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**Merchant Cash Advance Regulatory Developments**

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# OVERVIEW OF MERCHANT CASH ADVANCE REGULATORY DEVELOPMENTS

Discuss regulatory developments in the merchant cash advance industry to include state and federal developments.

- Where we were
- Where we are
- Where we are going

# Where We Were / Lack of Regulation

- Many small businesses obtained funding through factoring.
- Small businesses also obtained financing from traditional lenders, such as banks.
- Access to credit for small businesses tightened significantly in the late 90s/early 2000s.
- This led to an exponential increase in alternative financing arrangements including merchant cash advance transactions.

# Where We Were / Lack of Regulation

Business creditors must comply with the Equal Credit Opportunity Act (15 U.S.C. §§ 1691 *et seq.*) and its implementing Regulation B (12 C.F.R. 1002.1 *et seq.*)

- ECOA makes it unlawful for “**any creditor** to 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 (provided the applicant has the capacity to contract).” 15 U.S.C. § 1691(a).
  - An “applicant” is any person who applies to a creditor directly for an extension, renewal, or continuation of credit.
  - A “creditor” is any person who regularly extends, renews, or continues credit; any person who regularly arranges for the extension, renewal, or continuation of credit; or any assignee of an original creditor who participates in the decision to extend, renew, or continue credit.
  - A “person” includes a “natural person, a corporation, government or governmental subdivision or agency, trust, estate, partnership, cooperative, or association.

# Where We Were / Lack of Regulation

- This fair lending law is applicable to business creditors.
- The FTC was the main regulator with enforcement authority over non-bank business lenders. This authority was generally transferred to the CFPB through the Dodd Frank Act, which gave the CFPB authority to prescribe rules and issue guidance for ECOA.

# Where We Were / Lack of Regulation

Factoring transactions generally not subject to state or federal regulation.

- Uniform Commercial Code – Permits factor to file financing statement and obtain security interest in purchased accounts.
- Texas Account Purchase Transaction Statute (Tex. Fin. Code § 306.103) – States parties' characterization as purchase transaction is conclusive that transaction is a purchase and not a loan.
- Generally no regulator oversight.

Merchant cash advance transactions similar to factoring transactions

- Purchase transactions of future receivables instead of current receivables.

# Where We Were / Lack of Regulation

Laws applicable to factoring also applied to merchant cash advance transactions

- Uniform Commercial Code – Permits funders to file financing statements secured by business assets
- Texas Provision – Court held future receivables are accounts to which Tex. Fin. Code § 306.103 applies (Express Working Capital, LLC v. Starving Students, Inc., 28 F. Supp. 3d 660, 668 (N.D. Tex. June 24, 2014))
- Generally no regulator oversight

California courts recharacterized merchant cash advance transactions as usurious loans which led many companies to obtain the California Finance Lenders License so they would not be subject to any usury limit.

- Companies were subject to regulation as a licensed lender.

Approximately 6 states require commercial lenders to have a license to originate loans.

# Where We Are / State and Federal Monitoring

Increase in transactions led to media scrutiny and regulator interest.

- In 2008, U.S. Conference of Mayors adopted a resolution titled, Protecting Main Street Small Business Owners from Predatory Lenders to encourage cities to regulate or ban merchant cash advances.
  - The resolution was abandoned after the recession where traditional small business funding ceased.
- 2010 – Federal Reserve Bank of New York began Small Business Credit Survey.
  - Survey businesses to obtain information about financing needs, sources, and borrowing experiences.
  - May 15, 2014 – Held Small Business Credit Innovations summit.
- Alternative lenders are able to meet needs of businesses by quickly providing short-term credit.
- The downside is the cost of the alternative credit.
- Noted need for improved information to help businesses understand their credit risk.



# Where We Are / State and Federal Monitoring

- Dodd-Frank Act – Section 1071 amended the Equal Credit Opportunity Act to provide for small business lending data collection.
  - Financial institutions will ask applicants if they are minority-owned, women-owned or a small business.
  - Financial institutions will also compile data and provide the information to the CFPB.
  - Data collected will include the purpose of the loan, the amount of credit requested, the amount of credit approved, the gross annual revenue of the business, etc.
  - The CFPB was authorized to issue regulations governing the data collection.
  - The CFPB has yet to issue rules for this data collection process or collect data.

# Where We Are / New Regulatory Landscape

- 2013 – The FTC filed an action against Merchant Services Direct, an ISO organization, for deceptive practices.
  - Sales agents stated or implied that they were affiliated with current processor when they were not
  - Falsely represented that businesses would save money on website and in face to face meetings
  - Told businesses that their swipe terminals were out of date when the terminals were not to induce them to lease terminals from the company

# Where We Are / New Regulatory Landscape

- FTC Action against Merchant Services Direct cont.
  - Made unsubstantiated claims on website that customers would save 20-30% or 30-60% over current monthly processing expenses.
  - MSD deceived customers by failing to disclose miscellaneous fees or substantial lease cancellation fee.
  - Customers also were required to pay a higher price for terminals that were not needed.

# Where We Are / New Regulatory Landscape

- FTC Action against Merchant Services Direct cont.
  - Ordered to stop engaging in the deceptive practices and to clearly disclose costs.
  - Also required to monitor employees by:
    - Establishing and maintaining a complaints process
    - Aggregating the number and nature of complaints for each sales agent or employee
    - Promptly investigating and taking corrective action to remedy complaints.

# Where We Are / New Regulatory Landscape

- In July 2015, Treasury Department Request For Information on marketplace lending
  - published RFI to obtain information on marketplace lending industry for consumers and small businesses. Responses would allow Treasury to determine “how the financial regulatory framework should evolve to support the safe growth of this industry.”
  - Commenters said the same protections for consumers should be extended to small businesses.
  - Commenters also asked for greater transparency in the cost for small businesses.
  - In October 2015, Antonio Weiss, Counselor to the Secretary, said Treasury would continue to monitor market and work with state and federal regulators. He also encouraged the industry to implement best practices and improve customer experience from origination to default.

# Where We Are / New Regulatory Landscape

- August 2015 – Group of marketplace lenders (including ACCION, Fundera, Funding Circle, and Lending Club) issued the Small Business Borrowers’ Bill of Rights
  - Identifies practices for lenders and brokers to use to increase transparency, fairness, inclusion, and access to credit.
- October 2015 - California adopted SB 197 (effective on January 1, 2016) to limit the payment of referral fees to unlicensed ISOs by CFLL licensees. Referral fees to unlicensed person permitted upon consummation of commercial loan when:
  - The APR does not exceed 36%;
  - The lender obtains certain documentation from prospective borrower to verify commercial status; and
  - The lender obtains certain documentation from prospective borrower to verify borrower will have sufficient monthly gross revenue to repay loan according to the terms.

# Where We Are / New Regulatory Landscape

- CFPB Shows Interest and Hints at Regulation
  - November 2015 – CFPB employees attend small business lending conferences, the American Banker's Marketplace Lending + Investment conference and the American Banker's Small Business Banking conference
  - February 2016 priority statement states CFPB will do the following over the next two years:
    - Build a small business lending team to start market research in preparation for business lending data collection rulemaking;
    - Build infrastructure to begin taking small business complaints; and
    - Examine small business lenders for compliance with fair lending laws.

# Where We Are / Competition that May Lead to Self-Regulation

- In January 2015, Chicago Mayor Rahm Emanuel issued statement urging state and federal regulators to implement protections for small businesses similar to those for creditors.
  - Declared merchant cash advance companies offered predatory products with high interest rates that businesses could not afford.
  - Chicago also implemented program offering low interest rate loans up to \$25,000 to small businesses. The program connects small businesses with low rate lenders, including ACCION.



# Where We Are / Competition that May Lead to Self-Regulation

- Small Business Administration implements technology initiatives to increase number of low rate loans provided to businesses
  - In July 2014, developed a credit score that blends a business credit score and a personal credit score to quickly approve small loans up to \$350,000.
  - In February 2015, implemented SBA LINC, an online lending tool, to match small businesses with traditional lenders that can quickly provide low rate SBA loans.
  - In April 2015, implemented SBA One, an online application system that permits lenders to submit applications for quicker processing.
- In February 2016, the National Credit Union Administration adopted a new business lending regulation to make it easier for credit unions to offer affordable loans to small businesses. For example, the rule removes requirements that require waivers, including a personal guarantee requirement.

# Where We Are Going / Government Advocacy

- Agencies & Congress
  - Curiosity, interest, and action
    - Treasury RFI
    - Dodd-Frank 1071
    - Pressure for regulation
    - CFPB Assistant Director, Small Business Lending
    - House GOP's Innovation Initiative

# Where We Are Going / Government Advocacy

- Active Stakeholders

- Small Business Borrowers Bill of Rights (Aspen Inst.)
- Online Lenders Alliance (OLA)
- Small Business Finance Assoc. (formerly NAMAA)
- Coalition for Responsible Business Finance
- Commercial Finance Coalition
- Electronic Transactions Association (ETA)
- Financial Innovation Now (FIN)
- Company DC Representation
  - CAN Capital
  - OnDeck
  - Kabbage
  - Fundera
  - Funding Circle
  - Lending Club

# Where We Are Going / Government Advocacy



- High Industry Standards
  - Principles
  - Best Practices
- Choices for Small Business Borrowers
  - Advisory Board of Small Business Groups
  - Balance between increased regulation & product choice
- Education strategy with legislative agenda


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# Questions?

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