The Regulation of Marketplace Lending: A Summary of the Principal Issues

March 2017 Update

Chapman and Cutler LLP
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THE REGULATION OF MARKETPLACE LENDING:

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Breaking News: 
*Madden* Remand Decision

On Monday, February 27, 2017, the U.S. District Court for the Southern District of New York issued its long-awaited remand decision in *Madden v. Midland Funding, LLC*. The Second Circuit held in its May 2015 decision in *Madden* that a non-bank assignee of loans originated by a national bank was not entitled to the federal preemption afforded to the bank with respect to claims of usury. This controversial decision raised significant questions for the ability to enforce loans in accordance with their terms for non-bank marketplace lenders purchasing loans from an originating bank.

The Second Circuit remanded to the lower court to determine whether New York or Delaware law governed the contractual relationship of the parties. The account agreement specified Delaware law as the governing law, and the national bank that issued and administered the credit card account involved in *Madden* prior to default and assignment of the debt to Midland Funding had its principal place of business in Delaware. Delaware law authorizes creditors to charge any interest rate agreed upon by the borrower in a written contract. On remand, the district court held that applying Delaware law per the account agreement would violate a fundamental public policy of New York—namely, its criminal usury statute, which limits interest to 25% per year. Broadly interpreted, this decision could prevent the enforcement of choice of law provisions in credit agreements against New York consumers when the interest rate exceeds 25%, as is the case for many credit cards and other consumer loans.

The district court also found that although the New York criminal usury law does not provide a private right of action, Midland Funding’s violation of the usury limit could serve as a predicate for *Madden’s* Fair Debt Collection Practices Act ("FDCPA") and state unfair and deceptive acts and practices ("UDAP") claims, which the court allowed to proceed on a class basis.

The lower court’s holding compounds the uncertainty created by the Second Circuit’s decision in *Madden* by further undermining common law principles that are routinely relied upon by creditors and their assignees. While the Second Circuit’s decision undercuts the doctrine that loans are "valid when made" and do not become invalid when they are assigned to a third party, the district court has now called into question the enforceability of a choice of law provision in a credit contract against New York consumers where the interest rate exceeds the state law usury limits. However, the court did not directly address what happens when federal preemption and state public policy conflict. How similar cases in the Second Circuit (New York, Vermont and Connecticut) will be decided remains to be seen, as *Madden* has not been adopted specifically by any other court to date.
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Preface

We are pleased to offer once again our annual survey of the principal regulatory and securities issues applicable to marketplace lending. As in past surveys, we have no shortage of topics to discuss this year as the past 12 months have seen both significant court cases and regulatory initiatives. As to the former, the Supreme Court declined to review the controversial decision in Madden v. Midland Funding, LLC, leaving unanswered questions for banks and marketplace lenders alike; “true lender” claims have continued to be raised in litigation, with courts reaching differing results; and the decision of the U.S. Court of Appeals for the D.C. Circuit in PHH Corp. v. Consumer Financial Protection Bureau called into question the constitutionality of the structure of the Consumer Financial Protection Bureau (the “CFPB”). The white paper published by the U.S. Department of the Treasury following its 2015 request for comments on marketplace lending and the recent announcement by the Office of the Comptroller of the Currency (the “OCC”) that it will consider a special-purpose national bank charter for fintech companies show an increased regulatory interest in marketplace lending and suggest that the federal banking regulators may eventually propose regulations specific to this industry. We discuss the most significant developments of the past year in the “Recent Developments” section that immediately follows this Preface. The remainder of this white paper then describes in greater detail the status of marketplace lenders under existing securities, consumer protection, and other applicable laws.

At the outset, it may be helpful for us to briefly discuss the scope of this paper and some of the terminology we use. There is no single or universally accepted definition of “marketplace lending.” In general, though, marketplace lenders can be viewed as companies engaged in an Internet-based lending business (other than payday lending) which are not banks or savings associations or otherwise regulated as financial institutions. They may offer a wide variety of financial products, including student loans, small business loans, and real estate loans, in addition to the unsecured installment consumer loans on which the industry initially focused. However, “marketplace lenders” may or may not actually be lenders. This term is a generic term to identify participants in marketing, originating, selling, and servicing loans. They also may fund their loans through a variety of means, including equity capital, commercial lines of credit, sales of whole loans to institutional investors, securitizations, and/or pass-through note programs. In this paper we focus on the consumer lenders since they are the most heavily regulated and have the highest loan volumes. However, much of the discussion herein—outside of matters pertaining directly to consumer lending regulation—will also apply to non-consumer lenders.

The marketplace lending industry is best known to the public through the pass-through notes programs operated by LendingClub Corporation and Prosper Marketplace. These so-called peer-to-peer (or “P2P”) programs enable retail investors to purchase nonrecourse notes representing fractional interests in specific underlying consumer loans. It was once widely expected that P2P programs would become common. In fact, however, most marketplace lenders do not operate such programs on either a public or private basis, in part because of the availability of funding from other sources, but also in
part because of the costs and difficulties of securities law compliance. As marketplace lenders who operate P2P programs therefore face some compliance issues that may not apply to those who don’t, herein we refer to lenders who operate such programs as “Operators” and use the term “marketplace lender” or “lender” to refer to marketplace lenders generally.

Some marketplace lenders solicit borrowers to take loans that are actually made and originated by FDIC-insured financial institutions. For these types of programs, we refer to the bank that serves as the originating lender as the “Funding Bank.” The Funding Bank structure has generated legal challenges, as discussed in this white paper, particularly where the marketplace lender both solicits and then purchases and services the loans. Other marketplace lenders obtain state licenses in order to make loans directly to borrowers under state laws.

Of course, regardless of its source of funding, any prospective operator of an Internet lending platform must be careful to plan and operate its business in compliance with applicable laws and regulations. Regulatory costs have proven to be a significant barrier to entry in this industry; such costs will remain a significant expense for those platforms that commence operations, and any failure by a platform operator to comply with applicable laws and regulations can result in civil or criminal penalties, litigation expense, adverse publicity, or, in an extreme situation, the termination of its business. In this regard, we hope that our survey will help lenders and other market participants understand the key regulatory issues facing them.

As a final word, we must caution that this survey is intended only to identify the principal regulations that apply to Internet-based lending and does not provide detailed guidance on the steps required to comply with any particular law.
Recent Developments

The past year has seen a multitude of significant court cases and regulatory initiatives affecting marketplace lenders. This section of our survey summarizes those developments.

A. Madden v. Midland Funding, LLC

Summary. The May 2015 decision of the Second Circuit in Madden v. Midland Funding, LLC\(^1\) sent shockwaves through the marketplace lending industry, and nearly two years later the questions generated by this case remain largely unanswered as Midland Funding’s request for rehearing by the full Second Circuit and subsequent petition for review by the Supreme Court have both been denied. The district court has not yet issued a decision on the questions that were remanded for consideration.

The Madden decision has broad implications for the overall financial markets, but it is of particular concern to marketplace lenders because the court’s analysis, if applied to marketplace lending, could invalidate the funding structure under which many consumer marketplace lenders arrange loans made by commercial banks based on federal law preemption of interest rates otherwise exceeding the usury cap in the borrower’s state of residence. Under this funding structure, banks rely upon the principle of interest rate exportation to all states to offer loans at rates exceeding the usury limit in a borrower’s state of residence. Often the marketplace lender purchases the loans from the bank shortly after origination.

In Madden, the Second Circuit held that a non-bank assignee of loans originated by a national bank was not entitled to the federal preemption afforded to the bank under the National Bank Act (“NBA”) with respect to claims of usury. Under the NBA, national banks can make loans at the rates and fees allowed in the state where the bank is located and “export” them nationwide without being limited by the usury laws of individual states where the bank’s borrowers may reside. The Court held that preemption of state usury laws does not apply to non-bank loan purchasers where the bank has no continuing interest in the transaction unless the state law would “significantly interfere” with the bank’s exercise of its banking powers under the NBA. The Court found that failing to extend federal preemption to non-bank loan purchasers would have no such impact on the bank. As a result, the Court ruled that Midland, the debt collector and non-bank purchaser of a credit card account issued by a national bank to a New York resident, was required to adhere to New York usury limits.

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\(^1\) 786 F.3d 246 (2d Cir. 2015).
Key Consideration: *Madden* did not involve a marketplace lender or loan, but if the *Madden* holding were applied to a marketplace lender as a non-bank purchaser of an existing bank loan, the marketplace lender might be unable to enforce the loans in accordance with their terms or may be subject to claims of damages for charging excess interest.² *Madden* therefore has raised significant questions for the marketplace lending industry and, as discussed below, market participants have taken various actions to address the associated risks.

Although *Madden* is binding only in the states included in the Second Circuit (Connecticut, New York, and Vermont), there remains the risk that other jurisdictions will adopt the Second Circuit’s analysis.³

**Procedural History and Current Status.** In 2005, Saliha Madden, a New York resident, opened a credit card account with a national bank which was governed by Delaware law. Madden defaulted on the account and it was sold to Midland Funding, a debt collector. A Midland affiliate sent Madden a letter calculating interest at 27 percent per annum. Madden filed a class action lawsuit in the Southern District of New York alleging that this rate violated New York’s usury limitations. Midland constructed its defense on the principles of federal preemption based on the bank’s contract and its ability to charge this rate under the NBA. Since the loans purchased were lawfully made, Midland argued that as an assignee of the loan, it was exempt from compliance with the New York usury law. The federal district court agreed with Midland, and Madden appealed to the Second Circuit.

The Second Circuit reversed the decision of the lower court, finding that preemption worked for the benefit of non-banks only when application of state law would significantly interfere with the bank’s exercise of its powers under the NBA. The Second Circuit also remanded the case to the lower court to determine if New York or Delaware law governed the contractual relationship of the parties. The account agreement specified Delaware law as the governing law, and Delaware authorizes creditors to charge any interest rate approved by the borrower in a written contract. Accordingly, the 27 percent rate that Midland sought to enforce would arguably be valid if Delaware law controlled. The

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² Depending on the state, if a marketplace lender were found to have breached the applicable usury cap, it could render the related loans unenforceable in whole or in part and/or subject the lender to monetary or other regulatory penalties.

³ There are many good legal arguments why *Madden* is either distinguishable or wrong. For one, the debt involved in *Madden* was charged-off, defaulted debt. Also, failing to extend preemption to non-bank purchasers could prevent the bank from selling certain loans, or at least reduce the price at which the loans can be sold, and thereby significantly interferes with a bank’s powers to make and sell loans. The *Madden* court also failed to apply long-standing precedents from other courts holding that an assignee steps into the shoes of the assignor and is entitled to enforce the loan upon the same terms as the assignor. These cases are consistent with the long-standing common-law principle that a loan which is valid when made does not become invalid when transferred. Since the *Madden* decision, some marketplace lenders have restructured their loan marketing programs to provide the Funding Bank with both a continuing relationship with the borrowers and a continuing financial interest in loan performance, including restructured compensation arrangements under which the bank’s compensation is partly based upon the payments actually made by the borrowers over the life of the loans. See footnote 10 below.
governing law determination has not yet been made by the district court, though briefing on the issue has now been completed.\textsuperscript{4}

**Requests for Review.** Following the Second Circuit’s decision, Midland requested that the entire Second Circuit Court of Appeals rehear the case, but this petition was denied. In November 2015, Midland asked the United States Supreme Court to grant certiorari to hear the case. In its brief to the Supreme Court, Midland argued that the Second Circuit’s decision violates the long-standing doctrine that loans are “valid when made” and do not change character or become invalid when they are sold or transferred.\textsuperscript{5} In March 2016, the Supreme Court requested the views of the Solicitor General of the United States on whether the Supreme Court should hear the case.\textsuperscript{6} In its brief to the Supreme Court, the Solicitor General strongly criticized the Second Circuit’s analysis and called its holding incorrect.\textsuperscript{7} The Solicitor General said that the “valid when made” doctrine was incorporated into Section 85 of the NBA, which provides banks with their preemptive powers. The brief also stated that the Second Circuit failed to consider the effect of its decision on the marketability of loans. The Solicitor General’s brief is of particular significance because it was joined by the OCC, the federal regulator of national banks. However, the Solicitor General ultimately recommended that the Supreme Court deny certiorari for three reasons: (1) there is no circuit split on the question raised, (2) the parties did not present significant aspects of the preemption analysis to the lower courts, and (3) there is a possibility that Midland Funding may still prevail on remand.\textsuperscript{8}

In June 2016, after considering all of the briefing, the Supreme Court declined to hear the case.\textsuperscript{9} Thus, the Madden decision will remain the law in Connecticut, New York, and Vermont but is not binding in other states.

\textsuperscript{4} Courts will not necessarily apply the governing law stated in a consumer loan agreement if doing so is viewed as contravening public policy in the borrower’s state of residence. The Madden court noted that courts which have considered this issue under New York law in similar cases have reached differing results.

\textsuperscript{5} See FDIC v. Lattimore Land Corp., 656 F.2d 139 (5th Cir. 1981) (the identity of the original creditor is dispositive and the “non-usurious character of a note should not change when the note changes hands”); Olvera v. Blitt & Gaines, P.C., 431 F.3d 285 (7th Cir. 2005) (assignments allow assignees to collect interest at the rate allowed to the originating creditor); Munoz v. Pipestone Fin., LLC, 513 F. Supp. 2d 1076 (D. Minn. 2007) (state law claims for excessive interest charged by an assignee of a loan are preempted).

\textsuperscript{6} This request shows that the Court was interested in the potential effect of this case on the financial services industry and capital markets.

\textsuperscript{7} Brief Amicus Curiae of United States at p. 6, Midland Funding, LLC v. Madden, 136 S. Ct. 2505, 195 L. Ed. 2d 839 (2016) (No. 15-610).

\textsuperscript{8} Id.

\textsuperscript{9} Midland Funding, LLC v. Madden, 136 S. Ct. 2505, 195 L. Ed. 2d 839 (2016) (cert. denied). Interestingly, Madden’s brief explicitly stated that this case is limited to the sale of defaulted debt and does not apply to marketplace lending.
Implications: The Madden decision created uncertainty for marketplace lenders and their partner banks, which has yet to be resolved. Some marketplace lenders and their Funding Banks have revised their business relationship to address Madden concerns. In addition, some purchases and/or securitizations of marketplace loans have limited eligibility criteria to loans that comply with applicable usury rates in the Second Circuit.

Given that the district court has not yet decided which law governs in this case, Madden will remain a case to watch and may still dictate other changes in this area. Interestingly, Madden has not been adopted specifically by any other court, and a New York district court found the Madden analysis not applicable in a case involving state law claims brought by a consumer against a non-bank service provider to a national bank.

B. “True Lender” Litigation

Litigation continues to arise challenging third-party programs, particularly where banks fund high-rate payday loans. The claims made in these cases assert that the payday loan marketers are actually the “true lenders,” and that they are using bank lenders solely to evade compliance with state usury limitations, licensing regimes, and consumer protection laws imposed by the states where such payday loan marketers do business. The facts in these cases are often analogous to marketplace lending programs where a Funding Bank is utilized, and the variance among the decisions has created some uncertainty in the industry. Several of these cases are summarized below.

**CashCall Decision—West Virginia.** One of the leading “true lender” cases is a 2014 decision from West Virginia where the Attorney General sued CashCall, Inc., the operator of an Internet loan program that used a South Dakota bank to fund consumer loans. CashCall was not licensed under West Virginia law and the loans made by the bank were made at interest rates in excess of the usury rate in West Virginia. The state’s position was that CashCall was the “true lender” under this arrangement.

10 For example, in February 2016 WebBank, the bank which is the lender for loans solicited through the LendingClub website, revised its borrower account agreement to specify that the bank maintains the account relationship with the borrower for the life of each and all LendingClub loans. In addition, WebBank and LendingClub modified their compensation arrangements so that WebBank’s compensation is no longer front-loaded as a fixed origination fee calculated against the principal amount of each loan but instead is tied in part to the performance over time of the loans originated through the LendingClub platform. The revised borrower account agreement and compensation arrangements are intended to provide WebBank with an ongoing interest in each loan sufficient to protect the funding arrangements from a Madden-type challenge. Other marketplace lenders have engaged in similar restructuring.

11 See Edwards v. Macy’s, Inc., 2016 U.S. Dist. LEXIS 31097 (S.D.N.Y. Mar. 9, 2016), where the court rejected a theory relying on Madden against a bank and its non-bank partner, finding that the non-bank partner was acting on behalf of the bank in carrying on the bank’s business in originating and servicing loans and that state law claims were therefore preempted. The case was appealed to the Second Circuit but has been voluntarily dismissed.

12 Unrelated to litigation, we note that some websites such as Google now ban ads for loans with annual percentage rates of 36 percent or more.

13 CashCall was also sued by the State for debt collection practices. Interestingly, CashCall made inquiry to the State as to whether it needed to be licensed there and was told it did not need to be licensed. At trial, the State claimed that this
because it had the predominant economic interest in the loans, and therefore CashCall should have followed applicable restrictions of West Virginia law, including its usury rate. The court ruled in favor of the state, finding that CashCall was the de facto lender under this program. The court enjoined CashCall from making new loans in the state, voided the existing loans (thereby cancelling the debt of the borrowers), and awarded $1.5 million in civil penalties and $10 million in punitive damages against CashCall, in addition to attorneys’ fees and costs. On appeal, the West Virginia Supreme Court upheld the decision.¹⁴ CashCall sought review by the United States Supreme Court, but it declined to review this decision.¹⁵ The decision in CashCall created some degree of uncertainty in the industry and spawned additional litigation surrounding the use of Funding Banks, which are costly to defend.¹⁶

**Utah Case Supports Funding Bank as True Lender.** In contrast to the CashCall decision, a federal court in Utah dismissed a consumer class action against an online payment processor, Bill Me Later, Inc., alleging that the originating bank was not the true lender in that arrangement. The court stated in its decision that even accepting as true the allegation that the loans were designed to circumvent state usury laws more protective than Utah’s, the case had to be dismissed because the claims were preempted by federal law.¹⁷

The court based its decision in part on the fact that Bill Me Later, Inc. was a service provider to the bank. Under the provisions of the Bank Service Company Act, when a bank contracts with a third-party service provider for services, the performance of those services is “subject to examination and regulation” by the bank’s regulator “to the same extent as if such services were being performed by the depository institution itself on its own premises.”¹⁸

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¹⁴ See CashCall v. Morrisey, No. 12-1274, 2013 W.Va. LEXIS 587 (W. Va. May 30, 2014). Although some see this case as an aberration primarily because of the excessive interest rates being charged, the legal principles involved are the same whether the rates are 1 percent or 100 percent above the applicable usury rate.

¹⁵ Typically, the Supreme Court hears less than 1 percent of those cases appealed.

¹⁶ A January 2016 federal court decision in Commonwealth of Pennsylvania v. Think Finance, Inc., Case No. 14-cv-7139 (E.D. Pa. Jan. 14, 2016), demonstrates this point. A high-rate Internet payday lender utilized a Delaware state bank to make loans and then purchased the loans. The court denied a motion to dismiss on the basis of federal preemption, instead allowing the claims against the Internet payday lender to proceed on true lender theories.


¹⁸ Bank Service Company Act, 12 U.S.C. § 1867(c)(1). Based on coverage by this statute, the court found that loans serviced through contracts with third parties are included within applicable federal preemption and did not make the non-bank service provider the lender instead of the bank.
Worth Remembering: The Bank Service Company Act provides a potent defense to true lender allegations because it subjects bank service providers to regulatory scrutiny and accountability, providing both regulation and consumer protection. Rather than evading regulation, an arrangement that is subject to the Bank Service Company Act is subject to supervision and examination for compliance with applicable laws.

The court’s opinion also provided some guidance for the proper structuring of lending arrangements between banks and third-party service providers, including that the bank (not the service provider) was the party to the loan agreement, the bank funded the loans and owned the accounts and held them for at least two days, and the bank received interest on the loans until they were sold. Some marketplace lenders using a Funding Bank have sought to replicate this structure to combat potential “true lender” claims.

CashCall Decision—California. CashCall was again embroiled in litigation even after a change in strategy following the West Virginia litigation. In March 2014, the CFPB filed a lawsuit against CashCall in California. The complaint alleged that CashCall ran a loan program using a “tribal model” whereby the loans were made by Western Sky, a Cheyenne River Sioux Tribe entity. All loans issued under this model were governed by tribal law, such that no state usury laws would apply. The CFPB alleged that this was an abusive practice where CashCall was the true lender, not Western Sky, and that the laws of the borrowers’ home states should determine what usury law applies, despite the tribal choice-of-law provision contained in the loan documents. The court ultimately sided with the CFPB, finding CashCall to be the “true lender” and holding that courts should look to the substance and not the form of the loan transaction. The court further noted that there was no substantial relationship between the loans and the Cheyenne River Sioux Tribe. As such, tribal law did not govern these loans.

In December 2016, CashCall asked that the decision be certified for interlocutory appeal to the Ninth Circuit. The court granted CashCall’s request in early January 2017; however, the decision will only be reviewed by the Ninth Circuit if it decides to permit the appeal. One of the questions identified for review is whether the proper test for determining the true lender under a loan agreement allows the

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19 Sawyer v. Bill Me Later, Inc., 23 F. Supp. 3d 1339 (D. Utah 2014). In an earlier case, a court similarly placed greater emphasis on the bank’s role as the named loan originator and held that preemption applied even though the website operator marketed and serviced the loans and had the predominant economic interest in the loans. Hudson v. ACE Cash Express, Inc., No. IP 01-1336-C H/S, 2002 WL 1205060 (S.D. Ind. May 30, 2002). In that case, the court accepted as true the claims that a state-chartered bank played an insignificant role in a lending program that a non-bank had “designed for the sole purpose of circumventing Indiana usury law.” But the court held that the bank was still the true lender based on federal law principles, noting that “concerns about protection of state usury laws present questions of legislative policy better addressed by Congress.”


21 Additionally, the CFPB alleged that the debt-collection arm of the enterprise, Delbert Services, violated the law by collecting on accounts that did not have amounts due and owing. There are, of course, obvious differences between this case utilizing tribal law and marketplace loans. However, the case may help to define the parameters of a true lender analysis.
court to look past the documentation and its parties to investigate related transactions. If the Ninth Circuit permits the appeal, its decision could provide an important precedent in true lender litigation.

**California Case Finds that Funding Bank Is the True Lender.** Shortly after the California decision finding that CashCall was the true lender under its tribal model loan program, a judge in the same district issued a decision supporting the Funding Bank as the true lender for certain student loans.\(^{22}\)

In this case, class action plaintiffs that had obtained private student loans made by a national bank alleged that the “actual lenders” in the transactions were the companies that ended up buying and servicing the loans, in part because the national bank was required to sell all the student loans it made during the course of the program to these companies.

> **Noteworthy:** The plaintiffs argued that the court should review the substance of the transaction rather than the form and find that these companies were not authorized to charge rates in excess of the California usury limit. The court declined to do so, explaining that while there are cases where courts have considered the substance of a transaction when assessing whether it satisfies the elements of usury or falls under a common-law exemption to the usury prohibition, that analysis does not apply when a transaction falls under a constitutional or statutory exemption to the usury limit.\(^{23}\)

Interestingly, and perhaps the more salient point made, the court also took into account public policy considerations, noting that there are broader economic consequences in making it difficult for banks to assign or sell loans into the secondary market.

**LendingClub True Lender Class Action Going to Arbitration.** In April 2016, LendingClub was sued by borrowers in a class action for alleged violations of usury laws, the Racketeer Influenced and Corrupt Organizations Act (“RICO”), and New York state consumer protection laws.\(^{24}\) LendingClub originated loans through a state-chartered bank; the borrowers alleged that the loan program was a “pretext and a sham” and that the company was trying to avoid state usury laws by structuring its loan transactions through the bank. The plaintiffs relied on both *Madden* and true lender theories. Instead of answering the complaint, LendingClub moved to compel arbitration and stay the district court case pending that arbitration. Briefing on the motion to compel arbitration was completed in August 2016 and on January 30, 2017, the court ruled in favor of LendingClub, granting the motion to compel arbitration. The decision is significant because it finds that the arbitrator determines the question of whether the case is subject to arbitration or not. Under the Federal Arbitration Act, the decision is subject to immediate appeal to the Second Circuit. The decision is also significant because it compelled

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\(^{23}\) The ruling was based on a California statute limited to in-state banks and national banks. As such, the ruling may be narrow in scope. Had this action been against a non-national bank located out of state, a different result may have occurred.

\(^{24}\) *Bethune v. LendingClub Corporation*, No. 16-cv-02578 (S.D.N.Y. Apr. 6, 2016). The genesis of this action was certain irregularities at LendingClub, resulting in the departure of its founder and other senior executives, which precipitated a drop in the stock price of LendingClub and disruptions that reverberated throughout the marketplace lending industry.
the arbitration on an individual—and not class—basis, potentially reducing the impact of any adverse decision.

The court’s ruling on LendingClub’s motion to compel arbitration provides support for the use of arbitration clauses in consumer loan agreements. Any ultimate decision on the merits of the case may set important precedent for the industry since unlike the other true lender cases discussed above, this case applies directly to a marketplace lending arrangement with a Funding Bank.

**Takeaway.** Any finding by a court that a marketplace lender that utilizes a Funding Bank is the “true lender” of the loans originated through the platform could have serious consequences both for the marketplace lender and for investors in its loans, as the marketplace lender could be subject to sanctions for violations of state usury, licensing, or consumer protection laws and the loans themselves (depending upon the states involved) could be declared unenforceable in whole or in part.

So long as litigation and uncertainty surround the use of a Funding Bank for marketplace lending programs, when structuring arrangements with Funding Banks lenders should use care to establish facts and factors that promote a sound foundation for finding that the Funding Bank is the true lender of the Borrower Loans. Possible criteria to be considered include whether the Funding Bank shares or relinquishes control and risk to the marketplace lender, operational aspects and payment of costs with respect to the program, whether the Funding Bank has loss exposure, protections provided to the Funding Bank, the Funding Bank’s right to deny credit or refuse to sell loans to the marketplace lender, the length of time that the Funding Bank holds the loans prior to selling them to the lender, and the compliance requirements imposed by the Funding Bank on the lender. Courts have looked to loan documentation to determine the intent of the parties and also whether the Funding Bank truly funds the loans. Due to the complex issues involved, experienced counsel should be consulted to assist in the development of an appropriate strategy and drafting of arrangements between marketplace participants and Funding Banks.

Prospective marketplace lenders should also note that third-party relationships entered into by financial institutions are in any case subject to increased regulatory scrutiny. A marketplace lender can expect some challenges in finding Funding Banks willing to take on the regulatory risk of third-party relationships, and should be prepared for extensive due diligence and for the Funding Bank to take an active role in establishing, approving, and monitoring the program since the bank remains responsible for its credit policies, loan forms, and compliance with applicable law. Accordingly, lenders are

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25 While the CFPB proposed rules in May 2016 potentially limiting the use of arbitration, arbitration clauses in effect prior to the rule becoming effective remain valid. In addition, given the election results of 2016, this rule may be either delayed or not implemented.

26 For example, the parties should ensure that the bank has substantive duties and/or an economic interest in the program or loans. Banks should also take care to fulfill their obligations under applicable federal banking guidance to monitor and supervise the Internet marketer’s performance of its duties as a bank service provider.
advised to take note of this issue and to consult with counsel when appropriate concerning third-party programs with financial institutions as well as regarding potential changes in regulatory attitudes.

C. OCC Proposes Special-Purpose Charter for Fintech Firms

On December 2, 2016, the OCC announced that it will issue special-purpose bank charters to qualified fintech companies. In its press release, the OCC took the position that applying a bank regulatory framework to fintech companies will (i) benefit customers, businesses, and communities and will help ensure that these companies operate in a safe and sound manner; (ii) result in the OCC’s uniform supervision of fintech companies, promoting consistency in the application of laws and ensuring that consumers are treated fairly; and (iii) make the federal banking system stronger by including these companies. Many within the industry view the OCC’s announcement as a victory for fintech companies that have argued for a national charter so that they can establish a uniform national program and avoid obtaining various state licenses and facing different laws and restrictions in each state.

In conjunction with this announcement, the OCC issued a white paper titled “Exploring Special Purpose National Bank Charters for Fintech Companies,” detailing many issues that must be resolved by the OCC before it will grant a special-purpose bank charter to a fintech company. The white paper is not a proposed rule requesting a response to substantive proposals by the OCC; rather, it is a request for information from the industry and the public. This is another step in the direction of identifying the requirements that will be applied by the OCC to a fintech company seeking a national bank charter; it points out agency concerns, but not how these concerns will be resolved.

The white paper solicited perspectives on several questions concerning the benefits and risks associated with approving fintech companies for a national bank charter and specific areas such as capital and liquidity requirements, commitments to financial inclusion and protecting small businesses in light of both safety and soundness considerations, and a proper regulatory scheme for technological companies. Responses were due January 15, 2016.

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27 This development came almost simultaneously with the OCC promulgating a final rule addressing the receivership of banks not insured by the FDIC, which would presumably apply to fintech companies that obtain a national bank charter but are not insured by the FDIC. In September 2016, the OCC also revised the “Charters” booklet of its Licensing Manual, which describes the process of applying for and obtaining a national bank charter, presumably with revisions contemplating the limited-purpose aspects of a charter applicable to fintech companies. We also note that some state regulators both question and oppose the ability of the OCC to grant a limited-purpose charter. In response, some states have suggested that they may look to reciprocal licensing. The new administration (as of this writing) has not weighed in on the issue and the Comptroller’s term of office is set to expire in April 2017, which could lead to changes at the OCC.
Key Consideration: We note that the OCC has not said that there will be a “fintech charter.” Rather, the OCC will grant a special-purpose national bank charter to fintech companies engaging in at least one of the activities of banking: lending, taking deposits, or paying checks. The obvious benefits of a national bank charter include preemption of state usury laws, exemption from state licensing requirements, operationally being able to maintain a uniform national program, and autonomy and control not present in a Funding Bank arrangement. Since all national banks are members of the Federal Reserve System, there is also access to the Fed’s payment system.

Conversely, obtaining a national bank charter is complex, costly, and often subject to regulatory conditions. The chartering process usually takes at least several months and often a year or more. Public comment and field investigations are part of the process. Charter applicants must submit a three-year business plan and cannot deviate from it without OCC approval. This may inhibit the nimbleness that fintech companies utilize as a competitive advantage. Often the OCC will require a minimum level of capital and the ratio of capital to total assets must always be 8 percent or greater. At this time, it is not known how the OCC might impose financial inclusion requirements on marketplace lenders seeking a charter, whether retention of some portion of loans will be required, or how off-balance sheet items such as loan sales will be treated for capital purposes. Federal law also limits transactions with affiliated companies and absent a change in law, any parent company would become a bank holding company, subject to not only additional regulation but also a restriction on being engaged in activities constituting banking or being closely related to banking.

It remains to be seen whether a special-purpose bank charter will be an appealing alternative for fintech companies and what conditions the OCC may impose on granting such a charter. All but the largest marketplace lenders may find certain of the requirements, such as the capital and compliance risk management requirements, sufficiently burdensome to outweigh the benefits of obtaining a national bank charter. It is also a long-term business strategy, not one that can be deployed in a short time frame. The availability of a national bank charter to qualified marketplace lenders could also have an impact on the competitive balance of the industry if investors come to view chartered lenders as “safer” or “more sound” than those that do not obtain charters, and the latter companies, as a result, are put at a competitive disadvantage in raising lending capital.

D. Regulatory Promulgations

For several years, the federal banking regulators did not make many public comments about marketplace lending. Perhaps this was because banks play a variety of roles in this space and the regulators primarily are in the business of regulating what banks do. Banks can be competitors to online lenders and potential purchasers of them. Banks are lenders to platforms and investors in marketplace loans. Banks can serve as trustees in securitization transactions of marketplace loans and
have entered into “white label” programs where bank customers are referred to marketplace lenders for loans. Bank regulators have supervised and examined banks that serve as Funding Banks for online lending programs for some time, but largely without any public comment.

However, this has changed dramatically as the marketplace lending industry and the involvement of banks in this space continue to expand and grow. In the last two years, banking regulators have made some significant pronouncements regarding marketplace lending, some of which are described below.\(^{28}\)

**Looking Ahead:** These regulatory promulgations illustrate how marketplace lending programs have garnered the increasing attention of federal regulators. Regulation of marketplace lending is taking center stage with more acts to follow, which makes attention to compliance of critical importance for all market participants.

**OCC Exam Procedures.** On January 24, 2017, the OCC issued new Exam Procedures that supplement the OCC’s Third Party Guidance. The Exam Procedures specifically reference bank relationships with marketplace lenders, identifying certain aspects of these relationships that should be evaluated as part of a regulatory examination. These aspects include:

- Whether the bank has sufficient support systems, personnel, and controls to adequately support the volume of planned loan origination, servicing, or collections activities;
- Whether the marketplace lender uses underwriting methods that are new, nontraditional, or different from the bank’s underwriting standards;
- Whether the bank is subject to any recourse or participation arrangements as part of originating marketplace loans; and
- Whether the bank buys bonds, loans, or notes from marketplace lenders and, if so, whether the bank has performed a robust credit risk analysis of that lender, determined that the loans meet the bank’s underwriting standards, and determined whether the arrangement meets the OCC’s regulatory investment and lending limits.

The Exam Procedures emphasize that a bank must maintain its own procedures and systems to ensure that the bank’s core compliance and risk management responsibilities are not being outsourced to the marketplace lender.

**OCC Fintech White Paper.** On March 31, 2016, the OCC published a white paper on the fintech industry and requested public comment by May 31, 2016. While the paper is generally supportive of

\(^{28}\) In response, the marketplace lending industry is forming groups to study and advocate regulatory issues. In April 2016, the Marketplace Lending Association was formed as a lobbying group. The Online Lending Policy Institute was also formed and conducted a summit in September 2016.
innovation and the improvements it brings, the OCC cautions that it must accomplished in a safe and sound manner, consistent with principles of consumer protection. The OCC also announced that it had created a working group within the agency to monitor developments related to marketplace lending. On October 16, 2016, the OCC announced its decision to establish an Office of Innovation and to implement a regulatory framework supporting “responsible innovation.” The Office of Innovation is to become operational in the first quarter of 2017. This is similar to the CFPB’s Project Catalyst to allow development of financial fintech in tandem with compliance with consumer protection laws.\(^{29}\) This is indicative of the overall general interest of regulators in the space.\(^{30}\)

**FDIC Draft Guidance Concerning Purchased Loans, Third-Party Lending Relationships.** In November 2015, the Federal Deposit Insurance Corporation (“FDIC”) issued a Financial Institutions Letter (“FIL”) dealing with effective risk management practices for purchased loans and participations.\(^{31}\) While this advisory is general in nature and applies to all forms of loan purchases and participations, the timing of its issuance suggested that one of the focal points was marketplace lending. The letter addressed the need for effective management of third-party risk where loans are purchased from non-bank entities or third-party arrangements. Financial institutions are encouraged to perform extensive due diligence and monitoring of third parties, especially in out-of-market loans. Banks should also assess the ability of third parties to meet obligations to the institution and review and monitor compliance with laws and regulations such as consumer protection and anti-money laundering requirements. Although nothing in the guidance is either new or startling, its timing may affect marketplace programs with banks by encouraging banks to undertake a more extensive due diligence and monitoring process.

On February 1, 2016, the FDIC issued FIL 9-2016 announcing the publication of the Winter 2015 issue of “Supervisory Insights.”\(^{32}\) Part of this publication is devoted to the specific topic of bank relationships with marketplace lenders. It is clear that the FDIC understands that banks do participate in products and programs of this nature and that the FDIC understands the way the market operates whether through a direct funding model or a bank partnership model. The FDIC considers such arrangements as a third-party vendor relationship and expects banks, however they become involved

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\(^{29}\) There does not appear to be an appetite to allow a regulatory “sandbox” to experiment broadly as has occurred in the UK.

\(^{30}\) We note that a group of Republican congressman indicated in the Spring of 2016 that they would introduce an “innovation initiative.” Led by Congressman Patrick McHenry, the “Financial Services Innovation Act of 2016” (H.R. 6118) was introduced in Congress in September 2016 and subsequently referred to committee. The legislation is an attempt to create a fintech regulatory sandbox in the United States, a concept that already exists in the UK and Hong Kong. Specifically, the bill mandates the creation of a Financial Services Innovation Office (“FSIO”) within each of the federal banking and financial services regulators. Individuals who want to offer a financial innovation product or service could petition the affected agency’s FSIO for regulatory relief in the form of an enforceable compliance agreement modifying or waiving applicability of the regulation or statute implicated. A petition must propose an alternative compliance strategy and demonstrate that the financial innovation product or service: (i) would serve the public interest, (ii) improves access to financial products and services, (iii) would not present systemic risk to the U.S. financial system, and (iv) promotes consumer protection.

\(^{31}\) FIL-49-2015 (November 6, 2015).

\(^{32}\) The FDIC’s Winter 2015 edition of Supervisory Insights can be found at the following link: https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin15/SI_Winter2015.pdf.
in the industry, to follow third-party vendor management principles. This entails a determination that the bank’s role is consistent with the overall strategy of the bank, assessment of the potential risks involved, and mitigation and management of those risks. It requires due diligence of the third party involved and appropriate contract protections for the bank. It also involves monitoring and oversight of the third party and correction of issues that are identified as problems or risks. The FDIC will evaluate the bank’s role as part of its supervisory process.

Then, on July 29, 2016, the FDIC published FIL-50-2016, seeking comment on its proposed Guidance for Third-Party Lending applicable to FDIC-supervised institutions lending through a business relationship with a third party, including loan originator activities. The comment period closed on October 27, 2016. The guidance focuses on identification and assessment of risk commensurate with the third-party lending relationship. It would require due diligence, appropriate contract protections, ongoing monitoring, and remediation. Institutions with significant third-party lending relationships may be subject to increased supervisory attention and examination and review of the third parties.

These FDIC issuances offer a pragmatic approach to the current state of affairs. The FDIC treats a bank’s involvement in marketplace lending like any other product or service the bank offers, consistent with its historical approach of not approving or disapproving of particular bank programs. Therefore, there is nothing inherently amiss when banks participate with non-bank companies. But before banks enter into such an arrangement, they need to identify, assess, and mitigate risks; satisfy themselves that the third party (and the bank) is in compliance with applicable federal and state laws and regulations; and have a program for ongoing oversight and remediation. While some have assailed this pronouncement as yet another regulatory roadblock focusing the microscope on marketplace lending, in reality this practical approach of the FDIC, the most experienced federal banking regulator in this space, seems positive in that it reaffirms the position that banks can play a role so long as it is performed prudently, and the FDIC is putting banks on notice of the rules they must follow to be a participant.

**Treasury White Paper.** On May 10, 2016, the U.S. Department of the Treasury (the “Department”) published a white paper entitled “Opportunities and Challenges in Online Marketplace Lending” (the “White Paper”). The White Paper states that marketplace lending can provide both consumer and small business borrowers with expanded access to credit but may also create risks that existing regulatory structures do not adequately address.

The White Paper follows the “Request for Information” (the “RFI”) which the Department published in July 2015 to solicit public input on various topics concerning marketplace lending. The Department received approximately 100 responses from marketplace lenders, trade associations, consumer and small business advocates, academics, investors, and financial institutions. Building on the RFI comments and its own market research, the Department makes a number of recommendations in the

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White Paper for regulatory and/or industry actions. The Department stated that its recommendations are intended to facilitate the safe growth of marketplace lending while fostering affordable access to credit for consumers and businesses. The Department’s recommendations include the following:

- **Enhanced Protection for Small Business Borrowers.** The Department stated that more effective regulatory oversight could enable greater transparency in small business marketplace lending and lead to better outcomes for borrowers—particularly for small business loans under $100,000, which share common characteristics with consumer loans but are not entitled to the same consumer law protections.

- **Protecting the Borrower Experience.** The Department stated that all marketplace lenders should exercise prudence when engaging with borrowers in financial distress and should have in place comprehensive arrangements (including backup servicing plans) to provide for the continued servicing and collection of loans in the event the platform fails.

- **Promoting a Transparent Marketplace.** Certain RFI commenters stated that to improve its access to the capital markets, the industry will need to develop a wider investor base, an active and stable secondary market, and transparent securitization activity. The Department therefore recommended that the industry adopt (i) standardized representations, warranties, and enforcement mechanisms, (ii) consistent reporting standards for loan origination data and ongoing portfolio performance, (iii) loan securitization performance transparency, and (iv) consistent market-driven pricing methodology standards. The Department further recommended the creation of a private sector registry that is available to the public for tracking data on transactions, including the issuance of notes and securitizations, and loan-level performance.

- **Expanding Access to Credit for Underserved Borrowers.** The Department stated that for the industry to truly expand access to underserved markets, more must be done to serve borrowers who may be creditworthy but may not be scorable under traditional credit scoring models. The Department recommended that marketplace lenders consider partnering with Community Development Financial Institutions (“CDFIs”), which could be mutually beneficial as it would allow CDFIs to use the marketplace lender’s technology and back-end operations to lower their costs and the marketplace lender would gain access to the CDFIs’ knowledge of local credit markets.

- **Working Group for Interagency Cooperation.** Various aspects of marketplace lending and related financing activities by lenders are subject to regulation by a number of different federal and state agencies. The Department therefore recommended that regulators organize an interagency working group consisting of representatives of the Department, the CFPB, the FTC, the SEC, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Small Business Administration, and a representative of a state banking regulator, to consider the applicability of existing regulations to marketplace lenders, whether there are any gaps in the current regulatory structure, and the impact of nontraditional data on credit scoring models.
**CFPB Accepts Complaints on Marketplace Lenders.** On March 7, 2016, the Consumer Financial Protection Bureau announced that it is accepting consumer complaints about online marketplace lenders, giving consumers “a greater voice in these markets and a place to turn to when they encounter problems.” The CFPB also issued a bulletin to provide consumers with information on marketplace lending, including guidance on shopping for a loan. Significantly, the CFPB noted in its bulletin that while marketplace lending is relatively new, marketplace lenders are subject to the same state and federal laws as other lenders.

Although consumers have been able to file complaints regarding marketplace lenders with the CFPB since July 2011, it seems the CFPB wants to raise awareness in the industry and among consumers that the Bureau may seek to expand its oversight in this area like the other federal banking regulators. Marketplace lenders should review their complaint-handling policies and procedures and ensure that they are compliant with the CFPB requirements. The CFPB uses complaint data to identify areas that require additional regulatory guidance and rulemaking and to direct its investigations and enforcement actions. As a result, the complaint process should be monitored closely, as it can create additional compliance risk and possible litigation risk for financial institutions, including marketplace lenders.

**FTC FinTech Forum.** In June 2016, the Federal Trade Commission (“FTC”) held a FinTech Forum addressing marketplace lending. The forum focused on consumers and consumer protection. The FTC’s Director of Consumer Protection, who recently left the agency, identified areas that concern the FTC, including preauthorized transfers to repay loans, transparency of loan terms, privacy and data security, and potential discrimination arising from using nontraditional data to make credit decisions.

**Military Lending Act.** The Department of Defense (“DOD”) issued a final rule imposing new requirements under the Military Lending Act, which took effect in October 2016 (the “MLA Rule”). The MLA Rule is not specific to marketplace lending, but it applies to most non-mortgage consumer credit transactions and therefore implicates the practices and procedures of many marketplace lenders.

A “covered borrower” for purposes of the MLA Rule is any servicemember and his or her dependents, which includes a servicemember’s spouse, children under 21, and parents or parents-in-law that live in the servicemember’s home. The MLA Rule establishes a safe harbor for determining whether someone is a covered borrower by using information obtained from the DOD’s MLA database or a nationwide consumer reporting agency. The covered borrower determination may also be made using other methods, such as a covered borrower self-identification statement, but there is no safe harbor in this case.

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35 This was the first such forum. A second forum was held in October 2016 on crowdfunding and peer-to-peer payments and another is scheduled for March 9, 2017, on blockchain technology and artificial intelligence.

36 80 FR 43560 (Jul. 22, 2015).
Among other things, the MLA Rule establishes a maximum “military annual percentage rate” ("MAPR") of 36 percent for credit extended to servicemembers and their dependents. The MAPR includes certain fees that are not counted as finance charges for purposes of calculating the annual percentage rate under the Truth in Lending Act ("TILA") and Regulation Z; thus, a separate calculation is necessary to determine whether an extension of credit is within this limit. With respect to covered borrowers, the MLA Rule also imposes certain disclosure requirements (including some that must be provided orally), prohibits the imposition of a prepayment penalty, and prohibits mandating arbitration in the event of a dispute. As a result, a marketplace loan will need to include a provision in its loan documents giving the required disclosure and lenders must have in place a toll-free number for covered borrowers to call for the oral disclosure. Marketplace lenders should ensure that appropriate procedures are in place to identify covered borrowers and to comply with these additional requirements when applicable.

E. CFPB Expanded Oversight of Small Business Lending

The CFPB has expressed an interest in expanding its jurisdiction to small business lending, with Director Richard Cordray publicly commenting that his preference would be for the CFPB to protect both consumers and small businesses since both operate similarly in the marketplace.37 One way the CFPB could exercise jurisdiction over small business lenders is through the data collection provision mandated by Dodd-Frank, which amended the Equal Credit Opportunity Act ("ECOA") by adding a requirement for lenders to collect and maintain loan data for women-owned, minority-owned and small business credit applicants.38 The CFPB is the sole agency responsible for overseeing this requirement for all financial institutions regardless of their size or primary regulator,39 thus permitting CFPB oversight of smaller lenders including certain marketplace lenders that would otherwise be excluded from its ECOA enforcement authority. The CFPB has also indicated that it may begin accepting complaints regarding small business lending,40 further demonstrating the agency's interest in this area.

The CFPB could use the data collection requirement as a means to pursue fair lending actions against small business lenders since the data will enable the agency to analyze potential disparate impacts and redlining practices. The CFPB could also use the data to influence the lending practices among small business lenders, similar to its actions in the auto finance market.

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39 Financial institution is defined broadly as “any partnership, company, corporation, association (incorporated or unincorporated), trust, estate, cooperative organization or other entity that engages in any financial activity.” 15 U.S.C. § 1691c-2(h)(1). The definition covers both banks and non-banks, including online lenders that lend to applicable businesses.
Some commenters predict that marketplace lenders will be a focus of the CFPB’s attention with the data collection requirement since the agency has expressed concerns that the industry is not sufficiently regulated and issued a press release announcing its acceptance of consumer complaints against marketplace lenders, indicating the agency’s interest in this area.41

F. CFPB Status: The PHH Case and the Future of Arbitration

**PHH and Constitutional Challenges to the CFPB Structure.** A major case involving the CFPB is currently ongoing in the D.C. Circuit, *PHH Corp. v. Consumer Financial Protection Bureau.*42

**Noteworthy Developments:** In October 2016, the U.S. Court of Appeals for the D.C. Circuit issued a decision in the *PHH* case finding that the CFPB’s structure was unconstitutional, that the agency violated due process, and that it is subject to the statutes of limitations embodied in the laws it seeks to enforce. Then, on February 16, 2017, the Court granted the CFPB’s request for an *en banc* rehearing, vacating its October 2016 ruling finding the CFPB structure unconstitutional. Oral argument before the *en banc* court is set for May 24, 2017.

The case originated in 2014 with an administrative enforcement action brought by the CFPB against PHH, a New Jersey-based mortgage lender, alleging violations of the Real Estate Settlement Procedures Act ("RESPA"). The CFPB alleged that despite relying on prior regulatory guidance, which was widespread industry practice, PHH violated Section 8 of RESPA by referring customers to mortgage insurers, who in turn bought reinsurance from one of PHH’s affiliates. In the initial administrative enforcement action, the CFPB imposed a $6.4 million penalty for PHH’s RESPA violations. PHH appealed the decision to the CFPB’s director, Richard Cordray, who increased the penalty to $109 million (primarily related to extending relief beyond RESPA’s statute of limitations period). PHH then appealed directly to the Court of Appeals for the D.C. Circuit.

In a hundred-page decision, the Court analyzed three questions: (1) whether the CFPB’s structure is constitutional, (2) whether the CFPB properly applied RESPA in finding a violation, and (3) whether the statute of limitations in RESPA applies in administrative actions as well as court proceedings.

In considering whether the CFPB was constitutional, the Court noted that unlike all other federal agencies, there is no real “check” on the CFPB’s power. The CFPB is not administered by a commission, like the Securities and Exchange Commission or the Federal Communications Commission. Instead, only one individual is in charge. Unlike other agencies that feature a single director, the CFPB’s director can only be removed “for cause.” Thus, the Court severed the statute’s unconstitutional

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42 Case No. 15-1177 (D.C. Cir. 2016).
for-cause provision from the remainder of the Dodd-Frank Act. While the decision allows the CFPB to continue its work, it eliminates the director’s unique independence and subjects him to removal by the President, similar to other federal agencies.

In analyzing the second question raised, the Court agreed with PHH’s contention that Section 8 of RESPA allows captive reinsurance arrangements so long as the amount paid by the mortgage insurer for the reinsurance does not exceed the reasonable market value of the reinsurance, overruling the CFPB’s interpretation. In addition, the Court found that the CFPB incorrectly and retroactively applied its own interpretation of the law to PHH and had departed from the guidance of the Department of Housing and Urban Development (“HUD”), the agency previously tasked with interpreting RESPA on this issue. Here, rather than publicly changing the prior HUD guidance relied upon by the industry, the CFPB sought to impress its own views through an enforcement action. The Court was highly critical of this practice.

With respect to the third question, the CFPB argued that under Dodd-Frank, there was no statute of limitations for any CFPB administrative action to enforce any consumer protection law. However, the Court strongly disagreed, and noted that the Dodd-Frank Act incorporates the statutes of limitations in the underlying statutes enforced by the CFPB in administrative proceedings. In its decision, the Court firmly established that the CFPB cannot exact more than it could in a court proceeding by ignoring applicable statutes of limitation.

As expected, following the Court’s decision the CFPB petitioned for en banc review by the full D.C. Circuit. The CFPB argued in its petition that the Court’s constitutionality ruling “may be the most important separation-of-powers case in a generation,” affecting not only the CFPB but also other agencies headed by a single director removable only for cause, which includes the Social Security Administration and the Federal Housing Finance Agency. The CFPB also requested review of the Court’s RESPA ruling, stating that the Court’s interpretation of RESPA “fundamentally defeats the statutory purpose.” Notably, the CFPB did not ask for review of the Court’s ruling that statutes of limitation apply to the agency’s administrative enforcement actions. Presumably the CFPB agrees that it will be subject to the same statutes of limitation in its administrative proceedings that would apply to a lawsuit filed in court.

In its order granting the rehearing, the Court directs the parties to address the following three issues in their briefs: (1) whether the CFPB’s structure as an independent, single-director agency is consistent with Article II of the Constitution and, if not, whether the proper remedy is to sever the for-cause provision of the statute; (2) whether the Court can avoid deciding the constitutional question given the panel’s ruling on the statutory issues; and (3) what the appropriate disposition of the case will be if the en banc court concludes in a separate case that is also receiving en banc consideration, Lucia v. SEC, that the administrative law judge who handled the case was an inferior officer rather than an administrative law judge who handled the case was an inferior officer rather than an

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43 832 F.3d 277 (D.C. Cir. 2016).
employee.⁴⁴ The latter question is relevant in *PHH* because the claims were initially heard by an administrative law judge and one of the panelists for the Court filed a concurrence stating his belief that the CFPB’s administrative law judge had been unconstitutionally appointed.

Many suspected that, armed with the Court’s October 2016 decision, President Trump would try to remove Director Cordray from the CFPB. With that decision now vacated, it will be more difficult for Trump to remove him, and commenters expect that no action will be taken until after the Court issues a decision following the rehearing.

**The Future of Arbitration.** On May 5, 2016, the CFPB issued a proposed rule that would prohibit companies from including mandatory arbitration clauses with class action waivers in new consumer financial products and services contracts. The CFPB received nearly 13,000 comments on its proposed rule, which has been a source of controversy and differing opinions within the industry. Prior to issuing its proposed rule, the CFPB conducted an arbitration study and published a lengthy report of its findings in March 2015.⁴⁵ One of the main criticisms of the proposed rule has been that it was not justified based on the CFPB’s arbitration report, which some claim failed to adequately compare the outcomes for consumers between arbitration and class actions.

Commenters predicted that the CFPB would try to issue a final rule prior to President Trump taking office; otherwise, the rule would be unlikely to move forward under a Republican administration. However, since the arbitration rule was not finalized prior to President Trump taking office, some within the industry expect that the rule is unlikely to move forward.⁴⁶

**G. TCPA Developments**

Calls to cell phones have prompted large amounts of litigation—much of it in the form of class actions—against marketers, lenders, and servicers. These claims are being made under the Telephone Consumer Protection Act (“TCPA”).⁴⁷ Plaintiffs’ lawyers find TCPA litigation advantageous since violations result in automatic damages of $500 per call, which is tripled to $1,500 if the conduct is willful. Huge damage awards warrant a further discussion of the law and its implications.

**TCPA History and Interpretation.** The TCPA was enacted in 1991 to stem the costs and nuisance of unwanted telemarketing by prohibiting calls using an Automated Telephone Dialing System, commonly referred to as an “autodialer,” to call certain types of phones without prior consent. As part

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⁴⁵ CFPB Arbitration Study, Report to Congress pursuant to § 1028(a) of the Dodd-Frank Act (March 2015).
⁴⁶ One potential threat to the CFPB under the new administration is Congressman Hensarling’s Financial CHOICE Act (H.R. 5983). A memo describing updates to the CHOICE Act was released on February 9, 2017, including major changes to the CFPB’s authority such as the repeal of its (i) unfair, deceptive, and abusive acts and practices authority, (ii) supervisory authority, and (iii) consumer complaint database. In addition, the CFPB’s enforcement powers would be limited to cease and desist and CID/subpoena powers. However, the draft plan would not replace the CFPB’s director with a commission.
of the TCPA, prior consent (and in the case of telemarketers, prior written consent) is required when a company makes a call using an autodialer or uses a prerecorded message in a call to a cell phone.\footnote{48} Prior consent is also required for some landline telemarketing calls when the call uses a prerecorded message.\footnote{49}

Much has changed in technology, in business, and in the way that cell phones are billed since the TCPA was enacted that undermines or creates gray areas with respect to the law’s definitions and scope. Over the years the Federal Communications Commission (“FCC”), the regulator that has rulemaking and enforcement authority for the TCPA, has issued several Rules and Orders that attempt to interpret the law’s requirements, particularly with respect to non-telemarketing companies that use autodialers for debt collection purposes.\footnote{50} A Declaratory Ruling and Order issued in July 2015 (the “2015 Order”)\footnote{51} is the most recent of these interpretive efforts. The 2015 Order set forth an expansive interpretation of various TCPA concepts in a manner that is detrimental to those subject to its requirements, including financial companies.

**Challenges to the 2015 Order.** Several entities petitioned courts for review of the 2015 Order. These cases were ultimately consolidated and the U.S. Panel on Multidistrict Litigation randomly selected the U.S. Court of Appeals for the D.C. Circuit to hear the matters.\footnote{52} The petitions all argue that the FCC in its 2015 Order exceeded its authority and made it very difficult for companies to comply with the TCPA.\footnote{53} In October 2016, the U.S. Court of Appeals for the D.C. Circuit heard oral argument in the consolidated case.\footnote{54}

\footnote{49}47 U.S.C. § 227(b)(1)(B); 47 C.F.R. § 64.1200.
\footnote{52}The first was ACA Intl v. FCC, No. 15-1211 (D.C. Cir. filed July 10, 2015). Next was Sirius XM Radio, Inc. v. FCC, No. 15-1218 (D.C. Cir. filed July 14, 2015), and then Professional Association for Customer Engagement, Inc. v. FCC, No. 15-2489 (7th Cir. filed July 14, 2015). These cases, along with others, were consolidated since filing and the U.S. Panel on Multidistrict Litigation randomly selected the U.S. Court of Appeals for the D.C. Circuit to hear the matters.
\footnote{53}ACA International, et al. v. Federal Communications Commission, Case No. 15–1211, at ECF No. 1599016 (D.C. Cir. Feb. 16, 2015). The petition focuses on four issues: (1) the FCC’s interpretations of the TCPA are inconsistent, unclear, and ambiguous; (2) the FCC’s interpretation of what constitutes an autodialer is overly broad and inconsistent with other language in the statute; (3) the definition of “called party” under the TCPA is ambiguous due to the frequency of “ported” numbers; and (4) the revocation of consent rules is impractical and unjustified.
\footnote{54}The “one-call safe harbor” introduced by the FCC in its 2015 Order was another issue raised in oral argument. Many phone lines that used to be associated with a residential landline have now been “ported” to ring on a cell phone, and the safe harbor would give a company that is calling what it thinks is a landline one chance to ascertain if the number has changed to a cell phone, since the compliance requirements for cellular phones are much more stringent than those for landlines. The petitioners argued that the safe harbor is not effective and does not help companies comply with the TCPA.
Under the 2015 Order, any system that has the present or future capacity to be an autodialer counts as one for the purposes of the TCPA. This is contrary to the definition of “capacity” in the TCPA, which refers only to an instrument’s present capacity. In oral argument, counsel for the petitioners argued that devices like smartphones, with the ability to install and use certain applications, could therefore be included under the definition of autodialer. Indeed, it is hard to imagine a device that would not fall under this broad definition besides a rotary phone. The parties disputed what types of devices should qualify as an autodialer in oral argument, with the petitioners arguing for a narrower scope than that provided in the 2015 Order.

In addition, under the 2015 Order, consent to be called, one of the main defenses to TCPA litigation, has become easier to revoke. Some courts had previously held that because the TCPA was silent regarding revocation, it was impossible to revoke consent to be called. Others disagreed and pointed to the Fair Debt Collection Practices Act requirement that requests to cease and desist calling be in writing. The 2015 Order, however, allows consent to be revoked by “any reasonable means.” Thus, a very difficult burden is placed on companies who now have to make a decision and create new policies on whether an attempted revocation is “reasonable,” and can no longer require that revocation be in writing. Petitioners made this point in oral argument and argued that standardized methods of revocation should be codified.

While the interested parties await a decision from the D.C. Circuit, consumer class actions under the TCPA will likely continue to explode. Companies that are subject to new TCPA suits have requested stays pending the resolution of this case, pointing to the unsettled nature of the law. Some courts have obliged, and the oral argument before the D.C. Circuit reinforced the reasons a company may wish to consider requesting a stay. With the political changes that have occurred following the oral argument, namely the resignation of Tom Wheeler as FCC Chairman and the appointment of Ajit Pai as his successor, not to mention the possibility of a Republican majority on the FCC under the new administration, some have speculated that the FCC may not appeal an adverse ruling if that is the result from the D.C. Circuit.

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56 See Gager v. Dell Financial Services, LLC, 727 F.3d 265, 270 (3d Cir. 2013) for discussion of previous court interpretations of consent.

57 Id.


60 The new FCC chairman has suggested that he will roll back regulations, which could include the TCPA.
H. Impact of Supreme Court’s Standing Ruling in Spokeo

A recent Supreme Court decision on the sufficiency of standing in cases alleging violations of federal consumer protection statutes made ripples in the industry—though the ripples were not as large as some may have hoped. In May 2016, the Supreme Court handed down a much-anticipated ruling in Spokeo, Inc. v. Robins. The central issue in Spokeo was whether the plaintiff had standing for a claim under the Fair Credit Reporting Act (“FCRA”) if he could not show that any actual harm arose from the alleged statutory violation. While the Supreme Court ultimately answered this question in the negative, its holding was narrow and thus unlikely to have the effect of limiting potential claims under a variety of consumer protection statutes—particularly those that are often the basis of class actions.

The plaintiff alleged that Spokeo, a data aggregator that operates a people-search engine, reported false and inaccurate information about him—specifically, that he was better educated and more highly paid than was in fact true—and thereby violated the FCRA. The district court dismissed the plaintiff’s putative class action case on the ground that he lacked standing because he could not show any actual harm that arose from the alleged FCRA violation. The Ninth Circuit reinstated the case, which ultimately made its way to the Supreme Court. In its decision, the Supreme Court explained that to have standing, a plaintiff must show (among other things) an “injury in fact” from the particular allegation. The Court emphasized that the injury must be both “concrete and particularized,” though it need not be tangible. With this ruling, the Court sent the case back to the Ninth Circuit to determine if the plaintiff had actually alleged the kind of injury that would allow his suit to proceed. This means that the victory for the defendant was very narrow, and it is possible that the plaintiff could eventually win, or that the case could even return to the Supreme Court.

Because Spokeo did not create any new law and simply restated the requirements for standing, it has not been able to be applied in the way many companies had hoped. Courts have been inconsistent in applying Spokeo to a number of federal consumer protection statutes. For example, while in some instances TCPA cases have been dismissed on Spokeo grounds, many other courts have found sufficient injury based on invasion of privacy, or even de minimis costs, like the amount it costs to charge a cell phone battery drained by receiving unwanted telephone calls, or time spent answering unwanted phone calls. Similarly, courts have been split when reviewing Fair Debt Collection Practices Act (“FDCPA”) claims, where some courts have asserted that a bare FDCPA violation alone constitutes a violation of a right that Congress sought to raise to the level of a concrete injury. However, many others have disagreed, requiring an additional showing of some injury. The trend continues with...
courts reviewing TILA claims. In short, it is likely that this issue will remain unsettled until further litigation resolves the question. However, the decision provides a potential defense to claims brought under consumer financial protection laws.

For now, the Ninth Circuit heard oral arguments in December 2016 on whether the plaintiff actually alleged the kind of injury that would allow his suit to proceed. However, it has not yet ruled on the matter.

I. State Developments

**NYDFS Cybersecurity Rule.** On February 16, 2017, the New York Department of Financial Services ("NYDFS") announced that its final cybersecurity rule for financial institutions would take effect on March 1, 2017. The NYDFS had issued a revised version of the proposed rule on December 28, 2016 after receiving more than 150 comments in response to its initial proposed rule. The NYDFS cybersecurity rule imposes broad requirements that are more stringent than the federal requirements under the Gramm-Leach-Bliley Act Safeguards Rule. It will require banks, insurance companies, and other financial services institutions regulated by the NYDFS to establish and maintain a cybersecurity program designed to protect consumers and ensure the safety and soundness of the New York financial services industry.

Specifically, the NYDFS cybersecurity rule requires covered entities to encrypt certain nonpublic data both in transit and at rest; limit the retention and ensure the timely destruction of nonpublic information, essentially mandating a record retention policy; conduct vulnerability assessments at least quarterly; and conduct penetration testing and written risk assessments of their information system at least annually, among other requirements. Although the revisions to the rule included longer timeframes for compliance and more flexibility for covered entities in satisfying its requirements, the NYDFS cybersecurity rule remains substantially different from the federal regulatory approach, and commenters have expressed concern that compliance with the rule will require significant time and resources for covered entities.

Marketplace lenders that are regulated by the NYDFS should familiarize themselves with the cybersecurity rule and update their procedures as needed to comply with the rule’s requirements.

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66 See Jamison v. Bank of America, N.A., Case No. 2:16-cv-00422-KJM-AC, 2016 WL 3653456 (E.D. Cal. July 7, 2016) (finding bare procedural TILA violation insufficient to provide standing where omitted information from payoff was provided elsewhere); but see McQuinn v. Bank of America, N.A., Case No. 14-56038, 2016 WL 3947831 (9th Cir. July 22, 2016) (noting that there is some question as to whether a violation of TILA’s notice requirement under 15 U.S.C. § 1641(g), without more, creates an injury that is sufficiently concrete to confer standing, but finding sufficient concrete injury in this case).

California Enforcement Action. A recent California Department of Business Oversight (the “DBO”) action decision appears to expand entities that need to be licensed under the California Finance Lenders Law. The decision upheld a cease and desist order against an entity that did not fund loans to borrowers but solicited borrowers, evaluated the credit, proposed loan terms, and made or participated in credit advances. The DBO rejected the argument that a license was needed only if the entity made loans. Lending-related activities may also require licensing. It remains to be seen if this could be the DBO’s way of reaching marketplace lenders to require licensing.

Colorado Litigation. On January 30, 2017, the Colorado Attorney General on behalf of the Administrator of the state’s Uniform Consumer Credit Code (“UCCC”) filed actions against two marketplace lenders licensed as supervised lenders in the state. Even though the loans assigned or serviced by the licensees were made by an FDIC bank under the Funding Bank model, the state claims that the interest rate and certain fees exceeded the rate and fee structure of the Colorado UCCC. In addition, the state asserts that utilizing a choice of law provision of a state other than Colorado violates the UCCC.

Takeaway: These actions by the Colorado Attorney General are at the earliest of stages, but should be watched for further developments. It is possible that the state may also pursue other licensees using a Funding Bank model. There is added significance because multiple other states have enacted versions of the UCCC and a decision could impact those other jurisdictions. These actions are indicative of the risk of scrutiny by state regulators on marketplace lending programs.

State Legislation. Some states are contemplating additional licensing for marketplace lenders. For example, in New York, Governor Cuomo’s proposed budget contains a change to existing law regarding financial services licenses. While current law requires a license to make loans above 16 percent to consumers (up to $25,000) and to businesses (up to $50,000), the proposal, if enacted, would require licensing for anyone making loans at any rate and would ensnare many marketplace lending participants, as it would include entities soliciting and purchasing or acquiring consumer and business loans and those who arrange or facilitate the funding of loans. In mid-2016, a bill was introduced in the Illinois legislature that would impose licensing for online commercial lenders and for loan purchases, regulate commercial lending practices, and require significant loan disclosures and ability to repay assessments. While the legislation was never considered in 2016, it could be re-
introduced in the future and shows an interest in regulating small business lending in addition to consumer loans.

J. Enforcement and Court Actions

“Hard” vs. “Soft” Credit Inquiries. In August 2016, a California federal judge approved a $2.4 million settlement in a class action lawsuit against Social Finance Inc., an online lender. The complaint alleged that the lender claimed only soft credit inquiries (which generally do not affect a credit score) would be made on the applicants, when in fact hard inquiries were made (which negatively affect credit scores). The action was based on the FCRA and similar California laws.

West Virginia. In June 2016, an online lender reached a six-figure settlement with the Attorney General over allegations concerning licensing under the state’s Credit Services Organizations Act and charging rates higher than allowed by state law.

CFPB Action. In September 2016, the CFPB took action against an online lender, Flurish Inc. d/b/a LendUp, for failing to deliver promised benefits such as the opportunity to build credit and access to cheaper loans, as claimed. Some 50,000 customers received restitution and with a civil penalty, the online lender paid over $6.3 million in damages.

Maryland. Ongoing litigation by the state regulator against payday lender CashCall concluded when the state’s highest court ruled that CashCall was required to obtain a credit services business license and could not solicit loans with rates in excess of Maryland’s usury rate. This case has potential implications for platforms soliciting Maryland residents. It is more fully discussed in the “State Licensing Requirements” section below.

K. Investment Company Investments in Marketplace Loans

2016 witnessed the launch of the first marketplace lending funds registered with the Securities and Exchange Commission (“SEC”) as investment companies under the Investment Company Act of 1940 (the “Investment Company Act”). These two investment companies—the RiverNorth Marketplace Lending Corporation and the Stone Ridge Alternative Lending Risk Premium Fund (each, a “Fund,” and together, the “Funds”)—operate as closed-end investment companies, or “closed-end funds,” one of three basic types of investment companies.

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74 See RiverNorth Marketplace Lending Corp. (SEC File Nos. 333-204866; 811-23067).
76 The SEC prohibits the two other basic types of investment companies, open-end mutual funds and unit investment trusts, from investing more than 15 percent of their portfolio in “illiquid assets” in order to ensure that they can generate enough cash to meet redemption requests. An illiquid asset is one that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund. Revisions of Guideline to Form N-1A, 57 Fed. Reg. 9828, 9829 (Mar. 20 1992). As there is currently no developed secondary market for marketplace loans.
Noteworthy Development: The debut of registered investment companies organized to invest in marketplace loans expands the opportunities for retail investors to participate in the market and may lead to broader public knowledge and acceptance of the asset class.

**Interval Closed-End Fund Structure.** The Funds currently operate as an “interval closed-end fund.” Interval funds are classified as closed-end funds but they are very different from “traditional” closed-end funds in that their shares typically do not trade on an exchange in the secondary market. Instead, their shares are subject to periodic repurchase offers by the Fund.77 As an interval fund, the Funds will make periodic repurchase offers to their shareholders, generally every three, six, or twelve months, as disclosed in the Fund’s prospectus. When the Funds make a repurchase offer to their shareholders, they will specify a date by which shareholders must accept the repurchase offer. The price that shareholders will receive on a repurchase will be based on the per-share net asset value determined as of a specified (and disclosed) date. In addition, the Funds continuously offer their shares at a price based on the Fund’s net asset value.

**Platform Concentration Issuers.** Registered investment companies are required to meet a diversification test in order to qualify as a regulated investment company (“RIC”) under the Internal Revenue Code of 1986, as amended (the “Code”). An investment company is required to be treated as a RIC under the Code in order to avoid entity-level income taxes. If an investment company is not eligible to be treated as a RIC due to its failure to meet the RIC diversification test, it would be obligated to pay applicable federal and state corporate income taxes on its taxable income. At the close of each quarter of the taxable year, (a) at least 50 percent of the value of a RIC’s total assets must be represented by (i) cash, cash equivalents, U.S. government securities, or securities of other RICs and (ii) other securities whose value with respect to any one issuer is not greater than 5 percent of the value of the total assets and does not represent more than 10 percent of the outstanding voting securities of any one issuer and (b) not more than 25 percent of the value of the RIC’s total assets may consist of (i) the securities of any one issuer (other than U.S. government securities or RICs) or of any two or more issuers controlled by the RIC and that are engaged in the same or similar trades or businesses or a related business, or (ii) the securities of one or more qualified publicly traded partnerships.78 As a result of the above requirements, there is a concern that an investment company’s investment in

77 Rule 23c-3 of the Investment Company Act provides that a closed-end fund can adopt a policy of repurchasing between 5 percent and 25 percent of its outstanding common stock at periodic intervals pursuant to repurchase offers made to all shareholders.

78 I.R.C. § 851(b)(3).
marketplace loans concentrated in a particular platform would violate the RIC test.\textsuperscript{79} For general U.S. federal income tax purposes, the person who is obligated under a debt is viewed as the issuer of the debt. As such, for purposes of the RIC diversification test, the individual borrowers of the marketplace loans purchased by the Fund should be considered to be the “issuer,” not the platform through which such whole loans were originated. In regards to the marketplace loans purchases, the Funds become the owner of the marketplace loans for U.S. tax purposes, bearing the risk of loss and the potential for profit on the purchase. A Fund’s risk exposure on the marketplace loans is dependent upon the willingness and ability of the individual borrowers to pay—if one of the individual borrowers were not to pay, the platform seller would not be obligated to make the Fund whole. The platform seller, although retained as servicer, no longer bears the risk of loss on marketplace loans sold. This contrasts with Platform Notes, in which the applicable platform should be considered the issuer, as the Fund’s risk exposure is also dependent upon the platform’s ability to make the pass-through payments.

Separately, an investment company will need to limit the portion of its investments which it allocates to the marketplace loans from any single platform in order to avoid the potential for the SEC to require a platform to co-register as an issuer on the investment company’s registration statement during the continuous offering of the securities. As set forth in the registration statement for the Funds and as further discussed below, the SEC currently takes the position that marketplace loans facilitated by a platform involve an associated investment contract, or “security” under the federal Securities Act of 1933 (the “\textit{Securities Act}”), issued by the platform in connection with the prepurchase activity by the platform, as well as the servicing and other arrangements. Pursuant to Rule 140 under the \textit{Securities Act}, a co-issuer is generally considered to exist with respect to “[a] person, the chief part of whose business consists of the purchase of the securities of one issuer . . . .” The SEC has interpreted the term “chief” as used in Rule 140 to mean an investment of greater than 45 percent of a person’s assets in an issuer.\textsuperscript{80} Because the marketplace loans are treated as securities issued by a platform with respect to determining the co-issuer status of such platform, the RiverNorth Marketplace Lending Corporation was required to agree in its registration statement that it will not invest greater than 45 percent of its managed assets in the securities of, or marketplace loans originated by, any single platform.

\textbf{Investment Company Act Custody Requirements.} Section 17(f) of the Investment Company Act requires that an investment company’s “securities and similar investments” be placed and maintained in the custody of a bank, a member firm of a national securities exchange, or the investment company itself, subject to certain conditions or in accordance with the rules and regulations or orders as the SEC may prescribe. With respect to an investment company’s custody of traditional loans, the SEC has

\textsuperscript{79} In determining the issuer of a security for the purposes of the RIC qualification rules, the IRS will normally follow the guidance of the SEC on the issue. Rev. Rul. 77-342, 1977-2 C.B. 238. However, the IRS has also stated that the “issuer” of a security for the purposes of the RIC diversification rules is the entity whose economic fortunes ultimately determine the performance of the security—in short, the issuer is the person in whom the RIC invests. GCM 37233 (Aug. 25, 1977), underlying Rev. Rul. 83-69, 1983-1 CB 126. In other words, although the SEC guidance is normally determinative, the IRS has reserved the right to make an independent determination.

\textsuperscript{80} See, \textit{e.g.}, FBC Conduit Trust I, SEC No-Action Letter (Oct. 6, 1987).
conditioned compliance with Section 17(f) on whether (i) the fund’s custodian would hold relevant documentation evidencing the fund’s ownership in the loan; (ii) the documentation would permit the custodian to enforce all the fund’s ownership rights in a court of law; and (iii) the administrative agents, in transmitting interest and principal payments to the fund, do not hold assets of the fund, but act as paying agents.\footnote{81}{The SEC issued a no-action letter to a Merrill Lynch fund that invested in loans. Merrill Lynch Prime Fund, SEC No Action Letter (Nov. 4, 1992).}

As described in the Funds’ registration statement, each borrower under a marketplace loan electronically signs the loan documents, binding the borrower to the terms of the loan, including provisions authorizing the lender to transfer the loan to another party. In general, each Fund will direct its custodian to open an account with each platform selected by the Fund. The account will be opened in the name of the custodian as custodian for the Fund. When a Fund directs the purchase of a loan, the Fund custodian receives electronically from the platform the loan documents and evidence of the Fund’s purchase and ownership of the loan, thereby obtaining custody of the documentation that creates and represents the Fund’s rights in the loan. In addition to the promissory note, such documentation generally includes (depending on the platform) the borrower agreement, authorization to obtain a credit report for loan listing, truth in lending disclosure, terms of use and consent to electronic transactions and disclosures, credit profile authorization, bank account verification, and debit authorization (or equivalents thereof). The Fund’s custodian then wires funds to the platform in payment for the loan. The custodian maintains on its books a custodial account for the Fund through which the custodian holds in custody the platform account, the loan/loan documents, and, if applicable, any cash in the platform account including the interest and principal payments received on the loan. As transferee of the platform’s contractual rights in the loan, the Fund obtains all of the platform’s rights in the loan and is able to enforce those contractual rights against the platform and the borrower, as applicable.

**Valuation Considerations.** Investment companies are required to adopt and implement policies and procedures designed to prevent violation of the federal securities laws, including investment portfolio valuation requirements under the Investment Company Act.\footnote{82}{Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) (adopting rule 38a-1).} An investment company’s board must approve procedures pursuant to which the investment company will value its investments. If market quotations are not readily available (including in cases where available market quotations are deemed to be unreliable or infrequent), the Fund’s investments will be valued as determined in good faith pursuant to policies and procedures approved by its board of directors (“fair value pricing”). As there...
is no developed secondary market for marketplace loans and Platform Notes, these instruments will necessarily be required to be fair valued.

Each Fund generally relies on prices provided by a third-party pricing service for its marketplace loans, which will be based upon the specific factors relating to such instruments as described below and subject to review by its board of directors or its designee. The criteria that will be used to value marketplace loans include the transaction data on initial purchases of loans from platforms and other relevant market data regarding loan productions and purchases generally for the current valuation period including, but not limited to, FICO scores, borrower employment status, borrower delinquency history, credit inquiries, debt-to-income ratio, loan size, and loan age. Due to concerns with respect to the valuation of marketplace loans, the SEC required each of the Funds to represent in its registration statement that the Fund will invest solely in loans originated by platforms that will provide the Fund with a written commitment to deliver or cause to be delivered individual loan-level data on an ongoing basis throughout the life of each individual loan that is updated periodically as often as the Fund’s net asset value is calculated to reflect new information regarding the borrower or loan.

L. SEC Comments on the Status of Marketplace Loans as “Securities”

As previously discussed, in 2016 the SEC approved the registration of two closed-end investment companies organized to invest in marketplace loans. See “Recent Developments—Investment Company Investments in Marketplace Loans” immediately above. In the course of the registration process, each Fund was advised by the SEC staff that “it is the view of the SEC that the purchase of whole loans through alternative lending platforms involves the purchase of ‘securities’ under the Securities Act of 1933 ... issued by the originating platforms.” This statement by the SEC staff has created some concern that the SEC will seek to regulate whole-loan purchase programs as securities offerings. It is settled under Supreme Court precedent, however, that consumer loans ordinarily do not constitute “securities” for Securities Act purposes, and institutional transactions have been structured accordingly. The SEC therefore may be focused not on the institutional market but on the potential for marketplace loans to be marketed as retail investments (either directly or through funds). In order to regulate any such retail sales, however, the SEC must find a basis on which to conclude that “securities” have been sold. The definition of “security” in the Securities Act includes any “investment contract.” In this connection, it is significant that the SEC staff stated that it viewed the issuer of the marketplace loan “security” as the originating platform (and not as the borrower under the loan). In other words, the SEC could assert jurisdiction over marketplace lenders who sell loans to retail investors by deeming the lenders to offer an “investment contract” consisting of the investment-related services that the lender provides to loan purchasers. These related services may consist of (i) loan servicing, (ii) the platform’s assignment of credit ratings to the loans, (iii) representations by the platform that each borrower satisfies specified criteria, (iv) the platform’s undertaking to handle all related cash flows (including the application of purchase prices paid by the investors), (v) undertakings to maintain a secondary market or trading platform for the loans, (vi) any general solicitation of borrowers and/or investors by the platform to assemble the mass of participants needed to make the investment scheme
possible, and/or (vii) other similar activities. The manner in which the program is marketed to investors (e.g., if it is presented as an alternative to lower-yielding debt investments such as CDs) also can be relevant. It follows that a marketplace lender could reduce the risk that it will be deemed to be offering an “investment contract” by limiting the number of investment-related services it provides to investors. For example, the platform could require each investor to engage its own servicer. However, certain of the foregoing services are integral to any marketplace lending program and could not easily be withdrawn. It further could be difficult in connection with a retail offering to reduce the services provided to a level at which the SEC (and state regulators) would concur that no investment contract exists. It would be reasonable for the SEC to be concerned that individual marketplace loans can be risky and should not be marketed to unsophisticated individual investors without securities law compliance. The SEC therefore is likely to take an expansive view of its jurisdiction in connection with any such offerings. All this being said, an important factor in determining whether “securities” have been offered in connection with a loan sale remains the relative degree of sophistication, bargaining power, and financial capacity of the investor, and, unless the SEC clearly states to the contrary, market participants will probably continue to take the position that institutional whole-loan sale programs do not entail a securities offering.
Background

The number of Internet-based lenders in operation in the United States continues to grow each year. These lenders operate in many market segments, including consumer loans, small business loans, student loans, real estate loans, and microfinance (small loans directed to individual third-world entrepreneurs). In particular, the consumer sites have created a marketplace in which consumers can not only lower their financing costs but can also, in some instances, obtain credit when bank financing would have been denied. As described below, the consumer sites also have been the market leaders in using the Internet to sell pass-through notes representing fractional interests in individual loans to retail investors (so called “peer-to-peer,” or “P2P,” programs). These programs have made new investment opportunities available to the public by enabling investors to purchase indirect interests in specific consumer loans. Although over the last several years the amount of funding available to marketplace lenders from other sources has greatly increased, the P2P note programs continue to fund a significant amount of loan originations. Certainly these programs have attracted a great deal of media attention and they remain the form of marketplace lending best known to the general public. The remainder of this section therefore describes the structure of consumer-oriented P2P platforms, but readers are cautioned that most lenders do not operate such platforms and that, of those who do, most exclude retail investors from the notes offering in order to simplify securities law compliance.  

The goal of any P2P platform operator (hereinafter, an “Operator”) is to create a user-friendly Internet-based platform that permits an efficient matching of investors having capital to deploy with consumers seeking credit. To that end, the Operator will establish and manage a website that permits investors to register as prospective lenders and individuals to register as prospective borrowers. Each registered borrower that satisfies certain criteria fixed by the Operator may from time to time request the Operator to post loan requests on the website for viewing by prospective lenders. Each borrower must disclose or make available to the Operator, and through the Operator to prospective lenders, certain financial and other information including, among other items, the borrower’s credit score (as determined by a credit reporting agency), self-reported income range, debt-to-income ratio, 

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83 As mentioned in the Preface above, most marketplace lenders are not currently offering to sell pass-through notes to retail investors but are funding themselves principally through lines of credit, whole-loan sales to institutional investors, securitizations, and/or other arrangements that do not entail an Internet-based securities offering. The description of securities issuance procedures in this section of the survey therefore will not be relevant to all marketplace lenders. Similarly, some of the discussion below under “Regulatory Issues—Securities Laws” will apply only to lenders who are offering pass-through notes via the Internet. However, the term “Funding Bank,” as used throughout this survey, includes any bank that originates loans for a marketplace lender whether or not that lender operates a P2P program.

84 The remainder of this section summarizes the structures employed by the two leading operators of consumer-oriented P2P platforms—LendingClub Corporation (“LendingClub”) and Prosper Marketplace, Inc. (“Prosper”). The discussion is not, however, intended to provide a complete description of the LendingClub and Prosper structures or to identify all of the differences that may exist between them. It also does not describe all of the lending businesses in which LendingClub and/or Prosper is currently engaged.

85 The Operator may, for example, choose to arrange loans only for borrowers having credit scores that exceed a specified minimum and/or debt-to-income ratios that are lower than a specified maximum.
employment status, homeownership status, number of existing credit lines, intended use of funds, and number and/or amount of recent payment defaults and delinquencies. Borrowers may not, however, disclose their identities to prospective lenders or post information that would permit their identities to be determined. The identities of lenders similarly are not disclosed to borrowers as the platform posts all loan requests and reports all transactions only under the borrower’s or lender’s screen name. The Operator will use the information reported by each borrower to assign a proprietary credit rating to the requested loan and to fix the interest rate for the loan. The Operator will include in the website posting for each loan request the relevant borrower-reported information, the Operator’s proprietary credit rating of the loan, and the yield to lenders (i.e., the fixed interest rate on the loan net of the Operator’s servicing fees). Prospective lenders may view the posted information for each loan request and determine whether they wish to fund the loan or any portion of it. No borrower may request a loan in excess of a specified maximum (e.g., $35,000) or have outstanding multiple loans that, in the aggregate, exceed the maximum. A lender who chooses to invest in a loan may offer to fund any portion of the loan that equals or exceeds a specified minimum (e.g., $25). In order to minimize credit risk through diversification, it is in fact typical for lenders (other than certain institutional investors) to fund only a small portion of each loan in which they invest and to acquire over time investment portfolios comprised of partial interests in many different loans. A loan will fund if before the funding deadline stated in the loan request lenders subscribe for the full amount of the loan or, if the borrower has indicated that he or she will accept less than full funding, lenders subscribe for not less than the minimum amount of funding set forth in the loan request. The funding deadline for each loan request will be fixed according to the rules of the platform (e.g., 14 days after the request is posted) rather than by the borrower. The platform similarly will prohibit loans from funding at any level less than a specified percentage (e.g., 70 percent) of the requested principal amount. Each loan will have a fixed term (typically, two, three, or five years) and will amortize through equal monthly payments to its maturity date.

The Operator will maintain with a bank (the “Deposit Bank”) a segregated deposit account on behalf of the lenders (the “Funding Account”). Each lender must have deposited in the Funding Account, at the time it offers to fund any loan, an amount that is both sufficient to provide that funding and is not committed to the funding of any other loan. The lender will be required to maintain this amount on deposit in the Funding Account until either the relevant loan is funded or the related loan request is

86 Marketplace lenders have increasingly come to rely upon institutional rather than retail investors to finance their lending operations and most lenders (excluding LendingClub and Prosper) do not solicit retail funding. These institutional investors may include investment funds organized to acquire P2P loans. It is not efficient for institutional investors to purchase fractional interests in individual consumer loans, and in response most lenders have established “whole-loan” programs through which institutional investors may acquire the entire beneficial interest in individual loans. In certain programs the institutional investor will be able to select the specific loans it purchases; in others the marketplace lender will allocate whole loans to participating institutional investors with reference to category-wide loan eligibility approved by the investor. These programs have greatly facilitated the growth of the industry by accommodating institutional demand, but they also may reduce the opportunities for small investors to purchase interests in certain loans. Increased reliance on whole-loan programs and the securitization market is, to some extent, inconsistent with the argument that has often been made that P2P lending can level the playing field between institutional and individual investors and provide the latter with attractive investment opportunities previously denied to them.
withdrawn (e.g., because lenders did not commit to fund the loan at a level equal to or exceeding the minimum funding amount). The principal amount of each funded loan (hereinafter, a “Borrower Loan”) will be advanced by a bank (the “Funding Bank”) not affiliated with the Operator. The Funding Bank and the Deposit Bank may be different institutions. The Funding Bank will deduct an origination fee from the funds it provides to the borrower and will pay a portion of that fee to the Operator as its transaction fee. The amount deducted may vary with the credit rating assigned to the Borrower Loan by the Operator. Shortly after the funding of the Borrower Loan by the Funding Bank, the Operator will (i) purchase the Borrower Loan from the Funding Bank at par using funds of the applicable lenders on deposit in the Funding Account, and (ii) issue to each such lender at par a note of the Operator (or an affiliate of the Operator) (a “Platform Note”) representing the right to receive the lender’s proportionate share of all principal and interest payments received by the Operator from the borrower on the applicable Borrower Loan (net of the Operator’s servicing fees). The Platform Notes will be nonrecourse obligations of the Operator (except to the extent that the Operator actually receives payments from the borrower on the applicable Borrower Loan). Accordingly, lenders assume all of the credit risk on the applicable Borrower Loan and will not be entitled to recover any deficiency of principal or interest from the Operator if the borrower defaults. The Operator will service the Borrower Loans on behalf of the lenders and may refer any delinquent loan to a collection agency. The relatively low principal amounts of the Borrower Loans, however, generally will make it impracticable for the Operator to commence legal proceedings against defaulting borrowers. The Operator will maintain a segregated deposit account (the “Collections Account”) at the Deposit Bank into which it will deposit all payments it receives on the Borrower Loans. The Operator will deduct its servicing fee from each Borrower Loan payment it receives before forwarding the net amount to the applicable lenders as payments on their Platform Notes.87

As might be expected in connection with an Internet-based lending system, both the notes evidencing the Borrower Loans and the Platform Notes are executed electronically, and physical Borrower Loan notes and Platform Notes are not delivered. The Platform Notes are not listed on any securities exchange and are transferable by the lenders only through an electronic trading system operated by a broker-dealer not affiliated with the Operator. The Operator provides no assurances as to the liquidity or value of the Platform Notes. Notwithstanding the associated credit and liquidity risk, potential investors—including investment funds and other institutional investors—may find P2P lending attractive, as the available performance data indicate that a well-diversified portfolio of Platform Notes can produce attractive risk-adjusted rates of return.

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87 The servicing fee deducted from each Borrower Loan payment is typically in the area of 1 percent of the payment amount.
Regulatory Issues

A. Securities Laws

One of the greatest regulatory challenges facing Operators who fund themselves through Platform Notes is securities law compliance. The P2P platforms are subject on a continuing basis to a number of separate federal and state securities laws. These laws are complex and compliance entails substantial costs. The relevant laws include the following:

1. Securities Act

The Securities Act requires any issuer engaged in a public offering of its securities to register the securities with the SEC unless an exemption from registration applies. The registration exemptions in the Securities Act are rather narrow in scope and none of them will be available for a public offering of Platform Notes. An Operator therefore must register its Platform Notes with the SEC before commencing public sales of its securities.

The SEC registration process is not simple. The Securities Act requires each issuer engaged in an offering of registered securities (or the dealer or underwriter selling the securities) to deliver to the investors a prospectus that sets forth specified information concerning the issuer and the securities. Among other matters, the prospectus will need to include a detailed description of the Operator and the Platform Notes, an analysis by the Operator’s management of the Operator’s financial condition and its recent results of operations, specified financial information, a discussion of the applicable risk factors, certain information concerning the issuer’s directors and executive officers, and descriptions of the Operator’s material contacts; any material transactions between the issuer and its directors, officers, and/or affiliates; any material legal proceedings affecting the Operator; and the plan for distributing...

88 Although certain categories of “notes” are not treated as “securities” under the Securities Act, the SEC determined in an enforcement proceeding in 2008 that Platform Notes don’t fall within those categories but instead create an “investment contract” and are subject to regulation as “securities.” Among other factors that it deemed relevant to this determination, the SEC noted that P2P lenders and borrowers would not connect but for the Internet platform; that the lenders would rely entirely upon the Operator to service the loans and manage all aspects of the repayment process; that a “reasonable investor” would likely believe that Platform Notes are “investments”; and that lenders would not be protected under any alternative regulatory scheme if the Platform Notes were deemed not to be “securities.” The SEC ruling leaves no doubt that the Securities Act will apply to Platform Note offerings.

89 As used in this survey, the term “Platform Notes” includes loan pass-through obligations issued by any Operator and is not limited to obligations issued by LendingClub or Prosper.

90 Operators that do not issue Platform Notes but rather simply sell whole loans (or participations in such loans) are advised to consider whether such loans (or participations therein) are in fact “securities” under the Securities Act. Among the factors relevant to this determination are whether the loan purchaser is a regulated lender or an investor not principally engaged in lending as a business, the plan of distribution of the loans (i.e., whether the loans will be marketed to many unrelated investors in small denominations in a manner more typical for securities distributions than for lending arrangements), the reasonable expectations of the investors, and whether the program will be subject to an alternative regulatory scheme (such as banking and consumer lending laws) that could make the application of the securities laws unnecessary for the protection of investors. The analysis of whether a marketplace loan (or certain commitments by the Operator to investors) is a “security” can also be affected by the composition of the investor base for the loans.
the securities. The SEC developed its disclosure guidelines long before Internet-based lending became a possibility and accordingly certain of them are not an exact fit for P2P companies. Although each of LendingClub and Prosper has successfully registered its Platform Notes with the SEC, and although LendingClub’s and Prosper’s prospectuses may provide some guidance regarding the disclosure formats and level of disclosure that the SEC will approve, prospective Operators should allow at least several months (and probably more) to complete the SEC registration process and should expect to incur substantial related expenses. The timeline for obtaining approval will largely be driven by the number and significance of the comments submitted by the SEC staff on the applicant’s filings—a variable that the applicant can affect but not control through careful preparation of its documents.

At the same time, newly formed Operators are likely to qualify for certain advantages that the Jumpstart Our Business Startups Act (enacted in April 2012) (the “JOBS Act”) provides to “emerging growth companies.” The JOBS Act defines an “emerging growth company” as an issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year and that, as of December 8, 2011, had not sold any of its equity securities under a Securities Act registration statement. Among other matters, an emerging growth company is permitted to (i) reduce the scale of certain financial disclosures that would otherwise be required in its prospectus, (ii) not provide an auditor attestation of its internal controls over financial reporting procedures (as would otherwise be required by the Sarbanes-Oxley Act), and (iii) choose to implement new or revised accounting procedures (when promulgated by FASB) under the extended transition period available to nonpublic companies. An emerging growth company (unlike other issuers) also is permitted to submit its initial registration statement to the SEC on a confidential basis so that the issuer can consider and address initial SEC staff comments before any filings become public. An issuer’s status as an emerging growth company does not continue indefinitely but will terminate on specified dates. Of particular relevance to Operators, an issuer will lose its emerging growth company status once it has issued more than $1 billion in nonconvertible debt securities in the prior three years.

An Operator that registers its securities will need to rely on Securities Act Rule 415. This rule permits issuers to file “shelf” registration statements under which they register a specified amount of a generic category of securities (e.g., “notes” or “debt securities”) but don’t specify the maturity dates, interest rates, or other negotiated financial terms that will apply to individual securities. When the issuer (or its underwriter) reaches agreement with an investor for an issuance of specific securities, the issuer will take the requisite amount of securities off the “shelf” by delivering to the investor and filing with the SEC a prospectus supplement that specifies the amount of securities sold and the applicable negotiated terms. The alternative approach—under which the issuer files a separate registration statement for each security that it sells—would not work for Operators because of the sheer volume of securities they will sell. Stated differently, if Rule 415 were not available, each Platform Note—because its underlying borrower, maturity date, and interest rate won’t in combination match those of any other Platform Note—would constitute a distinct series of securities and would have to be separately registered. The cost of filing multiple registration statements would be prohibitive. Rule 415 therefore makes
registered offerings of Platform Notes possible but, at the same time, the Rule was not specifically designed to accommodate P2P lending. In particular, Operators remain subject to the requirement to file with the SEC separate preliminary or final prospectus supplements for each security offered or sold under the shelf registration. Unlike corporate issuers that utilize Rule 415, and that ordinarily will sell debt securities off their shelf registrations only on an occasional basis, Operators will expect to offer and sell multiple series of Platform Notes to multiple investors every day. An Operator therefore will be required to prepare and file with the SEC each year numerous prospectus supplements or “listing reports,” which briefly summarize the terms of each Borrower Loan underlying a Platform Note. An Operator can significantly reduce the burden of this filing requirement by automating the preparation and filing of the supplements. The filing nonetheless seems to impose an unnecessary expense on Operators (except, of course, to the extent that it enables them to remain in technical compliance with the Securities Act) since P2P investors almost universally will rely upon the platform website and not on SEC filings to access the terms of their Platform Notes.

Planning Tip: The SEC registration process is complex, time-consuming and expensive. Operators who choose to register their Platform Notes for sale to the general public must be prepared to devote substantial resources to the effort.

Regulation AB under the Securities Act sets forth the disclosure requirements that apply to registered offerings of asset-backed securities and to certain periodic reports that the issuers of registered asset-backed securities must file. Operators have not structured their disclosures to Platform Note investors to satisfy Regulation AB requirements and in view of the effort and expense involved may prefer not to do so. Although Platform Notes could, in one sense, be characterized as “asset-backed” obligations since each Platform Note is backed by the cash flow from a specific Borrower Loan, the SEC has not treated Platform Notes as “asset-backed securities” for purposes of Regulation AB, nor should it have done so. Regulation AB defines an “asset-backed security” as a security that is “primarily serviced by the cash flows of a discrete pool of receivables or other financial assets” (emphasis supplied). As each Platform Note is backed by only a single Borrower Loan and not by a “pool” of financial assets, Platform Notes are not covered by the Regulation AB definition. In addition, Regulation AB limits

91 The SEC approved significant amendments to Regulation AB in 2014. See “Securitization” below.

92 It’s true that Regulation AB can apply to certain issuers that hold only a single cash-generating asset. For example, single-property commercial mortgage-backed securities (“CMBS”) may be viewed as asset-backed securities even though the securities are backed by a single asset (a mortgage loan on the underlying real estate). Such CMBS are not backed by a “pool” of separate mortgage loans but still will have two features that are commonly associated with asset-backed securities: (i) the CMBS will create credit tranches (i.e., the securities will be issued in multiple senior and subordinate classes), and (ii) the CMBS issuer will make payments on each class of its securities from the cash flow paid by a number of different underlying obligors (e.g., the lessees holding separate leaseholds at the mortgaged property). Neither of these features applies to Platform Notes. In other cases, the issuer will hold no material assets other than a single security representing an indirect interest in a pool of financial assets (e.g., the issuer in a credit card securitization may invest in an underlying credit card master trust that holds the credit card receivables). It’s reasonable to conclude that such issuers are issuing “asset-backed securities” since they are indirectly investing in a broad group of self-liquidating financial assets and will use the cash flow generated by those assets to make the payments on their securities. This is not the case for Platform Notes since each Platform Note is backed by only one Borrower Loan.
the concept of “asset-backed security” to securities of an issuer that limits its activities to “passively owning or holding the pool of assets, issuing the asset-backed securities ... and other activities reasonably incidental thereto.” An Operator, however, will not limit its activities to “passively owning or holding” the Borrower Loans and issuing the related Platform Notes but will instead be actively engaged in structuring, promoting, and operating its proprietary Internet-based lending system. The Operator, in other words, should be considered an operating company that is fundamentally different from the securitization trusts and other special purpose issuers that historically have been subject to Regulation AB. However, the fact that Platform Notes are not “asset-backed securities” under Regulation AB does not necessarily mean that they are not “asset-backed securities” under certain other federal securities laws. See “Risk Retention Requirements” below.

Another issue that prospective Operators should consider is the potential for liability to investors for inaccurate disclosures. The Securities Act provides investors with recourse against issuers who sell securities through offering materials that contain an untrue statement of a material fact or omit to state a material fact (the standard of liability can vary in certain respects between registered and unregistered offerings). All issuers therefore face potential liabilities to investors if their offering materials are inaccurate. Most issuers, however, are in a position to verify the accuracy of the information they disclose to investors since the information concerns or derives from the issuer itself. In contrast, Operators may also have liability for inaccurate information submitted to them by prospective borrowers and disclosed to prospective lenders through the platform website. Operators may verify some of the information submitted to them by prospective borrowers but almost certainly will not have the time or resources to verify all such information. The information so disclosed will be considered part of the Operator’s prospectus for Securities Act purposes, and some of the information (e.g., the borrower’s self-reported income range or intended use of proceeds) may be deemed material by investors who fund the related loans. Accordingly, investors who lose money on their Platform Notes and can identify borrower misstatements in the related loan postings possibly could bring claims against the Operator under the federal securities laws. However, it is far from certain that any such claims would succeed. The Operator will have disclosed in its prospectus that not all borrower-reported information is verified by the Operator and that investors must assume the risk that such information is inaccurate. A court might well decide that the Operator satisfied its Securities Act disclosure obligations by disclosing this risk. In addition, as most Platform Notes have relatively low principal amounts it generally will be impractical—unless there are grounds for class certification—for investors to initiate legal proceedings against an Operator. The scope of Operator liability for inaccurate borrower information nonetheless has not yet been considered by any court. Prospective Operators should be aware that, in a worst-case scenario, they could face liability under the federal securities laws for inaccurate borrower information (including intentional borrower misstatements).

As discussed above, registration of Platform Notes with the SEC is an expensive and time-consuming process. An Operator therefore might choose not to register its securities but to offer them in a private placement exempt from registration pursuant to Section 4(a)(2) of the Securities Act. The SEC has
adopted Rule 506 of Regulation D under the Securities Act to provide a “safe harbor” that issuers may follow to ensure that their offerings will be exempted by Section 4(a)(2). Until relatively recently, it would have been difficult for an Operator to conduct a valid private placement under Rule 506 because the exemption was not available to issuers that offered their securities through “general advertising” or “general solicitation.” A securities offering made over the Internet—even if sales of the securities were limited to the institutions and high net worth/income individuals that qualify as “accredited investors” under Regulation D—might be deemed by the SEC to involve “general advertising” or “general solicitation” and thus would not qualify for the exemption. In the JOBS Act, however, Congress directed the SEC to revise Regulation D so that the issuers of offerings made pursuant to Rule 506 of Regulation D are not prohibited from using general advertising or general solicitation if the securities are sold only to “accredited investors.” The SEC approved implementing rules that became effective in September 2013. Under these rules, Operators are able to sell Platform Notes over the Internet to “accredited investors” without incurring the substantial time, expense, and paperwork that would be required to register the securities with the SEC. The following section of this survey provides details on Rule 506 offering procedures.

2. The Private Placement Rules

The freedom that Operators enjoy under amended Rule 506 to engage in general solicitations of accredited investors without registering their Platform Notes with the SEC has made the path of many start-up companies much easier. Most marketplace lenders who issue Platform Notes, including various companies engaged in consumer, small business, and real estate lending, in fact accept investments only from accredited investors. A prospective Operator must nonetheless consider whether restricting the sale of its Platform Notes to accredited investors will unduly limit its investor base. In relevant part, the term “accredited investor” includes most institutional investors and individuals who (i) individually, or with their spouse, have a net worth exceeding $1 million exclusive of the value of the person’s primary residence (and subject to certain adjustments for “underwater” mortgages), or (ii) individually had an income in excess of $200,000 in each of the two preceding years, or had a joint income with spouse in excess of $300,000 in each of those years, and have a reasonable expectation of reaching the same income level in the current year. An Operator that intends to sell

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93 The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) requires the SEC to reexamine the definition of “accredited investor” every four years to determine whether the definition should be revised to enhance investor protection and/or to reflect prevailing economic conditions. Pursuant to this mandate, in December 2015 the SEC staff published a report outlining possible changes that could be made to the definition. The staff noted that because the financial tests for individual accredited investors have not been changed since they were approved in 1982, inflation has over time greatly increased the percentage of U.S. households who qualify as accredited investors. The staff therefore recommended that the SEC consider changes to the financial tests that would better match them to their original purpose—i.e., to identify individuals who can reasonably be presumed to have the financial sophistication and resources needed to protect their own interests in securities transactions—while at the same time cautioning that defining “accredited investor” too narrowly could have an adverse impact on capital formation. The staff also discussed alternative approaches under which certain individuals could qualify as “accredited investors” by reason of their professional qualifications or investing experience whether or not they satisfy specific financial criteria. As an example, the SEC could choose to treat as “accredited investors” any individuals, regardless of their personal financial circumstances, who have passed certain securities industry examinations administered by the Financial Industry Regulatory Authority. The staff ultimately did not recommend any
Platform Notes to individuals may not use Rule 506 unless it excludes nonaccredited investors. Operators whose business plans require a broader investor base should continue to register their Platform Notes with the SEC or, possibly, consider using Regulation A+ (discussed below). The strong interest of institutional investors in marketplace loans as an asset class, however, may well reduce the pressure for prospective Operators to register their notes for public sale.

The Rule 506 amendments that made general solicitation possible also added two important conditions to the Rule 506 exemption. First, the Operator is required to take “reasonable steps to verify” that each purchaser of the Platform Notes is, in fact, an accredited investor. Congress and the SEC have imposed the verification requirement to reduce the risk that general solicitation by Rule 506 issuers will result in sales of securities to nonaccredited investors. This concern applies with particular force when sales are made to natural persons. The SEC has not required that issuers employ any specific procedures to confirm that their investors are accredited but, to facilitate compliance, it has listed in the Rule certain nonexclusive procedures that it will deem sufficient to verify a natural person’s status. If, for example, the Operator proposes to sell Notes to a natural person who represents that he or she satisfies the income test, the Operator could verify the prospective purchaser’s status by (i) reviewing copies of any Internal Revenue Service form that documents such person’s income for the two most recent years (e.g., Form W-2 or 1040), and (ii) obtaining a written representation from such person that he or she has a reasonable expectation of having an income during the current year that is sufficient to satisfy the test. Alternatively, if the prospective purchaser represents that he or she satisfies the net worth test, the Operator could (among other possible approaches) verify the purchaser’s status as an accredited investor by reviewing copies of personal brokerage or bank account statements (to confirm assets) and a consumer report from at least one nationwide consumer reporting agency (to confirm liabilities). It will be important for the Operator (or any third party that it engages for the purpose) to perform the verification review diligently as the Operator must have a "reasonable belief" that each of its investors is accredited to qualify for the exemption. An Operator must also consider whether any verification procedures that require natural persons to deliver personal financial information to the Operator (or its agent) will impair the marketability of the Platform Notes.

single course of action to the SEC and it is not certain what changes, if any, the SEC will make to the “accredited investor” definition in response to the staff report. In a separate development, in February 2016 and again in December 2016 the U.S. House of Representatives passed a bill which, if enacted into law, would expand the definition of “accredited investor” to include any natural person who (i) is registered as a broker or investment adviser with the SEC or any state securities commission, or (ii) is determined under an SEC regulation to have demonstrable education or job experience that qualifies such person to invest in the particular offering.

An issuer technically may sell its securities to not more than 35 nonaccredited investors and continue to rely upon Rule 506. If, however, the issuer makes any such sales the offering will become subject to certain disclosure requirements. Accordingly, as a practical matter Rule 506 issuers almost always sell the securities only to accredited investors.

Private placements that use general solicitation will be made pursuant to Rule 506(c) of Regulation D. Alternatively, it remains possible for issuers to undertake Regulation D private placements without using general solicitation pursuant to Rule 506(b). In such event, the issuer still must have a “reasonable belief” that each accredited investor is, in fact, accredited, but in the absence of general solicitation the issuer is not required to take additional actions to verify the investor’s status as described herein. An Operator that offers its Platform Notes over the Internet to accredited investors with whom it does not have a preexisting relationship would likely be deemed to be engaged in “general solicitation” and therefore subject to the verification requirement.
Second, the SEC has added disqualification provisions to Rule 506 that make the exemption unavailable if the issuer or any of various persons associated with it or the offering (including, among others, its directors, executive officers, other officers participating in the offering, 20 percent equity holders, and any placement agent) has been convicted of specified felonies or misdemeanors or is subject to specified court or regulatory orders (collectively, “Disqualifying Events”). The list of Disqualifying Events includes a broad range of criminal, regulatory, and administrative proceedings. As examples, an Operator will be unable to rely upon Rule 506 if it, or any of its relevant associated persons, has within the past ten years (or five years, in the case of the Operator itself) been convicted of any felony or misdemeanor in connection with the purchase or sale of any security; is subject to any court order or judgment entered within the past five years that enjoins the Operator or such person from engaging in any practice arising out of the business of an underwriter, broker, dealer, or investment adviser; or is subject to a final order of any state securities, banking, or insurance commission that bars such person from engaging in the business of securities, banking, or insurance. It should not be difficult for an Operator to monitor its own status under the disqualification provisions but, if it engages any placement agent to assist it in the sale of the Platform Notes or of other securities offered under Rule 506, it must also confirm (and monitor on an ongoing basis) that the placement agent and its associated persons are not subject to any Disqualifying Event.

**Takeaway:** Operators who don’t need unrestricted access to a retail investor base will often find it quicker and cheaper to sell their Platform Notes only to “accredited investors” in a private placement exempt from SEC registration.

A final point to consider in relation to Rule 506 offerings is the potential application of broker-dealer registration requirements. Any company that makes direct offers of securities through an Internet platform (rather than through a broker-dealer registered with the SEC and in the applicable states) potentially is subject to registration as a broker-dealer at both the federal and state levels. To address this issue Congress included in the JOBS Act (codified as Section 4(b) of the Securities Act) an exemption from broker-dealer registration for persons who maintain a platform or mechanism (which may include a website) to offer securities if (i) the securities are offered only under Rule 506, and (ii) certain other conditions are satisfied. Among such other conditions, neither that person nor any person associated with it may receive any compensation in connection with the sale of the securities. The SEC interprets the term “compensation” broadly and the Section 4(b) exemption narrowly. The SEC would likely view the origination fees payable to the Operator in connection with new Borrower Loans as “compensation” for these purposes. The SEC has in fact stated that “the prohibition on compensation makes it unlikely that a person outside the venture capital area would be able to rely upon the [Section 4(b)] exemption.” Other elements of Section 4(b) also indicate that the exemption is meant for platforms through which third-party issuers undertake Rule 506 offerings rather than for issuers engaged in offering their own securities. Accordingly, although at first glance Section 4(b)
appears to be helpful to Operators that undertake Rule 506 offerings, such Operators will in fact need to look elsewhere for exemptions from broker-dealer registration. See “Securities Exchange Act” below.

3. Regulation A+

The SEC some years ago adopted Regulation A under the Securities Act to provide an exemption from registration for certain relatively small offerings. Regulation A permitted an issuer to offer its securities publicly but imposed a number of conditions that are not applicable to Rule 506 private placements, including specified disclosure and presale filing requirements. In addition, an issuer could not use Regulation A to sell more than $5 million of securities in any 12-month period. These provisions made Regulation A less flexible than Rule 506, and issuers did not often use it. Having concluded that Regulation A was too narrow and that it could promote capital formation by allowing small issuers a broader exemption from Securities Act registration, Congress directed the SEC in the JOBS Act to adopt regulations that would permit certain issuers to publicly offer and sell up to $50 million of their securities in any 12-month period. On March 25, 2015, the SEC responded to this mandate by heavily amending Regulation A. The revised version of Regulation A (so-called “Regulation A+”) is proving useful to many privately held operating companies that are seeking to raise equity capital from both accredited and nonaccredited investors. Unfortunately, Regulation A+ includes a number of restrictions and requirements that will likely make it unsuitable for most public offerings of Platform Notes.

Regulation A+ is divided into two tiers: Tier 1, for securities offerings of up to $20 million, and Tier 2, for offerings of up to $50 million. Both Tier 1 and Tier 2 issuers will be required to make certain specified disclosures to investors, file an offering statement with the SEC, and obtain SEC clearance before commencing sales. Each issuer must also provide investors with certain financial statements including, in the case of Tier 2 issuers, audited statements. The disclosure requirements are broader for Tier 2 issuers than for Tier 1 issuers and in many respects resemble those that would apply in a registered public offering by the same company. In addition, Tier 2 issuers will be subject to ongoing reporting requirements pursuant to which they must file annual, semiannual, and current event reports with the SEC similar to (though less comprehensive than) the periodic reports that registered issuers must file under the Securities Exchange Act of 1934 (the “Exchange Act”). See “Securities Exchange Act” below. The issuer also would be required to file a pricing supplement with the SEC in connection with the sale of each Platform Note similar to the prospectus supplements that are filed for individual sales of registered Platform Notes. Tier 1 issuers will be required to register their securities under the Blue Sky laws of the states in which they are sold (or qualify for an exemption from such registration), whereas Tier 2 securities will be exempt from state registration requirements. Regulation A+ will not

96 Regulation A+ cannot be used to offer “asset-backed securities” as defined in Regulation AB under the Securities Act. As previously discussed, Platform Notes should not constitute “asset-backed securities” for this purpose. See “Securities Act” above.

97 The Securities Act authorizes the SEC to define classes of “qualified purchasers” to whom securities may be sold without Blue Sky registration. Pursuant to this authority, the SEC has exempted all Tier 2 securities from Blue Sky registration by
be available if the issuer or certain other transaction participants are subject to a Disqualifying Event (as described under “The Private Placement Rules” above). In addition, Tier 2 issuers may not sell their securities to any purchaser (other than accredited investors) in an amount exceeding 10 percent of the greater of the purchaser’s (i) annual income or net worth (in the case of natural persons), or (ii) annual revenue or net assets at fiscal year-end (in the case of nonnatural persons).

Securities issued under Regulation A+ will not constitute “restricted securities” under the federal securities laws. Holders of the securities therefore may resell them free from any Securities Act restrictions as to the amount or timing of sales. In contrast, securities sold under Rule 506 do constitute “restricted securities” and are subject to resale restrictions. See “Secondary Trading” below.

The principal difficulty posed by Regulation A+ for offerings of Platform Notes remains the cap on the permitted offering amount. The respective Tier 1 and Tier 2 caps refer to the amount of securities sold by the issuer in reliance upon the exemption in any 12-month period. The increase in the offering cap relative to prior Regulation A will permit many privately held operating companies to raise substantial amounts of capital, but an Operator engaged in a continuous offering of Platform Notes is unlikely to achieve long-term success if it cannot sell more than $20 million principal amount of Platform Notes (in the case of a Tier 1 offering) or $50 million (in the case of Tier 2) in any 12 months. An Operator could consider selling Platform Notes under Regulation A+ as it ramps up operations and then registering its Platform Notes under the Securities Act (at which point the Operator could sell Platform Notes to the public in amounts not exceeding the amount registered with the SEC). However, since we expect that most new Operators will choose not to register their Platform Notes with the SEC because of the costs involved, and since an Operator can sell unlimited amounts of its Platform Notes to accredited investors under Rule 506 without becoming subject to the filing, disclosure, and reporting requirements that apply under Regulation A+ (which are particularly burdensome in Tier 2 offerings), it seems that Operators will have an incentive to use Regulation A+ rather than Rule 506 only if they can accept the offering cap and want to (i) sell a limited amount of Platform Notes to nonaccredited investors, and/or (ii) exempt their Platform Notes from Securities Act resale restrictions.

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98 A study of the Regulation A+ offerings that have been undertaken through December 2016 found that over 85 percent of Regulation A+ issuers have used the Regulation to sell equity rather than debt securities. A. Knyazeva, “Regulation A+: What Do We Know So Far,” available at https://www.sec.gov/dera/staff-papers/white-papers/Knyazeva_RegulationA+.pdf. This finding is consistent with our expectation that Regulation A+ will likely be more useful to marketplace lenders seeking to raise limited amounts of equity capital than to those hoping to issue Platform Notes to retail investors.

99 An Operator might be able to undertake simultaneous Rule 506(c) and Regulation A+ offerings pursuant to which it could sell unlimited amounts of Platform Notes to accredited investors and not more than $50 million of Platform Notes in any 12 months to nonaccredited investors. The Operator would remain subject to the Regulation’s ongoing filing and reporting requirements. An important question is whether the SEC would “integrate” the Regulation A+ and Rule 506(c) offerings (i.e., treat the two offerings as a single combined offering for Securities Act purposes). Although the SEC has indicated that it will not integrate Regulation A+ offerings with other exempt offerings if certain safeguards are observed, the Operator...
**Takeaway:** Regulation A+ may sometimes be helpful to Operators seeking to raise limited amounts of capital (particularly equity capital), but is unlikely to provide an attractive framework on which to base a Platform Notes program.

4. **Blue Sky Laws**

In addition to registering its securities under the Securities Act, an issuer must register its securities in every state in which the securities are offered for sale to the public unless an exemption from registration applies. Platform Notes generally will not qualify for any exemption from registration under the state securities laws (the so-called “Blue Sky” laws) other than an exemption available in every state for the sale of securities to specified classes of institutional investors (the categories of exempt institutions vary between the states but typically include banks, insurance companies, investment companies, pension funds, and similar institutions). Accordingly, any Operator that intends to engage in a broad public offering of Platform Notes must register its securities in multiple states and pay the associated filing fees.

In many states, the state securities commission has authority to apply “merit” regulation and to deny registration to any securities it deems unsuitable for sale. A limited number of states—often citing the novel nature of Platform Notes and/or the Operator’s failure to provide lenders with fully verified borrower information—have in fact refused to permit the sale of Platform Notes to retail investors. Alternatively, a state may agree to register the Platform Notes but only subject to suitability criteria that will limit the scope of the offering therein. A state could, for example, limit sales of Platform Notes to investors whose annual income and/or net worth exceeds specified amounts or limit the dollar amount of Platform Notes that any single retail investor may purchase. The Operator must observe these restrictions in the applicable state even though the SEC has not imposed any equivalent restrictions at the federal level. In addition, prospective Operators should note that the Blue Sky laws contain provisions that may impose civil liability on the Operator for (i) disclosure violations (in much the same manner as previously discussed in relation to the Securities Act), or (ii) any failure to maintain required registrations in effect. In particular, the Blue Sky laws generally permit investors to rescind their investments and recover the full purchase price from the issuer (plus interest) if the issuer sold them unregistered, nonexempt securities. In view of the fact that most Blue Sky registrations must be renewed annually, it will be very important for Operators to monitor their Blue Sky filings and timely renew each registration before it expires.

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and its counsel would need to consider the question carefully because integration, if applied, could result in the loss of both the Regulation A+ and the Rule 506(c) exemptions.
Take Care: When structuring a securities offering, issuers sometimes focus on the Securities Act and the SEC and pay insufficient attention to the Blue Sky laws. This can be a very costly mistake given the civil, administrative and criminal penalties that can result from Blue Sky violations.

The Securities Act does preempt the right of the states to require the registration of certain categories of securities offerings. In particular, the states are not permitted to require the registration under the Blue Sky laws of any securities that are offered in a private placement pursuant to Rule 506 of Regulation D (although the states may require the issuer to submit certain notice filings and pay associated filing fees). Accordingly, an Operator that offers Platform Notes solely to accredited investors in a Rule 506 private placement (as described above) will be entitled to offer the securities in all of the states, and the states may not impose suitability criteria or otherwise restrict the categories of eligible investors. As previously mentioned, the Securities Act also preempts Blue Sky registration requirements in relation to securities sold under Tier 2 of Regulation A+.

The Securities Act also prohibits the states from requiring the registration of any securities listed on the New York Stock Exchange or the Nasdaq National Market System (“Listed Securities”) or of any securities of a listed issuer that are senior or equal in rank to the Listed Securities. Some commentators have stated that an Operator that lists its common stock will thereby be exempted from Blue Sky restrictions because its Platform Notes will be “senior” securities. However, that statement might not be correct. The Blue Sky laws historically have included exemptions for the securities of listed companies because such companies (i) must satisfy stock exchange listing standards (which can, to some degree, be used as a proxy to identify “quality” companies), and (ii) are subject to ongoing regulation under both stock exchange and SEC rules. The exemption nonetheless does not extend to any subordinate securities of a listed issuer (i.e., securities of the issuer that would be subordinate to its listed common stock in the event of an issuer insolvency) as these securities, by definition, entail a higher degree of risk than the Listed Securities. It follows that the Platform Notes of a listed Operator will be exempt from Blue Sky registration requirements only if, in the event of the Operator’s insolvency, the Operator’s assets would be applied to pay the Platform Notes before any distributions are made to the common stockholders (or, at a minimum, if the assets would be distributed between the noteholders and the stockholders on a pari passu and pro rata basis). Platform Notes generally do not satisfy that requirement since they are not full-recourse obligations. Specifically, the noteholders would have at most a claim, in any insolvency proceeding, only to the proceeds of the specific Borrower Loans allocated to their notes and could not make a claim against other Operator assets that might remain available for distribution to the common stockholders. Some states therefore may take the view

100 The Blue Sky laws in most states for many years included exemptions for listed securities. In 1996 Congress effectively codified these exemptions, on a nationwide basis, by amending the Securities Act to preempt the application of state securities registration requirements to all listed securities and all securities of the same issuer of equal or senior rank.
that Platform Notes are not “senior-to-list” or “equal-to-list” securities and that Blue Sky filings must continue to be made notwithstanding the Operator’s status as a public company.\footnote{It would not be possible for an Operator to obtain Blue Sky exemptions for the Platform Notes by listing the notes on the New York Stock Exchange since, among other issues, the principal amount of each note will be far too small to satisfy the listing criteria. Also, as discussed under “Bankruptcy Considerations” below, an Operator may elect to isolate its noteholders from Operator insolvency risk by issuing the Platform Notes through a wholly-owned subsidiary. Under this structure, the issuers of the Listed Securities \textit{(i.e., the Operator)} and of the Platform Notes \textit{(i.e., the subsidiary)} will be different companies and Blue Sky preemption definitely will not apply.}  

LendingClub completed its initial public offering in December 2014 and listed its common stock on the New York Stock Exchange. LendingClub to date has chosen not to claim Blue Sky preemption for its Platform Notes but has continued to register them under state securities laws. In view of the significant civil and even criminal liabilities that could result from a failed claim of preemption, this appears to be a prudent decision.

5. Secondary Trading

Our discussion of securities law issues has to this point focused on the federal and state securities registration requirements that apply when Operators sell their Platform Notes to investors. A complete analysis of the registration requirements, however, must also consider their application to secondary market transactions. Investors in Platform Notes are not necessarily free under the securities laws to resell their notes whenever or wherever they choose. The scope of the applicable resale restrictions will depend significantly upon the manner in which the Operator originally placed the Platform Notes.

If the Operator sold the Platform Notes in a registered public offering, holders of the notes will be permitted to resell them without restriction under the Securities Act. The registration statement filed by the Operator with the SEC, as a practical matter, covers both the initial placement of the notes and subsequent resales, and no further filings with the SEC by either the Operator or the selling holders will be required. The Blue Sky laws, however, may nonetheless impose significant restrictions on resales. An important point—and one that is sometimes overlooked—is that the Blue Sky laws apply not only to an issuer’s sale of its securities but also to all secondary market sales. A holder of Platform Notes that have been registered under the Securities Act therefore will be entitled to resell the notes in those states in which they have been registered but may \textit{not} resell them in the remaining states except pursuant to an exemption from registration. The Blue Sky laws do in fact contain various exemptions for “nonissuer” transactions that may be available to Platform Note investors. It therefore will often be possible for holders of outstanding securities to resell into a state securities that have not been registered in that state. Any such holder—and any securities broker acting for the holder—still should confirm the availability of a registration exemption in the applicable state before making such sale.\footnote{The Securities Act preempts the application of Blue Sky securities registration requirements to certain nonissuer transactions in the securities of “reporting companies” \textit{(i.e., issuers who file periodic reports under the Exchange Act). As discussed in “Securities Exchange Act” below, any Operator engaged in a continuous offering of registered Platform Notes will be subject to these reporting requirements. When preemption applies, investors will be permitted to resell their Platform Notes in all states without regard to the terms of the individual state securities laws. Although federal preemption therefore appears to exempt secondary trading in SEC-registered Platform Notes from all Blue Sky registration}
If the Operator sold the Platform Notes under Regulation A+, holders of the securities may freely resell them without restriction under the Securities Act. In this respect, Regulation A+ securities have the same Securities Act status as registered securities. In addition, the Securities Act and Regulation A+ preempt the application of Blue Sky registration requirements to all securities sales made under Tier 2 of Regulation A+ (but not Tier 1). The preemption of Blue Sky requirements extends, however, only to the initial placement of the Tier 2 securities and not to any resales; any such resales therefore must comply with applicable Blue Sky laws.

If the Operator sold the Platform Notes in a Rule 506 private placement, the Platform Notes will constitute “restricted securities” for purposes of the Securities Act. A holder of restricted Platform Notes may not resell them unless the holder (i) registers the notes under the Securities Act, or (ii) sells them in an exempt transaction. The first of these options is not practical because of the expense that registration would entail. In contrast, several exemptions from registration are available for resales but each such exemption is subject to significant restrictions. The SEC has imposed these restrictions to help implement one of the Securities Act’s fundamental policies: that issuers must register their securities with the SEC (or satisfy Regulation A+) before offering them publicly. Stated differently, if the SEC permitted holders of Rule 506 securities to resell them without restriction, secondary market transactions could result in the securities being distributed broadly to the public in much the same manner as if the issuer had originally registered them for public sale.

**Worth Remembering:** The fact that an Operator has lawfully sold its Platform Notes to an investor does not necessarily mean that the investor can freely resell the Platform Notes to others. In all resales, the Platform Notes must either be registered or resold under an available exemption from registration.

There are three principal exemptions that may be available for resales of privately placed Platform Notes: Rules 144 and 144A under the Securities Act and new Section 4(a)(7) of the Securities Act.

**Rule 144.** Rule 144 permits a holder of unregistered securities (other than an affiliate of the issuer) to resell the securities without registration under the Securities Act if the holder has held the securities for at least (i) six months, if the issuer is a reporting company under the Exchange Act, or (ii) one year, if the issuer is not a reporting company. There is no limit on the amount of securities that may be sold in reliance upon the exemption or the types of persons to whom the sales may be made.103 Rule 144 requirements, preemption in fact applies only if the seller is not acting as an “underwriter” of the securities. The Securities Act defines “underwriter” broadly and the term could extend to any holder who resells its Platform Notes prior to the expiration of certain waiting periods calculated from the notes’ original issuance dates. Federal preemption therefore will sometimes be helpful in creating Blue Sky exemptions for resales of SEC-registered Platform Notes but does not provide a basis for unrestricted trading in all such Platform Notes without regard to the circumstances of the resale.

103 The discussion of Rule 144 in this paragraph is limited to transactions by non-affiliates of the issuer. Rule 144 imposes a number of additional important restrictions, including limits on the volume of securities that may be sold, on transactions by affiliates.
therefore provides a very useful and straightforward exemption for holders of restricted Platform Notes who have satisfied the applicable holding period (which generally will be one year since Operators who have not registered their Platform Notes under the Securities Act are unlikely to be reporting companies under the Exchange Act). The very fact that the holding period applies, however, will prevent broker-dealers from using the Rule to develop a broad trading market for unregistered Platform Notes.

**Rule 144A.** Rule 144A exempts from registration any sale of securities made by a nonissuer to a “qualified institutional buyer” (“QIB”) if certain conditions are satisfied. Among other matters, each holder and prospective purchaser of the securities must have the right to obtain upon request certain basic information concerning the issuer and specified issuer financial statements. Rule 144A imposes no holding period and, like Rule 144, does not limit the amount of securities that the investor may sell. However, no sales to individual investors may be made under Rule 144A and, with limited exceptions, an institution must hold at least $100 million in securities investments to qualify as a QIB. Rule 144A is designed to facilitate secondary trading of unregistered securities between large institutional investors and therefore also is unsuited to the development of a broad trading market for privately placed Platform Notes.

**Section 4(a)(7).** In December 2015, Congress amended the Securities Act to provide a registration exemption for private resales of “restricted securities” to accredited investors. Under new Section 4(a)(7) of the Securities Act, holders of privately placed securities, including securities originally sold under Rule 506, will be permitted to resell the securities to accredited investors subject to certain conditions. Among other requirements, the seller cannot use the exemption if it is subject to certain disqualifying events (including those discussed above in relation to Rule 506) and may not offer the securities through general solicitation or general advertising. The seller must make available to the purchaser substantially the same issuer information and financial statements as would be required under Rule 144A. Although Section 4(a)(7) does not impose any holding period, the securities being sold must be part of a class of securities that has been authorized and outstanding for at least 90 days. Section 4(a)(7) substantially broadens the exemptions available for the resale of privately placed securities and, as discussed below, could enable accredited investors to trade unregistered Platform Notes that have been outstanding for the requisite period.

Any secondary market seller must also consider Blue Sky compliance. As previously discussed, the Securities Act preempts state securities registration requirements in all Rule 506 offerings. The preemption, however, applies only to the issuer’s initial sale of the securities and not to any resales made by the purchasers. Accordingly, each holder of Rule 506 securities will need to identify and comply with an available Blue Sky exemption—or identify a basis for federal preemption other than Rule 506—in connection with any resale it makes. Along these lines, Section 4(a)(7) resale transactions qualify for federal preemption in the same manner as Rule 506 offerings. It follows that both an issuer’s initial sale of Platform Notes under Rule 506 and any resales of the notes made by the purchasers to other accredited investors will be exempt from Blue Sky registration (subject to the issuer’s duty to
submit state notice filings (in the case of the initial placement) and the seller’s compliance with the specific terms of Section 4(a)(7) (in the case of resales)). Any resales of notes made by investors to QIBs under Rule 144A also generally will be exempt from state registration under exemptions the Blue Sky laws provide for sales to institutional purchasers. In contrast, Rule 144 transactions don’t qualify for federal preemption and, depending upon the states involved, such transactions may not be exempt from state registration when the purchaser is not an exempt institution.

It’s quite clear that Platform Notes will be more attractive as an investment if they are freely tradable. As discussed above, the Securities Act will not restrict trading in Platform Notes originally issued in a registered public offering or under Regulation A+. In addition, Securities Act registration will not be required for any resales of privately placed Platform Notes made to accredited investors under Section 4(a)(7). An Operator might therefore choose to facilitate secondary trading by establishing an electronic marketplace on which outstanding Platform Notes may be resold. The marketplace could be made available to all investors if the Platform Notes were originally sold in a registered offering or pursuant to Regulation A+ (subject to compliance with applicable Blue Sky laws in connection with each such resale) and to any accredited investor if the Platform Notes were sold in a Rule 506 private placement (subject to a determination that the seller’s action in listing its securities for sale on an electronic marketplace does not constitute “general solicitation” or “general advertising”). Any such marketplace must be operated by a registered broker-dealer and will likely have to be registered with the SEC under the Exchange Act as an “alternative trading system.” In this regard, LendingClub has arranged for a registered broker-dealer, FOLIOfn, to operate an alternative trading system on which its outstanding Platform Notes may be traded.104

Some market participants also have expressed interest in developing an electronic platform for the trading of consumer loans originated by Internet-based consumer lenders. If the loans (in contrast to Platform Notes) are not “securities,” they could be actively traded by investors without being registered under federal or state securities laws (or complying with Regulation A+ disclosure and reporting requirements) and without being subject to the restrictions that would otherwise apply under nonissuer resale exemptions such as Rules 144 and 144A. The Supreme Court has stated that notes evidencing consumer loans ordinarily will not constitute “securities” under the Securities Act. In addition, banks and other institutional investors routinely trade very substantial volumes of commercial loans (or participations therein) between themselves without deeming the loans or participations to be “securities.” These facts could provide some basis for arguing that the securities laws should not restrict trading in consumer loans originated by Internet-based lenders. Unfortunately, both the SEC and state securities regulators are very unlikely to accept that argument, at least in relation to any trading platform that permits participation by nonaccredited investors. Case law has made it quite clear that instruments that are not “securities” when originated—such as notes evidencing consumer loans—can become “securities” (or can be deemed to entail the offering of an

104 Prosper previously sponsored a similar FOLIOfn trading system for its Platform Notes but terminated it in October 2016 due to low trading volumes.
associated “investment contract”) because of the manner in which they are marketed or the types of investors to which they are sold. Both the factors the courts have deemed relevant in those cases and the SEC’s analysis in the enforcement proceeding in which it held that Platform Notes are “securities” would strongly support a decision by the regulators to treat consumer loans as “securities” to the extent they are made available for trading by the general public on an electronic platform.\footnote{See the discussion of certain of those factors and the SEC enforcement proceeding in footnotes 88 and 90 above. See also the discussion above under “Recent Developments—SEC Comments on the Status of Marketplace Loans as ‘Securities.’”}

6. **Securities Exchange Act**

Any issuer that sells securities under a registration statement declared effective under the Securities Act automatically becomes subject to certain ongoing reporting requirements pursuant to Section 15(d) of the Exchange Act. Any Operator that sells registered Platform Notes therefore will be required to file various reports with the SEC, including Annual Reports on Form 10-K and Quarterly Reports on Form 10-Q. These reports must contain such information concerning the Operator (including financial statements) as the SEC shall specify by rule. The preparation of these reports—particularly the Form 10-K—will require significant effort.

The Exchange Act also requires “brokers” and “dealers” to register with the SEC. The term “broker” means “any person engaged in the business of effecting transactions in securities for the account of others.” The term “dealer” means “any person engaged in the business of buying and selling securities for such person’s own account.” An issuer selling its own securities is not required, solely by reason of such sales, to register as either a broker or a dealer. The exemption does not necessarily extend, however, to employees of the issuer who represent the issuer in effecting the securities sales, particularly if the employees receive transaction-based compensation. An Operator that sells its Platform Notes directly to investors (rather than through a registered broker-dealer) therefore should observe the terms of a safe harbor that the SEC has adopted under the Exchange Act to provide an exemption from “broker” registration for issuer employees and, in particular, should not pay its own employees compensation that is directly tied to the number or principal amount of Platform Notes that are sold.

The need for broker registration must also be carefully considered if the Operator does not itself issue the Platform Notes but instead (i) organizes an affiliate to issue the Platform Notes (an option that the Operator could consider to address certain issues discussed under “Bankruptcy Considerations” below) and, as the affiliate’s manager, supervises or otherwise participates in its sale of the Platform Notes, or (ii) organizes an investment fund to invest in Borrower Loans and, as the fund’s general partner or managing member, places interests in the fund with unaffiliated investors. In these situations the Operator potentially could be viewed as a “broker” that is placing securities on behalf of an issuer other than itself. At the same time, any person or company is much less likely to be deemed a “broker” if it does not receive transaction-based compensation. An Operator therefore will greatly strengthen its
argument that SEC registration is not required for either it or its employees if, to the extent that the Operator has organized an affiliated issuer or investment fund, it does not take transaction-based fees from such issuer or fund and does not pay transaction-based compensation to its own employees.

Finally, each Operator should also consider the potential application of state broker-dealer registration requirements. In contrast to Blue Sky securities registration requirements, state laws requiring the registration of broker-dealers and/or sales personnel are not preempted by federal law in offerings by listed companies or in any Regulation A+ or Rule 506 offerings. A breach of the requirements will expose the Operator to civil and/or criminal penalties and may entitle each purchaser of Platform Notes in the relevant state to rescind its investment. Most states exempt issuers from registration as broker-dealers, but a small number do not.

7. Investment Company Act

The Investment Company Act of 1940 (the “Investment Company Act”) requires “investment companies” to register with the SEC before selling any of their securities to the public. The Act defines an “investment company” (in relevant part) as any person engaged in the business of investing in or holding “securities” and that (subject to certain adjustments) owns “securities” having a value exceeding 40 percent of the value of its total assets. Although the Borrower Loans funded through an Internet-based platform will not constitute “securities” for purposes of certain of the federal securities laws, the Investment Company Act definition of “securities” is very broad and will include the loans. The value of the Borrower Loans held by an Operator typically will greatly exceed 40 percent of the value of its total assets. Accordingly, absent an exemption, the Operator could be subject to registration as an investment company. As a practical matter, however, Operators cannot register as investment companies—even if they were otherwise prepared to do so—because the Investment Company Act imposes certain restrictions on registered investment companies (including restrictions on affiliated party transactions and permitted levels of aggregate indebtedness) that would make it impossible for the Operator to conduct its business. An exemption from registration therefore is needed.

Key Consideration: An Operator should not sell any Platform Notes unless it has identified an exemption from Investment Company Act registration and it strictly complies with the terms of the exemption.

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106 In June 2013 the Ohio Division of Securities initiated against an online platform that was facilitating small business lending enforcement proceedings for multiple alleged violations of the Ohio Securities Act, including the platform’s failure to register itself as a dealer under the Ohio Securities Act.

107 The registration requirement applies to the investment company itself, rather than to its securities, and the investment company remains obligated also to register the securities under the Securities Act. In practice, the investment company will be able to file a single registration statement with the SEC that covers both investment company and securities registration.
Operators may in fact qualify for several different exemptions. Section 3(b)(1) of the Investment Company Act, for example, exempts from registration as an “investment company” any issuer primarily engaged in a business or businesses other than that of investing in, holding, or trading securities. An Operator could reasonably take the position that its primary business (even if the Borrower Loans are “securities”) is not investing in or holding loans but is, instead, the operation of an Internet-based financing platform intended to match borrowers needing credit with third-party lenders. In this regard, it is significant that the Operator, unlike a traditional investment company, does not purchase assets with a view to earning investment returns in the form of interest payments or capital gains but instead is compensated for its services through the onetime origination fees paid by borrowers and the servicing fees paid by lenders. Certain Operators might also claim exemption under Section 3(c)(4) of the Investment Company Act, which exempts from registration any person “substantially all of whose business is confined to making small loans.” The SEC deems the term “small loans” to include only consumer loans made to individuals for consumption (and not business) purposes. The availability of Section 3(c)(4) to consumer-oriented platforms is, however, not entirely clear because the platform technically does not “make” loans to consumers but instead purchases bank loans that indirectly are funded by the third-party lenders.

A separate exemption may be available for commercial lenders under Section 3(c)(5) of the Investment Company Act. Specifically, Section 3(c)(5) exempts companies primarily engaged in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, loans, accounts receivables, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Although Section 3(c)(5) is broad in scope, it is important to note that it does not extend to all commercial loans and that, in particular, unrestricted working capital loans will not qualify under Section 3(c)(5)(B) because such loans are not made to fund the purchase of “specified” merchandise, insurance, or service. Any small business lender that relies upon Section 3(c)(5) therefore will need to impose certain restrictions on its borrowers’ use of the loan proceeds to ensure that the platform is engaged “primarily” in making eligible loans.108

A further exemption may be available to Operators that issue their securities in a private placement pursuant to Rule 506 of Regulation D (as discussed above). Section 3(c)(7) of the Investment Company Act exempts from registration any issuer whose securities are held only by “qualified purchasers” and that does not make a public offering of its securities. As previously discussed, private placements made

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108 The Investment Company Act does not specify the percentage of a lender’s loan portfolio that must consist of eligible loans in order for the lender to satisfy the “primarily engaged” standard. In the case of lenders making commercial loans other than real estate loans (Sections 3(c)(5)(A) and (B)), some SEC no-action letters suggest that a lender can qualify for the exemption if at least 55 percent of its assets consist of eligible loans. These letters do not provide a definitive interpretation of the statute, however, and to help ensure compliance most platforms will choose to operate under a higher minimum. In the case of real estate lenders (Section 3(c)(5)(C)), the SEC has stated that the lender must invest at least 55 percent of its assets in mortgages and other liens on and interests in real estate and an additional 25 percent in real estate-related assets.
pursuant to Rule 506(c) of Regulation D are not deemed “public offerings” for Securities Act purposes. The SEC has stated that it similarly will not deem Rule 506(c) offerings to constitute “public offerings” under Section 3(c)(7). Accordingly, Operators who sell Platform Notes only to investors who are both “accredited investors” and “qualified purchasers” should be able to claim the Section 3(c)(7) exemption. As a practical matter, however, Section 3(c)(7) will be useful only to Operators who intend to solicit only large institutional investors and high net worth individuals. In particular, individuals generally will qualify as “qualified purchasers” only if they beneficially own at least $5 million in “investments” (as defined by the SEC).

Another private placement exemption under the Investment Company Act, Section 3(c)(1), may be useful to Operators who organize investment funds to invest in Borrower Loans (as discussed below). Specifically, Section 3(c)(1) provides an exemption for issuers not engaged in a public offering of securities and that have fewer than 100 securityholders (subject to certain exceptions not relevant here). An investment fund that invests in Borrower Loans may qualify for this exemption if it appropriately limits the number of its investors. The Operator itself, however, will not be able to use Section 3(c)(1) to issue Platform Notes because it will expect, at any one time, to have substantially more than 100 holders of its Platform Notes.

The SEC to date has not required Operators to register as investment companies. A prospective Operator nonetheless should carefully consider the Investment Company Act implications of any changes it proposes to make, relative to established programs, in the securities that it offers, the manner in which it offers the securities, or the classes of assets that it finances.

8. **Investment Advisers Act**

The Investment Advisers Act of 1940 (the “Advisers Act”) requires “investment advisers” to register with the SEC unless an exemption applies. The Advisers Act defines an “investment adviser” as any person who for compensation engages in the business of advising others as to the value of securities, or as to the advisability of investing in, purchasing, or selling securities, or who issues reports or analyses concerning securities as part of a regular business. Registered investment advisers are subject to a detailed regulatory regime that governs, among other matters, required disclosures to clients, procedures for handling client assets, recordkeeping and reporting requirements, and the content of investment adviser advertisements. Although the related expense would not be insignificant, an Operator required to register as an investment adviser likely could comply with most of the applicable regulations. At the same time, investment advisers are deemed to be fiduciaries to their clients and, as such, are required at all times to act solely in the client’s best interests. As discussed below, an Operator that manages an investment fund formed to invest in Borrower Loans will be deemed an investment adviser and, as such, will need to resolve the conflicts that may exist between its fiduciary duty to the fund and its duties to other purchasers of Platform Notes.
As previously described, to help prospective lenders evaluate their options, an Operator may prepare and post a proprietary rating of each loan request. These ratings disclose the Operator’s view of the expected credit quality and loss ratio of each loan. It could be argued that in posting these ratings the Operator is acting as an investment adviser. In particular, registration could be required if (i) the ratings are deemed to provide advice as to the value of, or the advisability of investing in, “securities,” and (ii) the Operator is compensated for providing such advice. There are grounds to argue both that these requirements are satisfied and that they are not. As a practical matter, the SEC to date has not required Operators to register as investment advisers solely because they post proprietary loan ratings, and that policy is likely to continue.

The result will not be the same for Operators (or their affiliates) who manage investment funds. As discussed under “Bankruptcy Considerations” below, an Operator may choose to organize an investment fund that will invest in Borrower Loans generated by the platform. These funds provide a mechanism for investors to purchase indirect interests in Borrower Loans without also having exposure (as may the holders of Platform Notes) to the credit risk of the Operator. As an example, the Operator could form an affiliated investment fund that will use investor capital to purchase Borrower Loans generated through the platform. As investment manager, the Operator will determine the specific Borrower Loans the fund will purchase and will receive related management fees. The status of consumer loans as “securities” under the Advisers Act is not entirely clear but it will be prudent for the Operator to assume that the Advisers Act applies. It follows that, in receiving compensation for selecting and managing the fund’s investments, the Operator (or, if applicable, an affiliate thereof formed to be the general partner/manager of the fund) will be acting as an “investment adviser.”

No Free Rides: The fact that an Operator and any fund it manages are exempt from Investment Company Act registration does not necessarily mean that the Operator is exempt from investment adviser registration. The Operator’s status under the Investment Advisers Act and the investment adviser provisions of any applicable Blue Sky laws must still be considered.

It is important to note that not all Operators who act as investment advisers will be required, or indeed eligible, to register with the SEC. The Advisers Act establishes a bifurcated regulatory scheme under which larger investment advisers register with the SEC and smaller advisers (unless an exemption applies) register with the states in which they provide advice. In general, an investment adviser may not register with the SEC unless it has at least $100 million of assets under management. An Operator that manages investment fund(s) and/or managed accounts that invest in Borrower Loans but does not satisfy the $100 million threshold should consider the possible application of state registration requirements. In this regard, the Operator generally will be permitted to treat each of its managed funds as a single client and will not be deemed, for purposes of the state requirements, to be providing advice in each state in which fund investors are located. It should also be noted that the Operator will be deemed a “private fund adviser” for purposes of the Advisers Act if any of the funds it manages
relies upon Section 3(c)(1) or 3(c)(7) of the Investment Company Act (which very likely will be the case). Investment advisers who advise such funds, so-called “private fund advisers,” are subject to certain reporting and recordkeeping requirements that the SEC has promulgated pursuant to the Dodd-Frank Act to help it monitor their private fund activities. At the same time, U.S. private fund advisers having less than $150 million in assets under management may qualify for a specific exemption from SEC registration.

As previously noted, investment advisers must act as fiduciaries to their clients. An Operator that manages an investment fund therefore must endeavor in selecting the fund’s investments to act solely in the fund’s best interests. To the extent, however, that the investment fund and self-directed investors who purchase Platform Notes directly through the platform are competing to fund a limited supply of desirable loans, the Operator will face a clear conflict of interest between its duty to select for the fund the best possible investments (determined in view of the fund’s stated investment strategy) and its obligation to treat the direct investors fairly. As the Operator will enjoy certain advantages over the direct investors in any such competition (it will, for example, have more information than the direct investors concerning the borrowers, the loans, and the total amount of lender funds available for investment and generally will be more financially sophisticated), this conflict will not be easily resolved if the Operator is allowed complete discretion to select specific loans for the fund. It therefore likely will be necessary for the investment fund to purchase loans only under a predefined investment strategy that restricts both the amount of fund capital that may be employed at any one time and the total amount that may be invested in specific ratings categories of loans. The goal will be to develop parameters that will permit the fund to attract investors but will also provide direct investors with continued access to the most attractive loans. The investment fund must of course fully disclose these parameters in its offering materials.

9. Risk Retention Requirements

Much of the blame for the “Great Recession” has been placed on the “originate-to-distribute” model of asset securitization. Certainly it’s reasonable to believe that asset originators who transfer all of the credit risk on the securitized assets may have incentives that won’t necessarily advance investor protection. Accordingly, the Dodd-Frank Act required the SEC, the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”), the Federal Deposit Insurance Corporation (the “FDIC”), the Federal Housing Finance Agency (“FHFA”), and the Office of the Comptroller of the Currency (the “OCC” and, together with the SEC, the FDIC, the Federal Reserve Board, and FHFA, the “Agencies”) jointly to prescribe regulations that (i) require a securitizer to retain not less than 5 percent of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party, and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that it is required to retain.109 The risk retention requirement is

109 The Dodd-Frank Act required the Agencies to exempt securitizations of certain assets (most significantly, “qualified residential mortgages”) from the risk retention requirement. Marketplace loans will not qualify for any of these exemptions.
intended to create economic incentives for securitizers to structure transactions carefully and to monitor the quality of the securitized assets. The ultimate goal is to help align the interests of securitizers with those of investors.

Final regulations implementing the risk retention requirement became effective in December 2016 (the “Final Regulations”). The requirements apply to both public and private offerings of asset-backed securities and securitizers therefore cannot avoid the requirements by selling their securities only in private placements exempt from Securities Act registration. Marketplace lenders need to consider two questions under the Final Regulations. First, does the risk retention requirement apply to Platform Notes? And second, in securitizations of marketplace loans (to which the Final Regulations unquestionably apply), who will be deemed the “sponsor” required to retain the credit risk?

As to the first of these questions, technical arguments can be made that Platform Notes constitute “asset-backed securities” to which the retention requirement applies. If that were the case, the Funding Bank would likely be deemed the party required to retain the risk. At the same time, technical arguments also can be made that the Final Regulations do not extend to Platform Notes. It

110 The Final Regulations became effective in December 2015 for residential mortgage securitizations that are not otherwise exempted.

111 A number of securitizations of marketplace loans have been completed and many more are expected. However, to date there have been no securitizations of Platform Notes. Securitizing Platform Notes (as opposed to marketplace loans) offers no advantages to either the sponsor or investors and would create additional expense and complexity.

112 As previously discussed, Platform Notes do not constitute “asset-backed securities” for purposes of Regulation AB under the Securities Act because (i) each Platform Note is backed by a single Borrower Loan and does not represent an investment in a “pool” of assets, and (ii) the Operator is not a “passive” issuer as contemplated by Regulation AB. The risk retention requirements therefore would not apply to Platform Notes if Congress had incorporated the Regulation AB definition of “asset-backed security” in the Dodd-Frank Act. In fact, however, the Dodd-Frank Act amended the Exchange Act to include a new (and broader) definition of “asset-backed security” that will govern the retention requirements. Under this definition, an “asset-backed security” will include any “fixed-income … security collateralized by any type of self-liquidating asset (including a loan … or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset.” It follows that a Platform Note will constitute an “asset-backed security” for purposes of the risk retention requirements if (i) it is “collateralized” by a loan, and (ii) the holder’s right to receive payments depends primarily on the cash flow from such loan. Platform Notes appear to satisfy both clauses of this test. In regard to the first clause, the Final Regulations state that an asset “collateralizes” a security (whether or not the issuer grants the investors a security interest over the asset) if the asset provides the cash flow that the issuer will use to make payments on the securities. The Borrower Loans do of course provide the cash flow that the Operator will use to make payments on the Platform Notes. In regard to the second clause, payments on the Platform Notes will depend not only “primarily” but in fact solely on such Borrower Loan cash flow. In contrast to Regulation AB, the Exchange Act definition does not require the “asset-backed security” to be backed by the cash flow from a “pool” of financial assets.

113 If Platform Notes are “asset-backed securities” subject to risk retention, the Funding Bank arguably is the “sponsor” subject to the retention requirement since it transfers assets (i.e., the Borrower Loans) to the issuing entity. If this is the case, the Funding Bank would be required to retain credit risk and would not be permitted to sell 100 percent of any Borrower Loan to the Operator. Regulators might also deem the Operator to be a “sponsor” (whether in addition to, or in place of, the Funding Bank) since the Operator manages the overall program and helps to select the “securitized” assets by determining the loan underwriting criteria in conjunction with the Funding Bank.

114 Under the Final Regulations the retention requirement applies only if assets are transferred to an “issuing entity” and the asset-backed securities are issued in a “securitization transaction” (which similarly requires that the asset-backed securities be issued by an “issuing entity”). Although the Operator (or an Affiliated Issuer or a Trust, as further discussed under “Bankruptcy Considerations” below) unquestionably is the issuer of the Platform Notes, it may not be an “issuing entity.” The Final Regulations define “issuing entity” as the entity that (i) owns or holds the pool of assets to be securitized, and (ii) issues the asset-backed securities in its name (emphasis supplied). Each Platform Note is backed not by a pool of underlying...
is unnecessary for us to debate the relative merits of these opposing arguments as the Agencies (although they have made no formal pronouncement) have not applied risk retention to Platform Notes nor have they indicated any intention to do so. In this regard, the industry may consider itself fortunate since, if risk retention did apply, the economic and regulatory capital costs that Funding Banks incur in funding Borrower Loans would increase significantly.

The second question noted above—identifying the party subject to the retention requirement in actual marketplace loan securitizations—sometimes has an easy answer. The Final Regulations apply the risk retention requirement to “sponsors” and define “sponsor,” in relevant part, as “a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, ... to the issuing entity.” If a balance sheet lender securitizes loans that it originated and holds on its balance sheet, the lender unquestionably will be the “sponsor” since it is both “organizing” and “initiating” the securitization and selling assets to the securitization issuer. At the same time, in many marketplace loan securitizations the loan seller is not the originator but rather a commercial bank, investment fund, or other loan aggregator (each, an “Aggregator”) which has acquired a pool of loans that it intends to refinance. In this latter situation, should the sponsor be deemed the Funding Bank, the marketplace lender, or the Aggregator? Each of these entities plays a crucial role in the overall process through which loans are originated and later transferred to the securitization issuer through a series of transactions. The Funding Bank and the marketplace lender both know that the loans they are originating and/or selling may subsequently be securitized, and the marketplace lender has very likely agreed to provide specified assistance to the Aggregator in connection with future securitizations.115 It therefore could be argued that each of the Funding Bank, the marketplace lender, and the Aggregator is a “sponsor” for purposes of the Final Regulations.116 However, the Aggregator will make no commitment to the Funding Bank or the marketplace lender to securitize the purchased loans but instead will have complete discretion to retain, securitize, or resell them (outside of a securitization). It follows that the Funding Bank and the marketplace lender cannot require the Aggregator to securitize the purchased loans and do not control the timing, amount, structure, or collateral selection in any securitizations which it does undertake. Under these circumstances there is

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assets but by a single Borrower Loan. It therefore may be reasonable to conclude that, although Platform Notes are “asset-backed securities” for purposes of the Final Regulations, they are not issued by an “issuing entity” in a “securitization transaction” and therefore are not subject to risk retention requirements. Although in certain circumstances the SEC has deemed pass-through securities backed by a single asset to constitute “asset-backed securities” within the meaning of Regulation AB (notwithstanding the pooling requirement in Regulation AB), there are reasons to differentiate those securities from Platform Notes and to view them as not controlling. See footnote 92 above.

115 Among other matters, the marketplace lender may agree to review and/or provide indemnities in regard to certain disclosures in the securitization offering memorandum and to allow the securitization issuer to exercise any rights that the Aggregator has to require the marketplace lender to repurchase loans that failed to satisfy specified eligibility criteria. See “—Securitization” below.

116 It is possible under the Final Regulations for a securitization to have multiple sponsors. In this situation, it is sufficient that at least one of the sponsors retains 5 percent credit risk. The remaining sponsors are not required to retain credit risk (though they may do so voluntarily) but are obligated to ensure that at least one of their members is satisfying the retention requirement.
a strong argument that only the Aggregator should be viewed as the “sponsor” of any securitizations of the purchased loans.\textsuperscript{117}

\begin{quote}
\textbf{Don’t Forget:} In every securitization of marketplace loans (including private placements) there must be at least one “sponsor” who retains not less than five percent of the credit risk on the securitized loans.
\end{quote}

A sponsor may satisfy its retention obligation by holding an “eligible horizontal residual interest,” an “eligible vertical interest,” or a combination of eligible horizontal and vertical interests, or by posting cash collateral in an “eligible horizontal cash reserve account.”\textsuperscript{118} In all cases, however, the interest retained by the sponsor must represent not less than 5 percent of the credit risk on the securitized assets. The sponsor may hold the retained interest directly or through a “majority-owned affiliate.” The latter term includes any entity that owns a majority of the sponsor’s equity, in which the sponsor holds a majority of the equity, or which is under common majority control with the sponsor. The option to hold the risk position through a majority-owned affiliate enables sponsors to reduce the economic cost of risk retention by arranging for third parties to provide part of funding for the risk position. Although the third-party investor will require appropriate compensation for the risk it assumes, marketplace lenders who choose to securitize their loans but face capital constraints in funding their risk positions may be able to increase their securitization volumes by holding the positions through majority-owned affiliates organized with outside investors. Alternatively, or in addition, the Final Regulations also permit a securitization sponsor to finance its retained interest and to pledge it as collateral under a loan, repurchase, or other financing agreement so long as the lender has full recourse against the sponsor.

10. Securitization

The past year has seen continued substantial growth in the number and volume of marketplace loan securitizations. Securitization entails the creation of asset-backed securities (“ABS”) that represent the right to receive the cash flow from a pool of segregated financial assets. The goal in the securitization is to create ABS whose credit risk derives solely from the credit quality and payment characteristics of the asset pool and is not tied to the credit standing of the asset originator. Asset classes that have long been securitized include trade receivables, commercial and residential mortgages, credit card receivables, student loans, and auto loans and leases. Marketplace loans are now being added to that

\textsuperscript{117} The Agencies have indicated that an entity will not be a “sponsor” for purposes of the Final Regulations unless it has “actively participated” in the “underwriting and selection of the securitized assets.” See Credit Risk Retention, 79 Federal Register 77609 (Dec. 24, 2014). The marketplace lender and the Funding Bank should not be deemed “sponsors” under this test so long as they are not actively involved in selecting the assets the Aggregator chooses to securitize.

\textsuperscript{118} An “eligible horizontal residual interest” refers to a subordinate class of securities in the securitization structure to which losses will be allocated before any losses are allocated to other ABS interests. An “eligible horizontal cash reserve account” refers to a cash account funded by the sponsor in the required amount to provide credit support for the ABS interests issued in the securitization. An “eligible vertical interest” refers to the purchase by the sponsor of an equal proportionate interest (but not less than 5 percent) of all classes of ABS interests issued in the securitization.
mix and could someday represent a significant portion of overall consumer ABS. Although the first marketplace loan securitizations were completed little more than three years ago, securitization has already become an important funding source for certain lenders, and expanded access to the ABS markets will be important to the industry’s growth.

Look to the Future: Although several transactions have not performed to expectations, marketplace loan securitizations are gaining increasing investor acceptance and continued rapid growth is likely.

The first step in the securitization process is to establish a special purpose issuer. A “special purpose” issuer is an entity (an “SPE”) formed specifically for the purpose of issuing ABS. The SPE will not engage in any business other than issuing ABS to finance its purchase of the financial assets to be securitized. Its organizational documents and contracts will contain operating restrictions and covenants intended to make it very unlikely that it will ever become subject to bankruptcy proceedings. The SPE may be organized as a limited liability company, as a statutory trust, or, particularly if it is organized in an offshore tax haven jurisdiction, as a corporation. In all cases, however, the SPE must be completely isolated from the potential insolvency of any associated companies including, in particular, the originator and/or seller of the securitized financial assets (who is sometimes referred to as the “sponsor” of the securitization). If the securitization is structured properly, the credit risk on the securitized assets is segregated from the sponsor’s own credit risk. Securitizations thus allow investors to evaluate the credit risk associated with the underlying financial assets independently of the sponsor’s overall business.

The sponsor’s sale of financial assets to an SPE doesn’t eliminate the need for someone to continue to service the assets. Accordingly, in most marketplace loan securitizations the SPE will appoint the marketplace lender as the loan servicer and the lender will continue to collect payments on the loans, pursue delinquent borrowers, and otherwise interact with borrowers in much the same manner as if the securitization had not occurred. Appointing the marketplace lender as the servicer, however, could leave investors exposed to lender credit risk since the lender’s ability to perform its duties as servicer will, to a large extent, depend upon its continuing solvency. A properly structured securitization therefore will include robust backup servicing arrangements under which a preapproved backup servicer will assume the servicing function should the lender become insolvent or otherwise unable to service the marketplace loans. The market will ultimately dictate the backup servicing requirements for marketplace loan securitizations but “hot” backup servicing arrangements—in which the backup servicer stands ready to assume the servicing duties on short notice—will often be required, especially with respect to securitizations of loans originated by a marketplace lender with a short operating history.

Another key concept in securitizations is credit enhancement, which can be achieved through a number of means. Most typically, the SPE will issue multiple classes of ABS with different levels of seniority.
The more senior classes will be entitled to receive payment before the subordinate classes if the cash flow generated by the underlying assets is not sufficient to allow the SPE to make payments on all of the classes of ABS. Naturally, the senior classes of ABS will carry higher credit ratings whereas the subordinated classes will carry higher interest rates. In any securitization of marketplace loans careful thought will need to be given to the amount of credit enhancement to be provided for the senior classes of ABS through the sale of subordinated or equity tranches. A sponsor may also provide credit enhancement by funding a reserve account upon which the SPE will draw to make payments due on the senior securities if the transaction cash flow would otherwise result in a shortfall. Credit enhancement can also be provided by monoline insurers or other financial institutions that “wrap” the securities and effectively guarantee scheduled payments of principal and interest on the most senior class of ABS and/or by requiring the SPE to pay down the senior securities at an accelerated rate if specified financial triggers are tripped. As the long-term performance of marketplace loan securitizations has not yet been proven, it is likely that for the foreseeable future investors in marketplace loan ABS will require higher credit enhancement levels than might be expected for similar asset classes.

Until recently, rating agencies had been somewhat reluctant to rate P2P securitizations because of the limited performance history available for P2P loans (including default, prepayment, and recovery characteristics). The agencies had been particularly concerned that Operators cannot supply performance information covering a complete credit cycle. The decision by Moody’s in early 2015 to grant the first investment-grade rating to marketplace loan ABS therefore represented something of a milestone, and investment-grade ratings have subsequently become more common. Although the Dodd-Frank Act required federal regulators in many instances to replace references to securities ratings in federal banking and securities regulations with alternative metrics, many institutional investors by law or policy continue to be limited in their ability to purchase unrated debt securities. In consequence, the investor base for P2P securitizations should broaden as more transactions obtain ratings (particularly investment-grade ratings when available).

Of course, the rating agencies consider many factors beyond performance history when rating P2P securitizations. Among other factors, the agencies will consider (i) default correlation among borrowers, (ii) the limited operational history of marketplace lenders, (iii) whether lenders are able to

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119 The reserve account will be funded by the sponsor at a specified level on the transaction closing date. Thereafter, the SPE will apply available funds from its cash flow on each scheduled distribution date to maintain the reserve account balance at a predetermined level after giving effect to any drawings made on the account. The sponsor is not permitted after the closing date to make discretionary contributions to the reserve account to support the senior securities, as any such contributions could undermine the SPE’s status as a bankruptcy-remote entity.

120 The risks inherent in securitizing a relatively new asset class were demonstrated in 2016 when certain marketplace loan securitizations hit early amortization triggers because of poor loan performance.

121 In January 2015 Moody’s Investors Service assigned a Baa3 (sf) rating to the Class A Notes of Consumer Credit Origination Loan Trust 2015-1. The Class A Notes were collateralized by a portfolio of consumer loans originated by Prosper. There is strong market interest in the ratings analysis of P2P securitizations, and a number of rating agencies have published related research reports or policy statements.
detect fraud among potential borrowers, (iv) the lack of secondary liquidity in marketplace loans, (v) the unique aspects of servicing consumer loans originated through an Internet platform and the adequacy of the backup servicing arrangements, (vi) the number and depth of the credit tranches contemplated by the proposed structure, (vii) whether the lender has the financial capacity to repurchase ineligible loans from the SPE if so required (and whether repurchase obligations are triggered by a breach of any of numerous eligibility criteria or only in limited circumstances such as verifiable identity theft), (viii) the possibility that some borrowers may place a lower priority on repaying marketplace loans than other personal obligations (e.g., residential mortgages or auto loans), and (ix) regulatory issues affecting the industry. At least in the short term, certain of these considerations could lower the ratings of marketplace loan ABS below the ratings that might otherwise be assigned to securitizations of traditional consumer loans of an equivalent credit quality (as measured by borrower credit scores).  

Most securitizations of traditional asset classes are sponsored by the loan originator or one of its affiliates. In contrast, many marketplace loan securitizations have been sponsored by banks, investment funds, or other institutional investors (each, an “Aggregator”) who are securitizing loan portfolios purchased from marketplace lenders with whom they are not affiliated. The absence of any such affiliation complicates the documentation of ABS transactions. To take one example, much of the disclosure in the ABS offering materials will focus on risk factors specific to the marketplace lender who originated the securitized loans as well as the lender’s underwriting policies, servicing practices, regulatory status, and loan performance information. Unless otherwise agreed in the loan purchase agreement pursuant to which the Aggregator has purchased loans from the marketplace lender (the “Loan Purchase Agreement”), the Aggregator, because it is not a lender affiliate, cannot require the lender either to provide information needed to prepare the offering materials or to certify that the relevant portions of the offering materials (once prepared by the Aggregator) are accurate. The underwriters or placement agents for the ABS will nonetheless want the Aggregator’s counsel and their own counsel to provide unqualified “negative assurance” letters as to the accuracy of the offering materials. Similarly, the Aggregator will want the SPE to have the benefit of any undertakings made by the marketplace lender to the Aggregator to repurchase ineligible loans (i.e., loans the lender sold to the Aggregator in breach of the eligibility criteria stated in the Loan Purchase Agreement). Again, however, because the Aggregator is not an affiliate of the marketplace lender it cannot—except by contract—compel the lender to consent to any such assignment of the Aggregator’s rights. Aggregators therefore will want the marketplace lender to provide certain undertakings intended to facilitate future securitizations. Among other matters, the marketplace lender may agree in the Loan Purchase Agreement (or in a related “multi-party” agreement) to provide certain lender-related information for use in the securitization offering memorandum (including loan performance information); to indemnify the SPE and the underwriters against material inaccuracies in that disclosure; to arrange for

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122 The challenges rating agencies face in evaluating marketplace loan ABS were perhaps demonstrated in early 2016 when one rating agency put on watch for downgrade the junior tranches in three marketplace loan securitizations it had rated within the preceding 12 months. In each case, payment defaults on the securitized loans were higher than expected.
its counsel to provide a “negative assurance” letter in relation to such disclosures (other than any financial disclosures); to authorize the SPE to rely upon its representations in the Loan Purchase Agreement; to repurchase ineligible loans from the SPE as if the SPE were the Aggregator; and, if the securities will be rated, to assist the Aggregator in responding to pertinent questions raised by the rating agencies. Marketplace lenders generally have been willing to provide some or all of these types of undertakings as they recognize that Aggregators can (and very often will) reinvest the securitization proceeds in new marketplace loans. The exact terms negotiated between marketplace lenders and Aggregators can nonetheless vary substantially from one transaction to the next. Of particular importance, the scope of the marketplace lender’s obligation to repurchase ineligible loans (or to pay related indemnities) has not been uniform across transactions. The lack of uniform terms can reduce secondary market demand for marketplace loan ABS and thereby impair the industry’s overall access to the securitization markets.123

The trade association for the securitization industry, the Structured Finance Industry Group (“SFIG”), recognized both the growing importance and the growth potential of marketplace loan securitizations by forming a Committee on Marketplace Lending in July 2015. One of the Committee’s first goals is to develop recommended “best practices” for certain aspects of marketplace loan securitizations, including certain disclosure practices and loan repurchase procedures. Any “best practices” the Committee publishes will be recommendations to the industry, rather than mandates, and will not have the force of law. SFIG nonetheless hopes that the “best practices” initiative will help to promote uniformity across certain aspects of marketplace loan securitizations. This, in turn, could make marketplace loan ABS more liquid by making it easier for secondary market investors to review and compare the terms of individual securitizations. SFIG also believes that industry-developed disclosure standards may provide a helpful model if the SEC someday decides to apply Regulation AB II disclosure requirements to privately placed ABS.124 From a broader perspective, initiatives of this type also can help demonstrate to regulators an industry commitment to self-regulation.125

123 As discussed below, to date all marketplace loan ABS has been sold in private placements exempt from registration under the Securities Act. An active secondary market for the ABS that includes retail investors is therefore not possible. The ABS do remain eligible for resale to QIBs under Rule 144A. However, QIBs may have less interest in purchasing marketplace loan ABS in the secondary market if they believe that more effort is required to analyze the terms of individual marketplace loan securitizations than is needed for other ABS classes.

124 As previously discussed, Regulation AB under the Securities Act governs disclosure requirements in registered ABS offerings. In August 2014 the SEC approved broad amendments to Regulation AB (so-called “Reg AB II”) that significantly expanded many of the required disclosures. Marketplace loan securitizations have not been subject to Reg AB II because to date all such securitizations have been sold in private placements rather than registered public offerings. It’s likely that marketplace loan ABS will continue to be privately placed due to cost considerations and comparative ease of execution. The SEC nonetheless has reserved the right to expand Reg AB II disclosure requirements to some or all ABS private placements.

125 Outside of the securitization and consumer loan contexts, another significant example of industry efforts at self-regulation is provided by the joint adoption in August 2015 of a “Small Business Borrowers’ Bill of Rights” by a number of leading non-bank small business lenders, loan brokers, and other market participants. Small business lenders adhering to the Bill of Rights pledge themselves to respect certain fundamental borrower rights in their lending operations, including (among others) rights to transparent pricing and terms, to be offered nonabusive products, and to fair collection practices.
Any marketplace lender or Aggregator who sponsors a securitization will be subject to the federal risk retention rules previously discussed. The sponsor therefore will be required to retain at least 5 percent of the credit risk on each of the securitized loans. See “Risk Retention Requirements” above. The sponsor also must comply with a number of other SEC rules governing ABS offerings. Among other matters, the sponsor will be required to file periodic reports with the SEC disclosing the amounts of any demands that it receives from investors (or from an indenture trustee on behalf of investors) to repurchase ineligible loans and of any such repurchases that it makes. Any marketplace lender or Aggregator who sponsors a securitization should take care to review and understand the applicable requirements.

B. Lending Laws and Lender Registration/Licensing

The extension of consumer credit in the United States is regulated at both the federal and state levels. A marketplace lender that conducts a nationwide business therefore may be subject to regulation under various laws and, potentially, by multiple jurisdictions. Generally, an Internet-based consumer lending program will utilize a Funding Bank because a lender who makes loans directly and does not use a Funding Bank will need to obtain applicable state lending licenses. The Funding Bank will be subject to both federal and state regulation but may, in certain instances, be able to rely upon federal law to preempt state laws that would otherwise apply. As discussed below, federal preemption is particularly important to the Funding Bank in connection with state usury laws.

Lenders who facilitate loans made through Funding Banks will typically purchase each loan from the Funding Bank at the time or soon after the loan is made.

Worth Remembering: Due to the amount of regulatory attention that marketplace lending is receiving from the federal banking regulators and continued litigation challenging the structure whereby a Funding Bank is used (although primarily in the context of payday lending rather than marketplace lending), the use of Funding Banks creates some degree of uncertainty and potential regulatory and litigation risk and requires that particular attention be paid to the structuring of the program.

A full discussion of the financial institution regulations that will affect Internet lending businesses and the extent to which specific regulations will apply to specific persons is beyond the scope of this survey.

126 The extension of commercial credit, while less regulated than consumer credit, is still subject to some federal and state laws including usury limitations and licensing requirements in some states, most notably in California, and in New York for loans less than $50,000 to sole proprietors. Several other states also have licensing requirements that might be applicable.

127 It cannot be assumed that federal laws governing consumer lending activities will preempt state laws that impose additional or different requirements. The analysis of the application of the federal preemption doctrine to any particular market participant, transaction, or contract must be fact-specific and careful attention must be paid to the identities of the parties involved, the terms of the applicable statutes, and any relevant regulatory or judicial interpretations.

128 Other purchase arrangements can also occur. Sometimes loans may be sold to investors or into trusts, for example.
Below we briefly discuss some of the main banking or lending regulations, licensing requirements, and consumer protection laws that may apply to the marketplace lender and/or the Funding Bank.129

1. Usury Laws

Most states limit by statute the maximum rate of interest that lenders may charge on consumer loans.130 The maximum permitted interest rate can vary substantially between states.131 Some states impose a fixed maximum rate of interest while others link the maximum rate to a floating rate index. Absent an exemption, these laws would be binding on the lender making the Borrower Loans (whether making loans directly under a license or utilizing a Funding Bank) and would have to be observed in setting the interest rate for each loan. Given the nature of an Internet platform, it could be difficult for a marketplace lender conducting business in multiple states to set different maximum rates for the Borrower Loans based on the borrower’s state of residence. Doing so would prevent the lender from conducting its business on a uniform basis across jurisdictions. State laws may also prohibit or limit the amount of fees that can be charged to consumers for delinquency or returned payments, presenting another compliance burden for lenders who conduct a multistate business. Violations of usury laws can result in various penalties from state to state, including voiding the entire loan in some states.132

In addition, the lender may want the ability to set interest rates that exceed the maximum rate that the applicable state usury laws would permit. One of the stated goals of Internet-based lending is to provide broader access to credit to certain borrowers who are unable to obtain bank loans. Although the lender may require each borrower on the platform to have a specified minimum credit score (and may set the minimum score at a relatively high level), many of these borrowers—despite having acceptable credit scores—may have other attributes indicating that they are less creditworthy than their credit scores, considered alone, would suggest. In order to make loans to these individuals, the lender will need to set interest rates high enough to offset expected losses.

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129 This survey is not intended to (and does not) identify all such laws and regulations that will be applicable to the lender and/or the Funding Bank in connection with their operations nor does it discuss all of the obligations that will be imposed by those laws and regulations that are identified. Prospective marketplace lenders are advised to consult with counsel for a more complete statement of the applicable requirements.

130 State usury laws also may limit or restrict other loan terms and the duration of loans. Usury is a complicated subject and can be affected by the type of entity making the loan, the type of loan, or the amount of the loan.

131 The application of state usury laws to commercial loans also varies from state to state but, as a general matter, state usury laws have less application to commercial loans than to consumer loans, as commercial rates are often deregulated. Choice-of-law provisions are also used in a commercial lending context by lenders, particularly in states where no licensing requirements exist as the basis for usury purposes. Choice of law is often given effect where the jurisdiction has a reasonable relationship to the parties or the transaction.

132 For consumer loans, it should be noted that a governing law provision may not be upheld with respect to questions of usury. For example, a consumer loan agreement specifying that the loan will be governed by the laws of State X for a loan made to a consumer in another state will not generally allow the usury laws of State X to supersede the usury laws of the borrower’s state. State regulators take the position that loans made over the Internet to residents in their state must follow the usury and licensing requirements of that state. In Minnesota, a court decision upheld an $8 million judgment against an online lender located in Delaware making loans to Minnesota residents over the Internet using a Delaware choice-of-law provision. The court found that the lender had to comply with both Minnesota licensing laws and its interest rate restrictions. See State v. Integrity Advance, LLC, 2014 BL 90886 (Minn. Ct. App. Mar. 31, 2014).
A potential solution to these difficulties is provided by the so-called “rate exportation rules” that may be utilized by FDIC-insured financial institutions. These are a set of federal laws, interpretative letters, and court decisions that remove most state usury law restrictions for the benefit of certain categories of lenders. The Depository Institutions Deregulation and Monetary Control Act of 1980 (“DIDA”) permits federally insured state-chartered banks to charge loan interest at rates not exceeding the higher of (i) the maximum rate allowed by the state in which the loan is made, and (ii) the maximum rate allowed by the bank’s home state. For example, the Funding Bank engaged by both LendingClub and Prosper is WebBank, an FDIC-insured, Utah-chartered industrial bank. Utah law does not currently limit the interest rates that lenders may charge on loans that are subject to a written agreement. As a result, WebBank relies on DIDA to fund Borrower Loans for both LendingClub and Prosper at interest rates that are not limited by the state usury laws of other states. It should be noted, however, that DIDA permits a state to opt out of the federal rate exportation rules insofar as such rules apply for the benefit of state-chartered institutions. Other issues related to use of a Funding Bank, including court challenges to this model, were discussed above in the “Recent Developments” section.

Non-bank lenders will not be subject to direct supervision by federal banking or financial institution prudential regulators such as the FDIC, the OCC or the Federal Reserve Board. However, each Funding Bank involved in an Internet lending program will remain obligated to comply with applicable laws in originating and funding the Borrower Loans.

Prospective marketplace lenders evaluating potential Funding Banks should be aware of the potential application of the so-called “most favored lender” doctrine. This doctrine, if applicable, permits a depository institution to fix as its interest rate ceiling for any category of loans the highest interest rate that the relevant state permits to any lender for such category. As an example, if a particular state permits finance companies to make consumer loans at a higher interest rate than it permits to banks, a national or state bank making loans in that state could rely upon the most favored lender doctrine to make loans at the higher rate permitted to finance companies. The so-called state “parity” laws also may be of use in Internet lending. These laws, where available and in relevant part, may permit banks chartered in a particular state to extend credit in that state on the same terms as are permitted to national banks. The most favored lender doctrine and the state parity laws, when applied in conjunction with the rate exportation rules, may permit Funding Banks to fix the interest rates for Borrower Loans at rates significantly higher than the usury laws would otherwise permit. In any case, reliance on the most favored lender doctrine and state parity laws should not be necessary where the Funding Bank is FDIC-insured and located in a state that does not cap the interest rate that banks may charge on consumer loans.

Loans made by state-chartered institutions in states that opt out of the federal rate exportation rules will remain subject to the state’s usury laws. At this time, only Iowa and Puerto Rico have opted out of the federal rate exportation rules for state-chartered depositories. An election by any state to opt out under DIDA will be effective as to loans “made” in that state, although it may not be entirely clear in which state the loan should be deemed to be “made” when the borrower and lender are located in different states. Proper structuring can influence where the loan is “made.”

However, lenders will be subject to possible state licensing and regulation and to possible oversight and regulation by the FTC and/or the CFPB. We note that there is a difference between being subject to supervision such as examination by regulatory authorities and the need to comply with applicable regulations of those authorities.

Internet lending platforms that provide services to banks, however, may be subject to examination and regulation by federal banking regulators under the Bank Service Company Act (12 U.S.C. § 1867).
Worth Remembering: To ensure its own compliance with applicable laws, the Funding Bank will likely require the marketplace lender to provide policies and procedures demonstrating regulatory compliance and agree by contract to comply with laws that are binding on banks but may not be directly applicable to the entity.\textsuperscript{138} The Funding Bank may also require the lender to have policies and procedures addressing these areas and require the lender to submit to compliance protocols or audits and to take corrective action if deficiencies are found. Accordingly, financial institution laws and regulations—in addition to the consumer protection laws discussed below—will have a significant impact on the platform structure and operations where a Funding Bank is involved.

2. Issues Related to the Third-Party Use of Bank Charters

As described above, it is often desirable for marketplace lenders to utilize the services of a Funding Bank in order to operate a consumer loan platform, in particular, to establish preemption of various state usury laws. However, the use of a Funding Bank raises several issues including availability, regulatory concerns including vendor management requirements and “rent-a-bank” criticism, and the potential of litigation based on who is the “true lender” for the program.

\textit{a. Availability.}

Although the marketplace lending industry has grown exponentially in the last few years, only a handful of FDIC-insured banks are currently operating as Funding Banks. Most of them are smaller institutions. Trade publications indicate that these banks are receiving scores of inquiries related to serving as a Funding Bank for marketplace lenders. This demand is likely to increase the fees charged by Funding Banks to provide origination and funding for Borrower Loans. Some Funding Banks may also limit the number of marketplace lenders they work with. In addition, if these programs grow inordinately, regulatory considerations might arise, such as increased due diligence and compliance requirements (see below).

\textit{b. Regulatory Issues.}

\textbf{Bank Vendor Management Requirements.} In recent years, federally insured institutions have been subject to new and expanded guidance on programs they have with third-party providers of services.\textsuperscript{139} In short, this guidance requires banks to conduct due diligence on proposed third-party arrangements, enter into agreements that protect the bank from risk (or effectively manage or mitigate

\begin{footnotesize}
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\item \textsuperscript{138} As discussed below, marketplace lenders may also be considered to be vendors of the bank and subject to the Bank Service Company Act and vendor management requirements. This makes the marketplace lender, as a service provider to the bank, responsible for complying with applicable laws and regulations and subject to examination by the regulators of the bank.
\item \textsuperscript{139} See, \textit{e.g.}, OCC Bulletin 2013-29, FDIC FIL-44-2008, and CFPB Bulletin 2012-03.
\end{itemize}
\end{footnotesize}
identified risks), and monitor the third-party service provider, and it mandates that the service provider take corrective action where gaps or deficiencies occur. This guidance is in addition to the existing legal framework provided by the Bank Service Company Act, which requires service providers to comply with laws and regulations applicable to the bank and subjects them to supervision and examination by the bank’s primary federal banking regulator. Banks that enter into arrangements with marketplace lenders will be subject to these rules for their programs. This means that a marketplace lender will undergo scrutiny from its Funding Bank, and start-ups or other entities without a track record may not meet the bank’s standards or may have to agree to additional burdens or restrictions in order for the bank to justify the third-party relationship.

In response to the increased regulatory scrutiny on third-party arrangements, some banks are tightening their due diligence requirements and demanding up-front policies and procedures from marketplace lenders with respect to legal and regulatory compliance. Banks are likely to seek contractual and other protections in structuring their third-party relationships to minimize risk of loss. Banks will also be required to monitor the activities of their service providers and subject them to audit, and bind their service providers to strict compliance and information security requirements.

**Key Consideration:** As a result, marketplace lending arrangements with Funding Banks are likely to become more complex and costly. Practically speaking, a marketplace lender will have to give up some degree of control over its lending program in order to accommodate the regulatory regime applicable to its Funding Bank.

**“Rent-A-Bank” Criticism.** Funding arrangements where a bank contracts with a third party to provide origination services to bank customers have sometimes been criticized as “renting-a-bank charter,” particularly in the context of payday loan marketers. The perceived improper use of a bank charter by these entities has been challenged by both governmental authorities and private litigants, in part because of the high rates and fees charged to consumers in those particular programs. In 2001, the OCC issued a bulletin about the risks of payday lending relationships, warning banks to “be extremely cautious before entering into any third-party relationship in which the third party offers products or services through the bank with fees, interest rates, or other terms that cannot be offered by the third

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141 12 U.S.C. § 1867. The institution must also provide notice to its federal banking regulator of the third-party arrangement and provider.

142 As used in this survey, payday loans are small-dollar (e.g., $500), short-term (e.g., two weeks), unsecured loans that borrowers promise to repay out of their next paycheck or regular income payment. In addition to charging borrowers a stated rate of interest, payday loans are usually priced with a fixed-dollar fee (e.g., $3 for every $25 borrowed), which represents the finance charge to the borrower. Because payday loans generally have a short term to maturity, the total cost of borrowing, expressed as an annual percentage rate, can typically be in excess of 400 percent.
party directly.”

Bank regulators have even required banks to exit third-party programs that the regulators determined involved unsafe and unsound practices. However, most of these programs have involved high-rate payday loans.

More recently, banks may seek a competitive advantage by contracting with marketplace lenders to enhance the bank’s product offerings and diversify assets. For example, some small community banks have entered into arrangements with Prosper and LendingClub to originate consumer loans with their customers. These programs offer Funding Banks additional fee income generally at little risk, which arguably enhances the safety and soundness of the institution. However, regulators may become concerned if a bank concentrates too much of its portfolio in one area. Thus, it is possible that regulators could limit the number or size of these third-party marketplace lending programs based on safety and soundness concerns.

3. **State Licensing Requirements**

Depending on how a program or platform is structured, various state licensing requirements could potentially apply. Even when a Funding Bank is utilized, participants may need state licenses in order to perform certain functions in the origination, funding, or servicing of loans. The role and functions that an entity performs will determine whether licenses are required or not, and what licenses may be required. The general types of state licenses are described below. In some instances, more than one state license may be required.

**Keep in Mind:** The federal laws that permit banks to “export” interest rates apply only to the rates and some related fees charged by the lender, and do not preempt state licensing laws or most other state consumer credit regulations and protections. Accordingly, the states will retain significant jurisdiction to regulate a marketplace lender in connection with loan origination and servicing activities even where a Funding Bank is utilized.

Licenses are granted on a state-by-state basis and the requirements vary on that basis. In some states the licensing process is fairly simple and straightforward; in other states they are quite complex. Similarly, in some states licenses can be obtained fairly quickly while in other states (e.g., California and New York) the process can take several months. In addition to filing fees, license applicants may be subject to background checks and fingerprinting and may be required to submit business plans and financial statements. A marketplace lender subject to state licensing requirements must also comply with any associated recordkeeping, financial reporting, disclosure, minimum net worth, surety bond,

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144 On the commercial side, it was announced in 2015 that JP Morgan Chase has entered into a relationship with OnDeck, an online commercial marketplace lender, to refer small business customers to OnDeck. Similar arrangements exist with others in the marketplace.
or similar requirements imposed by state law; must observe any limitations that applicable state laws impose on the business activities or practices of licensed entities (including any limits imposed on permitted rates or fees); and will be subject to examination by the applicable state regulators. Some states have subscribed to a national licensing registration service that allows use of submitted information in multiple jurisdictions for licensing purposes. At least one state, Nevada, has a requirement of an in-state office. Accordingly, state licensing requirements may create significant compliance burdens and the need for a compliance infrastructure. This multistate compliance burden generally impedes having a uniform national program, which is one reason why the Funding Bank approach has been utilized for marketplace lending programs.

State licensing authorities are taking an increased interest in marketplace lending as the sector grows. The California Department of Business Oversight (the “DBO”) launched an inquiry into online programs in December 2015 with the objective of determining whether market participants are fully complying with the state lending and securities laws. The DBO sent an online inquiry to fourteen consumer and business lenders including merchant cash advance businesses, requesting five years of data about each such company’s loans and investors. Responses from those entities were due March 9, 2016, and the DBO published a summary report of the aggregate transaction date on April 8, 2016. It is not yet known whether the DBO intends to propose any changes in California law or whether other state regulators will undertake similar inquiries. In general, though, state regulators are starting to focus more attention on marketplace lending and on the need for licensing depending upon how such businesses are conducted.

Below is a brief description of the different types of state licensing requirements that could apply to a marketplace lending program.

**Broker Licenses.** Certain states require the registration or licensing of persons who assist in the loan origination process under “loan lender,” “loan broker,” or “credit service organization” statutes. Some states, such as Arizona and Connecticut, require licensing for persons who solicit loans for others. Other statutes may define a “loan broker” to include any entity that, for compensation, arranges for the extension of credit for others. Any participant hosting a website or soliciting loans for a Funding

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145 Loan broker and collection agent registration and licensing requirements as well as other requirements imposed on loan brokers and collection agents vary from state to state. Careful consideration of applicable laws is required before arranging or servicing loans in any given state.

146 However, a recent DBO enforcement action decision appears to expand entities that need to be licensed under the California Finance Lenders Law. The decision upheld a cease and desist order against an entity that did not fund loans to borrowers but solicited borrowers, evaluated the credit, proposed loan terms, and made or participated in credit advances. The DBO rejected the argument that a license was needed only if the entity made loans. Lending-related activities may also require licensing. In the Matter of the Desist and Refrain Order Against Financial Services Enterprises dba Pioneer Capital, OAH No. 2016040551 (Nov. 29, 2016). It remains to be seen if this could be the DBO’s way of reaching marketplace lenders to require licensing.

147 Each statute is potentially different and needs to be reviewed for applicability. Compensation, for example, could be general such that any compensation received in a transaction gives rise to licensing, while in other jurisdictions compensation may be required from a borrower.
Bank may fall within one or more of these broad definitions and, absent an exemption, will need to comply with any associated licensing requirements imposed by those applicable states for loan brokers, marketers, or originators.\textsuperscript{148}

**Lending and Assignee Licenses.** Consumer marketplace lenders that do not utilize a Funding Bank are subject to lending license requirements in virtually all states. State regulators take the position that Internet lenders must be licensed by the state to make loans to residents of that state.\textsuperscript{149} Persons who “arrange” loans for others are also covered by the lending license statute in some states.\textsuperscript{150} In some cases, a purchaser or assignee of a Borrower Loan may become subject to licensing requirements.\textsuperscript{151} Some states require licensing of commercial lenders.\textsuperscript{152}

**Collection/Servicing Licenses.** States may also require marketplace lenders who undertake collection activities for others to be licensed as “collection agents.” Servicers including marketplace lenders who are administering and servicing Borrower Loans for others may also be subject to servicing and/or state debt collection licensing. This could apply to an entity that sells loans to a third party and retains servicing of the loans. Additional state-level requirements that may be applicable to lenders that service Borrower Loans are described in “Debt Collection Practices” in Section C below.

**Credit Services Organizations Licenses—Maryland Decision.** A recent decision of the Maryland Court of Appeals demonstrates the need for marketplace lenders to review state licensing requirements carefully since nonuniform requirements can prove a trap for the unwary. On June 23, 2016, the Court

\textsuperscript{148} Some states have enacted credit service organization laws that have potential application depending upon how the statute is drafted. These laws could impose licensing or other restrictions on marketplace lenders. In some states, money transmitter licenses could be a consideration.

\textsuperscript{149} See, e.g., \textit{Cash America Net of Nevada, LLC v. Commonwealth of Pennsylvania}, 2010 Pa. LEXIS 2386 (Pa. Oct. 19, 2010), holding that an Internet lender making loans to Pennsylvania residents over the Internet from its location in Nevada required licensing under the state’s Consumer Discount Company Act even if it had no offices or employees in the state. In October 2016, the Georgia Supreme Court ruled that out-of-state Internet lenders are subject to the state’s payday lending law, which prohibits making loans of $3,000 or less without a license. \textit{Western Sky Financial, LLC v. State of Georgia}, No. S16A1011 (Oct. 31, 2016).

\textsuperscript{150} For example, the Regulated Lender statute in Texas contains this type of language and the regulator there has indicated that Internet platforms sourcing loans for a bank located in another state need to be licensed under this law. In addition, in late 2016 the California regulator took action against a company that arranged commercial loans, finding that a license was required under the California Finance Lenders Law because the company was engaged in the business of making commercial loans even though it did not actually lend money or take security.

\textsuperscript{151} Any loan assignee (even a passive investor) is subject to licensing in Kansas (Supervised Lender License required with respect to loans over 12 percent; see KAN. STAT. § 16a-2-301(1)(6)) and South Dakota (Money Lender License, S.D. STAT. § 54-4-52). Assignees who also service and collect consumer loans are potentially subject to licensing in several states including Colorado, Connecticut, Idaho, Iowa, Louisiana, Maine, Oklahoma, South Carolina, Utah (notification), and Wyoming. In addition, certain types of loans may be subject to restrictions on assignment. Loans made under the Illinois Consumer Installment Loan Act may only be sold to regulated financial institutions or other licensees. Loans made under the Massachusetts Small Loan Act may only be assigned to other licensees or exempt entities. The same is true for Ohio Small Loans (loans under $5,000).

\textsuperscript{152} Some seventeen states potentially have licensing requirements applicable to commercial lenders. Some are based upon type of entity (e.g., sole proprietor lending requires licensing in some states) or rates in excess of certain amounts.
filed a decision in *CashCall, Inc., et al. v. Maryland Commissioner of Financial Regulation*, upholding the $5.6 million in sanctions imposed by the Commissioner against CashCall.

CashCall, a payday lender, utilized the Internet to market loans to Maryland residents that were made by two federally chartered banks not located in Maryland at rates up to four times greater than the maximum rate allowed under Maryland’s usury laws. Soon after the banks made the loans, CashCall purchased the loans and serviced and collected them. The regulator in Maryland cited CashCall for failure to obtain a license under the Maryland Credit Services Business Act (the “CSBA”). In addition to requiring a license for any credit services business, the CSBA contains a provision that prohibits a person from arranging loans for banks that would be in excess of allowable Maryland rates. The regulator claimed CashCall was a credit services business and fined it $1,000 for each loan it arranged for the banks with Maryland residents that exceeded Maryland’s applicable usury rate.

CashCall argued on appeal that it was not engaged in a “credit services business” and therefore had not violated the CSBA. The CSBA defines a “credit services business” as one in which a person obtains or assists a consumer in obtaining an extension of credit “in return for the payment of money or other valuable consideration.” In an earlier decision the Court of Appeals had held that under the quoted language, a business is a “credit services business” only if the payment it receives for arranging an extension of credit comes “directly from the consumer.” CashCall argued that it received no compensation from borrowers, but only royalty fees paid by the Funding Banks; thus, it had not received any payments “directly from the consumer” and was not subject to the CSBA. The Court rejected CashCall’s argument, clarifying that the direct payment requirement only applies to companies that are primarily engaged in providing goods or services to consumers other than arranging extensions of credit and does not extend to a company that is exclusively engaged in assisting Maryland consumers in obtaining loans. The Court further stated that the Maryland legislature had intended the CSBA to prohibit payday lenders from partnering with non-Maryland banks to extend loans at rates exceeding the Maryland usury caps, and that it would undercut the purpose of the legislation to limit its application to loan marketers who receive direct payments from the borrowers beyond the payments made on the loan. In fact, the Court said that CashCall’s activities were exactly what the Maryland legislature had intended the CSBA to prohibit.

The Court did, however, acknowledge that the CSBA only applies to loan marketers who provide their services “in return for the payment of money or other valuable consideration.” In this regard, the Court held that CashCall’s right to receive principal, interest, and fees on the loans it purchased from the Funding Banks constituted adequate “consideration” for purposes of the statute. In fact, said the Court, the overall arrangements between CashCall and the Funding Banks (under which the latter retained no economic interest in the loans) appeared to constitute a “rent-a-bank scheme” that “rendered CashCall the *de facto* lender.” This latter statement is interesting to the extent it suggests that the

153  MD. COM. LAW § 14-1901(e).

Maryland courts may be willing, at least in some circumstances, to apply the “true lender” doctrine to loan marketers if the originating bank has no continuing economic interest in the loans.

**Takeaway:** The Court’s decision potentially creates significant issues for marketplace lenders who partner with non-Maryland banks to offer consumer loans to Maryland consumers. First, the decision impacts licensing as it could require non-bank marketplace lenders to obtain credit services business licenses to market loans originated by a financial institution. The decision may also indicate that marketplace lenders need to adhere to the substantive provisions of the CSBA, including the prohibition on soliciting Maryland residents for loans at interest rates exceeding the applicable usury caps permitted under Maryland law (24 percent). Accordingly, the decision has implications for unlicensed entities that are marketing loans and/or for entities who solicit loans for others in excess of Maryland permissible rates.155

C. Consumer Protection Laws

Internet platforms must comply with a number of different federal and state consumer protection laws. Generally, these laws (i) require lenders to provide consumers with specified disclosures regarding the terms of the loans and/or impose substantive restrictions on the terms on which loans are made, (ii) prohibit lenders from discriminating against consumers on the basis of certain protected classes, and (iii) restrict the actions that a lender or debt collector can take to realize on delinquent or defaulted loans. In addition, the Dodd-Frank Act has significantly changed the regulation of the consumer credit market by establishing the Consumer Financial Protection Bureau, which can bring enforcement actions for unfair, deceptive, or abusive acts or practices. Since marketplace lending is Internet-based, special consideration must be given to legal requirements that allow for electronic contracting and consent to receive disclosures electronically and requirements related to customer authorization for making payments electronically from their bank accounts. The remainder of this section briefly discusses some of the principal consumer protection laws that marketplace lenders will need to consider for program regulatory compliance purposes.

1. Truth in Lending Act

The federal Truth in Lending Act and its implementing Regulation Z156 require lenders to provide borrowers with standardized and understandable information concerning certain terms and conditions of their loans and certain changes in the terms of the loans.157 The TILA disclosure requirements will

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155 The decision could also have ramifications in other states with credit services organization licensing laws where ostensibly payment is required directly from the consumer.


157 Different disclosures are required for closed-end (installment) loans than for open-end (revolving) loans. Disclosures for closed-end loans include the amount financed (i.e., the amount that the borrower will actually have use of—but not necessarily the amount of the loan), the applicable annual rate of interest expressed as an annual percentage rate or “APR,”
apply to the Funding Bank or licensed entity that is the named lender of each Borrower Loan. In addition, borrowers are generally permitted to assert claims for TILA violations against any assignee of a loan, which could result in the assignee (in an Internet situation, the marketplace lender or investors as subsequent purchasers) becoming liable for TILA violations.\footnote{158} As described above, the predominant consumer Internet platform structures provide that the marketplace lender will purchase and take assignment of each Borrower Loan from the Funding Bank using funds received from the issuance of the related Platform Notes or from outside investors. Each lender and its Funding Bank therefore will need to ensure that the disclosures made to borrowers contain the information and are made in the format that the TILA requires.

The TILA and Regulation Z impose certain substantive restrictions and significant disclosure requirements in relation to certain other categories of loans.\footnote{159} The TILA also applies to advertising of loans. Most websites are likely to be considered advertising. Thus, marketplace lenders must comply with TILA advertising requirements regardless of whether a Funding Bank is involved or not. Most important, if certain “triggering” terms are used (such as the term of a loan or interest rate), other disclosures must be made.

\section*{2. FTC Act, UDAP Laws, and the CFPB’s UDAAP Authority}

Marketplace lenders must comply with Section 5 of the Federal Trade Commission Act ("FTC Act")\footnote{160}, which declares as unlawful any unfair or deceptive act or practice in or affecting commerce. Of particular importance is the Credit Practices Rule that the FTC has adopted thereunder to protect consumers against abusive terms and conditions in credit contracts.\footnote{161} Among other requirements, the Credit Practices Rule prohibits loan agreements from including terms that:

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\footnote{158} Generally, for TILA violations to accrue to assignees, the violations must be apparent on the face of the documents; but in the case of some higher-priced loans, the liability can be broader.

\footnote{159} For example, subpart F of Regulation Z mandates special disclosure requirements for loans the proceeds of which will be used to pay for postsecondary educational expenses (a “Private Education Loan”). Furthermore, once a Private Education Loan is offered and its terms have been adequately disclosed, the lender must allow the borrower 30 calendar days to decide whether to accept such loan. Unless a marketplace lender is establishing a lending platform specifically targeted at the student loan market and is prepared to comply with the additional disclosure requirements and to allow the borrower a 30-day window in which to accept any proffered funding, the lender should require each borrower to represent that he or she will not use his or her loan to pay for tuition, fees, required equipment or supplies, or room and board at a college, university, or vocational school.


\footnote{161} Section 5 of the FTC Act does not apply to banks. While Regulation AA adopted by the Federal Reserve Board imposed on banks restrictions substantially similar to the Credit Practices Rule, in August 2014 the federal banking agencies repealed this rule for banks. However, guidance issued by those agencies indicates that the banking agencies retain enforcement authority over unfair practices, which may include the acts and practices previously addressed in Regulation AA. 15 U.S.C. §§ 57a(a)(1)(B), 45(a)(1).
require the borrower to generally waive the right to notice and an opportunity to be heard in the event of a lawsuit (confession of judgment clauses);

require the borrower to waive the benefit of any laws that protect the consumer’s real or personal property from seizure or sale to satisfy a debt (waiver of exemption);\(^\text{162}\)

assign to the creditor the borrower’s wages or earnings unless (a) the borrower may revoke the assignment at any time, (b) the assignment is a preauthorized payment plan established at the time the debt is incurred, or (c) the assignment applies only to wages or earnings already earned at the time of the assignment; or

pyramid late charges (i.e., impose multiple late charges based on a single late payment).

Marketplace lenders will need to confirm that the loan agreements used to document the Borrower Loans conform to the applicable requirements of the Credit Practices Rule.

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**Caution:** A variety of marketing or servicing practices could be found to be unfair and deceptive based on the facts and circumstances of the situation. For example, placing important provisions (such as an arbitration provision, an E-Sign or EFTA consent, or a power of attorney authorizing the lender to sign documents on behalf of the borrower) in long documents without calling attention to them instead of placing them in separate, more clear, and conspicuous formats could be subject to challenge as an unfair or deceptive practice. Not providing opt-outs or failing to make them clear and conspicuous could also be subject to challenge under the FTC Act.

Marketplace lenders, Funding Banks, and loan servicers may also be required to comply with certain state laws that prohibit unfair and deceptive acts and practices ("UDAP Laws"). Some provisions of UDAP Laws that may be applicable to marketplace lenders include specific disclosure requirements related to the terms of loans, prohibitions on excessive prepayment penalties, and the availability to borrowers of certain causes of action and remedies.\(^\text{163}\)

The Dodd-Frank Act mandated the establishment of the Consumer Financial Protection Bureau and authorized the CFPB to adopt rules prohibiting unfair, deceptive, and abusive acts or practices ("UDAAP") within the consumer finance market under (amongst other laws) the TILA, the ECOA, the FCRA, the FDCPA, and the EFTA (each as defined below). The CFPB has not issued regulations regarding unfair, deceptive, or abusive practices to date, but it has articulated certain standards to assist

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\(^{162}\) A contractual waiver is not prohibited if it is restricted to property pledged as collateral for the debt.

\(^{163}\) The Dodd-Frank Act provides that state consumer financial laws shall be deemed preempted for national banks only if the applicable state law (i) discriminates against national banks in comparison to its effect on banks chartered in that state, (ii) is preempted by a federal law other than the Dodd-Frank Act, or (iii) “prevents or significantly interferes with the exercise by a national bank of its powers.” The standard may make it difficult for national banks to challenge UDAP Laws on the basis of federal preemption unless a federal statute provides for preemption. In this regard, each of the TILA, the ECOA, and the EFTA includes its own standard for preemption of state laws.
entities in identifying whether an act or practice is unfair, deceptive, or abusive.\textsuperscript{164} In addition, the CFPB has used enforcement actions to articulate its UDAAP standards and define the scope of that authority.

In May 2015, the CFPB filed a complaint and consent order in the U.S. District Court in Maryland against PayPal, Inc., and its subsidiary, Bill Me Later, Inc., related to unfair and deceptive practices in the financing of Internet-based purchases.\textsuperscript{165} One of the practices the CFPB complained of was the prefilling of drop-down boxes by the companies.

\textbf{Worth Remembering:} The use of prefilled drop-down boxes resulted in customers being signed up for financing or payments that they did not want or intend. This CFPB enforcement action should serve as guidance (and a warning) that in documents, forms, and disclosures on a website or Internet platform, boxes should not be prefilled or pre-checked but should rather allow the borrower to make an informed and independent choice after full disclosure of the options.

3. Fair Lending and Other Laws

The Equal Credit Opportunity Act\textsuperscript{166} prohibits lenders from taking any action related to any aspect of a credit transaction, including making any credit determination, on the basis of the applicant’s race, color, sex, age (except in limited circumstances), religion, national origin, or marital status; the fact that all or part of the applicant’s income derives from any public assistance program; or the fact that the applicant has in good faith exercised any right under the federal Consumer Credit Protection Act or any applicable state law ("Prohibited Bases").\textsuperscript{167} The ECOA applies during all aspects of the credit transaction, including advertising, the application and approval process, and servicing and collection activities. For example, a lender’s credit scoring systems must not be discriminatory. When determining whether to approve or deny a loan application, a creditor may use either an empirically derived and demonstrably and statistically sound credit scoring system, a judgmental system, or a

\textsuperscript{164} The CFPB has indicated that an act or practice is unfair if: (1) it causes or is likely to cause substantial injury to consumers, (2) the injury is not reasonably avoidable by consumers, and (3) the injury is not outweighed by countervailing benefits to consumers or to competition. A representation, omission, act, or practice is deceptive if: (1) the representation, omission, act or practice misleads or is likely to mislead the consumer; (2) the consumer’s interpretation of the representation, omission, act, or practice is reasonable under the circumstances; and (3) the misleading representation, omission, act, or practice is material. An abusive act or practice: (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or (2) takes unreasonable advantage of (i) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service; (ii) the inability of the consumer to protect its interests in selecting or using a consumer financial product or service; or (iii) the reasonable reliance by the consumer on a party to act in the interests of the consumer.

\textsuperscript{165} Among other things, the complaint alleged that the firms illegally signed up customers for their online credit products, engaged in misleading advertising, signed up customers without their permission, and in some cases made customers use their service rather than their preferred method of payment. The action resulted in $25 million in penalties.

\textsuperscript{166} 15 U.S.C. § 1691. Regulation B implementing the ECOA is found at 12 C.F.R. pt. 1002.

\textsuperscript{167} Various state laws may also provide for additional categories of protected classes that may not be used as a basis for determining whether to grant or refuse credit.
combination of the two. The lender must validate and periodically revalidate its credit scoring system to ensure that it does not have a disparate impact on protected classes. In addition, if an applicant is denied credit or the cost of credit is increased, the ECOA requires that the lender provide an adverse action notification.

Since marketplace lenders are very much involved in many aspects of the credit transaction, they must structure and operate their lending platforms in compliance with the ECOA and applicable state law counterparts. In addition, the criteria used to determine creditworthiness must not have a disparate impact on the basis of any Prohibited Basis.

When reviewing a loan application, a marketplace lender will typically rely on a “consumer report” as defined in the federal Fair Credit Reporting Act. Often, this will be a credit report or score from a credit reporting agency or credit bureau. The FCRA specifically applies to users of consumer reports; thus, if a lender uses consumer reports, the FCRA will be applicable. FCRA requirements include certain restrictions on obtaining and/or using consumer reports, specific notice requirements if the terms of a loan are less favorable than the terms provided to other borrowers (risk-based pricing notice), restrictions on sharing customer information with affiliates and third parties, and implementation of an identity theft prevention program. Similar to the ECOA, the FCRA requires a lender who rejects a borrower’s loan application for any reason to send the borrower an adverse action notice that discloses specified information. In addition, the FCRA imposes certain requirements that lenders must observe in reporting loan delinquencies or defaults to credit reporting agencies. Lenders must review the FCRA requirements and should consult legal counsel as to their obligations under the FCRA to ensure that their program is in compliance.

As an example, the ECOA and Regulation B thereunder generally will prohibit marketplace lenders from requesting certain types of information from borrowers including the borrower’s race, color, religion, national origin, or sex (“Prohibited Information”). To reduce the risk of violations of the ECOA (or similar state laws), lenders should prohibit prospective borrowers from posting Prohibited Information in their loan requests and should require lenders to represent that they will not base any funding decisions on Prohibited Bases. Lenders similarly should adopt internal policies intended to ensure that they do not assign proprietary credit scores, make loan servicing decisions, or take any other actions affecting lenders or borrowers on the basis of Prohibited Bases.

The ECOA is not limited to consumer loans but also applies to commercial loans, including whether a guarantor on a commercial loan is acceptable if required to approve that loan. The one area where the CFPB has jurisdiction over commercial lenders is in the enforcement of the ECOA. The CFPB has stated that one of its goals for 2017 is to enforce fair lending in the small business lending sector. Under Section 1071 of the Dodd-Frank Act, the CFPB is also charged with writing rules on data collection on small business loans. This is potentially similar to the data collection for consumer loans under the Home Mortgage Disclosure Act, ostensibly to identify whether there is discrimination in lending to women and minorities and on any other Prohibited Basis. Recently, the CFPB changed consumer rules to enlarge the amount of data collection required under that law. For commercial lenders, including marketplace lenders, the potential impact is at least twofold. First, systems will need to be developed and implemented to collect the data the CFPB will require. Second, as with the consumer data, such data will be publicly available, and in the case of consumer lending such publicly available data has led to litigation. Since the ECOA is designed to be neutral, the collection of data is potentially in conflict with the law. To alleviate this concern, the persons collecting the data must be separate from anyone involved in the underwriting or credit decision process. This rule will undoubtedly pose many compliance challenges for commercial lenders.

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Looking beyond more traditional sources of information like consumer reports, the Internet provides access to new sources and types of information on credit applicants, including through social media channels. It is widely reported that some lenders are using information obtained from social media to determine the creditworthiness of loan applicants.171

**Key Considerations:** Incorporating the use of social media data into a lender’s underwriting criteria raises fair lending compliance issues. A lender that desires to use social media data in its credit scoring system must establish that the data used is predictive of an applicant’s creditworthiness. If social media data is used as a basis to deny an application, the adverse action notification needs to reflect that. Lenders need to ascertain whether the information obtained from social media channels is accurate and reliable since such channels are not consumer reporting agencies subject to FCRA requirements, and confirm that their use of social media data in credit decisions will not result in an unfair, deceptive, or abusive act or practice. Further, lenders should ensure that unfair treatment does not occur for applicants who do not use social media.172 Finally, a lender that uses social media data may obtain information about an applicant that it is prohibited from acquiring and using as part of its credit decision under the ECOA, thereby impacting its fair lending compliance.

Another fair lending consideration is the potential application of the Servicemembers Civil Relief Act (“SCRA”).173 The SCRA limits the interest rate that may be charged on loans made to borrowers on active military duty and may require a rate adjustment on loans that were made to borrowers prior to the borrowers entering active military duty.174 In the loan servicing context, it is important to have procedures to ensure SCRA compliance so that servicemember benefit requests are properly handled and monitored on an ongoing basis.

4. **Debt Collection Practices**

Any third-party collection agents or servicers that a marketplace lender employs, and any marketplace lender who collects debts on behalf of others, must comply with the federal Fair Debt Collection Practices Act175 and similar laws in the applicable state when attempting to collect overdue payments from delinquent borrowers. Such laws prohibit abusive and harassing debt collection practices, limit certain communications with third parties, and impose notice and debt validation requirements. A

171 The CFPB has not issued guidance on the use of social media in the context of access to credit but has stated that creditors must “ensure that their scoring models do not have an unjustified disparate impact on a prohibited basis.”

172 The ECOA issues presented by social media should be addressed in credit policies and procedures to ensure that use of social media data is consistent and verifiable, that exceptions are managed, that underwriting is both predictive and fair to customers without a social media presence, and that adverse action notifications correctly reflect social media usage.


174 The CFPB has been aggressive in enforcing violations of the SCRA in servicing situations.

lender that acts as its own collection agent for any Borrower Loans will not be directly subject to the FDCPA but as a matter of prudence should comply with its provisions and will be subject to mandatory compliance with similar laws in certain states. The lender will be directly subject to the FDCPA if it acts as a collection agent for an affiliated issuer, purchasers of the Borrower Loans, or funds. See Section D, “Bankruptcy Considerations,” below. In the event a borrower files for bankruptcy, becomes the subject of an involuntary bankruptcy petition, or otherwise seeks protection under federal bankruptcy law or similar laws, a marketplace lender and its third-party collection agents must comply with the Bankruptcy Code automatic stay and immediately cease any collection efforts. Finally, marketplace lenders must consider provisions of the SCRA that permit courts to stay proceedings and the execution of judgments against servicemembers and reservists who are on active duty.

It should be noted that the CFPB has adopted rules setting forth its authority to supervise non-bank debt collectors that generate annual revenue in excess of $10 million from consumer debt collection activities. Even lenders whose revenues from collection activities are not sufficient to make them subject to direct CFPB supervision should consider voluntary compliance with the standards that the CFPB has established for debt collectors regulated by it.

5. Privacy Laws

Because of the personal and sensitive nature of the information that is collected from prospective borrowers, it is imperative that marketplace lenders comply with applicable laws and regulations governing the security of nonpublic personal information. In particular, the federal Gramm-Leach-Bliley Act (“GLBA”) limits the disclosure by a financial institution of nonpublic personal information about a consumer to nonaffiliated third parties and requires financial institutions to disclose certain privacy policies and practices, including with respect to the sharing of such information with both affiliates and/or nonaffiliated third parties. A privacy notification or policy must be provided at the time an account is opened and on an annual basis. If a financial institution chooses to share information with nonaffiliated third parties, borrowers must be given the right to opt out of such information sharing. States also have enacted privacy laws that may be applicable to marketplace lenders. Lenders are advised to consult with legal counsel to determine which, if any, state privacy laws may be applicable.

The GLBA also requires financial institutions to establish an information security program to ensure the security and confidentiality of customer records and information, protect against anticipated threats or hazards to the security or integrity of those records, and protect against unauthorized access to or use of those records or information. In order to assist financial institutions in developing an

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176 See the previous section on the FCRA which also contains requirements with respect to privacy and information sharing.
177 The GLBA governs “financial institutions,” which is defined to mean any institution the business of which is engaging in financial activities as described in section 4(k) of the Bank Holding Company Act of 1956 (which includes the lending of money). Marketplace lenders will most likely be deemed “financial institutions” for these purposes. The GLBA is codified at 15 U.S.C. § 6801-3809 and regulations are found at 12 C.F.R. pt. 1016.
appropriate information security program, the related federal agencies published the Interagency Guidelines Establishing Standards for Safeguarding Customer Information (“Security Guidelines”).\(^{178}\) Due to the inherent risks associated with maintaining information that is accessible over the Internet, a marketplace lender should review the Security Guidelines in connection with the development of its information security program.

Finally, the GLBA requires financial institutions to develop and implement a response program designed to address incidents of unauthorized access to customer information maintained by the institution or its service provider. The related federal agencies have also published Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice. In addition, most states have laws that would require a marketplace lender to notify customers of a breach of security in which personal information is reasonably believed to have been acquired or accessed by an unauthorized person. For example, the NYDFS recently finalized its cybersecurity rule, which imposes requirements that are more stringent than those imposed under the GLBA, as discussed further above under “Recent Developments.” As these laws vary from state to state in their applicability, the type of information that is covered, and the notification requirements, lenders are advised to consult legal counsel to determine the appropriate course of action should a data breach occur.

6. Electronic Commerce Laws

**E-Sign Act.** It goes without saying that Internet loan platforms execute borrower/lender registration agreements and process credit transactions in electronic form and that virtually all payments are processed through the Automated Clearing House (“ACH”) electronic network. Accordingly, marketplace lenders need to comply with the federal Electronic Signatures in Global and National Commerce Act (“E-Sign Act”)\(^{179}\) and similar state laws (particularly the Uniform Electronic Transactions Act), both of which authorize the creation of legally binding and enforceable agreements utilizing electronic records and signatures and set forth certain disclosure and consent requirements.\(^{180}\)

Federal consumer protection and disclosure laws allow consumers to receive legally required disclosures electronically if they consent to electronic disclosure prior to receiving the disclosure. Specifically, the E-Sign Act and regulatory guidelines provide that a borrower can consent to receive electronic records only if the consent is provided electronically in a manner that reasonably demonstrates that the borrower can access the information in the electronic form that will be used to provide the information. In addition, any information required by law to be provided in writing can


\(^{179}\) 15 U.S.C. § 7001 et seq.

\(^{180}\) It is suggested that applicants and borrowers be required to click through any legally required disclosures and terms and conditions of agreements to show that they have read the disclosures and agreements. Use of links to disclosures or legal documents poses additional risk, particularly if a link does not indicate the significance of the link. If it cannot be shown that the link was accessed, there may not be a legal basis to assert that the customer has received and read the disclosure or agreement. E-Sign requirements are also applicable to commercial lending arrangements.
be made available electronically to a borrower only if the borrower affirmatively consents to receive the information electronically and the lender clearly and conspicuously discloses certain required information to the borrower prior to obtaining his or her consent.

Worth Remembering: Having a proper form of E-Sign Act authorization and consent to receive disclosures electronically is crucial to the successful operation of an Internet lending platform. As a result, the timing and placement of the customer’s consent to electronic disclosures and contracting is important. It is a best practice to put the E-Sign consent first in a transaction as it must be obtained prior to the time that any disclosures are received or any contract is entered into. The consent should not be buried in a longer document but preferably presented as a standalone document requiring an affirmative act to show assent.

Courts are beginning to pay attention to these types of matters. In a recent case, the Seventh Circuit held that an arbitration clause in an online terms of use, eight pages into a ten-page agreement, was not sufficient to give proper notice of the arbitration agreement. In another recent case, also dealing with an arbitration agreement, a federal court held that checking a box to confirm reading of an agreement was not enough to bind the borrower where the online lender held all of the electronic records. These recent cases demonstrate that courts are scrutinizing online programs and documentation in light of consumer protection considerations. This suggests that marketplace lenders need to provide disclosures clearly and obtain a consumer’s agreement to important documents such as electronic contracts and arbitration agreements by affirmative action to effectively demonstrate their consent.

Electronic Funds Transfers. With respect to electronic payments, since marketplace lenders are not typically organized as banks, they must rely on eligible financial institutions (such as FDIC-insured banks) both to fund the Borrower Loans and to receive payments over the ACH network. The Electronic Funds Transfer Act (“EFTA”) and its implementing Regulation E establish the rights, responsibilities, and liability of consumers who use electronic fund transfers and of financial institutions and certain other parties that offer these services. These laws contain disclosure and

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181 In an Internet context, additional legal concerns can be created if more than one individual is involved in the process. For example, joint applicants or guarantors raise the issues of appropriate customer identification, E-Sign consent, and authorizations. Legal counsel should be consulted on these matters. Special issues also arise with respect to lending secured by real or personal property.

182 Sgouros. TransUnion Corp. et al., Case No. 15-1371 (7th Cir. Mar. 25, 2016). The “I Agree” button appeared below a notice that the consumer was agreeing to have its personal information viewed and that said nothing of arbitration. The court said that the site did not sufficiently notify customers that they were signing the agreement and consenting to arbitration. The court also stated that where terms are not displayed but must be brought up via hyperlink, there should be a clear prompt directing the user to read such terms. Contract law requires that a website provide a user reasonable notice that use of the site or clicking on a button constitutes assent to an agreement.


dispute resolution requirements and require a party that wishes to automatically debit a consumer account for a payment to obtain written authorization from the consumer for such automatic transfers.185

Key Consideration: Under the EFTA, a lender cannot require a borrower to make payments by electronic means. However, a lender may provide an incentive for making payments electronically.186 Thus, an appropriate customer authorization for automatic debits and compliance with Regulation E are essential to Internet lending programs.187 The authorization must be in writing and signed by the borrower, and a copy of the authorization must be provided to the borrower. As suggested by the recent cases, placing such an authorization within another document may not be sufficient to show proper consent to the electronic transfer of funds as is required by the EFTA. As a result, it is a best practice to have a separate authorization for a preauthorized transfer from a borrower’s account for payment of a loan.

Two courts have considered the practice of requiring the borrower to sign an electronic funds transfer ("EFT") authorization for loan payments but allowing the customer to cancel at any time, even before the first loan payment is made. Both courts found this practice to be a violation of Regulation E and the EFTA. In De La Torre v. CashCall, Inc., the lender used a promissory note containing an EFT authorization which included language allowing cancellation of the authorization at any time.188 In order to comply with the signed writing requirement, the lender required the borrower to check a box indicating its authorization for EFTs. If the borrower did not check the box, it could not obtain a loan. Once the loan was funded, the borrower could cancel the authorization at any time, including prior to the first loan payment date. The court found that this practice violated the EFTA and Regulation E, which prohibit conditioning an extension of credit on repayment via EFT. The court reasoned that the violation occurs at the time the lender requires the authorization to receive the loan, notwithstanding any later ability to revoke or use another means of payment. This case was decided on a motion for summary judgment, so it was a ruling on the merits and the court ordered a hearing to determine

185 The law and regulation impose certain requirements upon these authorizations. The authorization may be in a set amount (e.g., the monthly payment amount) or a range (which could provide for the inclusion of late payment or other fees). However, the customer is entitled under the law to receive notice of any amounts varying from the specified transfer amount or range. The customer must also have the right to terminate the automatic payments.

186 Although it might seem proper to provide an interest rate reduction for making payments electronically, a disincentive could violate the EFTA. For example, charging a fee for paying by check could violate both the EFTA and state laws that may prohibit such fees. Litigation is pending on this subject. Care should also be taken with respect to how payment options are presented. Prefilled boxes are likely to be viewed as a potential unfair practice.

187 It should be noted that payday lenders have been subjected to regulatory scrutiny for electronic payments. The New York banking regulator instructed financial institutions not to make ACH transfers to high-rate lenders. Similarly, the Department of Justice has been criticized for “Operation Choke Point,” aimed at cutting off high-rate Internet lenders from the ACH and payments systems. Several subpoenas were issued under this program and at least one bank has entered into a settlement with the DOJ for processing payments for a high-rate Internet lender. Access to the payment systems for Internet lenders continues to be an evolving issue, particularly for high-rate or payday lenders.

188 56 F. Supp. 3d 1073 (E.D. Cal. 2014).
damages on the claim. The court also found that this practice violated the California Unfair Competition Law.

Similarly, another court reached the same conclusion on similar facts. In FTC v. Payday Financial, LLC, the lender had an EFT authorization in its loan agreement and required borrowers to sign it in order to obtain a loan.189 As in De La Torre, the borrower had the ability to revoke its authorization prior to the first loan payment. However, since the borrower had no choice but to authorize the EFT to obtain a loan, the court found that the lender had violated the EFTA and Regulation E. Based on these cases, there is a significant risk of violation of law and regulation, and the potential for UDAP/UDAAP-type claims as a result of such a practice. Our experience is that lenders are now providing choices for payment and making loans regardless of what payment option is chosen. Accordingly, any practice that does not provide a choice or payment or that prevents a borrower from obtaining a loan if it does not sign an EFT authorization under current precedent and in this regulatory environment would likely be subject to challenge, litigation, and a finding of a violation.190

Although the EFTA requirements are not new, the CFPB recently issued a Compliance Bulletin reiterating the importance of complying with the provisions of the EFTA.191 Specifically, the CFPB emphasized that an EFT authorization must be identified as such, must be clear and understandable, and must evidence the consumer’s assent to allow the authorization.192 This issuance suggests that the CFPB may be concerned about the compliance of online lending programs.193

### 7. Other Relevant Laws

**Bank Secrecy Act Regulations.** The federal Bank Secrecy Act194 and related laws require any bank making a loan, and therefore the Funding Bank in the case of Internet loans and, in some cases, the marketplace lender, to adopt policies and procedures to monitor and enforce the following:

- Establish a customer identification program to verify the true identities of borrowers before an account is opened and provide a notice regarding its use of personal information to confirm a customer’s identity;

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190 It is our understanding that the CFPB analyzes the EFT practices of creditors for compliance with the EFTA, has issued civil investigative demands (CIDs), and considers enforcement actions related to compliance with EFTA.


192 The EFTA contains specific requirements about preauthorized transfers. Recurring amounts are allowed if they are of the same amount or within a reasonable range. However, amounts that vary from the preauthorized amount are subject to additional requirements and restrictions.

193 Typically when the CFPB promulgates a compliance directive, it means that it will be examining institutions for compliance with the directive and will bring enforcement actions for violations.

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- Determine whether borrowers are on any list of known or suspected terrorists or terrorist organizations issued by federal agencies such as the Office of Foreign Assets Control (“OFAC”) and reject any borrower whose name appears on such list;\(^\text{195}\)

- Report suspicious account activity that meets the thresholds for submitting a Suspicious Activity Report (“SAR”); and

- Implement an anti-money laundering and information sharing program.

The marketplace lender will need to cooperate with the Funding Bank in the implementation of these policies and procedures and also adopt internal procedures to establish compliance with those regulations to which it is directly subject.

In addition to banks, the Bank Secrecy Act applies to finance companies, including commercial lenders.\(^\text{196}\)

**Fair Credit Reporting Act.**\(^\text{197}\) The FCRA contains several provisions potentially applicable to marketplace lending. First, a consumer report (or credit bureau report including a credit score) may be obtained only for a permissible purpose, which includes application for credit. However, until there is a clear desire to apply for credit, written authorization is required in order to provide the permissible purpose. The one exception is where prescreening is utilized in connection with a preapproved offer of credit. Where a consumer report is used for this purpose, a firm offer of credit must be provided and a notice and right to opt out of future prescreening must be provided.

The FCRA requires financial institutions that wish to share certain customer information with their affiliates to provide a notice and the right to opt out of such sharing. A disclosure regarding risk-based pricing must be provided to consumers in certain circumstances, and a notice must be provided prior to or within 30 days of submitting negative information about a consumer to a credit bureau. In addition, financial institutions are also subject to the “Red Flag Rule,” which requires policies and procedures to identify patterns, practices, or activities that indicate the possible existence of identity theft and appropriate responses.

**Telephone Consumer Protection Act.**\(^\text{198}\) The TCPA requires that an entity obtain prior written consent before contacting consumers on their mobile phones via an automatic telephone dialing system and/or using an artificial or prerecorded message. Most marketing messages to any phone are also covered.

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\(^{195}\) This topic surfaced in December 2015 when it was reported that one of the shooters in the San Bernardino, California killing of 14 people had obtained a loan from a marketplace lender just weeks prior to the attack. However, the individual had passed both identification checks and an OFAC screening. Thus, any lender would not have been able to make a determination that this individual should not have received a loan.

\(^{196}\) 31 C.F.R. pt. 103 (Customer Identification Procedure Rule).


Worth Remembering: It is recommended as a best practice that appropriate TCPA consent be obtained where the consumer’s phone number is requested. If consumers are asked to provide phone numbers as part of a loan application, and in particular if mobile numbers are specifically requested, the TCPA disclosure should be provided and consent obtained. Consumers must also have the ability to revoke their consent to be called under the TCPA.

The TCPA poses compliance challenges and has been a hotbed for current litigation, as discussed above under “Recent Developments.” Damages are $500 per call for negligent violations and $1,500 per call for willful violations. Over 2,000 lawsuits are pending due to the potential windfall from such damages, which are unlimited under the TCPA. As a result, most TCPA actions are filed as class actions.

The Federal Trade Commission also manages the National Do Not Call Registry that prohibits telemarketing sales calls to individuals who have signed up on the registry. In addition, some 40 states have laws restricting telemarketing. The state laws are not uniform. Care should be taken in any telephone marketing situation and where autodialers, prerecorded messages, or calls to cell phones are being made.

CAN-SPAM. The CAN-SPAM Act establishes requirements for anyone who sends commercial or transactional messages by email and gives recipients of commercial emails the right to ask to be placed on an opt-out list. A commercial email is one whose primary purpose is promoting or advertising a commercial product or service, while a transactional email is one that facilitates an agreed-upon transaction or updates a customer in an existing business relationship. A commercial email is subject to more restrictions than a transactional one, for example, restrictions on sender information and subject line, identification as an advertisement, and provision of an opt-out method. However, a transactional email cannot contain false or misleading routing information. The CAN-SPAM Act applies to emails sent to both consumers and business entities.

The law provides penalties for noncompliance for both the company that sends the email and the company whose products are advertised in a commercial email. The sender is subject to a penalty of up to $16,000 for each unlawful email. Due to the potential for damages, care should be exercised if email messages are utilized as part of a marketplace lending program.

D. Bankruptcy Considerations

1. Addressing Insolvency Risk

As Platform Notes are pass-through obligations of the Operators, and not direct obligations of the borrowers under the related Borrower Loans, holders of Platform Notes are exposed to the Operator’s

credit risk. An Operator that becomes subject to bankruptcy proceedings may be unable to make full and timely payments on its Platform Notes even if the borrowers under the related Borrower Loans timely make all payments due from them. A number of different aspects of the bankruptcy proceedings could result in investor losses. First, other creditors of the Operator may seek access in the bankruptcy proceeding to payments made on the Borrower Loans. Second, a bankrupt Operator may no longer have the financial capacity to continue to service the Borrower Loans and/or may reject its servicing agreement as an executory contract. Third, the investors will be subject to the Bankruptcy Code’s “automatic stay” and therefore will be prohibited from taking legal action against the Operator to enforce their rights to payment. Fourth, the Bankruptcy Court may not recognize investor claims for interest that accrued on the Platform Notes after the bankruptcy proceedings commenced. An Operator could endeavor to mitigate some of these risks by granting the indenture trustee a security interest over the Borrower Loans, the Collections Account, and the proceeds thereof. It may also enter into a “backup” servicing agreement with an unaffiliated company pursuant to which the backup servicer agrees to service the Borrower Loans if the Operator can no longer do so. Any such measures, however, will provide the holders with less than complete protection. The holders of secured Platform Notes, for example, will remain subject to the automatic stay. It’s also not certain that the Bankruptcy Court would require that the proceeds of each Borrower Loan pledged as collateral be applied to the payment only of the related Platform Notes. If, instead, the Bankruptcy Court (which has broad discretionary powers under the Bankruptcy Code) permitted the proceeds of the Borrower Loans to be applied on a pari passu basis to pay all amounts due on the Platform Notes, holders of Platform Notes could incur losses by reason of defaults on Borrower Loans other than the specific loans that they had elected to fund. Similarly, a backup servicer—particularly if it has not been appointed under a “live” backup servicing arrangement—may be unable immediately to service the loans if the Operator stops servicing them. Any lag that occurs between the termination (or withdrawal) of the Operator as servicer and the backup servicer’s assumption of full servicing duties could significantly reduce loan collections and cause related losses on the Platform Notes.

**Caution:** Platform Note investors are not necessarily isolated from Operator insolvency risk. The degree of the risk is significantly affected by the platform structure and can be reduced by organizing a bankruptcy-remote issuer.

The risks to the Platform Note holders will be particularly acute if, as may be the case, the Operator does not pledge the Borrower Loans to secure the Platform Notes and is permitted by its governing documents to incur other indebtedness that is not subordinated to the Platform Notes and/or is permitted to pledge the Borrower Loans to secure indebtedness other than the Platform Notes. In this situation the holders may see some or all of the collections on the Borrower Loans paid to other creditors of the Operator if the Operator becomes bankrupt. The risk to investors also is heightened if the Operator is thinly capitalized and/or has exposure to significant potential liabilities (e.g., pending litigation claims). It seems likely that many retail investors in Platform Notes—withstanding any
related prospectus disclosures—will not fully appreciate the scope of the Operator credit risk that they have assumed. Institutional investors, however, are well aware of these risks and have insisted that Operators address them as a condition to committing significant capital to Platform Notes. In response to this pressure, Operators have implemented two different operating structures that are intended to isolate investors from Operator credit risk.

The first of these structures provides for the Operator to form a wholly-owned subsidiary (the “Affiliated Issuer”) that will assume the rights and obligations of the Operator under its agreements with the Funding Bank, the indenture trustee, other service providers, and the borrowers and lenders. The Affiliated Issuer will purchase the Borrower Loans from the Funding Bank and issue the Platform Notes in its own name. The Affiliated Issuer also will license or purchase the Operator’s proprietary technology and become the website operator. Simultaneously, the Affiliated Issuer will appoint the Operator to provide back-office services, to perform (or supervise the performance of) all of the Affiliated Issuer’s obligations to third parties, to service all of the Borrower Loans, and to manage both platform operations (including the issuance of Platform Notes) and the website as its agent. The Affiliated Issuer will pay the Operator a servicing fee tied to the amounts of origination and servicing fees it receives from borrowers and investors. The Affiliated Issuer will have no employees and the Operator will perform its servicing duties through its own employees. The Operator will remain the sole lessee under all office and equipment leases. The Affiliated Issuer will not incur any indebtedness other than the Platform Notes and will not accept liability for any claims made against the Operator including, if applicable, any preexisting litigation claims. The Affiliated Issuer’s governing documents will prohibit it from engaging in any business other than the issuance of Platform Notes and related activities and otherwise will impose limitations on its activities intended to reduce the likelihood that it will become subject to voluntary or involuntary bankruptcy proceedings. The structure therefore (i) makes the Operator solely responsible for the platform’s operating expenses (other than the servicing fees payable to the Operator itself), (ii) isolates the Affiliated Issuer from the Operator’s preexisting or future liabilities, and (iii) provides for the issuance of the Platform Notes through a special-purpose, bankruptcy-remote entity (i.e., the Affiliated Issuer) that will have no significant liabilities other than the Platform Notes.

The issuance of Platform Notes through an Affiliated Issuer will not benefit investors, however, if the Operator becomes bankrupt and the Bankruptcy Court uses its equitable powers to order “substantive consolidation” of the Affiliated Issuer and the Operator. Substantive consolidation is a judicially developed doctrine that, if applied, disregards the separate legal existence of a bankruptcy debtor and one or more of its affiliates, resulting in a combination of assets and liabilities and the elimination of intercompany claims between the entities being consolidated. Creditors of each entity become creditors of the combined entity. Although the court decisions that have ordered substantive consolidation have not always used the same analysis, in general a Bankruptcy Court could decide to consolidate two entities if (i) creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, or (ii) their financial affairs are so entangled
that consolidation will benefit all of their creditors. The Bankruptcy Court may also consider whether the benefits of substantive consolidation would outweigh the harm it would impose on any particular creditors. In the context of P2P lending, substantive consolidation of an Affiliated Issuer with a bankrupt Operator could make the Affiliated Issuer’s assets (i.e., the Borrower Loans) available for the payment of the Operator’s liabilities (although, as discussed above, the risk that creditors other than investors would have access to payments on the Borrower Loans may be mitigated if the Affiliated Issuer grants a security interest in the Borrower Loans and the Collections Account). Any such result would make the Affiliated Issuer structure pointless since holders of the Platform Notes would remain exposed to the Operator’s credit risk.

An Operator that forms an Affiliated Issuer therefore must structure its program carefully to reduce the risk of substantive consolidation. The fact that the Affiliated Issuer will engage the Operator to manage the website and oversee the performance of the Affiliated Issuer’s contractual duties does not by itself mean that substantive consolidation would (or should) be ordered if the Operator were to become bankrupt. It is instead common in securitization transactions for the transaction sponsor and the special purpose issuer that it forms and services to address substantive consolidation risk by making certain “separateness covenants” intended to ensure that the parties will maintain separate legal identities and to make clear to investors that neither party is liable for the other’s debts. Although P2P lending does not involve traditional asset securitization, Operators and any Affiliated Issuers should follow the same approach. To that end, among other covenants the Affiliated Issuer should undertake to (i) conduct its business only in its own name, (ii) strictly comply with all organizational formalities required to maintain its separate existence, (iii) maintain its own separate books, records, and bank accounts, (iv) prepare its own financial statements and tax returns, (v) pay its liabilities only out of its own funds, (vi) maintain adequate capital in light of its contemplated business purpose, transactions, and liabilities, (vii) not hold out its credit or assets as being available to satisfy the obligations of others, and (viii) maintain an arm’s-length relationship with the Operator and its other affiliates. Without limitation to the foregoing, the Affiliated Issuer should operate the P2P website in its own name (rather than that of its parent) and should execute in its own name all contracts with borrowers and lenders. If these and similar steps are taken (and the parties in fact observe their respective undertakings), there should be little risk that a Bankruptcy Court overseeing Operator bankruptcy proceedings would substantively consolidate the Operator and the Affiliated Issuer.200

200 It should be noted, however, that if the Affiliated Issuer structure is used, because of the nature and extent of the Operator’s continuing involvement in managing the website, evaluating proposed loan postings, assigning proprietary credit ratings, participating in the loan origination process with the Funding Bank, and servicing the Borrower Loans, the SEC may deem the Operator to be offering “management rights” or an “investment contract” that constitutes a security that must be separately registered under the Securities Act. See “Recent Developments—SEC Comments on the Status of Marketplace Loans as Securities” above. Because such an approach results in prospective lenders being offered two separate securities by distinct but affiliated issuers in order to make an investment in Platform Notes, and therefore may arguably be confusing to investors as to whether they are looking to the Operator or the Affiliated Issuer, or both, as the party responsible to them for specific aspects of their investment, the substantive consolidation analysis becomes more complex. Under these circumstances, in addition to strict adherence to the “separateness covenants,” the manner in which the respective roles and obligations of the Operator and the Affiliated Issuer are presented in the disclosure in the offering materials, as well as
The second approach that Operators have utilized to address Operator credit risk also entails the formation of a special purpose entity to issue pass-through securities but differs from the first approach insofar as the Operator itself continues to issue Platform Notes. Specifically, under the second approach the Operator forms (i) an investment fund that offers partnership interests or similar securities to institutional and/or high net worth investors on a private placement basis (the “Fund”), (ii) a subsidiary that acts as the Fund’s general partner and investment manager (the “Manager”), and (iii) a statutory trust or similar special purpose company that purchases Borrower Loans (or portions thereof) from the Operator (the “Trust”). The Fund will use its members’ capital contributions to purchase certificates (“Certificates”) from the Trust and the Trust in turn will use the Certificates’ purchase price to purchase the Borrower Loans from the Operator. Each Certificate will represent the right to receive all principal and interest payments (net of servicing fees) made on the related Borrower Loan. The Trust will appoint the Operator to service all Borrower Loans that it purchases. Although all Borrower Loans will continue to be funded through the website and initially will be purchased by the Operator from the Funding Bank, this structure largely eliminates Operator credit risk for the Fund investors by enabling them indirectly to invest in pass-through securities issued by an SPE (i.e., the Trust) rather than in Platform Notes issued by the Operator.

The establishment of Funds rather than an Affiliated Issuer may offer the Operator greater flexibility in tailoring investment opportunities to specific investor interests. Stated differently, the Operator may be able to broaden its appeal to different institutional investors by forming multiple Funds that differ from one another in investment periods, management fees, minimum commitments, and/or investment strategies. An Operator that uses an Affiliated Issuer will not have such opportunities. At the same time, the use of Funds can have some disadvantages. As an initial matter, unless the Fund registers its interests under the Securities Act (and incurs the substantial related expenses) or is willing to observe the Regulation A+ offering cap, it will be permitted to offer its interests only to institutional and/or high net worth investors. The Operator accordingly will want to continue to sell Platform Notes through its website. The purchasers of the Platform Notes, however, will continue to have exposure to Operator credit risk. The Fund structure therefore can result in retail investors who purchase Platform Notes having greater exposure to such credit risk than institutional investors who acquire Fund interests. In addition, the Manager (i) may need to register as an investment adviser, and (ii) will need to develop an investment strategy that fairly allocates the Borrower Loans available for investment (or portions thereof) between the Fund and direct purchasers of Platform Notes. See “Investment Advisers Act” above. Finally, although Fund investors may find it convenient to invest in Borrower Loans through the Fund (and thereby rely upon the Manager rather than their own efforts to identify specific Borrower Loans for investment), the management fees they pay to the Fund may exceed the servicing fees that Platform Note purchasers pay to the Operator.

the context in which each appears on the website, becomes critical if potential confusion as to which entity is responsible for what (which could provide an argument in favor of substantive consolidation) is to be avoided.
As a final point, it should perhaps be noted that neither of the two structures fully eliminates the servicing risks associated with an Operator bankruptcy. In particular, a bankrupt Operator may be entitled to reject its servicing agreement as an executory contract and/or may need to obtain bankruptcy court approval to transfer its servicing duties to a backup servicer. Any such rejection or delay would not by itself expose investors to claims by the Operator’s creditors but could result in collections on the Borrower Loans being delayed or reduced. The funds available for distribution to investors similarly would be reduced if the backup servicer charges higher servicing fees than the Operator had charged.

2. Security Interests in Electronic Collateral

As described above, careful structuring can significantly reduce the risk that the Platform Notes issuer will become subject to bankruptcy proceedings. It’s nonetheless impossible to be certain that such proceedings won’t occur or that outside creditors won’t assert claims against the issuer’s assets. An Operator therefore may choose to offer the noteholders additional protection by issuing its Platform Notes under an indenture and granting the indenture trustee a security interest over the underlying Borrower Loans. If the Operator subsequently does become insolvent, the security interest should provide the indenture trustee with a first priority claim on any Borrower Loan proceeds. The security interest thus helps to ensure that any collections received on the Borrower Loans (including the proceeds of any dispositions) will be applied in the insolvency proceeding to the payment of the Platform Notes in priority over any claims that other Operator creditors might assert. An SPE that issues ABS in a securitization similarly will pledge its pool of Borrower Loans to an indenture trustee for the benefit of the ABS investors. Outside of the context of securities issuances, any bank or other commercial lender that extends credit to an institutional investor for the purchase of Borrower Loans will try to reduce its potential exposure to a borrower default by requiring the borrower to grant a security interest over the purchased loans.

Any security interest taken by an indenture trustee or lender must be properly “perfected” to have its intended effect. The perfection of security interests in most types of collateral is governed by Article 9 of the Uniform Commercial Code (the “UCC”). The UCC has been enacted in every state (subject to certain variations between the states). The specific actions that creditors must take to perfect their security interests differ depending upon the type of collateral. The payment obligations due under an unsecured consumer note should constitute “payment intangibles” for purposes of Article 9. A creditor can perfect its security interest in a payment intangible by (i) taking possession of the instrument evidencing the payment obligation (e.g., a physical promissory note), or (ii) filing a financing statement disclosing the security interest with the Secretary of State (or other appropriate authority) of the state in which the debtor is organized. A security interest perfected by possession will take priority over one perfected by filing. Accordingly, lenders who extend credit against physical promissory notes typically take actual possession of the original loan note and related documents (or require the borrower to deliver the same to a lender custodian).
The drafters of Article 9 did not anticipate the widespread use of electronic promissory notes. Accordingly, with the exception of electronic chattel paper (as discussed below), no procedures are specified for the perfection of security interests in electronic promissory notes other than those that generally apply to payment intangibles. As electronic notes can be transmitted, reproduced, and/or printed in multiple copies at any time, there is no apparent mechanism by which a creditor can take physical “possession” of an unsecured electronic note in a manner that would necessarily be recognized as sufficient to perfect the creditor’s security interest. The creditor should instead file a financing statement covering the collateral in the applicable jurisdiction. A properly filed financing statement covering unsecured electronic notes should take priority over any creditor who claims to have “possession” of the notes. If more than one financing statement is filed in relation to the same notes, the financing statement with the earliest filing date will have priority.201

The UCC does include specific provisions governing the perfection of security interests in electronic chattel paper. In relevant part, “chattel paper” is defined as a “record or records that evidence both a monetary obligation and a security interest in specific goods.” The Borrower Loans funded through a P2P program are not “chattel paper,” because the borrower’s payment obligations are not secured. Other types of Internet-originated loans, such as a commercial loan that is secured by specific equipment or goods, may constitute electronic chattel paper. The UCC permits a creditor to perfect a security interest in electronic chattel paper through “control,” and security interests thus perfected will take priority over any perfected by filing. A creditor will be deemed to have “control” of electronic chattel paper if, among other requirements, there exists “a single authoritative copy” of the paper which is “unique, identifiable and [with limited exceptions] unalterable” and such authoritative copy is “communicated to and maintained by the secured party or its designated custodian.” Although the UCC does not indicate how the parties are to create a “single authoritative copy,” creditors who are secured by electronic chattel paper often arrange for an e-service provider to act as custodian of the electronic records. The custodian will hold each electronic record in a dedicated electronic “vault” (with the copies so held being deemed to constitute the authoritative copies), will “tag” each authoritative copy with an electronic identifier that permits it to be distinguished from all other electronic copies of the same record, and will otherwise employ procedures intended to provide the creditor with requisite degree of “control.”202

201 Under the UCC, a purchase of payment intangibles technically is perfected when the security interest “attaches” (e.g., when a loan purchaser has paid the purchase price to the seller under a written agreement). However, given the large number of Borrower Loans that are typically transferred to institutional investors in whole-loan purchase programs or to ABS issuers in securitizations, and the multiple electronic copies of the promissory notes and other loan documents that typically will exist, the purchaser should file a financing statement rather than rely solely upon automatic perfection. Doing so helps to ensure that the purchaser will retain a perfected security interest even if the characterization of the transaction as a “sale” is later disputed.

202 The creditor also should file a financing statement so that it will retain a perfected security interest even if the custodial arrangements are later determined not to have established “control.” A creditor secured by electronic notes other than electronic chattel paper also could decide to implement custodial arrangements of this type but, as discussed, doing so will likely not be sufficient under Article 9 to perfect the creditor’s security interest.
The Regulation of Marketplace Lending: A Summary of the Principal Issues (March 2017 Update)

**Takeaway:** The UCC has not been updated to address the perfection of security interests in unsecured electronic notes. Warehouse lenders and whole loan purchasers should carefully review the security arrangements in their transaction documents to ensure that their interests are fully protected.

E. **Tax Considerations**

1. **Tax Treatment of Platform Notes**

The appropriate treatment of Platform Notes for U.S. federal income tax purposes is uncertain and the related rules are complex. Among other possibilities, the Platform Notes could be characterized for tax purposes as debt instruments of the Operator (the "Debt Approach") or as loan participations, or even as an equity interest in the Operator. The tax consequences to both the Operator and investors can vary substantially depending upon the characterization chosen. In the absence of guidance from the Internal Revenue Service (which has not yet been publicly provided), it’s not possible to be certain which characterization is "correct." Both LendingClub and Prosper, however, have opted for the Debt Approach, and this choice does appear to be among those best suited to the economic substance of Platform Notes. The remainder of this section therefore focuses on the consequences of the Debt Approach. Prospective Operators are nonetheless reminded that they must carefully review with their counsel the tax treatment of any Platform Notes that they issue.

Under the Debt Approach, the Operator generally will recognize as income all interest that accrues on the Borrower Loans and will take a corresponding deduction for all interest amounts payable on the Platform Notes. Accordingly, the Operator will recognize as taxable income only those amounts (such as its servicing fee) that will not be paid through to the investors. The Debt Approach also requires that the Operator and the investors treat the Platform Notes as debt instruments issued with original issue discount, or "OID." In subjecting the Platform Notes to reporting under the OID rules, investors effectively are required to report income for federal income tax purposes with respect to Platform Notes on an accrual rather than a cash method of accounting. Accrual accounting does, in general, more clearly reflect the investor’s economic income—but it also requires the investor to forego the otherwise potentially tax-advantageous income deferral that cash method accounting might allow.

While the application of the OID rules to the Platform Notes is complex, the rules generally will require each investor to include in income for each taxable year an amount equal to the accrued, constant yield earned with respect to its Platform Note, determined on the basis of the Platform Note’s projected

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203 Platform Notes treated as debt instruments, and treated as issued by the Operators, would be subject to the OID rules to the extent that interest on those notes is not regarded as "unconditionally payable"—a reasonable assumption given that interest is payable only to the extent received on an underlying Borrower Loan.

204 Illustrative discussions of these modifications and other related Platform Note tax consequences (e.g., market discount and premium) may be found in the tax discussions set forth in the disclosure documents for Prosper and LendingClub.
payments (net of Operator servicing fees but without regard to any potential default on the underlying Borrower Loan) and the Platform Note’s issue price (generally, its principal amount). This treatment will cause all stated interest on the Platform Note to be reported as OID, which (like interest) would constitute ordinary income; payments of interest and principal on the Platform Note would be treated first as a payment of accrued OID, and then as a payment of principal. A variety of special rules address and modify this baseline treatment in the event of payment delays on the underlying Borrower Loan (generally requiring a continuing accrual of Platform Note OID, notwithstanding late payment or nonpayment of the related underlying cash), Platform Note prepayment (or extension), Platform Note worthlessness, and Platform Note sale.

**Don’t Get Caught Short:** Platform Note investors who hold their notes in taxable accounts should remember that, under prevailing practice, they will be required to recognize income on an accrual basis for federal income tax purposes and accordingly, during any given reporting period could be required to recognize taxable income in excess of their related cash receipts.

Operators will be required under the Debt Approach to provide each investor with an annual statement on Form 1099-OID (or other applicable form) reporting the aggregate amount of OID accrued on the investor’s Platform Notes. The Operator also must file a copy of each such statement with the Internal Revenue Service. As investors typically will purchase multiple Platform Notes representing partial interests in a substantial number of different Borrower Loans, an Operator must implement procedures to aggregate the OID accrual information for each investor across multiple investments and to prepare and timely file the related reports. An Operator that fails to do so could be subject to financial penalties imposed by the Internal Revenue Service for deficient information reporting.

The fact (as discussed above) that the Debt Approach is not the only possible tax characterization of the Platform Notes does leave the investors at some risk of economic disruption if the Internal Revenue Service later requires a different characterization. Any such change in tax characterization could significantly affect the amount, timing, and character of the income, gain, or loss that an investor will recognize for tax purposes from an investment in Platform Notes. Equity for tax treatment of the Platform Notes—i.e., treatment as Operator stock—in particular could be adverse as the Operator could no longer claim interest or OID deductions for payments or accruals made on the Platform Notes, and non-U.S. holders of the Platform Notes could become subject to 30 percent withholding tax (i.e., the Operator would be required to withhold 30 percent of each interest or OID payment due to the non-U.S. holder, remitting the same to the Internal Revenue Service in satisfaction of the holder’s presumed U.S. tax liability in respect of such payments). In general, tax withholding on payments to non-U.S. holders would not be required if (as contemplated by the Debt Approach) income on the Platform Notes is properly treated as interest or OID. In order to limit the risk to investors that would result
from equity recharacterization, an Operator might choose to offer its Platform Notes only to U.S.
persons.205

2. Direct Investments in Marketplace Loans by Non-U.S. Persons

As previously discussed, most marketplace lenders do not issue Platform Notes but instead fund
themselves through other means. In many cases, these other means include securitizations and sales
of whole loans to institutional investors. A full discussion of the tax issues facing securitization and/or
whole-loan investors is beyond the scope of this white paper. We would, however, like to highlight
one issue that can strongly discourage foreign investors from purchasing whole loans and certain ABS
tranches: U.S. withholding tax. Specifically, absent an exemption, non-U.S. investors generally will be
subject to 30 percent U.S. withholding tax on gross payments of interest (and OID) made on any direct
investments they make in marketplace loans. For these purposes, “direct” investments include both
whole loans directly purchased by the foreign investor and equity tranches in marketplace loan
securitizations or other funding vehicles. The potential for U.S. withholding tax can create a particular
problem for start-up marketplace lenders who intend to borrow their initial lending capital from
foreign investors (as can often happen when the sponsors of the lender are themselves foreign).
Fortunately, certain structures can be employed that may provide an exemption from the withholding
requirement. First, it is becoming increasingly common for marketplace loans to be documented with
terms intended to satisfy the “registered form” provisions of the Internal Revenue Code.206 The goal
is to qualify any whole-loan purchasers for a withholding exemption generally available to non-U.S.
purchasers of bonds and similar debt securities (the so-called “portfolio interest” exemption).207
Securitization and funding structures also are often designed indirectly to achieve the same result with
respect to loans that are not in registered form, by first repackaging the loans in pass-through trusts
that issue certificates of beneficial interest which are themselves in registered form.208 Second, some
foreign investors who purchase newly originated marketplace loans may be subject to U.S. net income
taxation if by reason of those investment activities (together with any other similar activities) the
investor is deemed to be engaged in a trade or business of making loans in the United States. To help
reduce that risk, some marketplace loan purchase facilities provide for the originator or a third party
to “season” or warehouse the loans by retaining them for a specified period of time (often at least 30

205 Prosper, for example, does not permit non-U.S. residents to register as members on its platform. LendingClub restricts only
non-U.S. borrower members while evidently allowing non-U.S. residents to purchase Platform Notes, but its disclosure
documents indicate that the percentage of such notes held by such persons from inception through June 30, 2014, amounted
to just 2.4 percent (by principal)—and the disclosure informs investors that those sales could result in fines and penalties
(which may refer to penalties for failure to withhold tax). Further, neither Operator provides assurances or comfort in its
tax disclosure regarding the tax consequences of an investment in Platform Notes to non-U.S. investors, perhaps shifting
(or, at least, allowing for shifting by allowing for withholding) the withholding risk introduced by any such investors.

206 Generally, these provisions condition transfers of ownership interests in the loan upon the recording of that transfer in a
registry of ownership.

207 The portfolio interest exemption is not available to certain affiliates of the loan seller and/or securitization sponsor.

208 This technique was originally authorized by U.S. Treasury Regulations in order to facilitate non-U.S. investment in pools
of mortgage loans, since such loans were also traditionally not documented in registered form.
days, but ranging as widely as from 5 to 90 days) before they are sold to the investor. The extended retention period bolsters the argument that the investor is purchasing the loans in a secondary market investment transaction (rather than as part of a business of originating loans) and therefore is exempt from U.S. net income tax under a safe harbor provided for “securities trading.”

**F. Crowdfunding Rules**

The term “crowdfunding” is often used broadly to include any Internet platform that matches multiple investors with natural persons and/or companies seeking debt or equity financing. In this sense, peer-to-peer platforms engage in crowdfunding. So also do sites that permit interested persons to contribute funds to a company or project without any expectation of earning a financial return. There is yet another category of crowdfunding, however, that had long been anticipated by small investors and that is now a reality: small business equity or debt securities offerings. Specifically, Congress in 2012 concluded that the federal securities laws unduly impeded small business capital formation and, accordingly, in the JOBS Act directed the SEC to provide an exemption from securities registration to small businesses that engage in crowdfunding in compliance with specified criteria. After considerable delay—resulting partly from the need to consider the views of multiple constituencies but also from significant concerns within the SEC that the exemption could be abused—the SEC in November 2015 adopted final rules (the “Rules”) to implement the crowdfunding exemption. The Rules became effective in May 2016. The remainder of this section summarizes the key provisions of the Rules.

**Worth Remembering:** The SEC crowdfunding rules relate to a specific Securities Act exemption and include restrictions which make them unlikely to be useful to marketplace lenders.

Section 4(a)(6) of the Securities Act (as added by the JOBS Act) exempts from Securities Act registration any sale of equity or debt securities made by a company in compliance with the Rules. The company therefore will not be required to register its securities with the SEC or sell them in a Regulation D private placement but may instead sell them through a crowdfunding platform to any investor regardless of the investor’s annual income or net worth. It merits noting, though, that Section 4(a)(6) and the Rules can be used to provide financing only to companies and not to individuals. The Rules therefore cannot be used to provide credit directly to consumers. The Rules also cannot be used by certain other categories of companies, including any company that files periodic reports with the SEC.

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209 The securities trading safe harbor also requires that the purchaser purchase the loans at their market value on the purchase date. The required delay in the purchase date, together with the fact that the purchaser eventually may purchase the loans for less than par, very often makes it difficult for originators to offer these “season and sell” structures to interested non-U.S. investors.

210 These latter sites include such well-known venues as Kickstarter. The companies or projects that obtain funding through these sites may provide their backers with nonfinancial “perks” (e.g., samples of the company’s products), but they don’t transfer ownership interests to the backers and don’t undertake to repay the backers’ contribution with interest. As the sites don’t entitle the backers to any financial return on the contributed funds, they are not deemed to offer “securities” and therefore are not subject to securities or broker-dealer registration requirements under the federal securities laws.
under the Exchange Act (thus excluding any public company and many large private companies); any investment company, hedge fund, or similar vehicle; or any foreign company. Those companies that are eligible to use the Rules must observe a number of important conditions, including the following:

* The aggregate amount of securities sold by the issuer in reliance upon the Section 4(a)(6) crowdfunding exemption may not exceed $1 million in any 12-month period. Securities sold by the issuer in offerings registered with the SEC or pursuant to other exemptions will not count against the $1 million limit. An issuer therefore could undertake simultaneous Regulation D and Section 4(a)(6) offerings and could, in theory, sell unlimited amounts of the securities to accredited investors under Regulation D and not more than $1 million of securities to other investors under Section 4(a)(6). Since, however, issuers may not advertise crowdfunding securities (except to the limited extent discussed below), issuers and crowdfunding platforms must take certain precautions if the issuer will undertake concurrent Rule 506(c) and Section 4(a)(6) offerings, as any general solicitation the issuer uses in the Regulation D offering could otherwise be deemed an unlawful advertisement for the crowdfunded securities.

* Investors are strictly limited in the amount of securities they may purchase under Section 4(a)(6) in any 12-month period. Investors having an annual income and/or a net worth of less than $100,000 may purchase not more than the greater of $2,000 or 5 percent of the lesser of the investor’s annual income or net worth, and investors having both an annual income and a net worth of $100,000 or more may purchase not more than the lesser of $100,000 or 10 percent of the lesser of the investor’s annual income or net worth. Note that these caps are applied against the aggregate amount of securities the investor purchases from any issuer through any crowdfunding platform and therefore any purchase of crowdfunding securities by an investor will reduce the amount of other crowdfunding securities that the investor may purchase during the following 12 months.

* Neither the issuer nor certain associated persons may be subject to specified criminal convictions or other disqualifying events. The relevant events are substantially similar to those that apply under Rule 506. See “The Private Placement Rules” above.

* The issuer must conduct its offering through a single intermediary that is registered with the SEC as either a broker-dealer or a “funding portal.” The funding portal concept is new to the securities laws. It permits crowdfunding intermediaries—who otherwise would likely be subject to mandatory registration as broker-dealers—to register with the SEC under a simpler process and to avoid most of the ongoing compliance costs associated with broker-dealer registration. However, the Rules impose significant restrictions on funding portal operations. Among other matters, the funding portal may not offer investment advice or recommendations; solicit purchases, sales, or offers to buy the securities displayed on its platform; pay transaction-based compensation to its employees or agents; or hold, manage, or possess investor funds or securities. The funding portal also may not (absent suspicion of fraud) deny access to its website to an issuer based on the portal’s evaluation of the merits of
the offering. The portal may, however, apply objective criteria to screen issuers (for example, the portal could choose to list only issuers that are involved in a particular industry, are located in a particular geographic region, or are offering common stock or another particular kind of security). The funding portal must maintain communication channels by which investors can communicate with one another and issuer representatives regarding each offering on the platform. The portal also must become a member of the Financial Industry Regulatory Authority ("FINRA"), provide investors with certain educational materials, and comply with certain FINRA rules and applicable privacy laws, anti-money laundering laws, and recordkeeping requirements.

- The issuer must make specified disclosures. Among other items, the issuer must provide the intermediary and investors with descriptions of its business, ownership, capital structure, and financial condition; the names and backgrounds of its officers and directors; statements of its anticipated business plan and of any material risk factors; the target offering amount and the intended use of proceeds; and the offering price or method for determining the price. Any issuer offering more than $500,000 of securities must provide audited financial statements (subject to an exception for certain first-time issuers).\footnote{First-time issuers may provide financial statements reviewed (rather than audited) by an independent public accountant if the offering amount exceeds $500,000 but not $1 million. In determining the financial disclosure requirements, the offering amount will be deemed to include the current offering and any other offering made by the issuer under Section 4(a)(6) of the Securities Act in the preceding 12-month period.} If the offering amount exceeds $100,000 but not $500,000, the issuer must provide audited financial statements (if such statements are available) or statements reviewed by an independent public accountant (if they are not). If the offering amount is $100,000 or less, the issuer must provide audited or reviewed financial statements or, if such statements are not available, must disclose its total income, taxable income, and total tax for its most recently completed fiscal year and must provide its financial statements, in each case certified by its principal executive officer. The issuer must file the disclosure information with the SEC before commencing the offering and must make certain other filings during the course of the offering.

- The issuer may not advertise its offering except for notices that direct investors to the intermediary’s platform and contain only limited categories of information as specified in the Rules. The issuer nonetheless may communicate with investors regarding the offering through the communication channels maintained by the intermediary as described above.

- If the issuer succeeds in selling its securities it must thereafter file annual reports with the SEC containing information specified in the Rules until such time as (i) the issuer becomes a reporting company required to submit periodic reports under the Exchange Act, (ii) the issuer or another party repurchases all of the crowdfunded securities, (iii) the issuer has filed at least one annual report and has fewer than 300 holders of record, (iv) the issuer has filed at least three annual reports and its total assets do not exceed $10 million, or (v) the issuer liquidates or dissolves its business.
Any securities sold by an issuer pursuant to Section 4(a)(6) will also be exempt from registration under state securities (Blue Sky) laws.

Many commentators have praised the crowdfunding exemption as an important step toward the "democratization" of finance since it can, in theory, permit small investors to make early-stage investments in promising companies that previously would have been funded only by venture capitalists and other accredited investors. At the same time, there is certainly reason to question whether crowdfunding will meet the expectations of its strongest proponents. The percentage of start-up enterprises that become successful public companies or otherwise achieve a profitable exit is quite small. Although the Rules provide an exemption from Securities Act registration, they impose significant compliance costs that don’t apply in Regulation D offerings (particularly in respect of the need for ongoing SEC filings and, depending on the offering size, independent accountant reviews or audits). The offering expenses incurred by an issuer will therefore often be greater under crowdfunding than under Regulation D and this, in turn, suggests that crowdfunding may be of particular interest to smaller, and frequently more risky, companies that are unable to obtain financing from traditional venture capital providers. It will be interesting to see whether Section 4(a)(6) crowdfunding, over the longer term, provides a net benefit to small investors.

212 Broker-dealers and funding portals are permitted under the Rules to provide issuers with assistance in the preparation of disclosure materials. An intermediary may be able to help issuers reduce their offering costs by developing automated procedures for the preparation of initial drafts of the disclosure materials and related filings.
More Information

If you would like further information concerning any of the matters discussed in this survey, please contact Peter Manbeck, Marc Franson, or Lindsay Henry of Chapman and Cutler LLP, or contact any other Chapman and Cutler attorney with whom you regularly work.

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Annex A

About Chapman

Chapman and Cutler LLP has represented nearly every type of financial services entity, from hedge funds to specialty lenders, to some of the world’s largest financial institutions. Our lawyers are actively involved in providing legal advice to and about marketplace lending programs.

We Know Lenders. For decades, we have represented lenders in capital structures ranging from the straightforward to the complex. For us, representing lenders isn’t just another service area—rather, representing lenders is at the heart of what we do every day. Our experience has helped us gain a thorough understanding of our clients’ processes, products, and systems, as well as their market challenges and legal needs.

Commitment to Value. We understand the evolving needs of financial services clients and skillfully combine legal acumen with business and market insight. Our commitment to value goes beyond closing a deal or resolving a matter—we share our market knowledge to help clients advance their own business goals.

Depth of Knowledge. We have extensive experience representing Internet-based platforms engaged in consumer, student, and small business lending and providing other financial products. We have the experience needed to help our clients comply with the novel legal and regulatory issues presented by these programs and to assist with expanding funding sources.

Comprehensive Counsel. With our singular focus on finance, Chapman has developed a deep bench of attorneys with the experience and skills necessary to tackle virtually any issue our clients may face. From beginning to end, Chapman provides a tailored, dynamic team of attorneys prepared to respond to any legal matter that may arise.

Securitization Experience. Chapman has been at the forefront of the efforts to develop securitization structures for marketplace lending platforms. Our broad experience in asset-backed transactions enables us to provide effective advice to our clients in connection with this developing sector of securitizations. We represent sponsors, agent banks, and investors in securitizations of consumer Internet loans as well as lenders and institutional investors in connection with securitization warehouse facilities.
Marketplace Lending Services

We handle funding arrangements for originators and purchasers of marketplace loans and also assist with development of programmatic whole-loan sale, servicing, and custodial agreements; due diligence and compliance reviews for investors; and assessment of federal and state regulatory requirements, including securities law compliance; lender, broker, and debt collector licensing requirements; usury and fee limitations; and disclosure, reporting, and fair lending regulations.

Start-Up Advice. We advise start-up online lenders (in both consumer and commercial loan segments) in connection with the negotiation of program/marketing, servicing, and loan sale agreements with originating bank partners.

Issuance Program and Regulatory Advice. We advise online lenders interested in establishing notes issuance programs and we counsel all participants on compliance with applicable federal and state laws, rules, regulations, and requirements.

Regulated Investment Companies and Private Funds. We represent regulated investment companies and private funds in connection with investments in marketplace lending products. We were the first to structure a closed-end fund filed with the SEC specializing in marketplace lending investments.

Consumer Loans. We represent various online lenders and loan investors in connection with loan sale and servicing agreements and participation agreements.

Small Business Loans. We represent online small business lenders in structured loan facilities and in the establishment of Internet-based notes issuance programs directed to individual and institutional accredited investors.

Student Loans. We were among the first to structure capital markets-based financing solutions for marketplace education finance platform sponsors and we have recently been involved as either bank/issuer counsel or counsel to lenders and note purchasers for three newly formed marketplace student loan originators.

Securitization. We represent issuers, platforms, and lenders/investors on a variety of warehouse and term securitizations of consumer loans, student loans, small business loans, and other asset classes.
The Regulation of Marketplace Lending: A Summary of the Principal Issues (March 2017 Update)

### Marketplace Lending Team

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