TREASURY ISSUES REPORT REGARDING NONBANK FINANCIALS, FINTECH, AND INNOVATION – MARKETPLACE LENDING SUMMARY

The U.S. Department of the Treasury (the "Treasury") has released a fourth report in a series of reports produced in response to Executive Order 13772, available here, which sets out the Administration's seven core principles for regulating the U.S. financial system (the "Core Principles"). This report, entitled "A Financial System That Creates Economic Opportunities: Nonbank Financials, Fintech, and Innovation" (the "Fourth Report", available here) analyzes and provides recommendations for the regulation of nonbank financial companies, the fintech sector and other forms of financial market innovation through the lens of the Core Principles. Thematically, the Fourth Report primarily addresses the following two Core Principles: (1) making regulation efficient, effective, and appropriately tailored and (2) enabling American companies to be competitive with foreign firms in domestic and foreign markets.

This briefing specifically discusses the Treasury's recommendations regarding online lending in the Fourth Report. The Clifford Chance fintech team will distribute a series of briefings over the next two weeks that will provide summaries and analysis of various topics within the Fourth Report. We will also distribute a separate summary of the proposed OCC Fintech Charter.

Key points with respect to online lending

In the Fourth Report, the Treasury notes that marketplace lenders are expanding access to credit for consumers and businesses in the United States, and that partnerships between banks and marketplace lenders have served to enhance the capabilities of mature financial firms. It recommends eliminating constraints brought about by recent court cases, principally *Madden v. Midland Funding, LLC*[1] and various "true lender" cases (discussed below in more detail). It considers these rulings to have resulted in unnecessary restrictions on the U.S. credit markets. Accordingly, the Report recommends that Congress should codify the "valid when made" doctrine and the role of a bank as the "true lender" of loans it makes (discussed below in more detail). In addition, the Report recommends that federal banking regulators should use their available authorities to address these challenges. More specifically, the Fourth Report includes a recommendation that the Office of the Comptroller of the Currency move forward with prudent and

1 786 F.3d 246 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

carefully considered applications for special purpose national bank charters.[2] It also calls for state regulators to strive for greater harmonization, including considering drafting of model laws that could be uniformly adopted for financial services companies currently challenged by varying licensing requirements of each state.

Overview of the marketplace lending sector

The Fourth Report includes an overview of the marketplace lending sector and outlines product segments covered by marketplace lenders and different business models used by them.[3] It specifically focuses on differences between platforms that use a bank partnership model and those that acquire their own regulatory licenses and discusses various funding and underwriting models.

In the Fourth Report's discussion of the regulatory landscape, the Treasury notes that marketplace lenders may be subject to federal- or state-level regulation and supervision depending on whether they use the bank partnership model or the direct lending model. The Treasury specifically refers to certain federal and state laws such as the Truth in Lending Act, Equal Credit Opportunity Act, anti-money laundering statutes and, in the context of securitizations, oversight by the U.S. Securities and Exchange Commission and application of U.S. risk retention rules. Interestingly, the Fourth Report omits any reference to the Bureau of Consumer Financial Protection in this context.

Support for the bank partnership model

The Treasury expresses support in the Fourth Report for the bank partnership model, which – if appropriately designed – can leverage advantages provided by both banks and fintech companies. Highlighting the fact that marketplace lenders generally compete below a 36% annual percentage rate threshold, the Fourth Report seeks to address concerns that bank partnerships may harm consumers by allowing the partnering fintech companies to bypass state usury limits and other state requirements Moreover, the Fourth Report indicates that federal banking regulators are now paying closer attention than in the past to third-party service provider relationships, specifically lending arrangements, which should reduce the risk of potential abuse of the sort that had been witnessed in connection with bank partnership arrangements. Consumer protection advocates would argue that while mainstream lenders may lend at "reasonable" interest rates, the regulatory regime must guard against bad actors who operate further down the credit spectrum. The Fourth Report does not address that concern in detail.

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2 Concurrent with the Treasury's release of the Fourth Report, the Office of the Comptroller of the Currency announced that it will begin accepting applications for national bank charters from non-depository financial technology (fintech) companies engaged in the business of banking.

3 For a more detailed overview of the marketplace lending sector, see U.S. Department of the Treasury, White Paper: Opportunities and Challenges in Online Marketplace Lending (May 10, 2016), available here.

Concerns regarding state usury laws following the Madden decision

The Treasury is concerned that the Second Circuit's *Madden* decision is having, and could have further, adverse effects on the U.S. credit markets. In that case, the court held that the National Bank Act (which generally pre-empts state usury laws with respect to the interest a national bank may charge on a loan) did not pre-empt state-law usury claims against a third-party debt collector that had purchased the loan. There are concerns that this ruling could apply to marketplace loans originated using the bank partnership model and then purchased from the originating bank by a non-bank marketplace platform or subsequently purchased by another type of non-bank purchaser.

The Treasury recommends that Congress codify the "valid when made" doctrine to preserve the functioning of U.S. credit markets and the longstanding ability of banks and other financial institutions, including marketplace lenders, to buy and sell validly made loans without the risk of coming into conflict with state interest-rate limits. The "valid when made" common law doctrine provides that a loan contract that is valid when it was made cannot be invalidated by any subsequent transfer to a third party. Applied to marketplace lending, a loan that was validly made by an originating bank could not be rendered invalid or unenforceable due to being transferred to a non-bank marketplace platform or subsequent purchaser. Legislative efforts have been made to address the *Madden* decision, but with concerns that any changes could facilitate predatory lending practices, it remains to be seen if Congress will be able to act on the Treasury's recommendation.

Uncertainty created by court cases regarding true lender status

The Treasury notes with dissatisfaction that court decisions in "true lender" cases have resulted in multiple standards for determining which entity is the true lender of a loan. For example, in *Sawyer v. Bill Me Later, Inc.*,[4] the court adopted a bright line test that focused on, among other things, the fact that the bank in question was a party to the consumer loan agreements and funded the related consumer loans. The court in *CashCall, Inc. v. Morrisey,*[5] however, applied a "predominant economic interest" test and held that the originating bank did not have such an interest in the loans in question and was therefore not the true lender of the loans. Subsequent cases have failed to provide clarity as to the applicable standard. As a result, parties to a bank partnership arrangement face a degree of uncertainty as to whether the bank or the nonbank partner is the true lender in providing credit. When a nonbank partner is deemed to be the true lender, it becomes subject to a range of state law requirements including interest rate limits and licensing requirements.

The Treasury recommends that Congress codify that the existence of a service or economic relationship between a bank and a third party (including fintech companies) does not affect the role of the bank as the true lender of loans it

[4] No. 2:11-cv-00988, 2014 U.S. Dist. LEXIS 71261 (D. Utah May 23, 2014).
[5] No. 12-1274, 2014 W. Va. LEXIS 587, at *39-44 (W. Va. May 30, 2014).

makes. Further, the Treasury recommends that federal banking regulators should also reaffirm that the bank remains the true lender under such partnership arrangements.

Credit services

In a final recommendation for the marketplace lending sector, the Treasury suggests that states revise credit services laws to exclude businesses that solicit, market, or originate loans on behalf of a federal depository institution pursuant to a partnership agreement. The Treasury's intention is to address the situation where a marketplace lender without an applicable state credit services license could be held to impermissibly perform a licensed activity if it arranged for a loan to be made by a bank partner.

Conclusion

The Treasury recommends a number of legislative or regulatory actions, each of which is characterized as clarifying an otherwise unclear situation in order to provide greater certainty and facilitate lending. Any such certainty is likely to be welcomed by the marketplace lending industry. The Treasury's assessment that "state laws [have a role] and oversight in protecting consumers, but such state regulation should not occur in a manner that hinders bank partnership models already operating in a safe and sound manner with appropriate consumer protections" may invite the question who determines what is a safe and sound manner? Attempts to implement the Treasury's recommendations by creating lighter-touch federal regulations to pre-empt more onerous state regulations will likely elicit challenges from some state regulators, which could result in less, rather than more, certainty for the marketplace industry.

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