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FEARLESS IN FINTECH

Regulatory Hot Topics

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CFPB, AI AND FAIR LENDING, CALIFORNIA DBO PRIORITIES

CFPB Innovation Policies

The CFPB has announced three policies to help reduce regulatory uncertainty in innovative financial products

- An updated policy on no-action letters (NAL Policy)
- A new compliance assistance sandbox policy (CAS Policy)
- An updated policy on trial disclosure programs (TDP Policy)

At the same time, the CFPB announced

- Its first NAL under the updated policy in response to a request by HUD
- ACFIN, a new partnership with state attorney general to facilitate financial innovation

CFPB Innovation Policies

The availability of, and relief provided by, each policy varies.

A NAL issued pursuant to the NAL Policy would constitute an exercise of the Bureau's supervisory and enforcement discretion

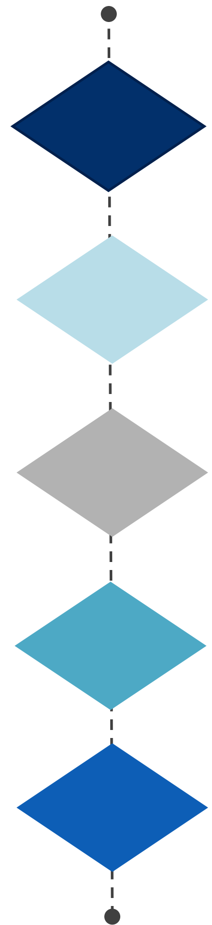
A CAS approval is issued to a particular entity pursuant to the statutory safe harbor authority under TILA, ECOA, or EFTA

A TDP waiver is a determination that the particular trial disclosure is in compliance with, or exempt from, the federal disclosure requirement

CFPB Innovation Policies

Under the new policies, the CFPB sought to streamline the application/review process and eliminate “redundant and unduly burdensome elements”

- Generally, the CFPB’s goal is to grant or deny a completed application within 60 days
  - CFPB staff commits to engaging with applicants to help the applicant understand the contours of each policy
- The policies also address regulatory coordination among federal and state regulators
  - In general, the CFPB indicates its intent to coordinate, consistent with its statutory obligations, with other regulatory authorities



CFPB UDAAP Authority

The CFPB has authority to enforce, supervise, and write rules concerning "unfair, deceptive, or abusive" acts or practices (UDAAP)

- Abusive acts or practices
    - Materially interfere with consumer understanding; or
    - Take unreasonable advantage of a consumer's
        - Lack of understanding of the material risks, costs, or conditions of the product or service;
        - Inability to protect his or her own interests in selecting or using a consumer financial product or service; or
        - Reasonable reliance on the covered person
- The concept of "abusiveness" was introduced by the Dodd-Frank Act in 2010
- The meaning of "abusiveness" is less developed than the meanings of "unfairness" and "deception"

CFPB "Abusive" Standard

- The interaction of the "abusive" standard and the definition of fair lending is unclear
  - Fair, equitable, and nondiscriminatory access to credit for consumers
  - Will the combination of standards lead to suitability requirements?
- In October 2018, the CFPB announced that it would add a regulation to define "abusive" acts and practices to its rulemaking agenda
  - This is consistent with the CFPB's prior statement that it would provide guidance through rulemaking rather than enforcement
  - The CFPB did not state when it would begin the rulemaking proceeding, but such actions are typically initiated within 12 months of announcement

- On June 25, 2019, the CFPB held a symposium on the "abusive" standard

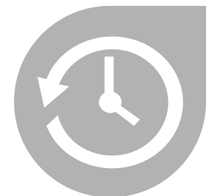
CFPB Constitutionality

PHH Corp. v. Consumer Financial Protection Bureau, 881 F.3d 75 (D.C. Cir. 2018)

The CFPB's structure is constitutional

- The D.C. Circuit sitting *en banc* held that Congress's decision to give the CFPB a single director that could only be removed by the President for cause did not violate the Constitution's separation of powers
- It reasoned from *Humphrey's Executor v. United States*, 295 U.S. 602 (1935), in which the Supreme Court considered a challenge to the FTC, an independent agency led by a multi-member commission whose members could only be removed by the President for cause
  - The Supreme Court found the for-cause removal provision to be a permissible means of ensuring the FTC's independence from the President's control

- The D.C. Circuit extended the holding of *Humphrey's Executor* to the single-director leadership structure of the CFPB
- It concluded that, like the FTC, the CFPB exercises quasi-legislative and quasi-judicial powers, and that it is therefore proper for Congress to seek to ensure that the agency discharges those responsibilities independent of the President



CFPB Constitutionality

Consumer Financial Protection Bureau v. Seila Law LLC (9th Cir. 2018)

Certiorari granted by the Supreme Court

- The Ninth Circuit adopted the D.C. Circuit's analysis in *Seila Law*
- The CFPB announced that it is *not* defending the for-cause removal restriction, reversing its previous position
- The Supreme Court granted *certiorari* to consider the question posed by *Seila Law*: "Whether the vesting of substantial executive authority in the [CFPB], an independent agency led by a single director, violates the separation of powers"
- It also asked the parties to brief an additional question: "If the [CFPB] is found unconstitutional on the basis of the separation of powers, can [the for-cause provision] be severed from the Dodd Frank Act?"
- Before he was elevated to the Supreme Court, then-Judge Kavanaugh wrote the original panel decision in *PHH* concluding that the CFPB's for-cause removal provision violates the Constitution's separation of powers and that the provision must be severed from the Dodd-Frank Act

Federal Reserve "FedNow"

The Federal Reserve Board has indicated that the Federal Reserve Banks intend to develop a new interbank real-time payments system

- "FedNow" will be an interbank real-time gross settlement (RTGS) service upon which other parties could build faster payment solutions
    - The FRB suggested a FedNow target launch date in 2023 or 2024
- FedNow will involve real-time payment-by-payment settlement through banks' accounts at the Reserve Banks
    - FedNow will support credit transfer use cases (e.g., P2P payments, bill payments, and low-value B2B payments (≤ $25,000)
- The Board also announced that it would explore expanding the operating hours of the Fedwire and the National Settlement Service as liquidity management tools to support faster payments

Tension in Lender Use of AI

Potential Benefits

- Identify new customers
- Particularly the unbanked and underbanked
- Federal regulators applaud the expansion of credit availability

Potential Costs

- Regulation B and the "effects test"
- Determinations of creditworthiness that have a disparate impact on protected classes of individuals

Disparate Impact Test

Sequence of a disparate impact allegation

Plaintiff/government agency alleges discrimination

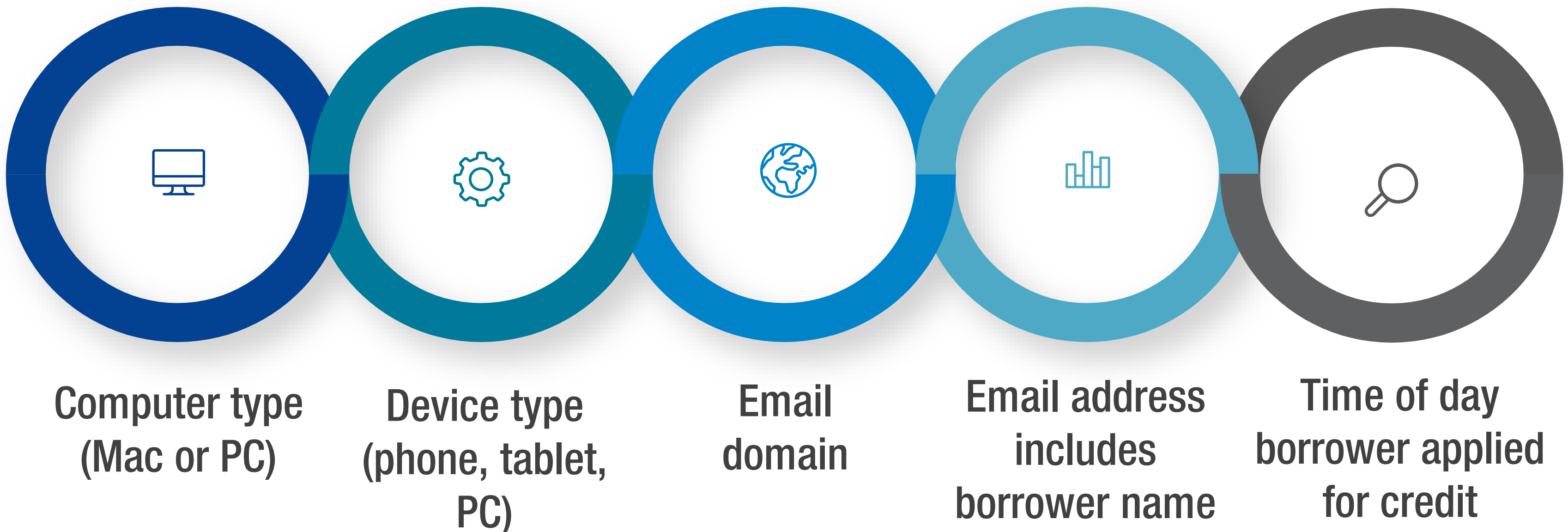
Defendant establishes business necessity (e.g., the predictiveness of the credit criterion/criteria)

Plaintiff/agency demonstrates criteria that are equally predictive, but less discriminatory

- Successful criteria – income, home ownership
- Unsuccessful criteria – neighborhood, finance company reference

AI and Compliance Considerations

- Potential for elements of AI algorithms to result in proxies that are the equivalent of a prohibited basis
- Example from a recent paper published by the FDIC*
- Found 5 variables better explained who would pay back a loan than traditional credit score model



*_On the Rise of the FinTechs—Credit Scoring using Digital Footprints_ (Sept. 2018), available at https://www.fdic.gov/bank/analytical/cfr/2018/wp2018/cfr-wp2018-04.pdf

California DBO Priorities

MANUEL P. ALVAREZ

Commissioner, California
Department of Business Oversight

- Appointed on March 28, 2019
- Affirm GC, COO, and Corporate Secretary since 2014
- Prior enforcement experience
  - CFPB enforcement attorney 2011-2014
  - Cal. deputy AG 2010-2011

Cal. Commercial Financing Disclosure Law

SB 1235 signed into law on September 30, 2018

- First of its kind law
- Requires consumer-style disclosures for commercial financing
- Applies only to non-banks
- Requires DBO to define the details in regulations

DBO issued draft regulations and disclosures on July 26, 2019

- Propose to cover 1) closed-end credit transactions; 2) open-end credit plans; 3) accounts receivable purchase transactions, including factoring; 4) lease financing; and 5) general asset-based lending
- Propose to use APR as the measure of interest and draw from other aspects of Reg Z
- Propose estimate methodology for certain types of financing

Will other states follow California's lead?

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MONEY TRANSMISSION, PAYMENT PROCESSING, MARKETPLACE LENDING, BSA/AML

Money Transmission

Regulatory Overview & Trends

State Money Transmission Regulation

- Federal impetus to improve state licensing regimes
- Conference of State Bank Supervisors Model State Money Transmission Law

Two Steps Forward

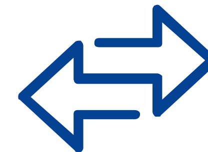
- NMLS
- Licensing Compact
- Removing Bespoke Requirements

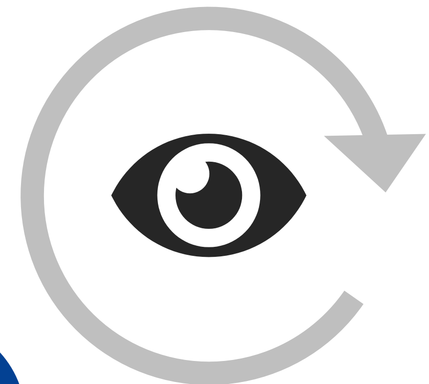
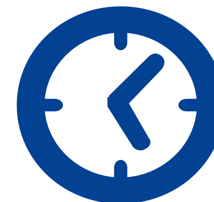
One Step Back

- Law by Checklist
- Wrong-Way convergence

Regulatory Focus Highlights

- Payroll Processing
- Agent of Payee



Money Transmission Regulatory Highlights

Payroll Processing – Subject to Money Transmission Regulatory Oversight?

A small number of states provide statutory exemptions from money transmission licensing:

- California – Cal. Fin. Code § 2010(j)
- Washington – Rev. Code Wash. § 19.230.020(15)
- North Carolina – N.C. Gen. Stat. § 53-208.44(a)(7)
- Ohio – Ohio Rev. Code § 1315.02(6)

Some states have indicated that they believe payroll processing companies that receive employer funds and transmit those funds to employees may be subject to money transmission licensing:

- Texas
- Connecticut
- Idaho

Money Transmission Regulatory Highlights

General Agent of Payee Update

We are aware of 21 states with an express "payee agency" exemption:

- Arkansas
- California
- Connecticut
- Hawaii
- Idaho
- Illinois
- Kansas
- Kentucky
- Michigan
- Nebraska
- Nevada
- New York
- North Carolina
- North Dakota
- Ohio
- Pennsylvania
- Texas
- Vermont
- Virginia
- Washington
- West Virginia

Many of the AOP exemptions have specific criteria that must be met in order for any particular activity come within the exemption

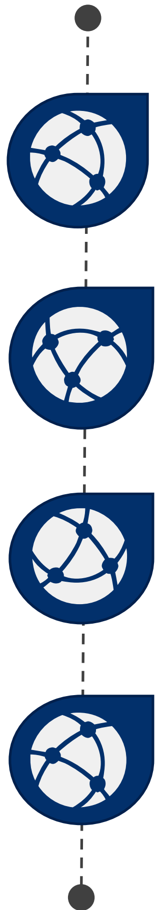
A number of states require pre-notification of the intention to avail oneself of the agent of payee exemption

Future and existing state exemptions may be influenced by the California agent of payee rulemaking

Money Transmission Regulatory Highlights

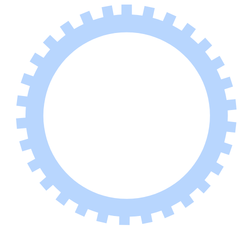
California Request for Comments on AOP Rulemaking

- On February 8, 2019, the California DBO issued an Invitation for Comments seeking input on its development of regulations to clarify the applicability of the California Money Transmission Act's agent of a payee exemption. Comments were due on April 9
- The DBO offered three potential topics for rulemaking (along with a number of other subtopics)
  - What constitutes "good or services"? Does it include "assets, rights, interests"? Does it include "payments in satisfaction of debts to the government"?
  - What does it mean to be a "payor" – to be the recipient of goods? The DBO asks, does one "receive goods" only by being an end consumer? Or could one receive goods by physically receiving them but not consuming them, such as "by being a retailer that maintains goods in stock"?
  - What does it mean to be a "payor" – to be the recipient of services? The DBO states, "Clearly, one 'receives services' by virtue of experiencing and enjoying such services as the end user," such as a passenger receiving services from a driver associated with a ride-sharing service. But, "[d]oes a commercial entity 'receive services' when contractors perform contractual duties owed to the entity?" Specifically, the DBO asks, does a ride-sharing service platform "receive services" from the aforementioned driver?
- What's next?



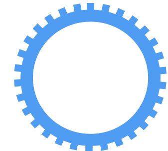
Money Transmission Regulatory Highlights

CSBS Proposed Model State Money Transmission Law

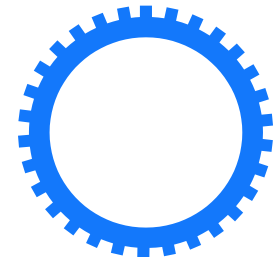


Five Areas of Key Coverage

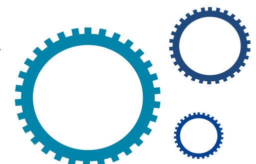
- Definitions of covered activities, such as money transmission, stored value/prepaid access, etc.



- Exempt activities, such as payee agency/payment processor, closed-loop prepaid access, bank agent service providers
- "Control" and the processes for changing control and for changes of control (i.e., ownership changes)



- Financial condition requirements, i.e., net worth, surety bonds, and permissible investments, as well as a potential proposed alternative "suspension bridge" that would provide for more flexibility in how licensees are able to satisfy financial safety and soundness requirements
- Proposals to bring about more coordination and consistency in supervision and oversight by providing for greater commissioner discretion to rely on and coordinate with other states



CSBS explains that the model language will be "used as a policy foundation for all other aspects of MSB regulation and supervision: streamlining implementation, process, and supervision based on the standards adopted in the model law"

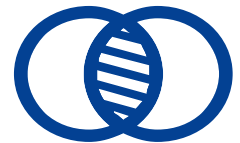
BSA/AML – What Is Money Laundering?

Money laundering is generally defined as "*engaging in acts designed to conceal or disguise the true origins of criminally derived proceeds so that the proceeds appear to have derived from legitimate origins or constitute legitimate assets*"

Anti-money laundering laws around the world make it a crime to engage in such conduct

Generally, money laundering occurs in three stages:

1. **Placement**. Illicit proceeds first enter the financial system at the "placement" stage, where funds generated from criminal activities are converted into monetary instruments, such as money orders or traveler's checks, or deposited into accounts at financial institutions



2. **Layering**. At the "layering" stage, the funds are transferred or moved into other assets, accounts, or financial institutions to further separate the money from its criminal origin

3. **Integration**. At the "integration" stage, the funds are reintroduced into the economy and used to purchase legitimate assets or to fund other criminal activities or legitimate businesses

BSA/AML – Program Requirements

Bank Secrecy Act of 1970, as amended (including the USA PATRIOT Act of 2001)

FinCEN regulations (31 C.F.R. Chapter X); regulations from federal functional regulators; state laws and regulations

Marketplace Lending

2015 Second Circuit Court of Appeals decision in *Madden v. Midland Funding, LLC*

The decision continues to create uncertainty for marketplace lenders and other situations where loans are originated by banks and then sold to non-banks

Madden invalidated the "valid when made doctrine" and held that the National Bank Act only applies to a bank and preempts state law only when the non-bank was acting on behalf of the national bank

Madden "fix" legislation was not acted upon in the last Congress, and has yet to be introduced in the current Congress

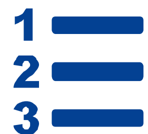
In addition, courts continue to focus on the role of non-banks in marketplace lending arrangements, including which party is the "true lender" in a bank partnership

Update on State Usury Law Preemption

The OCC and the FDIC on *Madden*

The OCC and the FDIC continue to assert that *Madden* was wrongly decided

- Together with the FDIC, the OCC filed an amicus brief in favor of the lender in *In re Rent-Rite Super Kegs West, Ltd.*
- The OCC also recently reiterated its disapproval of *Madden* in a letter to Representative Loudermilk (R-Ga.)
- On November 21, 2019, the OCC published a proposed rule to reaffirm the "valid when made" doctrine
  - The proposed rule would not address which entity is the "true lender"
- To maintain interest rate authority parity between national banks and state banks, on December 6, 2019, the FDIC published its own proposed rule
  - Like the OCC, the FDIC would not address the true lender question



Treasury FinTech Report

On July 31, 2018, Treasury issued a report, "Nonbank Financials, Fintech, and Innovation"

- The FinTech Report is the fourth in a series released in response to a 2017 Executive Order requiring Treasury to identify laws and regulations that are inconsistent with the "Core Principles" for financial regulation set forth in the Order

The FinTech Report recommends 81 regulatory improvements, including with respect to marketplace lending:

- Congress should codify the "valid when made" doctrine called into question by *Madden v. Midland Funding, LLC*
  - And federal banking regulators should use their authority to address challenges raised by *Madden*
- Congress should affirm that a bank is the "true lender" of the loans it makes
  - Federal banking regulators also should reaffirm that the bank remains the true lender under partnership arrangements

According to Treasury, these changes would "better support productive partnerships" between banks and newer technology-based companies

OCC FinTech Charter

On July 31, 2018, the OCC announced that it would start accepting Special Purpose National Bank charter applications from FinTech companies

- This coincided with Treasury's FinTech Report recommendation that the "OCC move forward with prudent and carefully considered applications" for such charters

On September 18, 2018, Comptroller of the Currency Joseph Otting published an opinion piece in which he defended the OCC's decision to accept applications for an OCC FinTech Charter

Comptroller Otting argued that the OCC FinTech Charter creates economic growth and opportunity, and is good for the dual banking system

- He said complaints about the OCC's decision to accept applications for an OCC FinTech Charter came down to "defending turf and licensing revenue of a few big states at the expense of economic opportunity for others"

Comptroller Otting also responded to arguments raised by the New York Department of Financial Services and the Conference of State Bank Supervisors

- He noted that the National Bank Act does not require a bank to take deposits to be engaged in the "business of banking"; rather, it is sufficient under the NBA that a bank perform "any one of" the three core banking activities

OCC FinTech Charter

At the same time as the announcement that the OCC was accepting applications for an OCC FinTech Charter, the OCC released a "Policy Statement on Financial Technology Companies' Eligibility to Apply for National Bank Charters"

- In the OCC Policy Statement, the OCC explains that:
  - The "business of banking evolves over time"
  - "[C]ompanies that engage in the business of banking in new and innovative ways should have the same opportunity to obtain a national bank charter as companies that provide banking services through more traditional means"

The agency also issued a revised version of the "Comptroller's Licensing Manual Supplement: Considering Charter Applications from Financial Technology Companies"

NYDFS, CSBS Challenge OCC FinTech Charter

On September 14, 2018 and October 25, 2018, the NYDFS and the CSBS, respectively, filed suit against the OCC seeking declaratory judgment and injunctive relief

- They argued that the OCC has the ability to charter only institutions that engage in the "business of banking," which "necessarily" requires that the institution receive deposits

- On May 2, 2019, the U.S. District Court for the Southern District of New York denied the OCC's request for dismissal of the NYDFS case
  - The court found that the NYDFS had sufficiently shown risk of harm and that the business of banking "unambiguously requires receiving deposits"

- On September 3, 2019, a D.C. federal district judge dismissed the CSBS complaint against the OCC because, as in a prior case, the CSBS "continues to lack standing and its claims remain unripe"
- Conversely, on October 21, 2019, the SDNY judge ruled in favor of the NYDFS

  - The judge approved a proposed judgment containing language sought by the NYDFS; specifically, that the OCC's special purpose national bank regulation be "set aside with respect to all fintech applicants seeking a national bank charter that do not accept deposits"

  - According to press reports, the OCC has said it plans to appeal the decision

Traditional Bank Charters

- The challenges by the CSBS and the NYDFS continue to serve as a deterrent to FinTech companies applying for an OCC FinTech Charter
  - As a result, some FinTech companies have opted to apply for more traditional banking charters

- The bank charter route is often viewed by FinTech companies interested in offering financial products and services as a way to avoid the myriad state licensing laws and state regulatory frameworks, and is seen as an alternative to the OCC FinTech Charter
  - In contrast to the OCC FinTech Charter, an ILC charter would not require a company to divest itself of its commercial non-banking businesses, which could make it attractive to entities that would like to engage in both commercial and banking activities
  - However, ILC charters still require companies to apply for and obtain FDIC deposit insurance
- The FDIC has not approved any applications for deposit insurance for an ILC since 2008, and the ICBA has openly urged the FDIC to deny ILC applications for deposit insurance and impose a two-year moratorium on future ILC deposit insurance applications
  - While cautious of non-traditional banks, FDIC Chairman Jelena McWilliams has said she would speed up agency review of bank charter applications

State Loan Broker/Lending Licenses

- Potential loan brokering or loan facilitation activities could require a marketplace lender to obtain one or more state loan broker, lending, or even credit services organization licenses

- Loan Broker/Credit Services Organization Licenses
  - The following facts could reduce the likelihood that a marketplace lender may be required to obtain a loan broker or credit services organization license:
    - The company does not receive fees in advance of an installment loan being made
    - Any fees the company receives are wholly contingent on the successful procurement of the installment loan (i.e., the borrower does not pay any fee if the borrower does not receive an installment loan)
    - The company does not receive any compensation directly from the borrower
    - The company does not receive any compensation from any person in connection with arranging or facilitating the making of the installment loans

State Loan Broker/Lending Licenses

- Lending Licenses
  - The following facts could reduce the likelihood that a marketplace lender may be required to obtain a lending license:
    - The loans are not marketed or branded as company installments
    - The company limits its role in the lending process, including with respect to providing or accepting loan applications, informing borrowers about loan terms and conditions, performing underwriting, etc.
    - The company does not receive any compensation directly from the borrower
    - The company does not receive compensation from any person in connection with arranging or facilitating the making of loans
    - The loan amounts and/or interest rates offered by lenders do not fall within the state's licensing threshold

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