



Recent Regulatory and Legal Developments

FinTech Update

September 17, 2019



Introductions



Jesse Carlson

Jesse is the Senior Vice President and General Counsel of Kapitus, a financial technology company focusing on small business finance. He is also an Adjunct Professor at Georgetown Law.

Prior to joining Kapitus in June of 2017, Jesse served as Counsel in the Professional Liability & Financial Crimes Section of the FDIC's Legal Division and practiced at Williams & Connolly LLP. He also served as the Judicial Law Clerk to the Honorable John M. Rogers of the U.S. Court of Appeals for the Sixth Circuit.

Jesse received his law degree from the Georgetown University Law Center and his undergraduate degree from Colby College.



Chris Gattuso

Chris Gattuso is the leader of Kilpatrick Townsend's Financial Institutions Team. She focuses her practice on corporate and securities matters, financial institution regulatory matters, and mergers and acquisitions.

Chris advises financial institutions on a wide range of regulatory, enforcement, consumer protection, and compliance matters, including cybersecurity and mobile financial services, before the federal and state banking agencies, including the Office of the Comptroller of the Currency, the FDIC, Federal Reserve Board, and the CFPB.

Chris received her law degree from the University of Baltimore School of Law and her undergraduate degrees from King's College.



Josh Benson

Josh Benson is an associate on Kilpatrick Townsend's Technology, Privacy & Cybersecurity Team. He focuses his practice on outsourcing agreements, technology licensing, and contracts and commercial agreements.

Prior to joining the firm, Josh was a corporate associate in the Dallas, Texas office of an international law firm where he practiced in the areas of mergers and acquisitions, securities law, private equity, and general corporate law.

Josh earned his law degree from Harvard Law School and his undergraduate degree from Cedarville University.

Agenda

- Overview of FinTech
- FinTech Regulation
- Recent Developments in FinTech Regulation and Supervision
- Negotiating FinTech Agreements
- On-Line Lending: Overview and Updates
- Block-Chain/Cryptocurrency: Overview and Updates



Overview of FinTech

What is FinTech?

- The use of technology to change the way people transact business by creating new and better financial services for consumers and businesses.
- Examples:
 - C2C Payments (PayPal, Venmo, Square Cash)
 - Retail POS solutions (Square, Stripe, Dwolla)
 - Consumer Lending (Rocket Mortgage, LendingClub, SoFi)
 - Business Lending (Kabbage, Kickstarter, Kapitus)
 - Wealth Management/Brokerage (Ellevest, Robinhood)
 - Insurance (Tractable, The Zebra)
 - Cloud Infrastructure (Amazon Web Services, Google Cloud Platform)
 - AI/Machine Learning (ZestFinance, Wells Fargo Bot)
 - Blockchain/Cryptocurrencies (Coinbase, Circle)

Who Uses FinTech?

- Examples of the Types of Companies Using FinTech:
 - Payment processors
 - Credit/debit card issuers
 - Mobile payment providers
 - Credit reporting and monitoring agencies
 - Marketplace lending
 - Online insurance platforms
 - A broad range of financial institutions, including money-center banks, regional and community banks, thrifts and credit unions
 - E-Commerce and traditional retailers
 - Restaurant, hotels, travel and hospitality companies
 - Entertainment and online gaming companies

Why Does FinTech Matter?

- Disruption of traditional business models
 - Mobile customer acquisition
 - Robo-advisers, AI investing
 - Blockchain: digital currency, instant trade settlement
- Major market impact & investment
 - Global Online Lending: 2017 = \$38.8B, Projected 2022 = ~ \$460B
 - Global Fintech investment = \$6.3B in 2019 Q1; \$40B in 2018 v \$18B in 2017
- Government & regulatory attention
 - July 2018 – OCC announces it will begin accepting applications for special purpose national bank charter
 - U.S. Department of Treasury Innovation Report
 - Government-sponsored sandboxes (U.S., U.K., Australia, Canada)

Who Participates in FinTech?

- Broad reach – As, Bs, Cs, Ds
 - A: Large financial institutions (JP Morgan, Wells Fargo, Goldman Sachs)
 - B: Large tech companies not exclusively in financial services (Apple, Google)
 - C: Infrastructure providers (MasterCard, Fiserv, Amazon Web Services)
 - D: Disruptors (Robinhood, Stripe, Lemonade, Chime, Credit Karma)
- Three Key U.S. Fintech centers:
 - Silicon Valley, Atlanta, New York

FinTech Companies Business Models

- Bank – FinTech Partnerships
 - Digital Account Opening
 - Credit cards/debit cards
 - Holding Customer Deposits/Deposit Accounts
 - Lending/Underwriting
 - Fraud/Risk Management
 - Insurance
 - New Products
 - Investment Management

FinTech Business Models (cont'd)

- Special Purpose National Bank Charter or an Industrial Loan Company Charter or federal or state bank charter
- Hold Risk on FinTech Balance Sheet (registration and licensing with states, as applicable)
- Interact with depository institutions through the payment system
- Connect capital from institutional investors to individual borrowers
- Provide technology services to financial institutions (i.e, RegTech)



Fintech Regulation

Regulation of FinTech

- Federal Banking Agencies (OCC, FDIC, Federal Reserve)
- SEC and State Securities Regulators
- CFPB (have authority over any non-bank FinTech firms)
- FTC
- FinCEN
- State Banking and Insurance Regulators
- Foreign Jurisdictions

Laws and Regulations Applicable to FinTech

- Federal Laws Relating to Financial Products and Services:

- Electronic Funds Act/Regulation E
- Equal Credit Opportunity Act/Regulation B
- Fair Credit Reporting Act/Regulation V
- Expedited Funds Availability Act/Regulation CC
- Truth-in-Savings Act/Regulation DD (deposit accounts)
- Truth-in-Lending Act/Regulation Z (consumer loans)
- Gramm-Leach-Bliley Act/Regulation P (consumer privacy)
- Federal Securities Laws
- Federal Commodities Laws
- Bank Secrecy Act/Anti-Money Laundering Laws

Laws and Regulations Applicable to FinTech (cont'd)

- Other Federal Laws That May Be Applicable:
 - Electronic Signatures Act
 - American with Disabilities Act
 - Telephone Consumer Protection ACT
 - Federal Arbitration Act
 - Patent, Trademark and Copyright Laws
 - Federal Trade Commission Act: Unfair and Deceptive Acts or Practices
- State Laws
 - Unfair and Deceptive Practices
 - Use of Electronic Records
 - Banking Laws relating to branching, ATMs, Kiosks
 - Securities Laws
 - Cybersecurity Laws (e.g., NY, CA) and Data Privacy Laws



Recent Developments in Fintech Regulation and Supervision

Enforcement Actions

- Conduent Business Services, LLC – Software Provider
 - Conduent entered into consent order with the CFPB to settle chargers that software errors in its automated software for auto loans caused inaccurate information about more than a million consumers to be reported to credit reporting agencies.
 - Failure to timely fix defects identified by its clients.
 - Failure to notify its other clients about known defects, which resulted in for erroneous reports for several years.
 - \$1.1 million fine/change in conduct provisions.
 - CFPB relied on authority over service providers of covered persons.

Enforcement Actions

▪ Pay Pal, Inc. – Peer to Peer Payment (Venmo)(2018)

- PayPal entered into settlement with FTC with respect to Venmo's practices regarding its privacy, security, and disclosure practices.
 - FTC investigation took several years.
 - No CMPs imposed; order prohibits PayPal from making similar misrepresentations in the future and requires PayPal to undertake certain security, reporting, and compliance obligations.
 - Alleged that PayPal engaged in deceptive acts or practices in violation of the FTC Act and the Gramm-Leach-Bliley Act by:
 - misrepresenting a consumer's ability to transfer money from a Venmo account to an external bank account;
 - failing to properly administer and disclose its privacy practices;
 - misleading consumers about its data security.

Enforcement Actions

▪ The Bancorp Bank – Prepaid Cards (2018)

- Bancorp settled a claim with the FDIC with respect to its Excella prepaid card program.
 - FDIC alleged Bancorp engaged in unfair and deceptive practices by improperly assessing transaction fees for certain point-of-sale, signature-based transactions.
 - Alleged violations of Electronic Signatures Act, Electronic Funds Act and Truth in Savings Act.
 - Restitution of \$1.3 million to affected consumers; civil money penalty of \$2 million.

Litigation

- LendingClub – Peer to Peer Lending (2018)

- FTC brought a suit against Lending Club alleging that it engaged in unfair and deceptive business practices in violation of the FTC Act.
 - Allegations included: (i) hidden up-front fees; (ii) misleading consumers on timing of disbursement of loan; and (iii) unauthorized withdrawals from customer accounts.
- Case remains pending.

Litigation

■ State of Colorado – True Lender Cases (2017 - present)

- True Lender Claim – brought against on-line lenders that utilize banks for funding. Claim is that the bank is not actively engaged in the lending program and does not receive the benefits or take the risks of a true lender. If a true lender challenge is successful, an on-line lender could face significant penalties for usury and unlicensed lending.
- *Madden v. Midland Funding* – the 2015 2nd Circuit Case held that a non-bank purchaser of bank-originated credit card debt was subject to New York State's usury laws.
 - Decision criticized as court did not apply "valid-when-made" principle – i.e., assignee stands in shoes of assignor.
- Colorado AG brought lawsuits against two marketplace lenders in 2017.
 - Suits challenged the bank funding model.
 - If resolved against the defendants, penalties could be severe.
 - Could have implications beyond Colorado.
- Colorado cases remains pending.

Regulatory Updates

- Varo Bank granted bank charter – not yet opened for business.
- Latest lawsuit challenging OCC authority to grant special purpose bank charter dismissed.
- CFPB issued proposed debt collection rules. (May 2019)
- CFPB issues new policies to promote innovation.
 - Final FinTech Sandbook Framework (now called a “compliance assistance sandbox”)
 - Revised policy for “no-action” letters
 - Program designed to all form alternative consumer disclosures



Negotiating FinTech Contracts

Key Considerations in Contract Negotiations

- Indemnity
 - Intellectual Property Infringement
 - Violations of Applicable Laws
- Limitation of Liability
 - Cap on Damages
 - Insurance Coverage Limits
- Business Continuity
- Define Project Scope, Testing, Timelines and Payment Schedule
- Auditing Rights/Access to SOC Reports
- Confidentiality, Data Protection and Procedures to Address Cyber Breach
- Responsibilities of Parties for Compliance and Record-Keeping Matters
- Third-Party Service Providers



Recent Developments in Fintech Regulation – Commercial and Small Business

Kapitus Overview

Leading provider of financing to small businesses in the US



2006

Established as
Strategic Funding Source



237

Employees



\$2B+

In Capital
Provided



**Institutionally
Backed**



40K+

Small Businesses
Served



**World Class
Board**



New York

120 W 45th Street
New York, NY 10036



Virginia

2500 Wilson Blvd.,
Suite 350
Arlington, VA 22201



Texas

2500 Discovery Blvd.,
Suite 200
Rockwall, TX 75032

Overview – Compliance Models for Non-Bank Lenders

- Become a Bank
 - Traditional bank
 - Regulatory certainty versus safety and soundness concerns
 - Two or three sets of regulators (OCC/Fed, or State/FDIC/Fed)
 - Industrial Loan Company
 - No ILC charter issued since before the 2008 financial crisis
 - Not subject to Bank Holding Company Act
- Find a Bank Partner
 - Non-bank lender is service provider to bank for regulatory purposes
 - Bank issues loan, sells loan or participation back to non-bank
 - *Madden v. Midland Marine*, “true lender” and “valid when made”

Overview – Compliance Models for Non-Bank Lenders

- Comply with the law in each state in which you do business
 - Products limited by state law and licensing regimes.
 - Law is evolving, adapt to changing conditions.
- Apply for a Fintech Charter from the OCC
 - Unclear if special purpose bank charter would be able to access to Fed payment systems, burden of regulation without clear benefits.
 - Litigation risk due to challenges by state regulators to OCC authority.

Recent Developments in Each Model

■ Industrial Loan Company

- Push for a moratorium on deposit insurance for ILCs in response to Square's ILC charter application.

■ Bank Partnership

- FDIC and OCC filed strongly worded amicus brief in appeal challenging bank partner loan as usurious, *Rent-Rite Super Kegs West Ltd. v. World Business Lenders LLC*, No. 1:19-cv-01552-REB, filed Sept. 10, 2019 (D. Colo.).
- Kabbage awarded \$3.2 million in attorney fees in arbitration of claim originally brought as class challenging bank partnership as a “rent-a-charter” scheme.

Recent Developments in Each Model

■ Compliance with State Law

- Conference of State Bank Supervisors (CSBS) announced over the summer that 23 states have agreed to participate in a streamlined licensing process under which nonbanks (such as Fintech companies) that require a license to operate under state law can benefit from the cooperative efforts of state regulators in approval of their applications.
- **New York** – Gov. Cuomo signed bill limiting use of confessions of judgment to cases in which the affidavit for the confession of judgment was executed in New York, and filed in the county where the borrower lived at the time executed. Chair of Senate Banking Committee introduced legislation to license non-bank lenders and bank partners offering products in state of New York.
- **California** – Process for implementing “TILA for Small Business” continues, California Department of Business Oversight (DBO) published draft rules for the new Commercial Finance Disclosure law in late July, soft comment period on draft closed September 9.

■ FinTech Charter

- OCC is continuing to litigate challenges to its authority to issue FinTech charters brought by Conference of State Bank Examiners and the NY Department of Financial Services. On May 23, the NYDFS suit was allowed to proceed to discovery in the S.D.N.Y. On September 5, the D.D.C. granted the OCC’s motion to dismiss a similar lawsuit filed by CSBS on standing and ripeness grounds, but litigation casts doubt on the Special Purpose National Bank charters.

Recent Developments, General

- FTC has taken regulatory interest in commercial lending
 - FTC has long-standing enforcement authority over unfair and deceptive acts or practices by non-bank financial institutions under Section 5 of the FTC Act, and has significantly increased its presence as a regulatory force in small business financing. Considers small businesses to be “consumers.”
 - Announced investigation of small business finance, including “merchant cash advance” providers, tendency to regulate through enforcement.
 - Has focused on marketing or lead generators, holding beneficiary responsible for behavior.

Recent Developments, General

- House of Representatives has focused on “FinTech”
 - On June 25, the House Committee on Financial Services’ FinTech Task Force (which was formed May 9) held a hearing on “Overseeing the Fintech Revolution.” The Task Force was formed by the House Committee on Financial Services on May 9, and covers a broad range of issues.
 - On July 25, the Task Force held a hearing on “Examining the Use of Alternative Data in Underwriting and Credit Scoring to Expand Access to Credit” because of the concern that the use of alternative data may harm consumers.
 - On June 26, the House Committee on Small Business held a hearing on the use of confessions of judgment. At the hearing, Congresswoman Nydia Velazquez (D-NY) called on lawmakers to address predatory lending to small businesses by ending COJs in commercial lending.
 - On September 26, the House Committee on Financial Services is scheduled to hold a hearing on Examining Legislation to Protect Consumers and Small Business Owners from Abusive Debt Collection Practices.



Blockchain

What is Blockchain?

- A way to **distribute** a source of information among network participants.
- Network participants – **nodes** – broadcast a proposed transaction for validation by other nodes.
- Grouped into **blocks** for validation and confirmation.
- The chain is **immutable** – once accepted a block cannot be changed or undone.



Why does this matter?

- Both perform essentially same function
- Disintermediation
- Trust
- Public v. Permissioned



Use Cases – Exceedingly Varied

- Keeping track of the distribution of produce, from farm to grocery store
- Voting systems
- Electronic money or cryptocurrency
- College diplomas
- Shipping
- Logistics
- Cross-border payments
- Managing medical records
- Prediction markets (gambling?)
- The quality of journalism
- Settlement of stock trades
- Data storage
- Real estate deed records
- Supply chain management
- Data security
- Automotive repair recordkeeping
- Electric power distribution
- Real estate mortgage origination and processing
- Electronic collectibles
- Video games
- Advertising transparency
- Travel booking settlement
- Awards programs
- Music distribution
- Corporate stock records
- Running computer programs

Concepts for In-House Counsel

- Understand The Fundamentals of the Technology
 - Better issue spotting → traditional legal concerns (IP, jurisdictional, data security / privacy)
 - What is the scope of application? (what external forces will be involved, what processes will be impacted)
 - Consortium challenges – e.g., TradeLens
- Learning Through Experience
 - Regulatory Trends: SEC / GDPR / CCPA
 - Practical considerations for holding / accepting digital assets

Securities Regulation of Tokens

- SEC Guidance Released in April applying the “Howey Test” to cryptocurrency tokens.
- *SEC v. Howey* (1946)
 - Transactions qualify as investments if:
 1. There is an investment of money
 2. The investment is in a common enterprise
 3. There is an expectation of profits
 4. The profits come from third party efforts



Securities Regulation of Tokens

- SEC No Action Letter for Turn Key Jets in April 2019
 - Funds from Token Sales would not be used to develop platform.
 - Tokens were immediately exchangeable for purchasing air charter services.
 - Tokens were redeemable by Turn Key Jets for a dollar each.
- SEC Lawsuit Against Kik Initial Coin Offering filed June 4, 2019
 - Kik sold \$100 million dollars of Kin tokens in 2017 without any registration.
 - Finite amount of Kin tokens generated to power a messaging app ecosystem.
 - Statements by Kik that token purchase could profit as the ecosystem grew.
 - SEC alleged Kin tokens recently traded at half purchase value.

What about Bitcoin and Ethereum?

- Bitcoin continuously generated and distributed via algorithm.
- Ethereum initially sold by a single organization.
 - Now generated via similar algorithm.
 - Thousands of decentralized apps (DApps) now built on its smart contract platform .
- Letter by SEC Chairman Jay Clayton in March 2019:

“I agree that the analysis of whether a digital asset is offered or sold as a security is not static and does not strictly inhere to the instrument... I agree with Director Hinman's explanation of how a digital asset transaction may no longer represent an investment contract if, for example, purchasers would no longer reasonably expect a person or group to carry out the essential managerial or entrepreneurial efforts.”

Data Privacy – Right To Be Forgotten

GDPR –

- Art. 17: “Right of Erasure”
- Art. 16: “Right of Rectification”

CCPA – Cal. Civ. Code 1798.105: “Right to Deletion”

- Provides GDPR-style privacy rights to California consumers.
- Right to deletion applies to business and its service providers.
- Personal information is broadly defined, including IP addresses and device identifiers.

Right To Be Forgotten

Clash with Blockchain - Immutability

- Late 2018 - French Data Protection Authority (CNIL):
 - “Solutions for a responsible use of the blockchain in the context of personal data”
- Guidance:
 - Don't use blockchain to process **personal data** if alternatives exist.
 - If you have to, use **permissioned networks** with better governance controls.
 - **Hash** or **encrypt** personal data stored on chain; deleted key = erasure?
 - If personal data must be stored on chain in cleartext, ensure a **data protection impact assessment (DPIA)** establishes acceptable residual risks.

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