the extent they specify types of damages (lost profits, expectancy damages, etc.) rather than specific amounts of money. Alternatively, the Bureau could set up its own reserve from which damages awards for regulatory contracts would be provided in the same way that private companies set up litigation loss reserves. In any event, consultation with the Bureau’s general counsel and the Department of Justice’s Office of Legal Counsel on these issues, and adoption of a

⁴³ *Centex Corporation v. United States*, 49 Fed. Cl. 691, 708 (Fed. Cl. 2001).

⁴⁴ *Centex*, 49 Fed. Cl. at 711-12.

⁴⁵ *Admiral Financial Corporation v. United States*, 378 F.3d 1336, 1343 (Fed. Cir. 2004).

standardized process for regulatory contract approval, can provide a thoughtful process for resolving these open questions about the optimal design of regulatory contracts.

It's important to note that *Winstar* contracts would not necessarily prevent the Bureau from using a compulsory process such as an injunction or restraining order, but instead they would merely make the United States government liable for a violation of the contract. Presumably the risk of a damages award for violating the regulatory contract would, however, serve to discourage the Bureau from violating regulatory contracts in the future. A pattern of violating regulatory contracts could, for instance, serve as grounds for termination for cause of the Bureau's director.

The court in *Winstar* did not find that the OTS attempted to contractually commit against a future change in statute, but instead it found that the OTS undertook to insure its counterparty against the financial risk of that subsequent legislative change.⁴⁶ *Winstar* contracts could thus serve as a form of insurance provided by the regulatory agency against three risks: (1) a change in statute, (2) a change in regulation, or (3) a change in regulatory interpretation or regulatory priorities in the use of regulatory discretion.

The forms of relief and regulatory certainty contained in a regulatory contract could vary. The agency's ability to provide certainty with respect to private litigation—for those statutes enforced by the Bureau, which provide for private rights of action—might be limited. The agency isn't the final word on interpreting the statutes in private litigation, after all. Agency interpretations do have legal significance in court interpretation of statute, and those interpretations can at times obtain *Chevron* deference even in private litigation. Thus even for private actions, regulatory contracts could provide some certainty. The Bureau could, for example, provide in a regulatory contract that it intends to maintain guidance interpreting a particular statutory provision in a certain way.

One option to further cement a regulatory contract, particularly if individual contracts were offered on a wide basis to multiple parties, would be to put the terms of a regulatory contract through an agency notice-and-comment process as part of an exemption. This could help to remedy any concerns that regulatory contracting may veer away from more traditional, notice-and-comment-based regulation under the Administrative Procedures Act. Alternatively, the agency could adopt a rule governing the process whereby it will enter into regulatory contracts through notice and comment as well.

As part of a public notice about the process for regulatory contracting, the agency could begin by seeking input from the public about terms and standard language that would prove helpful in a standard regulatory contract. The agency could deliberate over those provisions through discussions with its own general counsel, as well as via consultation with the Office of Legal Counsel (OLC), which advises the executive branch about the constitutionality of agency action. An OLC opinion regarding the constitutionality and Bureau statutory power to provide for standard language to be contained in regulatory contracts would help to bolster a subsequent regulatory contracting process. Individual tailoring of specific contracts for regulated entities could then build on that standard language provided through a notice-and-comment process.

⁴⁶ *Winstar*, 518 U.S. at 868–869.

CONCLUSION

The Bureau has an important mission to protect consumers. Supporting methods to encourage innovation and provide regulatory certainty while ensuring consumer protection can be an important step to help fulfil this mission. Regulatory sandboxes and contracting are just such tools; utilizing and supporting them can help the Bureau better foster a regulatory environment that provides consumers with more choice and protection.