CONSUMER FINANCIAL SERVICES SYMPOSIUM:

Hot Topics in FinTech Litigation

K&L GATES LLP
Irene C. Freidel
David D. Christensen

© Copyright 2015 by K&L Gates LLP. All rights reserved.

K&L GATES

AGENDA

- Introduction/Regulators
- Marketplace Lending
- Mobile Payments
- Mobile Banking
- Mobile Carrier Billing
- Crowdfunding
- Payment Processors
- Bitcoin/Virtual Currency
- Blockchain Technology

Regulators

K&L GATES

THE REGULATORS

- Office of the Comptroller of the Currency (OCC);
- Federal Deposit Insurance Corporation (FDIC);
- Consumer Financial Protection Bureau (CFPB);
- Federal Trade Commission (FTC);
- Commodities Futures Trading Commission (CFTC);
- U.S. Securities and Exchange Commission (SEC).

K&L GATES

CFPB OVERVIEW

- CFPB has broadly asserted jurisdiction over e-commerce and emerging-payment systems.
- CFPB can bring a UDAAP action against any person or entity that offers or provides a consumer financial product or service.
- On-line commerce under Dodd-Frank (12 U.S.C. § 5481(15)(A) includes:
  - Extending credit and servicing loans,
  - Selling, providing or issuing stored value or payment instruments;
  - Payment processing "by any technological means…or through any payments systems or network used for processing payments data, including payments made through an online banking system or mobile telecommunications network."
- CFPB authority extends to persons who materially participate in affairs of covered persons; persons who provide a material service to covered persons (vendors); any other person who knowingly or recklessly provides substantial assistance to a covered person committing UDAAP.

CFPB NO-ACTION LETTER POLICY

- Policy statement issued Feb. 18, 2016.
- Purpose is to "reduce regulatory uncertainty and facilitate innovation."
- Entity can submit a request for a NAL from CFPB staff.
- NAL would "include a statement that the staff has no present intention to recommend initiation of an enforcement or supervisory action against the requester with respect to particular aspects of its product, under specific identified provisions of statutes or regulations."
- NAL may be conditioned on enhanced disclosure requirements and consumer protections.
- NALs will be published on Bureau website.

Marketplace Lending

WHAT IS ONLINE MARKETPLACE LENDING?

- Lending that "uses investment capital and data-driven online platforms to lend either directly or indirectly to consumers and small businesses." (Treasury)
- "Any practice of pairing borrowers and lenders through the use of an online platform without a traditional bank intermediary." (FDIC)
- "Marketplace Lending connects consumers and small businesses who want to borrow with individuals and institutions who want to invest. This is distinct from business models that use a balance sheet to fund loans." (Marketplace Lending Association)
- Initially called "peer-to-peer" lending as platforms connected individual borrowers with individual investors.
- Industry has matured and loans are largely funded by institutional investors, hedge funds, and other financial institutions.

CHARACTERISTICS OF MARKETPLACE LENDING

- From Treasury white paper:
  - Faster access to credit; quicker funding decisions;
  - Ability to offer small loans with short-term maturities;
  - Automated online loan applications (no physical locations);
  - Reliance on variety of funding sources; and
  - Automated and data-driven underwriting models (using both tradition and non-traditional information).
- Use of algorithms, rather than loan officers, to underwrite.
- Emphasis on technological innovation to reduce costs – unburdened by legacy systems.
- Greater transparency to investors on loan-level risk and performance.

SCOPE AND GROWTH

- Dramatic rise in industry participants – three operators in 2009; 163 near the end of 2015 (FDIC).
- Marketplace loans cover the gamut: unsecured consumer loans, debt consolidations, student loans/refinancing, auto loans, mortgages, medical patient financing, and small business loans.
- Still represents only a fraction of the consumer lending market (1% or less).
- Estimated to grow to $90 billion market by 2020.
- Presents opportunity to fill credit gaps to underserved credit populations: low income, unbanked, migrant, and others without traditional creditworthiness indicators. Also presents risks that regulators are tracking.

K&L GATES

HEIGHTENED REGULATORY INTEREST

- U.S. Treasury white paper: “Opportunities and Challenges in Online Marketplace Lending” (May 10, 2016)
- OCC’s paper “Supporting Responsible Innovation in the Federal Banking System” (March 2016) and forum (June 23, 2016)
- CFPB announced that it is accepting complaints from consumers regarding alleged problems with online marketplace loans (March 2016)
- FTC’s FinTech Forum on Marketplace Lending (June 9, 2016)
- FDIC Winter 2015 Supervisory Insights (Feb. 1, 2016)

BUSINESS MODELS

- Direct lending model
  - Operator originates loans in its own name
  - Requires necessary licenses in each jurisdiction in which it originates loans
  - Subject to applicable state lending laws, including usury prohibitions
  - Expensive and resource intensive to obtain/maintain licensure and to ensure compliance with applicable laws

BUSINESS MODELS, CONT.

- Bank partnership model
  - Partners with a depository institution, which originates the loans that are sold to marketplace operators within several days.
  - May be able to take advantage of federal preemption and rate exportation to avoid state licensing requirements and lending laws – uniformity across jurisdictions.
  - May subject operator, as a third-party service provider, to federal banking supervisory authority (e.g., underwriting and marketing). See 12 U.S.C. § 1867(c).

BUSINESS MODELS, CONT.

- In both models, marketplace operator typically takes the application, assigns a proprietary credit grade or score, solicits investor participation, holds the borrower's loan after origination, and collects borrower payments.
- Operator issues separate unsecured notes to investors, payment on which is dependent on the borrower's repayment of note held by operator. Operator retains servicing fees.

MADDEN

- Madden v. Midland Funding, LLC, 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.

K&L GATES

MADDEN, CONT.

- Under National Bank Act ("NBA"), a national bank is permitted to charge interest at the rate allowed by the state where it is located, and can import that rate to loans made to borrowers in other states. 12 U.S.C. § 85.
- NBA thus completely preempts state-law claim for usury against a national bank.
- Second Circuit held that debt purchaser could not rely on national bank's preemption because it was neither a national bank nor otherwise acting on behalf of a national bank (e.g., not collecting on behalf of the bank).

MADDEN CONT.

- Second Circuit: application of state usury laws to third-party debt buyers would not “significantly interfere” with national bank’s powers under NBA. Only limits the activities of the third-party debt buyer.
- Nevertheless, Court recognized that its holding could decrease amount of interest a national bank could charge in certain states.

K&L GATES

IMPACT OF MADDEN

- Threat to bank partnership model of marketplace lending – opens loans up to state usury laws, which could render loans unenforceable, in whole or in part.
- Supreme Court denied petition for certiorari (decision now binding in NY, CT, and VT), but United States submitted amicus brief arguing that that preemption analysis was wrong because NBA extends right to enforce all terms of loan agreement to assignee.
- Continued regulatory and litigation risk uncertainty regarding use of funding banks/partnership model.

IMPACT OF MADDEN, CONT.

- Marketplace lenders may (and have) changed their business model so that the national bank continues to have an interest in the loan post-origination (risk retention).
  - Krispin (8th Cir. 2005) (preemption applied where national bank retained ownership and servicing of credit card account but sold receivables rights).
- Remaining uncertainty as to how courts will apply Madden to marketplace lending.
- Will regulators provide certainty?

MARYLAND CASHCALL DECISION

- CashCall, Inc. v. Md. Comm'r of Fin. Reg., 2016 Md. LEXIS 371 (Md. 2016)
  - 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; completed applications sent to out-of-state partner banks that were exempt from Maryland's usury law.
  - Loans were sold to CashCall, including right to collect origination fee.

MARYLAND CASHCALL DECISION

- Enforcement action: was CashCall a "credit services business" under the MD Credit Services Business Act (MCSBA), which would prohibit assisting consumers to obtain credit that exceeded state usury law?
- Maryland Court of Appeals: "Direct payment" requirement of MCSBA does not apply to entities like CashCall whose sole business is to arrange consumer loans.
- CashCall received exclusive right to collect all payments of principal, interest, and fees on loan, which satisfied compensation requirement; Court considered it the "de facto lender" but this was in dicta.

MARYLAND CASHCALL DECISION

- Example of how state licensing laws (combined with aggressive enforcement) can pose challenge to bank partnership model.
- In dicta, court took aggressive position on federal preemption: “**Although federal law allows federally insured banks to charge out-of-state consumers the same interest rate permitted by the bank's home state, regardless of the interest rate caps imposed by the law of the consumer's resident state, ‘a credit services business may not, under the MCSBA, assist a consumer in obtaining a loan, from any in-state or out-of-state bank, at an interest rate prohibited by Maryland law.**”

CALIFORNIA CASHCALL DECISION

- Consumer Financial Protection Bureau v. CashCall, Inc., No. 15-cv-7522-JFW (C.D. Cal. Aug. 31, 2016)
- Court held that purchaser of small dollar consumer loans is the “true lender” and subject to state usury laws, even though tribal entity funded and closed the loans in its own name.
- Decision renders loans unenforceable.

K&L GATES

LOANS EXEMPT FROM USURY LAWS

- Beechum v. Navient Solutions, Inc., et al., No. 15-8239 (E.D. Cal. Sept. 20, 2016).
- Plaintiffs brought claims for violations of California's UCL, California's Usury Law, usury in violation of the California Constitution, money had and received, and conversion based on student loans that carried interest rates greater than 10%. Court dismissed action with prejudice.
- Complaint alleged that loans were issued by a bank (Stillwater National Bank and Trust Company), and fell within California's constitutional exemption to the usury prohibition.

TRUE LENDER ISSUE

- Kane v. Think Finance, Inc.,Civ. No. 14-cv-7139, 2016 WL 183289 (E.D. Pa. 2016)
  - Pennsylvania AG alleged that defendants, who made "high-interest, short-term loans … over the Internet" engaged in a "rent-a-bank" scheme to evade PA lending laws.
  - Defendants partnered with non-PA state chartered bank to originate loans, but AG alleged that defendants were the "de facto lenders" based on their "level of control over the loans" and thus required to abide by PA lending laws.

K&L GATES

TRUE LENDER ISSUE

- Like NBA, 12 U.S.C. § 1831d permits state-chartered (and FDIC-insured) banks to export home state rate, and provide preemption protection against usury challenges.
- Defendants in Kane argued that preemption rights do not disappear when loan is assigned to non-bank entity.
- On motion to dismiss, Court held (citing Madden) that "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 preemption.
- Notably, the Court rejected preemption even though state bank retained some interest in the loans at issue.

TRUE LENDER ISSUE

- CashCall v. Morrisey, 2014 W. Va. LEXIS 587 (W. Va. 2014) (cert. denied by U.S. Supreme Court)
  - CashCall partnered with state-chartered, FDIC-insured bank to provide small, unsecured loans at high interest rates. Purchased loans within 3 days.
  - Supreme Court of Appeals affirmed trial court's decision that CashCall was the true lender and thus violated various W. Va. lending laws. Almost $14 million in restitution and punitive damages awarded.
  - Applied "predominant interest test," which purported to look to substance rather than form of lending partnership.
    - Economic burden and risk was entirely on CashCall, not partner bank
    - CashCall paid more for loan than the amount financed by bank.
    - CashCall's owner provided personal guarantee obligations to bank.
    - CashCall provided indemnification to bank as to all losses.
    - Loans underwritten to CashCall's guidelines.

K&L GATES

TRUE LENDER ISSUE

- Sawyer v. Bill Me Later, Inc., 2014 U.S. Dist. LEXIS 71251 (D. Utah 2014)
  - Plaintiff (CA) financed computer purchased on eBay with credit account from state-chartered, FDIC-insured bank (UT); receivables held for two days, and then sold to Bill Me Later. Credit account ownership retained by bank.
  - Plaintiff asserted various CA state law claims based on true lender theory.
  - Court rejected argument that Bill Me Later was the "true lender" and granted defendants motion to dismiss.
    - Bank was party to credit agreements and funded loans at issue.
    - Bank retained ownership of credit accounts.
    - Bank held receivables for two days and shared in the financial upside based on amount of interest that is collected.
  - Analysis was heavily guided by strong deference to federal preemption under FDIA. Did not matter that structure was intended to circumvent usury laws.
    - Court looked to originating entity and not assignee.
    - Because FDIA subjects third-party service providers to FDIC regulation and examination, loans serviced through contracts with such providers are expressly preempted by the FDIA, 12 U.S.C. § 1831d(a). Would be anomalous to treat such loans as loans subject to examination under FDIA, but yet not subject to preemption protection of FDIA.

CASHCALL AND TRUE LENDER CASES

- Uncertainty as to the strength and applicability of federal preemption surrounding bank partnership model.
- May embolden plaintiffs' counsel and state regulators/AG to chip away at scope of preemption so that state lending and usury laws can apply to marketplace loans.
- Need to assess structure of model to provide best protection in event of challenge.

FAIR LENDING

- U.S. Treasury's white paper notes use of "data-driven algorithms … carry the risk of disparate impact in credit outcomes and the potential for fair lending violations."
- Treasury paper also notes that marketplace lending's data-driven underwriting models have largely developed in favorable credit conditions, but need to be tested in less favorable ones.
- Regulators and consumer groups have expressed concern data-driven algorithms may have unintended disparate impacts (e.g., penalizing borrowers with limited digital footprint).
- Use of non-traditional or untested credit sources (e.g., social media, online business reviews) may invite challenges.

FAIR LENDING, CONT.

- ECOA makes it unlawful for any creditor to (among other things) discriminate against any applicant with respect to any aspect of a credit transaction on the basis of race, color, religion, national origin, sex or marital status, or age. Not limited to consumer credit and thus would apply to small business loans.
- ECOA covers creditor activities before (advertising, marketing), during (application, underwriting), and after (servicing, collection) the extension of credit.
- "Creditor" defined broadly to include all persons who regularly participate in the credit decision, including a creditor's assignee, transferee, or subrogee who so participates. It also includes a person who regularly refers applicants or prospective applicants to creditors, or selects or offers to select creditors to whom requests for credit may be made.

K&L GATES

FAIR LENDING, CONT.

- CFPB has interpreted Regulation B and ECOA to permit disparate impact claims:
  - A practice that is discriminatory in effect because it has a disproportionately negative impact on a prohibited basis, even though the creditor has no intent to discriminate and the practice appears neutral on its face, unless the creditor practice meets a legitimate business need that cannot reasonably be achieved as well by means that are less disparate in their impact. 12 CFR Part 1002 Supp. I Sec. 1002.6(a)-2.
- Supreme Court has upheld disparate impact theory under Fair Housing Act, but uncertain as to whether same reasoning would apply to ECOA. If it were to recognize the theory under ECOA, it should apply the same robust causality requirement.

FAIR DEBT COLLECTION PRACTICES

- Online marketplace loans are typically sold by the funding bank to the marketplace operator shortly after funding, which services loans for investors.
- Assuming that the loan is current when the marketplace operator obtains the loan, it may not be a "debt collector" under the FDCPA.

FDCPA CONT.

- "Debt collector" generally does not extend to: (1) the "creditor"; (2) persons to whom the debt is owed, if debt obtained when not in default; (3) an entity that is collecting debt it originated (but later sold) or servicing debt that it obtained prior to default.
- Be wary of state fair debt collection practices statutes, which can cover the same activities as the FDCPA, and which often define "debt collector" more broadly to include both the original creditor and servicer.
- FDCPA does not extend to business debt; limited to debt incurred for "personal, family, or household purposes."

CFPB ARBITRATION RULE

- Many marketplace lending agreements have arbitration provisions that preclude class actions.
- CFPB's proposed arbitration rule would ban arbitration provisions that "bar[s] the consumer from filing or participating in a class action with respect to the covered consumer financial product or service."
- Applies to a broad array of providers of consumer financial products or services, including any "extension of [consumer] credit" as defined by Regulation B (ECOA), as well as persons who:
  - "who regularly refers applicants or prospective applicants to creditors, or selects or offers to select creditors to whom requests for credit may be made";
  - who acquire, purchase, sell or service an extension of consumer credit.
- Ban will be effective 211 days after final rule is published (public comment period is still open).

OTHER LITIGATION CONSIDERATIONS

- Truth in Lending Act (TILA)
- Servicemembers' Civil Relief Act (SCRA)
- Fair Credit Reporting Act (FCRA)
- State consumer protection statutes (UDAP)
- Data privacy
- See Appendix A of Treasury white paper for more robust list of potentially applicable federal regulations and requirements for marketplace lenders.

PAYMENT SYSTEMS
MOBILE FINANCIAL SERVICES

K&L GATES

CFPB VISION OF CONSUMER PROTECTION IN NEW FASTER PAYMENT SYSTEMS (JULY 9, 2015)

- CFPB Consumer Protection Principles:
  - Consumer control over payments;
  - Data and privacy;
  - Fraud and error resolution protections;
  - Transparency;
  - Cost;
  - Access;
  - Funds availability;
  - Security and payment credential value;
  - Strong accountability mechanisms that effectively curtail system misuse.

K&L GATES

MOBILE BANKING/MOBILE FINANCIAL SERVICES

- Mobile banking not new, but smartphones have caused an explosion in the mobile market.
- 2014 – CFPB launched an inquiry into mobile financial services.
- November 2015 – CFPB issued summary of comments from the public on opportunities, challenges, and risks.
- The marketplace focus on mobile financial services is to reach the underserved by bringing them into traditional banking or enhancing access to “safe and affordable financial services from nonbank providers”

MOBILE BANKING, CONT.

- Risk considerations flagged in CFPB comments:
  - Text messaging creates Telephone Consumer Protection Act (TCPA) risk.
  - Compliance with Electronic Signatures in Global and National Commerce (ESIGN) Act, which requires consumers opt-in to receive certain communications electronically rather than in hard copy.
  - Lack of clear consumer dispute resolution procedures; and
  - Lack of understandable fee disclosures.

MOBILE BANKING, CONT.

- Who is liable for the loss? (FTC)
  - App developer
  - Operating system developer
  - Mobile device manufacturer
  - Cell phone carrier
  - Payment processor
  - Advertisers/marketers
  - Financial entity providing funds
  - Recipient of the funds.
- Agency

K&L GATES

CFPB ISSUES PRE-PAID ACCOUNT RULE

- Final rule issued for prepaid accounts on October 5, 2017, effective October 1, 2017.
- Under implementing regulations for Regulation E (Electronic Funds Transfer Act) and Regulation Z (Truth in Lending Act).
- Financial institutions must provide consumers easy access to account information and must resolve erroneous charges.
- Card issuers must ensure that consumers can repay debt before offering credit.
- Short and long form disclosures must be provided.
- Issuers must post prepaid account agreements on their own websites.

MOBILE REMOTE DEPOSIT CAPTURE (MRDC)

- MRDC use has skyrocketed since 2009.
- FFIEC issued policy statement on Remote Deposit Capture in 2009.
- The Check 21 Act of 2014 permits the creation of digital versions of paper checks for processing, but consumer holds onto paper version.
- Fraud risk resulting from serial deposits.

PRIVACY/SECURITY: MOBILE PAYMENTS

- Texas AG action against PayPal in connection with mobile payment app Venmo (May 2016):
  - Venmo permits peer-to-peer money transfers; processed $1 billion in transactions in January 2016.
  - PayPal charged with failing to provide Venmo users with adequate data privacy disclosures; AG asserted that consumers *may have* inadvertently exposed private information regarding their payments.
  - "Innovation in payment processing technology benefits consumers throughout Texas. However, it is important that businesses remain aware of the potential consequences regarding their users' privacy and security so that they can better protect consumers."
  - PayPal agreed to pay $175,000 and enhance privacy and security disclosures, and work to ensure that consumers understand the safeguards available on the app (including who will be able to view their transaction data and who is sending them communications).

PRIVACY/SECURITY: ONLINE PAYMENT PLATFORMS

- CFPB action against Dwolla, Inc. (2016)
  - Dwolla is an online payment platform that permits individuals to send or receive money through mobile or web-based applications.
  - CFPB charged Dwolla with deceiving customers about its data security practices and the safety of its online payment system; misrepresenting its compliance with Payment Card Industry Data Security Standard (PCI DSS).
  - CFPB used UDAAP authority to obtain an order requiring Dwolla:
    - not to misrepresent its data security practices;
    - train employees properly and fix security flaws; and
    - pay a $100,000 civil penalty.

MOBILE CARRIER BILLING

MOBILE CARRIER BILLING

- Enables consumers to charge goods or services directly to a mobile account.
- Considered potentially beneficial for unbanked or underbanked consumers who may not have a credit card.
- BUT risk of fraud, lack of adequate error resolution procedures, or impact on credit reports and scores from unpaid bills in dispute.
- "Mobile cramming" – practice of placing unauthorized third-party charges on mobile phone accounts.

K&L GATES

MOBILE CARRIER BILLING, CONT.

- CFPB/Sprint and Verizon
  - Settlements in May 2015.
  - Sprint and Verizon agreed to return $120 million directly to affected consumers.
  - Customers clicked on ads for digital content, not knowing that third parties could add charges to their wireless bills.
  - CFPB alleged that Sprint and Verizon did not have adequate process for tracking consumer complaints about the charges.
  - According to the Bureau, Sprint and Verizon received a percentage of every third-party charge.
  - CFPB relied on UDAAP authority.

CROWDFUNDING

K&L GATES

CROWDFUNDING

- Crowdfunding platforms allow individuals to solicit money for a new business or project.
- SEC's Regulation Crowdfunding (eff. May 16, 2016)
  - Result of JOBS Act (2012)
  - Allows investors to acquire small equity stakes in the new company.
  - Designed to enhance capital formation, while providing investor protections.
  - Requires crowdfunding to be conducted through a registered broker or funding portal, a new type of SEC registrant ("intermediary").
- New intermediaries intended to function "strongly" as "classic gatekeeper."
- "We are counting on brokers and funding portals to be bulwarks of investor protection in this space, and we will hold them to that responsibility." (Mary Jo White, Keynote Address at the SEC-Rock Center on Corporate Governance; March 31, 2016).

K&L GATES

CROWDFUNDING, CONT.

- Are crowdfunding platforms responsible for posted content?
- *Giveforward, Inc. v. Hodges*, Civil No. JFM-13-1891 (D. Md. Aug. 6, 2015)
  - Fundraising website not liable for fraudulent fundraiser under Communications Decency Act where it was not the "publisher or speaker" of the false content.
  - Website is an information content provider, but does not create content for each individual fundraiser.
- FTC action involving deceptive Kickstarter campaign (July 2015)

PAYMENT PROCESSING

K&L GATES

PAYMENT PROCESSORS

- *Guttman v. Visa, Inc. ,et* al.
  - Class action against FanDuel and DraftKings filed Nov. 2015.
  - Payment processors, banks, and credit card providers sued for violating state and federal law (RICO) in connection with allegedly aiding an illegal on-line gambling scheme.
  - Plaintiff alleges that each defendant enabled or facilitated the creation or collection of debts issued for illegal gambling.
  - Plaintiff seeks "restitution of all monies wagered and lost."
  - Case part of MDL (Massachusetts).

PAYMENT PROCESSORS, CONT.

- *CFPB v. Intercept, et al.*, No. 3:16-cv-144 (D.N.D. June 6, 2016)
  - Intercept processes electronic debits from consumer bank accounts using ACH for third-party lenders/creditors.
  - CFPB alleges that processor enabled clients to withdraw "millions of dollars' worth of unauthorized or otherwise illegal charges from consumers' bank accounts" when there were indications that clients were engaged in "fraudulent or illegal transactions."
  - CFPB alleges conduct caused substantial injury to consumers and violates Dodd Frank proscription against engaging in or "substantially assisting unfair acts or practices." (12 U.S.C. § 5536(a)(1)(B), (a)(3)."
  - CFPB seeking injunctive relief, consumer redress, and civil monetary penalties.

VIRTUAL CURRENCY/BITCOIN

K&L GATES

BITCOIN/VIRTUAL CURRENCY: MT. GOX

- Japan-based bitcoin exchange lost 750,000 bitcoins with $350 million (not including owner's 100,000 bitcoins for total value of $425m).
- Following investigation by authorities, the exchange filed for bankruptcy protection in Japan in February 2014, and then filed for Chapter 15 bankruptcy protection in Northern District of Texas (to stop class action and suit by CoinLab);
- CEO was accused of embezzling customer funds from the exchange.

K&L GATES

BITCOIN/VIRTUAL CURRENCY: MT GOX

- Class action filed against Mizuho Bank and Mark Karpeles in Illinois 2014 *(Greene v. Mizuho Bank, Ltd.*).
- Claims included tortious interference, unjust enrichment, and fraudulent concealment.
- US customers could do business with Mt. Gox by either directly transferring bitcoins into their Mt. Gox accounts or wiring currency to Mizuho Bank, which would deposit money into a bank account it held on behalf of Mt. Gox.
- Mizuho earned service fees from processing wire deposits.

MT. GOX, CONT.

- When Mizuho became aware of problems with Mt. Gox, it stopped or limited customers from withdrawing their deposits (8 months before the exchange went out of business).
- Plaintiffs alleged that Mizuho continued to charge customer fees on all deposits despite knowing they would not be able to make withdrawals.
- Mizuho responded that cause of customer losses was Mt. Gox CEO Mark Karpeles; it did not have a duty to disclose fact that exchange was struggling; case should be transferred to Japan and resolved under Japanese law.
- Court held that Mizuho was subject to personal jurisdiction in California because Mizuho purposefully directed its conduct to one of the named plaintiffs in California.
- Litigation continues.

K&L GATES

BITCOIN: WHEN IS IT "MONEY"?

- Bitcoin and other virtual currency exchanges are considered "money transmitting businesses" and subject to federal anti-money laundering regulations if doing business in the US. (31 U.S.C. §§ 5330)
- Bitcoin and other virtual currencies have been considered "money" or "funds" under 18 U.S.C. § 1960(b)(2) and 1956 (the federal anti-money laundering statute).
  - "Money transmitting" = "transferring *funds* … by any and all means."
  - Bitcoin = funds.
- *United States v. E-Gold, Ltd.*, 550 F. Supp. 2d 82 (D.D.C. 2008) (money transmitting not limited to cash transactions);
- *United States v. Faiella*, 39 F. Supp.3d 544 (S.D.N.Y. 2013) (bitcoin exchanger "clearly qualifies as a 'money transmitter'")
- *United States v. Ulbricht*, 31 F. Supp.3d 540, 570 (S.D.N.Y. 2014) (excluding bitcoin from 18 U.S.C. § 1956 would be "nonsensical").

K&L GATES

BITCOIN, CONT.

- Coin.mx was an unlicensed bitcoin exchange where customers could convert US dollars to bitcoin and vice versa. (*US v. Murgio*, et al., (SDNY; 2015).
  - Service operated through a federal credit union based in New Jersey, primarily with low-income members, to exchange money for criminals and provide bitcoin for people whose computers were subject to "ransomware" attacks.
  - Exchanged $1.8 million for bitcoins for thousands of customers; some involved in criminal activity.
  - US rejected argument that bitcoin exchange was not covered by AML statute.

K&L GATES

BITCOIN NOT “MONEY” IN FLORIDA

- *State of Florida v. Espinoza* (July 22, 2016)
  - Criminal complaint dismissed because sale of Bitcoin did not constitute a “money services business” under state law.
  - “Nothing in our frame of references allows us to accurately define or describe Bitcoin.”
  - “[A]ttempting to fit the sale of Bitcoin into a statutory scheme regulating money services businesses is like fitting a square peg in a round hole.”

BITCOIN: INSURANCE COVERAGE

- *Bitpay Inc. v. Massachusetts Bay Ins. Co.*, Case No. 1:15-cv-3238 (N.D. Ga. 2015)
  - Insurance coverage dispute following $1.85 million bitcoin loss.
  - Hacker induced Bitpay CFO to transfer bitcoins to a customer wallet controlled by the hacker.
  - Bitpay sought coverage under crime and fidelity policy (and definition of "money" included bitcoins); insurer denied claim because loss was "indirect" and stolen bitcoins were not taken from a physical location.
  - Settlement reached; likely more coverage litigation on the way.

BITCOIN: SECURITIES ENFORCEMENT

- *States v. Shavers* (July 21, 2016 SDNY)
  - Virtual bank Bitcoin Savings and Trust operated an online currency exchange to facilitate a bitcoin-related Ponzi scheme.
  - Bank sold bitcoin investments in 2012 and 2013 for stated purpose that bitcoins would be used for a market-arbitrage strategy for digital currency; plan not executed.
  - Shavers had raised more than 700,000 bitcoins valued at $4.5 million.
  - Court ordered payment back to victims; SEC ordered disgorgement.
  - Prosecution was the first federal securities case involving bitcoin.

BLOCKCHAIN TECHNOLOGY

BLOCKCHAIN TECHNOLOGY

- Blockchain distributed ledger technology (DLT) is still developing and subject to limited regulation. Used primarily in digital currencies.
- No centralized clearing houses means increased speed for settling transactions and greater transparency.
- DLT would enable parties (and regulators) to use data mining tools or other applications to dig into patterns of transactions – re fraud, creditworthiness, etc.
- DLT would also provide proof of the existence of the transaction, ownership, and process when a dispute arises.
- Absent express codification in the law, DLT may also create challenges in determining when a final settlement occurs in a financial transaction.
- How blockchain will impact or play a role in fintech litigation remains to be seen; each state has its own consumer protection standards, and will likely interpret digital currency and use of blockchain in distinct ways.

CONCLUSION

Subscribe to our fintech and consumer finance blogs for the latest updates:

www.fintechlawblog.com

www.consumerfinancialserviceswatch.com

Irene C. Freidel
irene.freidel@klgates.com
(617) 951-9154

David C. Christensen
david.christensen@klgates.com
(617) 951-9077

K&L GATES

Promises and Risks of “Big Data” in Online Lending

Fall 2016 Consumer Financial Services Symposium

October 18, 2016

David Skanderson
Vice President
CRA Charles River Associates

What is “big data” and who uses it

- In consumer finance, 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
- Likely to bleed over to traditional bank lenders increasingly over time

Some typical characteristics of marketplace lenders

- Online platform
- Focus on unsecured lending
- Specialization / niche focus
- High degree of automation – limited to no 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
- Considering behavioral psychology and dynamics of a consumer’s situation over time in design of products
- High “velocity: Rapid pace of change in decision criteria and scoring models in response to fluctuations in funding sources/costs and loan performance experience

Some types of marketplace lenders

- Payday
- Unsecured consumer installment & credit lines
- Student loan refinance
- Peer-to-peer
- Small business term loans & accounts receivable finance
- Debt consolidation
- Moving into mortgage and auto lending

CRA Charles River Associates

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
- 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

Complex new modeling methods & “machine learning”

- Exotic-sounding names
  - Decisions 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
- Combine the results of multiple models -- sometimes hundreds or thousands -- 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 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
  - Consumers with volatile income
  - 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
- Faster decision and funding
- Reduced search/shopping costs
- Reduced costs to originate
- Increased choice & flexibility in product choices (more customized product offering/presentment
- Potential to build credit history (in some cases) or just good payment habits

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

Potential fair lending risks

- Disparate impact or treatment related to credit and fraud scoring models and decision criteria
  - Novel criteria that are 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
  - 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

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?
- How representative are the data sets being used?
- 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?
- Can the modelers articulate a clear rationale for the predictive variables used?
- 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?

Steps being taken by regulators

- FDIC developing guidance to address the risks associated with banks making loans through third parties and risk management practices that 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 recently accepting consumer complaints about loans obtained through marketplace lenders
- CFPB is considering rules to define "larger participants" in markets for consumer installment loans (which would include marketplace lenders)
- CFPB considering developing guidance regarding risk model governance in relation to consumer financial protection compliance
- Treasury Request for Information and ongoing study of the sector
- Treasury studying potential establishment of a "FinTech charter"

Some 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*
- Federal Trade Commission, "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*
- Consumer Financial Protection Bureau, "List of consumer reporting companies," *http://files.consumerfinance.gov/f/201604_cfpb_list-of-consumer-reporting-companies.pdf*

David Skanderson

Vice President, Financial Economics

1201 F Street, NW

Suite 800

Washington, DC 20004-1229

202-662-3955

dskanderson@crai.com

CRA Charles River Associates