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Client Alert

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CFPB Poised to Expand Regulation to Small Business Lending: Expect the Unexpected

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Recent initiatives by the Consumer Financial Protection Bureau ("CFPB" or Bureau) to dramatically expand its regulation of small business lending present a confluence of concerns to industry participants. These initiatives include the CFPB's extension of fair lending rules to types of credit not ordinarily considered to be subject to the agency's jurisdiction. The CFPB's focus on business lending likely will have a particular impact on non-bank lenders making loans to small businesses, a product line that today is increasingly being served by FinTech and other online marketplace lenders. For example, recent articles in the trade press have covered issues arising out of the intersection of FinTech and fair lending.[1]

THE SCOPE OF FEDERAL CONSUMER FINANCIAL PROTECTION LAWS

Generally, federal consumer financial protection laws, such as the Truth in Lending Act, do not apply to business-purpose credit. One significant exception, however, is the Equal Credit Opportunity Act ("ECOA" or the "Act").[2] The Act and Regulation B promulgated thereunder generally apply to both consumer-purpose and business-purpose credit transactions. Requirements of ECOA and Regulation B that are of greatest significance to business-purpose credit transactions include: (1) the general bar against discrimination on a prohibited basis in any aspect of a credit decision, 12 C.F.R. § 1002.4; (2) the requirement that creditors notify applicants of adverse actions (although Regulation B gives creditors greater flexibility in notifying business applicants that recorded more than $1 million in gross revenue in the past fiscal year), 12 C.F.R. § 1002.9(a)(3); (3) the spousal signature rule, 12 C.F.R. § 1002.7(d)(1); and (4) record retention requirements, 12 C.F.R. § 1002.12(b).

Moreover, the Home Mortgage Disclosure Act ("HMDA") and recently amended CFPB Regulation C promulgated thereunder apply to certain commercial real estate secured loans.[3]

DODD-FRANK ACT UPS THE ANTE

Section 1071 of the Dodd-Frank Wall Street Reform and Consumer Protection ("Dodd-Frank") Act created a new Section 704B of ECOA (codified at 15 U.S.C. § 1691c-2). Under Section 1071, financial institutions, broadly defined to include banks and non-banks alike, must collect and report information concerning credit applications made by women-owned, minority-owned, and small businesses. The stated purpose of Section 1071 is to "facilitate enforcement of fair lending laws and enable communities, governmental entities, and creditors to

[1] John Heltman, *Can Fair Lending Keep Up with Fintech?*, American Banker (Apr. 15, 2016).

[2] 15 U.S.C. §§ 1691 *et seq.*, 12 U.S.C. pt. 1002. The federal Fair Housing Act is, in part, a fair lending law, but the CFPB has no jurisdiction over this statute. Hence, the discussion of fair lending laws administered and enforced by the Bureau necessarily is focused on ECOA. But the CFPB has jurisdiction over "fairness" in the market under its unfair, deceptive, or abusive acts or practices authority. *See* Dodd-Frank Act Section 1031, 12 U.S.C. § 5531.

[3] HMDA and Regulation C require collection of detailed borrower and transaction-level data in mortgage transactions that must be formatted and delivered to the CFPB. The CFPB's recent amendments to Regulation C are two-fold: substantive descriptions of covered transactions and detailed, system-driven data collection and reporting requirements. For further information, see our October 20, 2015, and November 30, 2015, client alerts on the recent amendments to Regulation C.

identify business and community development needs and opportunities for women-owned, minority-owned and small businesses."

Section 1071 requires financial institutions to collect certain data elements in connection with covered business loan applications, including the race, gender, and ethnicity of the principal owners of the business; the gross annual revenues of the business; the action taken on an application; and the loan type and purpose. With Section 1071, Congress in effect created a "mini-HMDA" for financial institutions that lend to women-owned, minority-owned, and small businesses. Financial institutions will be required to report data annually to the CFPB. As with HMDA, the CFPB is authorized to disclose the data, both in the aggregate and by financial institution, to the public, and financial institutions reporting data must make the data available to any member of the public who requests it, albeit in both cases with borrower-level personal information excluded.

Congress also made it clear that the purpose of the data collection requirements is to facilitate fair lending enforcement. In light of the potential for CFPB administrative penalties and the requirement to make application and loan data public, the importance of risk management for financial institutions is amplified. This is particularly the case for new, non-bank entrants that may not be accustomed to traditional depository institution risk management frameworks. The enhanced risks under the new law include legal, supervisory (e.g., CFPB), regulatory, operational, and reputational risks. Reputational risks loom large, as public disclosure of alleged discriminatory conduct could lead to devaluation of an entire enterprise.

Additionally, because Section 1071 is an amendment to ECOA, it appears that violations of Section 1071 would be subject to the full range of administrative enforcement actions under ECOA Section 704. *See* 15 U.S.C. § 1691c. While ECOA Section 706, 15 U.S.C. § 1691e, includes a private right of action that covers Dodd-Frank Section 1071, it remains to be seen whether violation of Section 1071 reporting could give rise to any cognizable harm. As such, plaintiffs may well lack standing to bring claims under ECOA for violations of Section 1071.[4]

THE SPECIFICS OF SECTION 1071

The key entry point to the law is the description of types of transactions covered. The statute establishes coverage through new and existing definitions.

- The law applies to "financial institutions," a term that is broadly defined in Section 1071 to include any partnership, company, corporation, association (incorporated or unincorporated), trust, estate, cooperative organization, or other entity that engages in any financial activity.
- The law requires financial institutions, as broadly defined, to gather certain data with respect to "any application . . . for credit for women-owned, minority-owned, or small business."
- Some terms in Section 1071 are defined in existing ECOA and/or Regulation B, and some terms are defined in the new section.
    - Regulation B defines "application" as "an oral or written request for an extension of credit that is made in accordance with procedures used by a creditor for the type of credit requested." 12 C.F.R. § 1002.2(f).

[4] *See Spokeo, Inc. v. Robins*, No. 13-1339 (U.S. May 16, 2016). In *Spokeo*, the plaintiff sought relief for alleged violations of the requirement under the Federal Credit Reporting Act that consumer reporting agencies "follow reasonable procedures to assure maximum possible accuracy of" consumer reports. Slip op. at 3 (citing 15 U.S.C. § 1681e(b)). The district court dismissed the plaintiff's complaint for lack of standing, but the Ninth Circuit reversed. The U.S. Supreme Court vacated the judgment and remanded the case back to the Ninth Circuit, holding that, in its Article III standing analysis, the Ninth Circuit failed appropriately to consider whether the plaintiff suffered harm that was "concrete and particularized." Slip op. at 2.

- ECOA defines "credit" as "the right granted by a creditor to a debtor to defer payment of debt or to incur debts and defer its payment or to purchase property or services and defer payment therefor." 15 U.S.C. 1691a(d). Regulation B echoes this definition, but uses the term "applicant" instead of "debtor." 12 C.F.R. § 1002.2(j).
- Section 1071 defines "women-owned business" as a business, "more than 50 percent of the ownership or control of which is held by 1 or more women; and more than 50 percent of the net profit or loss of which accrues to 1 or more women." 15 U.S.C. § 1692c-2(h)(6).
- Section 1071 defines "minority-owned business' as a business, "more than 50 percent of the ownership or control of which is held by 1 or more minority individuals; and more than 50 percent of the net profit or loss of which accrues to one or more minority individuals." 15 U.S.C. § 1692c-2(h)(5).
- Section 1071 defines "small business" by reference to the term "small business concern" in Section 3 of the Small Business Act, 15 U.S.C. § 632, 15 U.S.C. § 1692c-2(h)(2).

Substantively, covered financial institutions will have the following duties:

- Inquiring whether applications for business credit are made by women-owned, minority-owned, or small businesses. 15 U.S.C. § 1691c-2(b)(1).
- Compiling and recording certain data with respect to applications for business credit that are made by women-owned, minority-owned, or small businesses, including (a) the application number and date received; (b) the type and purpose of the loan or credit; (c) the amount of credit applied for and the amount of credit approved; (d) the action taken on the application and the date of such action; (e) the census tract in which the business applicant is located; (f) the gross annual revenue of the business applicant in the last fiscal year; (g) the race, gender, and ethnicity of the principal owners of the business; and (h) any additional data the CFPB determines by rule to be required to fulfill the purpose of Section 1071. 15 U.S.C. § 1691c-2(e)(1)–(2).
- Ensuring data reported to the CFPB does not contain personally identifiable information. 15 U.S.C. § 1691c-2(e)(3).
- Prohibiting underwriters from accessing the data required by Section 1071 to be collected (or, if a financial institution determines underwriters should have access to the data, providing notice of this fact to applicants). 15 U.S.C. § 1691c-2(d).
- Submitting data to the CFPB and making data available to the public. 15 U.S.C. § 1691c-2(f).

Congress imposed an enhanced duty on the CFPB to issue guidance accompanying the required Section 1071 rulemaking. 15 U.S.C. § 1691c-2(g)(1), (3). This would seem to be particularly important for defining specific situations that may or may not be covered by the final rule, and for direction with respect to implementation of and ongoing compliance with technical specifications in the resulting rule. In addition, the CFPB is empowered to release aggregate data derived from industry-wide reporting. Thus, legislators and regulators considering further regulation of business credit may use the data to inform policy for additional legislative and regulatory initiatives.

THE WAY FORWARD

Section 1071 is not automatically effective and will become binding only upon completion of the CFPB's rulemaking. So, until the CFPB rulemaking results in final regulations to implement the law, covered institutions will not need to comply with the law.[5] We expect that this rulemaking will be two-fold, as was the case with Regulation C. First, the rule likely will describe the financial institutions and transactions subject to the reporting

[5] *See* Letter from CFPB General Counsel Leonard Kennedy (Apr. 11, 2011), http://files.consumerfinance.gov/f/2011/04/GC-letter-re-1071.pdf; *see also* Federal Reserve Board rule at 12 C.F.R. § 202.17 (stating that no motor vehicle dealer covered by Section 1029(a) of the Dodd-Frank Act shall be required to comply with Section 704B of ECOA until the Board issues rules to implement Section 704B).

requirements. Second, the rule likely will provide detailed data collection and reporting requirements, including specified reporting formats. Based on the development of HMDA reporting over time, we expect the latter will include adoption of technology-based solutions at the CFPB for online acceptance of reports.

At this point, the CFPB has initiated preliminary steps to promulgate Section 1071 rules. On October 15, 2015, CFPB's Division of Research, Markets & Regulations posted a job opening for the position of "Assistant Director for Small Business Lending Markets." This posting provided an indication of the thrust of the CFPB's rulemaking process. According to the job posting, the Assistant Director "will lead an inter-disciplinary team in the Bureau's research and development of a landmark collection of data about loans to small, women-owned, and minority-owned businesses." Specifically, the Assistant Director will be responsible for market research that will lay the foundation for and assist in the development of the rulemaking implementing Section 1071's mandated data collection. On April 12, 2016, the CFPB announced that it filled this position with an individual with background in small business lending.

In addition, in February 2016, the CFPB released a statement of its "policy priorities over the next two years," which include small business lending as a "near-term priority goal." In the statement, the Bureau said it would take the following steps in the next two years:

- Build a small business lending team to conduct market research that will provide a factual foundation for rulemaking;
- Build the infrastructure to accept and analyze complaints regarding small business lending; and
- Conduct examinations to evaluate small business lenders' compliance with fair lending laws.

The CFPB is expected to proceed carefully and deliberately in the rulemaking process, especially since it has only recently hired a small business expert and has little experience dealing with small business loan products. It is likely that the new Assistant Director, working collaboratively with others at the Bureau, industry participants, consumer groups, and other affected constituencies, will gather significant input before a proposed rule is published for comment. For example, as was the case with the revised HMDA reporting rule, the Bureau very likely will seek informal comments from technology professionals regarding the creation of a CFPB-managed electronic platform for submitting the required reports and analyzing the data submitted. Consistent with the CFPB's stated policy priorities, a proposed rule could be issued in 2017, with the aim of finalization in 2018.

ISSUES FOR CONSIDERATION IN THE RULEMAKING

Financial institutions that will be covered by the rule have expressed concern about the details of on-the-ground compliance and the consequences of mandatory new processes that today have no real precedent, except for the sweeping HMDA reporting rule in mortgage lending. For example, smaller financial institutions may see a disproportionate burden relative to the cost of compliance and the consequences of non-compliance when compared with larger lenders.

In drafting the rule, the CFPB will be required to decide, among other things, what types of credit products (e.g., business credit cards, lines of credit, letters of credit, loans) and what size loans (e.g., loans up to $10,000, $50,000, or $100,000) the rule will cover. Additionally, if the CFPB's recent amendments to Regulation C are any guide, we expect the rule will require collection of many transaction-level data points in addition to those specifically enumerated in the statute.

Furthermore, there are concerns about how the Bureau will use the data once collected. After all, Section 1071 charges the CFPB and other agencies to use the data for fair lending enforcement, among other things. (According to the CFPB, "Congress intended section 1071 to produce reliable and consistent data that can be analyzed by the Bureau, other government agencies, and members of the public to facilitate enforcement of fair lending laws and identify business and community development needs." Letter from CFPB, *supra* n.5, at 1.)

In preparing a proposed rule, the CFPB is empowered (and, in some cases, required) by statute to use several tools to address coverage and implementation concerns among market participants and fair lending advocates. For example, in connection with the rulemaking, the agency is:

- Empowered to adopt exceptions to any requirement of Section 1071. 15 U.S.C. § 1691c-2(g)(2).
- Empowered to consider conditional and/or unconditional exemptions of covered persons, service providers, or consumer financial products or services from any rule issued pursuant to Title X of the Dodd-Frank Act (which includes Section 1071). 12 U.S.C. § 5512(b)(3)(A). When considering whether an exemption is necessary or appropriate to carry out the purposes and objectives of Title X, the CFPB must consider, as appropriate, the total assets of the class of covered persons; the volume of transactions involving consumer financial products or services in which the class of covered persons engages; existing laws that are applicable to the consumer financial product or service; and the extent to which such provisions provide consumers with adequate protections. 12 U.S.C. § 5512(b)(3)(B).
- Required to conduct an analysis of costs and benefits to consumers and covered persons. 12 U.S.C. § 5512(b)(2).
- Required to convene a panel of small business representatives potentially affected by the proposed rule, pursuant to Small Business Regulatory Enforcement Fairness Act. 5 U.S.C. § 609(d) (as amended by Dodd-Frank Act Section 1100G).
- Empowered to consider phasing in the final rule over a series of effective dates, which small entities may find particularly helpful. *See, e.g.*, Home Mortgage Disclosure (Regulation C), 80 Fed. Reg. 66,128 (phasing in amendments over three effective dates).

PRELIMINARY OBSERVATIONS AND TAKEAWAYS

Naturally, there is unease surrounding the apparent mismatch of an agency dedicated to consumer protection greatly expanding its activities in the field of commercial credit. Because the line between consumer lending and business lending can be fine in the case of small businesses (e.g., sole proprietors), the CFPB could well cross the boundary between consumer protection and the regulation of small business as it continues to establish its authority. For example, once the CFPB begins to analyze the new data and decides to bring fair lending enforcement actions against small business lenders, will it confine itself to its explicit authority under the ECOA? Although there is no explicit statutory authority to do so, could the CFPB seek to assert its authority to prohibit unfair, deceptive, or abusive acts or practices over commercial credit transactions? Until the industry has a proposed rule in hand, only one thing is certain: We should expect the unexpected.

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