

FinTech Regulatory and Litigation Landscape

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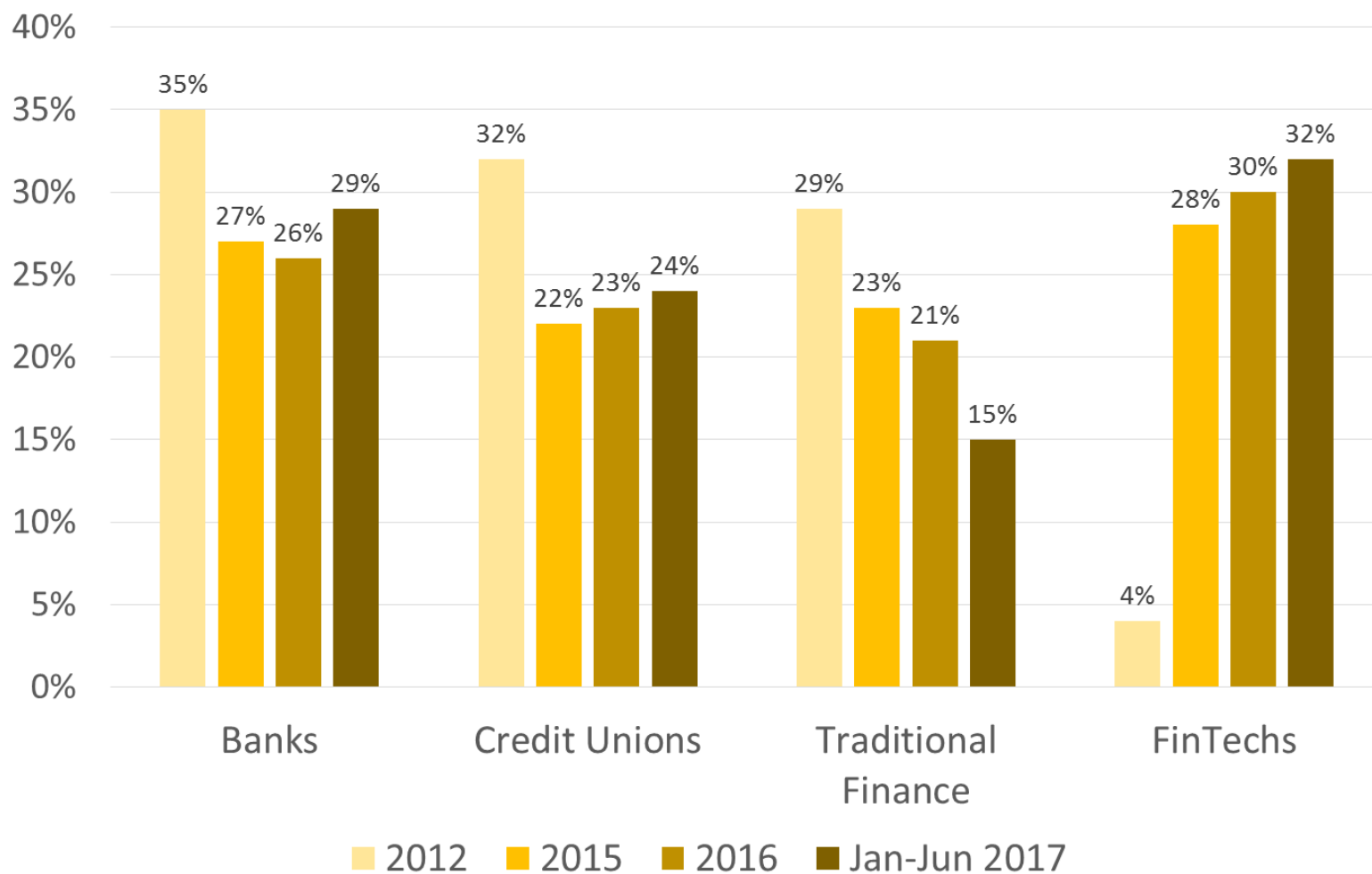
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Share of Originated Personal Loan Balances

Source: TransUnion - "Fact or Fiction: Are FinTechs Different from Other Lenders?"



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EXPANDING LENDING: PROMISES AND RISKS OF "BIG DATA" AND ITS USE IN FINTECH/ MARKETPLACE LENDING

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What is marketplace lending? Who are FinTech lenders?

Online marketplace lending "uses investment capital and data-driven online platforms to lend either directly or indirectly to consumers and small businesses." (Treasury)

It may pair borrowers and lenders without a traditional bank intermediary, connecting consumers and small businesses who want to borrow with individuals and institutions who want to lend.
(Marketplace Lending Association)

- Benefits: may reach markets otherwise underserved; may lead to much quicker approvals; may include less pricing variation and less discretion in underwriting
- Costs: FinTech lenders may be less versed in fair lending implications

Initially called "peer-to-peer" lending as platforms connected individual borrowers with individual investors

Some typical characteristics of marketplace lenders

Online platform (may be equity or debt funded)

Focus on unsecured lending, small business, student loans

Specialization / niche focus

- May be very narrow markets or particular credit worthiness thresholds

High degree of automation – limited to non-judgmental underwriting or pricing, or exceptions

Use of "non-traditional" data for marketing, underwriting, pricing

Use of proprietary and innovative approaches for predictive modeling in marketing, credit scoring, fraud detection and pricing

Rapid pace of change (high velocity) in decision criteria and scoring models in response to fluctuations in funding sources/costs and loan performance experience

Some types of marketplace lenders

Payday lending

Unsecured consumer installment & credit lines (Avant, Prosper)

Student loan refinance (Darien, SoFi)

Credit card refinance (Goldman's Marcus)

Peer-to-peer

Small business term loans & accounts receivable-based financing (underserved by traditional lenders) (FundBox)

Debt consolidation

Moving into mortgage and auto lending (ZestFinance)

FTC SURVEY OF MARKETPLACE LENDERS

- Lending Club
- Common Bond
- Prosper
- Net Credit
- SoFi
- Payoff
- Springleaf
- Peerform
- Avant
- Best Egg
- LendUp
- Earnest
- Affirm
- loanDepot
- Avant
- Upstart

Many lenders observed used the same loan issuers:

Cross River Bank: 5 of 15

WebBank: 3 of 15

https://www.ftc.gov/system/files/documents/public_events/944193/a_survey_of_15_marketplace_lenders_online_presence.pdf (last accessed Nov. 14, 2017)

What is "big data" and who uses it?

In consumer finance, "big data" usually refers to aggregating data about consumers from many disparate sources and using computationally intensive processes to discover patterns, trends and interrelationships that help predict consumer credit behavior

Heavy focus on quantity of data rather than (necessarily) quality

Often little focus on understanding the economics of relationships and correlations – more focus on the "what?" than the "why?"

Used by many FinTech/marketplace lenders who have highly automated and data/model-driven lending models such as machine learning models

Likely to bleed over to traditional bank lenders increasingly over time

The three "Vs" of big data (FTC Report)

Volume — vast quantities of data that can be gathered and analyzed cost effectively, leading to increased predictive power of consumer data analysis

- This also means more variables that may be correlated with protected factors (which are not available at the time of the model building exercise)

Velocity — how quickly companies can accumulate, analyze, and use new data. May be instantaneous.

- This may also result in updating models very frequently as additional application data and additional performance data makes its way to FinTech companies

Variety — increased breadth of data that companies that companies can collect or obtain (from third parties) — to infer consumer preferences and predict consumer behavior (such as probability of repayment)

May use information beyond bureau credit reports

Examples of "alternative" credit reporting agencies

Clarity Services

DataX

FactorTrust

ID Analytics / SageStream

CoreLogic Teletrack

LexisNexis Risk Solutions

Chex Systems

MicroBilt/PRBC

TransUnion Fraud Prevention Exchange

Examples of non-traditional data used in credit & fraud scoring

- Payday loan data
 - Nonprime short-term installment loan data
 - Nonprime auto loans and leases
 - Nonprime mortgage lending
 - Check cashing services
 - Rent-to-own transactions
 - Retail installment financing
 - Mobile phone account openings & payments
 - Utility accounts and payments
 - Other monthly bill payments
 - Property tax filings
 - Rental applications and evictions
 - Model-based income estimates
 - Trends in income
 - Geography-based economic data (unemployment rates, property values, income levels, growth)
- High-frequency application and account opening data ("loan stacking")
 - Bank account transaction data (number of accounts, pay frequencies/ dates/ amounts, returned items, debit transactions)
 - Social media data (contacts, texts)
 - Address stability
 - Number of e-mail addresses
 - IP address data
 - Education: degrees earned, school, GPA, SAT/ACT scores, graduation year
 - Profession / Job function
 - Real-time data directly from linked borrower accounts

Some FinTech benefits

Cheaper technology

- Can build front end and back end infrastructures without relying on expensive core bank legacy back-end systems

Innovations in risk

- Lack of reliance on traditional FICO scores alone (not necessarily new)
- "Lending to nonprime customers requires new, targeted credit scores built around specific types of consumers, often using alternative data sources and machine learning techniques." (see WSJ, Oct. 26, 2017)
- For example, "Affirm has tried to move past traditional methods of loan underwriting like credit scores by, for instance, asking borrowers to allow it to peak into their personal financial accounts to see their income." (see WSJ, Oct. 18, 2017)
- Combination of use of alternative data (or "big data") and fraud scores

Additional potential benefits & advantages

New insights into consumer behavior

Automated decision systems can reduce discrimination risk

Broaden credit access for

- Historically underserved/unbanked consumers
- Low/moderate income consumers
- Self-employed
- Younger consumers, e.g., recent graduates with little established credit history but good job prospects
- Small businesses — especially the micro-business

Availability of smaller loan amounts

Easy access through online platform with faster decision and funding

Reduced search/shopping costs/origination costs

Increased choice & flexibility in product choices (more customized product offering/presentation)

Potential to build credit history (in some cases) or just good payment habits

Another benefit? Expansion of competition?

Marketplace lending often characterized by

- Sophisticated credit underwriting techniques
- Technological sophistication
- Digital marketing experience
- Use of alternative data sources ("big data")
- Aggressive entrepreneurship strategies

Does this represent direct competition for traditional "brick and mortar" bank lending?

Or does it offer opportunities for banks to expand into alternative lending channels through

- Investment into marketplace lending by purchasing loans
- Purchasing already developed online marketplace lending platforms

Nonbank digital lending

Changes already occurring

- Student loans (SoFi)
 - SoFi is "pulling back" on plans to expand into foreign markets and asset management from its original business of lending to young, high-income U.S. consumers ... That retrenchment comes a month after SoFi dropped its bid to open its own bank. (see WSJ, Nov. 9, 2017)
- Personal loans (Lending Club)
 - LendingClub, the most prominent of the online lenders, said loans to certain borrowers at the low end of the prime credit spectrum "are not currently meeting our expectations. It will start limiting these loans, which account for around 3% of total loans, and temporarily halt their sale to investors. It will also temporarily halt this lending, which accounts for around 3% of its total loans, and also adopt a new credit model that tightens criteria for these borrowers." (see WSJ, Nov. 8, 2017)

Complex new modeling methods & "machine learning"

Exotic-sounding names

- Decision trees
- Classification and regression tree
- Ensemble-based models
- Random forest
- Gradient boosting
- Support vector machines

Focused on identifying correlations and "clusters" of variables that differentiate behavior and help predict repayment

Combine the results of multiple models — sometimes hundreds or thousands of variables — to increase predictive power (the sum is greater than the parts)

Not a fixed formula: algorithms "learn" — grow and change with exposure to new data

Some of the major litigation and regulatory risks

Fair lending & UDAAP

Use and oversight of third parties (e.g., advertising providers, lead generators)

Impact of inaccurate data that consumer may have no opportunity to check and correct

Use of social media data contrary to consumer expectations

"Madden risk" (*Madden v. Midland Funding*) State usury laws vs. National Bank Act preemption in "bank model" or tribal lending platform ("rent-a-bank," "rent-a-tribe")

FCRA/Credit reporting

- Adverse action notices, accuracy of credit reporting, dispute process
- Challenges in providing sufficiently specific adverse action reasons from complex models

EFTA

- Can't require ACH payments, authorization of recurring ACH, disclosures, dispute process

SCRA

- Rate limitations and restrictions on legal remedies

Open questions about the use of "big data"

How representative are the data?

- Consider underrepresentation and overrepresentation
 - Millennials may use social media more than older populations
 - Those with higher incomes may use internet more often
 - What were characteristics of populations from which data were derived?

Does the model account for any biases in the data?

- Models that use college related factors (e.g. Ivy League) may have inherent biases

How accurate are the model predictions using big data?

- May be great with respect to identifying correlations, but not have high economic significance

Does reliance on big data raise "fairness" concerns?

- Neighborhood- and geography-based economic factors may lead to disparate impact concerns

Open questions about cutting-edge modeling methods

Are the "theory-free" models truly capturing a robust economic relationship that is predictive of risk, or is it the idiosyncratic result of data mining?

Do the models truly perform better than more traditional models?

Are any predictive or segmentation variables, or any exclusion criteria, likely to be strongly correlated with a prohibited basis?

- Must be checked ex post once applications are received and origination decisions made (may require use of "proxy" methodologies such as Bayesian Improved Surname Geocoding ("BISG"))

Can the modelers articulate a clear (economic) rationale for the predictive variables used? What is needed for business justification?

How stable is predictive power over time?

Does frequent change & recalibration undermine empirical validity and business justification?

Will lack of transparency of models increase regulatory scrutiny and make it more difficult to demonstrate business justification?

Potential fair lending risks

Disparate impact or treatment related to credit and fraud scoring models and decision criteria

- Novel criteria that may be proxies for prohibited bases
- Models that score age (risk is less clear in marketing/prescreened solicitations)
- Model validity and business justification are critical

Redlining, reverse redlining or predatory lending resulting from

- Targeting higher-income/higher-credit quality consumers
- Targeting lower-income/nonprime consumers with higher cost products
- Targeting consumers who are internet-savvy, communicate heavily through social media
- Penalizing consumers who don't have a large "data footprint"

Risk of perpetuating bias if model development/training data is not representative of potentially qualified applicant population

Steps being taken by regulators

FDIC developing guidance to address the risks associated with banks making loans through third parties and risk management practices expected of banks engaging in these activities

- "will specifically address the risks associated with bank-model marketplace lending programs in which banks and non-banks typically partner in order to take advantage of Federal laws giving banks the power to charge interest nationwide at the rate permitted by the law of the state where the bank is located"

CFPB plans to continue meeting with FinTech participants and consultants to hear concerns

CFPB initiates Project Catalyst to encourage innovation: e.g. better disclosure, a pilot program, or a new type of product

- CFPB_ProjectCatalyst@consumerfinance.gov

Treasury put forth a Request for Information ("RIF") and a recent study of the sector

OCC offered a "FinTech charter"

- Current litigation brought by state regulators (see <https://www.americanbanker.com/news/state-regulators-sue-occ-over-fintech-charter>, April 26, 2017)

Consumer Financial Protection Bureau

Accepts consumer complaints about loans obtained through marketplace lenders

Exploring how alternative data is or can be used in the consumer reporting system to improve access to financial services

- CFPB issued "Consumer Protection Principles: Consumer-Authorized Financial Data Sharing and Aggregation," Oct. 18, 2017.

CFPB's new consumer protection principles

Access – consumers can access their own info in a timely manner or to authorize third parties to do so.

Data Scope and Usability – financial data subject to consumer or consumer authorized access include transaction data, terms of account data, costs and benefits, and info comes in readily usable forms

Control and Informed Consent – Terms of data access, including access frequency, data scope and retention period, are fully and effectively disclosed and consumers understand revocation terms

Authorizing Payments – authorization to access data is not payment authorization and consumers need to authorize both

Access Transparency – Consumers know are can readily know which third parties access or use their information on their accounts or use of financial services

CFPB's new consumer protection principles

Accuracy – data accessed by consumers or authorized others is accurate and current and consumers can reasonably dispute data inaccuracies

Ability to Dispute and Resolve Unauthorized Access – consumers have reasonable and practical means to dispute and resolve unauthorized access

Efficient and Effective Accountability Mechanisms – commercial participants are accountable for risks, harms, and costs they introduce to consumers.

(see <https://www.consumerfinance.gov/about-us/newsroom/cfpb-outlines-principles-consumer-authorized-financial-data-sharing-and-aggregation/>)

CFPB no-action letter ("NAL") through *Project Catalyst*

CFPB has also initiated a "no-action letter" policy (Feb. 18, 2016)

- Richard Cordray: "We recognize that companies may be uncertain about how existing regulations apply to novel products that do not fit neatly within the regulatory structure. Under our "no-action letter" policy, if CFPB staff is persuaded that a particular product holds promise for consumers and is structured in a way to mitigate risks to consumers, but is held back by regulatory uncertainty, the staff can issue a no-action letter to the company stating that we have no intent to initiate supervisory or enforcement action based on those particular innovations for a defined period."

First letter issued to Upstart Network, Inc.

- Upstart provides an online lending platform for credit card refinancing, student loans, and debt consolidation, evaluated using traditional factors such as credit score and income and non-traditional sources of information such as education and employment history
- <https://www.consumerfinance.gov/about-us/newsroom/cfpb-announces-first-no-action-letter-upstart-network/> (Sept. 14, 2017)

Reference materials

FDIC Supervisory Highlights, Winter 2015, "Marketplace Lending,"
<https://www.fdic.gov/regulations/examinations/supervisory/insights/past.html>

U.S. Department of the Treasury, "Opportunities and Challenges in Online Marketplace Lending," May 10, 2016, <https://www.treasury.gov/connect/blog/Pages/Opportunities-and-Challenges-in-Online-Marketplace-Lending.aspx>

FTC, "Big Data - A Tool for Inclusion or Exclusion? Understanding the Issues," January 2016, <https://www.ftc.gov/system/files/documents/reports/big-data-tool-inclusion-or-exclusion-understanding-issues/160106big-data-rpt.pdf>

CFPB, "List of consumer reporting companies,"
http://files.consumerfinance.gov/f/201604_cfpb_list-of-consumer-reporting-companies.pdf

CFPB, http://files.consumerfinance.gov/f/201602_cfpb_policy-priorities-over-the-next-two-years.pdf

CFPB, http://files.consumerfinance.gov/f/201603_cfpb_understanding-online-marketplace-lending.pdf

CFPB, <https://www.consumerfinance.gov/about-us/newsroom/cfpb-explores-impact-alternative-data-credit-access-consumers-who-are-credit-invisible/>

Additional resources

OCC, March, 2016, "Supporting Responsible Innovation in the Federal Banking System," <https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-responsible-innovation-banking-system-occ-perspective.pdf>

OCC Innovation Initiative (August, 2015), <https://occ.gov/news-issuances/speeches/2015/pub-speech-2015-111.pdf>

CFPB announced that it is accepting complaints from consumers regarding alleged problems with online marketplace loans (March, 2016), <http://www.consumerfinance.gov/about-us/newsroom/cfpb-now-accepting-complaints-on-consumer-loans-from-online-marketplace-lender/>

FTC's FinTech Forum on Marketplace Lending (June, 2016), <https://www.ftc.gov/news-events/events-calendar/2016/06/fintech-series-marketplace-lending>

Cleveland FRB, <https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/2017-economic-commentaries/ec-201718-3-myths-about-peer-to-peer-loans.aspx>



Thank You

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Promoting the Safe Use of Financial Technology in Financial Services Driving the Financial Sector Towards an Inclusive Financial Marketplace Leveraging Financial Technology to Improve Consumer Financial Health



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The Challenge Today

- **Rapid technology changes in the financial sector** present enormous potential but also considerable risk
 - **Policy and regulation are foundational** to ensure technology and data in financial services are able to evolve safely
 - **Regulators must have a practical and fact-based understanding** of the new technologies and data
 - **Dearth of evidenced-based research and analysis** of financial technology and data to advance informed public policy
-

How does the Current Regulatory Structure Compound the Challenge

- Differing regulatory agendas and priorities among over half a dozen federal regulators and 72 state regulators
- Lengthy, bureaucratic, and complicated rule writing process
- Lack of dedicated resources to study nonbank/fintech firms and new technology and data
- Significant concerns about external scrutiny
- No shared research facility across regulators
- No research facility that is responsive to pressing policy matters

A Solution

An Independent Real-time Learning and Insight Organization

Overcomes regulatory limitations and silos that stymie real-time learning and insights by providing timely, independent, and consumer-centric tests and experiments

Offers scalable technical capacity that enables large-scale experiments with multiple industry stakeholders simultaneously

Safely allows federal and state agencies and regulators to learn, share, and coordinate across agencies, thus helping to drive regulatory coordination

FinRegLab Core Activities

- **A Laboratory**
- **Regulatory Engagement**
- **Academic Learning Network**

The Laboratory (Lab)

- Capacity to perform multiple tests on an annual basis
- Technical and legal ability to perform credible, independent, and balanced experiments
- Experimental designs to produce actionable insights for regulators and stakeholders

Potential Lab Tests based on FinRegLab Priorities and Regulatory Feedback

Policy Relevant Topic and Potential Tests in Credit Access	Regulatory and Industry Demand	Meets FinRegLab Criteria (defined on prior slide)
<p>Credit Underwriting: Does alternative data in credit underwriting improve consumers/ small businesses' access to credit? Does it create disparate impact risks for protected classes?</p> <p>Test: Payments (cash flow) data in traditional underwriting model to assess for pricing, acceptance rates. [See Research Protocol].</p>	<ul style="list-style-type: none"> ✓ High policy interest ✓ High demand by industry 	<ul style="list-style-type: none"> ▪ High potential for financial inclusion and consumer benefit ▪ High potential for industry impact ▪ High potential for policy impact and regulatory harmony ▪ Complex but manageable political environment
<p>Credit Access: Can alternative data when used for marketing purposes result in expanded access to safe and affordable credit?</p> <p>Test: Implications of using alternative data to market credit products to consumers (increased credit access, change in price).</p>	<ul style="list-style-type: none"> ✓ High policy interest ✓ High interest by industry and others 	<ul style="list-style-type: none"> ▪ High potential for financial inclusion & consumer benefit ▪ High potential for industry impact ▪ Medium potential for policy impact ▪ High potential for regulatory harmony • Medium complexity re political environment

Potential Future Lab Tests based on FinRegLab Priorities and Reg Feedback

Policy Relevant Topic and Potential Tests in Identity and BSA/AML Areas	Regulatory and Industry Demand	Meets FinRegLab Criteria (defined on prior slide)
<p>Identity Proofing: What are the implications of new data for KYC/CIP and fraud mitigation?</p> <p>Test: Mobile phone registry data tested in five banks' KYC processes to compare the increase in the number of people successfully identified and the reduction in fraud against KYC process that rely on traditional KYC processes and data.</p>	<ul style="list-style-type: none"> ✓ High policy interest ✓ High industry demand 	<ul style="list-style-type: none"> ▪ High potential for financial inclusion & consumer benefit ▪ High potential for industry impact ▪ High potential for policy impact ▪ High potential for regulatory harmony ▪ Receptive political environment
<p>Data Sharing for Reducing Risks: Would regulatory allowance of data sharing among financial firms improve their ability to identify suspicious activities and reduce compliance costs?</p> <p>Test: A data sharing pilot with banks and nonbanks to assess fraud reduction and improve accuracy of SAR red flags when data is shared via a shared data system/utility.</p>	<ul style="list-style-type: none"> ✓ Moderate to high policy interest ✓ High industry interest 	<ul style="list-style-type: none"> ▪ Medium potential for financial inclusion and consumer benefit ▪ High potential for industry impact ▪ High potential for regulatory harmony & policy impact ▪ Complex but receptive political environment



Thank You

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LITIGATION IMPACTING LENDING MODELS

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LENDING MODELS

- **Direct lending** – platform originates its own loans
 - Requires appropriate licenses in each jurisdiction
 - Subject to state lending laws, including usury prohibitions
 - Provides more certainty
- **Bank/tribe partnership** – partner originates loans
 - Avoid burden of state lending license and supervision/compliance requirements
 - Interest rate exportation to avoid state usury laws
 - May subject entity, as a third-party service provider, to federal banking supervisory authority.

TRUE LENDER LITIGATION

- Series of recent cases challenging whether bank/tribe partner is the “true lender”
- Center on alleged violations of state usury limits
- Undermines rate exportation
- Collection activity on usurious loans = possible violation of state consumer protection laws, FDCPA, and the Consumer Financial Protection Act?
- No clear guidance – uncertainty
- Analysis generally focuses on bank/tribal entity’s risk on loans

***CFPB v. CashCall, Inc.*, 2016 WL 4820635, C.D. Cal. (Aug. 31, 2016)**

- CashCall offered unsecured personal loans that were funded/closed by tribal entity (Western Sky), then sold to CashCall subsidiary
- CFPB alleged that servicing and collecting on usurious loans was unfair, deceptive, and abusive under Consumer Financial Protection Act, because it alleged that loans were wholly or partially void under state law
- Theory of liability hinged on allegation that CashCall and not tribal partner was the true lender
- Court held that determining factor in analysis is whether partner bear sufficient monetary burden – “predominant economic interest”

CFPB v. CashCall, Inc., **2016 WL 4820635, C.D. Cal. (Aug. 31, 2016)**

- Court findings on arrangement:
 - Loans were funded through account into which CashCall deposited money sufficient to fund two days of loans
 - CashCall purchased all of the tribal entity's loans and paid more than the funded amount for each loan
 - CashCall promised the tribal entity a minimum monthly payment of \$100,000
 - CashCall purchased each loan before any payments were due and assumed all default risk upon assignment
 - CashCall agreed to indemnify the tribal entity with respect to any legal actions that arose from the lending program.
- On these findings, the Court held that “the entire monetary burden and risk of the loan program was placed on CashCall” and thus CashCall and not tribal entity was the “true lender”

***CFPB v. CashCall, Inc.*, 2016 WL 4820635, C.D. Cal. (Aug. 31, 2016)**

- Rejected choice-of-law provision in favor of the Cheyenne River Sioux Tribe (because no substantial relationship to the parties or the transactions), and thus loans were subject to borrowers' state lending/usury laws
- Court held that loans were void or uncollectable based on state usury laws
- Court ultimately found that CashCall violated CFPB because giving borrowers the “net impression” that loans were enforceable was a deceptive practice
- October 2017 bench trial on issue of restitution/penalties
 - CFPB seeking \$235 million in restitution and \$51 million in civil penalties

***Eul v. Transworld Systems*, 2017 WL 1178537 (N.D. Ill. Mar. 30, 2017)**

- Borrowers sued student loan holders/servicers for violating Illinois usury law and by extension, FDCPA re: student loans originated by a national bank
 - Borrowers allege non-bank “rented” national bank charter and supplied all loan documents, made underwriting decisions, determined loan terms, chose servicers, and controlled sale of loans; national bank only received a flat fee per loan.
- On motion to dismiss, Court held that plaintiffs sufficiently alleged that national bank “never had any economic interest in the loans,” even though identified as lender
- Court held that assignee protection under state usury law did not apply because plaintiffs alleged that a non-bank was the true lender

Recent True Lender Cases Against FinTech

- ***NRO Boston, LLC v. Kabbage, Inc. & Celtic Bank Corp.*, No. 17-cv-11976 (D. Mass. filed Oct. 12, 2017)**
 - RICO and UDAP claims based on allegations of rent-a-charter scheme to evade usury laws predicated on Kabbage as the true lender
 - Vague allegations that Kabbage has total control and all risk of loss
 - Motion to compel arbitration filed 11/30/17
- ***Bethune v. LendingClub Corp.*, 2017 WL 462287 (S.D.N.Y. Jan. 30, 2017)**
 - RICO and UDAP claims
 - Court granted motion to compel arbitration
- Arbitration may limit guidance from private litigation decisions

OTHER TRUE LENDER DECISIONS

- ***Kane v. Think Fin., Inc.*, 2016 WL 183289 (E.D. Pa. 2016)**
 - On motion to dismiss, Court held that PA AG sufficiently alleged that defendants were the “de facto lenders” based on their “level of control over the loans”
 - “Defendants, not the bank, are the real parties in interest and the defendants are not closely tied to the [state bank],” and thus not entitled to interest rate preemption, *even though state bank retained some interest in the loans at issue* (opinion not clear the extent of that interest).
- ***Sawyer v. Bill Me Later, Inc.*, 2014 U.S. Dist. LEXIS 71251 (D. Utah 2014)**
 - Bill Me Later partnered with state bank to finance eBay purchases. Court held that Bill Me Later was entitled to federal preemption for interest rates (FDIA). Did not matter that structure was intended to circumvent usury laws (but it seems to have helped that facts supported finding bank as the true lender).
 - Credit funded by state bank; receivables held for two days (received interest), and then sold to Bill Me Later. Credit account ownership retained by bank.
 - Analysis was heavily guided by strong deference to federal preemption under FDIA. Court looked to originating entity and not assignee.
 - More akin to credit card program rather than payday lending program

OTHER TRUE LENDER CASES

- ***CashCall v. Morrissey*, 2014 W. Va. LEXIS 587 (W. Va. 2014)**
 - Supreme Court of Appeals held that CashCall was the true lender and thus violated various W. Va. lending laws. Almost \$14 million in restitution and punitive damages awarded.
 - CashCall partnered with FDIC-insured bank to provide small, unsecured loans at high interest rates. Purchased loans within 3 days.
 - Court applied “predominant interest test” in finding that (1) Economic burden and risk was entirely on CashCall, (2) CashCall paid more for loan than the amount financed; (3) CashCall’s owner personally guaranteed obligations to bank; (4) CashCall indemnified bank as to all losses; (5) CashCall’s U/W guidelines used.
- ***Beechum v. Navient Solutions, Inc.*, (C.D. Cal. 2016)**
 - Student loan borrowers sued investors/servicers for usury violations.
 - Even though plaintiffs alleged national bank was lender in name only, and investor/servicer had near total control over origination and funding, Court rejected plaintiffs’ argument to look at substance/intent over form.
 - Very narrow distinction drawn between common law (substance) and statutory (form) exemptions to CA usury prohibition.
 - No mention of *CFPB v. CashCall* (same Court, decisions only 30 days apart)

LOANS STILL VALID WHEN MADE?

- Even if the bank is the true lender, will loans be enforceable once sold? More uncertainty.
- ***Madden v. Midland Funding*, 786 F.3d 246 (2d Cir. 2015)**
 - Credit card account issued by national bank was charged-off and sold to a third-party debt purchaser.
 - Debt purchaser calculated the interest rate at 27%, which exceeded the usury limit in New York (25%).
 - Debtor filed class action asserting claims under the FDCPA and New York usury statute.
 - Under National Bank Act, a national bank is permitted to charge interest at the highest rate allowed by the state where it is located, and can export that rate to loans made to borrowers in other states. 12 U.S.C. § 85.
 - Similar rule applies to FDIC-insured banks. 12 U.S.C. § 1831d

***Madden v. Midland Funding*, 786 F.3d 246 (2d Cir. 2015)**

- Second Circuit held that debt purchaser could not rely on NBA preemption because it was neither a national bank nor otherwise acting on behalf of a national bank (e.g., not a collection agent) – post-assignment, no national bank role
- According to Court, application of state usury laws to third-party debt buyers would not “significantly interfere” with national bank’s powers under NBA, even though Court recognized that its holding could decrease amount of interest a national bank could charge in certain states.
- Undermines the “valid when made” doctrine
- Added portfolio risk – potentially subjects loans to state usury laws, which could render loans unenforceable, in whole or in part

POST-MADDEN

- Supreme Court denied cert petition, but DOJ/OCC submitted amicus (upon Court's invitation) stating that Second Circuit's preemption analysis was wrong because NBA extends right to enforce all terms of loan agreement to assignee:
 - “A national bank’s federal right to charge interest up to the rate allowed by Section 85 would be significantly impaired if the national bank’s assignee could not continue to charge that rate. Under the long-established “valid-when-made” rule, if the interest-rate term in a bank’s original loan agreement was non-usurious, the loan does not become usurious upon assignment, and so the assignee may lawfully charge interest at the original rate.”

POST-MADDEN

- To ensure enforceability of loans, may be necessary for partner bank to maintain an interest in the loan post-origination and sale.
- To date, no other circuit court has addressed the issue (and no district courts have rejected *Madden*)
 - ***Eul v. Transworld Systems*, 2017 WL 1178537 (N.D. Ill. Mar. 30, 2017)** – follows *Madden*, rejecting application of NBA preemption to assignee of student loans
 - Recent academic study/paper concludes that, in NY/CT, *Madden* has (1) significantly reduced price of marketplace notes backed by above-usury loans, where such loans are in default and (2) led to extension of less marketplace credit (smaller loans and more denials to higher-risk borrowers)
 - *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment*, Columbia Business School Research Paper No. 16-38, Colleen Honisberg, Robert J. Jackson, Jr., & Richard Squire.

LEGISLATIVE SOLUTION TO *MADDEN*

- Protecting Consumers' Access to Credit Act of 2017(HR 3299/SB 1642)
 - Both introduced July 2017; still in committee
 - Would effectively overrule *Madden* by codifying “valid when made” doctrine regarding a loan’s maximum interest rate regardless of assignee
 - Applies to National Bank Act, the Home Owners’ Loan Act, the Federal Credit Union Act and the Federal Deposit Insurance Act.
 - Appear to enjoy bipartisan and OCC support
- Section 581 of the Financial CHOICE Act of 2017 (HR 10) – would also reverse *Madden*
 - Passed in House on June 8, 2017; in Senate Comm.

GOING FORWARD

- Absent fix, continued uncertainty as to the strength and applicability of federal preemption/rate exportation for bank partnership model.
- May embolden plaintiffs' counsel and state regulators to chip away at scope of preemption so that state lending and usury laws can apply to bank-partnership loans.
- Need to assess structure of model to provide best protection in event of challenge – mitigate risk.

BEWARE STATE REGULATORY TRAPS



- ***CashCall, Inc. v. Md. Comm’r of Fin. Reg.*, 2016 Md. LEXIS 371 (Md. 2016)**
 - Even if bank partner is the true lender, non-bank partner may still face state regulatory risk.
 - CashCall marketed loans to consumers in Maryland and other states with rates above Maryland’s interest rate cap of 33%.
 - Borrowers applied on CashCall’s website; funded by out-of-state partner; CashCall received exclusive right to collect all payments of principal, interest, and fees on loan.
 - Court held that CashCall was a “credit services business” under the MD Credit Services Business Act (MCSBA), which prohibits assisting consumers to obtain credit that exceeds usury limits
 - Penalties – \$5.6 million
 - Know your state law

CHOICE OF LAW PROVISIONS

- Loan agreements frequently contain a choice-of-law provision, designed to take advantage of lender-friendly laws, including states without usury limits
- Additional protection in addition to federal preemption/rate exportation
- Predominant test (from Restatement of Conflicts)
 - Law of state chosen prevails unless either (1) the chosen state has no substantial/ reasonable relationship to the parties or the transaction; or (2) application of the chosen law would be contrary to the public policy of a state with a materially greater interest than the chosen state.
- Courts reluctant to enforce where there is insufficient nexus
 - *CFPB v. CashCall, Inc.* (choice of law provision not enforced because tribe was not true lender and thus had no substantial relationship with transaction and borrowers' states had fundamental public policy against usurious loans)
 - *Madden v. Midland Funding, LLC*, 237 F. Supp. 3d 130, 147 (S.D. N.Y. 2017)
 - Loan agreement's choice-of-law provision selected Delaware law, which had no interest rate caps
 - Court determined Delaware law – with no interest rate cap - would violate a New York's long-standing prohibition against usury in New York.

CHOICE OF LAW PROVISIONS

- Sufficient nexus? Factors considered:
 - Parties' negotiation of the agreement, place of execution
 - Place of performance, inc. where funds received/payments made
 - Residence
 - Place of incorporation
 - Principal place of business (nominal operations not enough)
- Many courts hold that state usury laws (in borrower's state) create a fundamental public policy of that state (as well as application of borrower's home state consumer protection laws)
- If choice of law provision not enforceable, most courts look to jurisdiction with most significant relationship to parties
 - Very similar factors to above
- Hard to enforce choice of law in usury cases



Thank You

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Fintech Hot Topics – 2017

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FINTECH HOT TOPICS

- Blockchain and Initial Coin Offerings (ICOs)
- Digital and crypto currency regulation
- State money transmitter licensing vs federal fintech bank charters (or “passporting”)
- De-Risking

#1 - BLOCKCHAIN AND ICOS

What is the Blockchain?

- A “Distributed” or “Shared” Ledger
- A technology platform for holding data and authenticating data securely, transparently, and immutably.

IT IS NOT:





















- Bitcoin or etherium— these are “apps”
- Mt Gox or the Dark Web
 - *Few predicted the profound effect [the internet] would have on society. Today, blockchain—the technology behind the digital currency bitcoin—might seem like a trinket for computer geeks. But once widely adopted, it will transform the world. Ginni Rometty, IBM CEO*

INITIAL COIN OFFERINGS

- A means of raising funds for new businesses, by issuing and selling “tokens” that can be sold on various token/currency exchanges
- Digital tokens should be distinguished from primary cryptocurrencies.
 - Often issued pursuant to creation of a smart contract formed on Ethereum distributed ledger. Other ledgers, like Tezos, also provide this flexibility.
 - Many different purposes for tokens and can implicate various regulatory frameworks.
 - Often trade off-market. Not all cryptocurrency exchanges accept them.
- Digital tokens often have the following features alone or in combination:
 - Equity like features (e.g., voting rights and rights to distributions).
 - Debt like features (e.g., right to receive fixed additional tokens or revenue from mining or other activities).
 - Consumptive use tokens (e.g., prepayment of right to use services on the platform).

The ICO “BOOM”

- ICO “boom” heard ‘round the world – a fast way to raise big money
- Gap between what happened from 2016-2017 and the current legal landscape <https://www.tokendata.io/>

	Tezos	Completed	\$230,498,884.00	Jul 2017					
	EOS	Active	\$200,000,000.00	Jun 2018					
	Filecoin	Completed	\$200,000,000.00	Sep 2017					
	MobileGo	Completed	\$53,069,235.00	May 2017	\$0.758	\$0.519	0.68x		
	Centra	Completed	\$49,696,100.00	Sep 2017	\$0.731	\$1.135	1.55x		
	Kyber Network	Completed	\$49,304,000.00	Sep 2017	\$0.357	\$1.713	4.79x		
	Enigma Catalyst	Completed	\$45,000,000.00	Sep 2017					
	Monetha	Completed	\$36,388,800.00	Aug 2017	\$0.181	\$0.129	0.71x		
	Basic Attention Token	Completed	\$36,000,000.00	May 2017	\$0.036	\$0.214	5.96x		
	SONM	Completed	\$35,000,000.00	Jun 2017	\$0.106	\$0.155	1.47x		

INITIAL COIN OFFERINGS

- Why do an ICO? Perceptions of:
 - Easy fund raising
 - No dilution of ownership
 - No liquidation preferences
 - ***Easy Transferability***
- Primary role of secondary market
- Crowdfunding / General Solicitation
- Documents
 - Terms and Token Sale Conditions
 - White Paper
 - Risk factors

GROWING REGULATORY CONCERN

- Regulators globally have expressed concern about the potential for fraud, money laundering, tax evasion and cybersecurity risks.
- In addition to fraud concerns, securities law implications of certain digital-token offerings are also of particular concern.
- Regulators from the following countries have signaled concerns with ICOs:
 - Singapore
 - Canada
 - Peoples Republic of China
 - Republic of Korea
 - Russian Federation
 - Hong Kong
 - United Kingdom
 - Malaysia
 - Thailand
 - Dubai

FRAUD RISKS

The SEC Filed Fraud Charges Against 2 'Initial Coin Offerings'

<http://fortune.com/2017/10/01/sec-ico-fraud-charges/>

October 1, 2017

The two ICOs in question were touted as full-fledged companies with staff, lawyers, and relationships with retailers. But according to the SEC, neither scheme had “any real operations.” They made no investments on behalf of token buyers, and misrepresented their total level of investment.

Nearly as bad, the SEC says the digital tokens they claimed to be selling “don’t really exist,” meaning REcoin and DRC – much like the notorious global scam OneCoin – weren’t running on blockchains at all, and therefore weren’t even really ICOs.

SECURITIES RISKS

Recently, the U.S. Securities and Exchange Commission issued its report concluding that the tokens issued by the DAO constituted securities.

SEC applied the US Supreme Court's Howey test to determine whether DAO Tokens constituted an "investment contract" (and thus a security) under Section 2(a)(1) of the U.S. Securities Act of 1933 and Section 3(a)(1) of the U.S. Securities Exchange Act of 1934.

Pursuant to the Howey test a transaction is an "investment contract" if all of these features exist:

- (1) an investment of money
- (2) in a common enterprise
- (3) with a reasonable expectation of profits
- (4) to be derived from the entrepreneurial or managerial efforts of others.

SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946)

QUESTIONS TO ASK NEW ICO BUSINESSES

- Why an ICO? Needs a better reason than “makes money faster”
- What is the underlying New Business?
 - Must be REAL, financially viable, well planned, with experienced leadership
 - Must already have SOME funding; or be an extension of an existing business or platform. The ICO cannot be the sole source of seed money to start the New Business
- More businesses are taking a “securities” approach

SEC ENFORCEMENT ANTICIPATED

- New SE Unit targets (among other things)
Violations involving distributed ledger technology and initial coin offerings
- Recent comments suggest a major SEC “sweep”
Joseph Grundfest, who was a commissioner at the S.E.C. in the 1980s and is now a law and business professor at Stanford, said he had been contacting current commission officials and staff to urge them to bring cases, and fast.
“I.C.O.s represent the most pervasive, open and notorious violation of federal securities laws since the Code of Hammurabi,” Mr. Grundfest said in an interview.

[NY Times, 11/26/2017]

#2 – INCREASED REGULATION OF CRYPTOCURRENCIES

- Increasing value – increased investment
 - Value spurred by ICO boom
 - Report of increased use in jurisdictions where high instability
 - More companies accepting for payment
 - More opportunities to exchange or use with cards
- Increasing regulatory concern
 - Uniform Virtual Currency law – from the State Uniform Law Commission - - treating similar to prepaid payments
 - Some states already regulate (at partially) : AL, NY, CT, GA, ID, IL, TX, WA.

#3 MONEY TRANSMITTER LICENSING (VS OCC FINTECH CHARTER)

- Genesis: “Safety and soundness” of non-bank payments - Typically applies to entities that:
 - Receive and hold consumer funds, with promise of making funds available later / sending funds elsewhere;
 - Issue or sell “payment instruments,” which includes “stored value”
- 49 states have enacted MTL laws, which require:
 - Minimum capitalization (\$50,000 – \$1 million), AML programs; bonding, background checks. Protects consumers
 - NO “PASSPORTING” .
- *Do MTL laws stifle payment innovation?*

MTL ENFORCEMENT ACTIONS INCREASING

- Both in number of actions and amount of fines/penalties
- Pre-2005, penalties ranged from \$1,500 – \$50,000. Now penalties can exceed \$500,000, with some reportedly equaling more than \$1 million. Square penalized \$503,000 in Florida for unlicensed activity.
- Often no link to losses or actual criminal activity
- No need to prove intentional misconduct
- Penalty is seen as a necessary punishment and disincentive for other companies

OCC'S "FINTECH" NATIONAL BANK CHARTER

- Comment period ended 1/15/17; 98 Pro & Con
- Fintechs generally support; banks/state regulators critical; CSBS sued the OCC – no “authority”
- Major criticisms
 - High risk - will foster irresponsible lending practices
 - Less oversight than States provide
 - Could be outside the authority of the OCC
 - Fintechs worry that bar is set too high
 - Major themes of White Paper
 - Importance of financial inclusion
 - Level Playing Field
 - Current Status Uncertain

#4 - “DE-RISKING”

- Banks cancelling accounts of non-bank money services businesses
- Citing too much risk
- No specific violations – weighing the cost of enhanced compliance requirements vs revenues earned from the relationship
- FinCEN and other bank regulators provide positive guidance
- A global issue – PSD2
- Still no easy answers.



Thank You

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