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Developments affecting Marketplace Lending

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Overview—Legal Considerations: Investing in, or Partnering with, Marketplace Lenders

- Understand Risks Associated with Various Structures—Pros and Cons
- Understand Competition and Nonbank developments—OCC FinTech Charter
- Understand Risks of Recharacterization—Madden v. Midland Funding
- CFPB RFI on Use of Alternative Data for Consumer Access to Credit

Structures—Pros and Cons

Bank Partnership/Investment Structures

- Lending Framework:
  - Bank Partnership Model
  - Non-Bank as Lender

Lending Framework – Overview

- There are three potential ways in which to lend
  - Each individual is a lender
  - The non-bank partners with a bank or state-licensed lender (partnership model)
  - The non-bank serves as the lender
- Each potential option may require a license
  - Lending license to originate loans
  - Debt collection or servicing license to collect payments on the loans
  - Loan brokering license to assist in the procurement of loans

Lending Structure – Bank Partnership Model

- The non-bank enters into an arrangement with a bank (e.g., national bank, state-chartered bank) or a state-licensed lender in which the bank or the licensed lender originates the loans for the individuals, and the non-bank purchases the loan receivables from the bank/licensed lender
- Under this arrangement, the non-bank would perform certain functions for the bank/licensed lender, such as marketing, servicing and facilitating the platform
  - For example, the non-bank may assist in collecting application information, perform underwriting using the bank/licensed lender's credit criteria, etc.
  - This arrangement would be formalized into an agreement with the bank or state- licensed lender
- The bank lender would enter into an agreement with the individuals, and be able to charge interest on the loans

Advantages	Disadvantages
• Generally, avoids lending licenses for non-bank	• Depending on structure, could trigger loan broker, debt collection and/or servicing license obligations for non-bank
• Federal preemption when partnering with a bank (benefit that state usury laws would not apply to bank)	• Depending on the structure, "true lender" and *Madden* risk—regulatory scrutiny of partnership model (e.g., some states have moved or are moving toward requiring a license for such arrangements)
	• Bank will have ongoing oversight and monitoring of non-bank as service provider to bank
	• Exposure to bank as non-bank will be subject to regulatory supervision and examination by bank and regulators
	• Bank will need to demonstrate control over the program

Lending Structure – Bank Partnership Model, cont'd.

Lending Structure – Non-Bank as Lender

- The non-bank would act as the lender to the individuals
- The non-bank would enter into a loan agreement with each individual in which the individual agrees to repay the non-bank as the lender
- The non-bank would be required to file applications to obtain state lending licenses
  - License application requirements include net worth, experience, bond and approval by state regulators
- The non-bank would need to obtain funding or have funds to originate the loans

Advantages	Disadvantages
• Less regulatory uncertainty from a "true lender" and *Madden* standpoint	• Significant up-front costs related to application and approval of licenses
• Non-bank may be allowed to charge certain fees and interest on the loans in excess of the state usury limitations (in some instances)	• Administrative and regulatory burden of being a lender (e.g., disclosure requirements and restrictions on loan terms and conditions)
• Non-bank would have control over the lending program	• Compliance with federal and state consumer protection laws for lenders
	• Subject to regulatory examination and supervision

Lending Structure – Non-Bank as Lender, cont'd.

OCC FinTech Charter

OCC Special Purpose National Bank Charter

- On December 2, 2016, Comptroller of the Currency Thomas Curry confirmed that the OCC will begin considering FinTech company applications to become special purpose national banks
- The OCC also released a white paper, "Exploring Special Purpose National Bank Charters for Fintech Companies"
  - The white paper covers issues associated with, and conditions for, extending national bank charters to FinTech companies
- The White Paper says the OCC could grant a special purpose national bank charter to companies that either engage in fiduciary activities or engage in at least one of the three core banking functions: (1) receiving deposits, (2) paying checks, or (3) lending money
  - The OCC says that issuing debit cards or engaging in other means of facilitating payments electronically is the "modern equivalent of paying checks"
  - This should include money transmission
- The OCC says it is willing to consider "on a case-by-case basis" the permissibility of a new activity that a FinTech company seeking a special purpose national bank charter may want to conduct

- According to the OCC white paper, a special purpose national bank charter could:
  - Eliminate the need for the FinTech company to obtain certain state licenses
  - Allow the FinTech company to benefit from interest rate exportation and federal preemption even if the special purpose national bank does not take deposits
  - Make the FinTech company subject to the OCC's safety and soundness requirements, obligations to provide fair access to financial services, and the requirement to comply with applicable law
- A FinTech company may be subject to the Bank Holding Company Act
- The OCC's supervisory expectations for FinTech companies would be at least comparable to the supervisory expectations for traditional national banks, including requirements related to capital and liquidity, recovery, and exit strategies
  - These expectations may be tailored to the particular activities of the FinTech company

OCC Special Purpose National Bank Charter, cont'd.

Madden v. Midland Funding LLC

Madden v. Midland Funding LLC

- In May 2015, the U.S. Court of Appeals for the Second Circuit issued a decision in Madden that created uncertainty for the bank-origination model used in connection with marketplace lending platforms
- Issue: whether interest charged by a non-bank assignee of debt originated by a national bank is protected by the National Bank Act from state usury laws
  - The plaintiff in Madden defaulted on her bank-issued credit card account, and the bank sold the debt to Midland Funding
  - The interest rate on the credit card account was higher than the maximum rate permissible under the usury law of Madden's state, New York
- Under the NBA, the bank could rely on federal preemption of the state usury law because it is a national bank that could charge the interest permitted under the laws where the bank is located, i.e., exportation
  - Nonetheless, Madden sued non-bank debt collector Midland Funding for charging a rate in excess of the New York usury limit after the bank sold the debt to Midland
- In 2013, the U.S. District Court for the Southern District of New York found for Midland Funding, but the Second Circuit overturned that decision

Midland Funding LLC v. Madden

- In November 2015, Midland Funding petitioned for certiorari
- On June 27, 2016, the U.S. Supreme Court denied certiorari in Midland Funding
- The case could have significant implications for the secondary loan market, which relies on the long-standing 'valid when made' principle of contracts
  - And in particular for marketplace lenders, which routinely purchase and sell bank-originated loans
- At present, the Madden holding applies only in the Second Circuit, which is comprised of Connecticut, New York and Vermont
- It is possible that, when reintroduced, the federal Financial CHOICE Act will include a "fix" for the Second Circuit decision
- On February 27, 2017, the U.S. District Court for the Southern District of New York ruled that Madden may proceed with a class lawsuit against Midland Funding

CFPB RFI on Use of Alternative Data for Consumer Access to Credit

CFPB RFI on Use of Alternative Data for Consumer Access to Credit

- On February 16, 2017, the CFPB issued a Request for Information on the use of alternative data in the consumer lending "credit process"
  - The CFPB defines "credit process" broadly as all processes and decisions made by a creditor during the life cycle of the credit product, including marketing, pre-screening, fraud prevention, application, underwriting, account management, credit authorization, pricing and terms, and servicing and collection of debts
- The Bureau plans to review the responses it receives as the agency begins to consider future activity to:
  - Encourage responsible use of this technique
  - Reduce regulatory burdens that could impede its use
- The CFPB seeks information on the types of alternative data, information on their stages of development, the extent to which alternative data have been adopted, and their uses and impact

- The RFI cites examples of alternative data including:
  - Data showing trends or patterns in traditional loan repayment data
  - Data related to payments on non-loan products that require regular payments, such as telecommunications, rent, utility, or insurance payments
  - Checking account transaction and cash flow data
  - Data related to a consumer's stability, such as frequency of changes in residence or employment
  - Educational and employment data (for example, degrees obtained or job positions held)
  - Behavioral data
  - Social media connections
- The CFPB requests information about past, current and potential uses of alternative data, types of data used, policies and procedures to ensure responsible use, comparisons of alternatives with traditional data, and an empirical understanding of current and potential benefits and risks to both consumers and market participants
- Responses to the RFI are due by May 19, 2017

CFPB RFI on Use of Alternative Data for Consumer Access to Credit, cont'd.