The Regulation of Marketplace Lending

A Summary of the Principal Issues (2016 Update)

April 2016

Chapman and Cutler LLP
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THE REGULATION OF MARKETPLACE LENDING:

A Summary of the Principal Issues (2016 Update)

April 2016
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Preface

We are pleased to offer once again our annual survey of the principal regulations applicable to marketplace lending. We have no shortage of topics to discuss this year as the past 12 months have seen both significant court cases and significant regulatory initiatives. As to the former, the May 2015 decision of the U.S. Second Circuit Court of Appeals in *Madden v. Midland Funding, LLC*, although binding only in the states of Connecticut, New York and Vermont, called into question the funding structures used by many consumer marketplace lenders to establish exemptions from state usury laws. As to the latter, the decision of the U.S. Department of the Treasury in July 2015 to solicit comments from the public on marketplace lending, and the announcement by the Consumer Financial Protection Bureau (the “CFPB”) in March 2016 that it will accept complaints from the borrowers under consumer marketplace loans, show an increased regulatory interest in marketplace lending and suggest that the CFPB and/or other regulators may eventually propose regulations specific to the 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 discuss briefly 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) but which are not banks, 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 consumer loans on which the industry initially focused. 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 — also will 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, we refer to lenders who operate such programs as “Operators” herein and use the terms “marketplace lender” or “lender” to refer to marketplace lenders generally.

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 regulations. Regulatory costs have proven to be a significant barrier to entry into 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 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 number of significant court cases and regulatory initiatives affecting marketplace lenders. This section of our survey summarizes those developments. Subsequent sections discuss the relevant regulatory issues in greater detail.

1. **Madden v. Midland Funding, LLC**

**Summary.** Certainly no regulatory action or court decision affecting marketplace lending in the past 12 months has attracted greater attention than the May 22, 2015 decision of the United States Court of Appeals for the Second Circuit in the case of *Madden v. Midland Funding, LLC*.\(^1\) It did so not because the parties to the case included any marketplace lenders — they didn’t — but because the court’s analysis, if applied to marketplace lending, could invalidate the funding structure under which many consumer marketplace lenders arrange loans through commercial banks at interest rates exceeding the usury cap in the borrower’s state of residence. Any such breach of the usury laws could, depending on the state, render the related loans unenforceable in whole or in part and/or subject the marketplace lender to monetary or other regulatory penalties. Specifically, 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. As a result, the Court ruled that the 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.

The *Madden* decision has broad implications for the overall financial markets but is of particular concern to marketplace lenders because many of them arrange for commercial banks to fund the loans they offer. The bank relies upon federal preemption under the NBA (or other similar federal statutes) to offer certain of these loans at interest rates exceeding any applicable state usury caps (“Excess Rate Loans”). The marketplace lender then purchases the loans from the bank shortly after origination. If the marketplace lender, as a non-bank purchaser of an existing bank loan, cannot benefit from federal preemption, it may be unable to enforce Excess Rate Loans in accordance with their terms or may be subject to claims of damages for charging excess interest. *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 (unless and until the Supreme Court reverses the decision) that other jurisdictions will adopt its analysis.

**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 the loan was sold to Midland Funding, a debt collector. A Midland affiliate sent Madden a letter calculating interest at 27% per annum. Madden filed a class action lawsuit in the Southern District of New

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1. 786 F.3d 246 (2nd Cir. 2015).
York alleging that this rate violated New York’s usury limitations. Midland based 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 which 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.

However, the Second Circuit also remanded the case to the lower court to determine if New York or Delaware law governed the relationship of the parties. The account documents specified Delaware law as the governing law and Delaware authorizes creditors to charge any interest rate approved by the borrower in a written contract. The 27% rate that Midland sought to enforce therefore arguably would be valid if Delaware law controlled. That determination has not been made. Midland Funding requested that the entire Second Circuit Court of Appeals rehear the case, a petition that was denied. Subsequently, Midland has asked the United States Supreme Court to entertain an appeal of the case. Midland argued that the case violates the long-standing doctrine that loans are “valid when made” and do not change character or become invalid when the loan is sold or transferred. Initially Madden did not file a brief with the Supreme Court, but the Supreme Court ordered Madden to file a brief, which Madden did. Interestingly Madden asserted that the case was narrow in its scope and only applied to sales of loans to debt collectors. 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. After hearing these views, the Court could decide before the end of 2016 whether it will take the case. In the interim, the case is the law of the states comprising the Second Circuit (Connecticut, New York and Vermont) but is not binding in other states. At least one recent New York case has rejected a theory of proceeding against a non-bank partner based on the Second Circuit’s decision, although it did not involve usury claims.

Implications. The Madden decision presents an element of uncertainty for all lenders including marketplace lenders. The uncertainty could be resolved if the Supreme Court decides to hear the case. Some purchases and/or securitizations of marketplace loans have limited eligibility criteria to loans which comply with applicable usury rates in the Second Circuit. At least one bank and one marketplace lender have revised

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2 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. See footnote 57 below. The Madden court noted that courts which have considered this issue under New York law in similar cases have reached differing results.

3 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).

4 This request shows that the Court is interested in the case and its effect on the financial services industry and capital markets. There is no set time for the Solicitor General to file its brief.

5 Edwards v. Macy’s, Inc., 2016 US Dist. LEXIS 31097 (S.D.N.Y. 3/9/2016). Although not a case dealing with usury, the Court found that federal law preempts state law claims for unfair and deceptive practices against a national bank and its non-bank partner where the non-bank entity was acting on behalf of the bank. It specifically rejected the contention that Madden allows such a claim to move forward. This type of analysis and ruling may be helpful where marketplace lenders are providing services to the bank such as origination, marketing, underwriting, servicing or collection.

6 If the Court does not agree to hear the case, Madden remains valid in the three Second Circuit states, but would not be controlling elsewhere, although it is likely to be cited as precedent if similar cases were to be litigated.
their business relationship to address *Madden* concerns.\(^7\) Given the significance of this case we expect there to be further developments in the coming months.

2. **Maryland Credit Services Business Act Decision**

A recent case decided by the Maryland Court of Special Appeals demonstrates the need for marketplace lenders to review state licensing requirements carefully since non-uniform requirements can prove a trap for the unwary. Specifically, on October 27, 2015, the Court decided the case of *Maryland Commissioner of Financial Regulation v. CashCall, Inc., et al.* 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”). That law requires a license for any credit services business. It also contains a provision that does not allow a person to arrange 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. The total fine was $5.6 million. CashCall appealed and won at a lower court, but on appeal the lower court was reversed and the fine re-imposed. The Court disregarded CashCall’s arguments that it was acting on behalf of the banks and not the borrowers and that it did not accept direct payment from consumers for marketing the loans, arguably a requirement of the CSBA. The Court found that CashCall received compensation indirectly from its purchase and collection of the loans and payment by the banks of part of an origination fee. The case is currently on appeal to the Maryland Court of Appeals, Maryland’s highest court. This case however has implications for marketplace platforms that assist in the marketing of loans for funding banks. Depending on the ultimate resolution of this case, there are risks that marketplace lenders who arrange loans in Maryland through funding banks may require licenses under the CSBA and that such lenders may be subject to fines or penalties if they arrange loans at interest rates exceeding the Maryland usury cap (24%). Note that the regulator did not allege that the loans made by the banks were violative of the law, but rather it was a violation by the marketer to arrange such loans in excess of Maryland rates. Unfortunately, the question of federal preemption was not raised in this action and so will not be litigated on appeal.

3. **Treasury Department Request for Information**

In July 2015 the U.S. Department of the Treasury (the “Treasury Department”) published a Request for Information (the “RFI”) in which it asked the public to provide written responses to a series of questions concerning the operations, regulation, financing, products and marketing strategies of both consumer and small business marketplace lenders. The Treasury Department also held a series of roundtable meetings in Washington, D.C. and other cities in mid-2015 in which it solicited direct input from certain market participants. These Treasury Department initiatives — as much or more so than any other regulatory actions

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\(^7\) In February 2016 WebBank, the bank which makes loans for the LendingClub program, 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 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.
in the past year — clearly demonstrated the increasing importance of marketplace lending in the U.S. financial markets. Although the Treasury Department does not (and will not) directly regulate marketplace lenders, it has recognized that marketplace lending can have a significant impact on both the availability and the terms of consumer and small business credit. The Treasury Department undertook the RFI in part to gain a better understanding of the current regulatory status of marketplace lenders and to help it and other regulators determine whether additional regulation is needed. At the same time, if public statements made in the past year by Treasury Department officials can be taken at face value, it can fairly be said that the Treasury Department has (in broad terms) a positive outlook on the marketplace lending industry and is interested in its potential to serve borrowers who currently have inadequate access to credit.

All responses submitted under the RFI are publicly available and no doubt will be considered by any federal or state regulator who considers enacting regulations specific to marketplace lending. It therefore is not surprising that market participants viewed the RFI as providing an important opportunity to inform regulators of the scope and nature of their businesses, of the benefits that marketplace lenders can provide both to individual borrowers and the broader economy, and of the manner in which marketplace lenders are currently regulated and how they should be regulated. Many leading consumer and small business marketplace lenders submitted very detailed and thoughtful comment letters. A full discussion of the industry responses is beyond the scope of this white paper. A number of commenters, though, summarized the principal regulations under which they operate in order to dispel any notion (sometimes expressed by consumer advocates) that marketplace lenders fall through a gap in the regulatory structure. The sheer length of this publication should be evidence that, whether or not marketplace lenders are optimally regulated, they are hardly unregulated.

One key regulatory question on which a number of respondents commented is that of risk retention. As discussed elsewhere herein, pursuant to the Dodd-Frank Act the Securities and Exchange Commission and other federal regulators have enacted regulations that generally will require sponsors of securitizations to retain not less than 5% of the credit risk in each of the securitized assets. These regulations will apply to marketplace loan securitizations. See “Securities Laws — Risk Retention Requirements” herein. In contrast, there are strong grounds to argue that P2P pass-through notes (“Platform Notes”) are not “asset-backed securities” subject to the retention requirement and it appears that regulators will not in fact apply the existing federal rules to Platform Note programs. The Treasury Department nonetheless asked in the RFI whether marketplace lenders should be required by regulation to retain some amount of credit risk on each of the loans they originate even when the loans are not being securitized. Although some marketplace lenders retain ownership of the loans they originate or arrange, at present most consumer lenders either sell the loans to institutional whole loan purchasers or transfer the related credit risk to third parties by selling Platform Notes. The fact that the lender does not under these circumstances have a continuing economic interest in the loans can create concerns that its financial interests and those of loan investors are not adequately aligned. Certainly the same considerations that drove the enactment of the federal risk retention rules for securitizations; i.e., that mandatory risk retention promotes careful underwriting and responsible behavior, could be deemed equally applicable to marketplace lenders who are not directly engaged in securitizations but are originating loans for purposes of sale. Whatever the strength of that argument, industry comment letters identified several factors which create strong incentives for marketplace lenders to behave responsibly and which distinguish marketplace lending from the “originate to distribute” model associated with the credit crisis. First, most marketplace lenders continue to service the loans they sell to third parties and servicing fees constitute a significant portion of the lender’s revenues. Lenders therefore
want to originate loans which will perform well and generate ongoing servicing fees. In this respect marketplace lenders differ from many pre-crisis lenders who originated and sold loans but did not retain the servicing rights. Second, the reputations of marketplace lenders are closely tied to loan performance. If the loans they originate perform poorly, they likely will lose access to institutional funding. This argument as to the importance of market reputation also could be (and was) made with reference to pre-crisis lenders and, clearly, such considerations were not sufficient to prevent the crisis. The argument nonetheless carries more weight in regard to marketplace lenders because, in contrast to bank lenders, they do not have access to a stable retail deposit funding base and therefore must remain on the “good side” of ABS investors and institutional loan purchasers if they are to continue to operate. Third, marketplace lenders generally provide their investors with detailed loan-level information and, in contrast to the situation in many pre-crisis securitizations, do not require investors to base their investment decisions solely on pool-level disclosures. Marketplace loan investors therefore have the data they need to make informed investment decisions and one of the stated rationales for mandatory risk retention — that it helps to compensate for an information imbalance between originators and investors — will not apply. Finally, market considerations may lead to voluntary risk retention by Funding Banks and/or marketplace lenders even if retention is not mandated. Voluntary risk retention by Funding Banks may in particular help lenders address the regulatory uncertainty created by the Madden decision and “true lender” claims. See “Madden v. Midland Funding, LLC” above and “Lending Laws and Lending Registration/Licensing — True Lender Litigation and the CashCall Case” below.

Whether federal regulators will at some point propose specific risk retention requirements for marketplace lenders remains to be seen. In analyzing this issue, regulators will need to consider the potential impact of any such requirements on both the competitiveness of marketplace lenders and on their ability to provide funding to underserved communities.

At a broader level, most industry commenters who addressed the question stated that existing securities and consumer protection laws provide an adequate regulatory framework and that new regulations tailored to marketplace lending are not needed. Several commenters nonetheless complained that the need to comply with state securities and consumer protection laws that can differ (or be applied differently) from one state to the next can impose unnecessary costs and create barriers to entry. One commenter proposed that the federal government address this latter issue by providing for federal licensing of marketplace lenders. The concept of a federal regulatory regime for marketplace lenders that would preempt inconsistent state laws is certainly an interesting one, but also one that won’t be implemented soon if ever.

In public comments after the RFI submissions, officials from the Treasury Department have indicated that they are supportive of both financial and technological innovation with appropriate consumer protections and a “level playing field” for all players. The Treasury Department has indicated in particular that there may be a need for additional regulation in the small business sector where consumer protections do not apply.⁸ Areas of possible consideration are transparency/disclosure, fair lending and servicing considerations (with the latter becoming increasingly important as marketplace lending moves through credit cycles).

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⁸ In this regard, it’s significant that a number of small business lenders have signed on to a “Small Business Borrowers’ Bill of Rights”. The Bill of Rights represents an industry effort at self-regulation that is intended to ensure that small business borrowers are treated fairly and are provided with certain fundamental rights. See footnote 50.
4. FDIC Supervisory Guidelines

Until recently, federal banking regulators have not made too many public comments about marketplace lending. Perhaps this is 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 some online lending programs for some time, but largely without any public comment. However, banking regulators have recently made some significant pronouncements.

In November 2015, the Federal Deposit Insurance Corporation (“FDIC”) issued a Financial Institutions Letter\(^9\) dealing with effective risk management practices for purchased loans and participations. 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.”\(^10\) 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 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.

The FDIC issuance is 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


\(^10\) 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.
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 puts banks on notice of the rules they must follow to be a participant.

On March 31, 2016, the Office of the Comptroller of the Currency (“OCC”) published a “white paper” on financial technology (FinTech) and requested public comment by May 31, 2016. The paper is generally supportive of innovation and the improvements it brings, but 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. This is indicative of the overall general interest of regulators in the space.11

5. CFPB Accepts Consumer Complaints

On March 7, 2016, the Consumer Financial Protection Bureau ("CFPB") 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, we anticipate that these recent actions by the CFPB may lead to an increase in complaints against marketplace lenders. As a result, we encourage marketplace lenders to review their complaint-handling policies and procedures and ensure that they are compliant with the CFPB requirements.

CFPB Complaint Process. The CFPB accepts complaints from consumers by telephone, mail, fax, email and the CFPB web portal (the “Portal”). The CFPB then routes the complaint through the Portal to the company identified by the consumer. The CFPB has published a Company Portal Manual that includes detailed guidance and instructions for companies to respond to consumer complaints via the Portal.

The CFPB reviews each complaint and forwards it and any documents provided by the consumer to the company for response. In order to respond to a complaint, the company should gather all relevant information, including the relevant consumer file, and consider contacting the consumer to resolve the matter. As part of its review, the company should determine whether the complaint is an isolated or company-wide issue. After gathering and reviewing relevant information, the company must submit its response to the CFPB. The response must include, at a minimum:

- a description of the company’s efforts to investigate the issue and address the complaint, including attaching all communications to the consumer related to the issue;

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11 We note that a group of Republican congressman have indicated that in the Spring of 2016 they will introduce an “innovation initiative” to reduce the regulatory burden on small businesses. Though details are slim at the time of this update, it is being suggested that the proposal may include a national regulatory registration for small business lenders which may include some form of federal preemption to alleviate the need to obtain state licenses to do business because they view lending as a national marketplace. Such a move would be novel, since small business lending is generally regulated, if at all, at the state level. Given the election year, prospects for this type of legislation may not be favorable.
• a description of communications received from the consumer in connection with the steps the company took to respond to the complaint, including attaching all communications received from the consumer;

• a description of any planned follow-up actions the company intends to take related to the consumer’s complaint; and

• designation of the general nature of the company’s response by selecting one from a menu of the categories provided on the Portal.

The CFPB expects companies to respond to a complaint within 15 calendar days of receipt and will publish the complaint on its complaint database at that time. If a company cannot respond within 15 days, it can request an extension of up to 60 days.

The CFPB complaints database may publish a consumer’s narrative description of the complaint if the consumer “opts-in” and agrees to publication. The consumer narrative is not published until the company has had the complaint for 60 days. The company may, but is not required to, include its response to the consumer narrative by selecting one from a menu of public-facing comments provided by the CFPB.

The CFPB reviews the information submitted by the consumer and the company and can choose whether to investigate the complaint further. The agency can share the information with other state and federal enforcement and regulatory agencies for further action as well. Presumably the CFPB is more likely to exercise these options if the complaint identifies a systemic issue that poses risk to other consumers. For this reason, companies should evaluate all complaints to ensure that a given complaint does not identify a larger, institution-wide issue.

The CFPB has handled over 800,000 consumer complaints since 2011 and has published eight snapshots of these complaints in its monthly Complaint Report. It also files semiannual reports to Congress that include data on consumer complaints. 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.

Due to the CFPB’s recent announcement, marketplace lenders should become familiar with the Company Portal Manual for responding to consumer complaints. They should ensure that they keep detailed customer service records and supporting documents that identify their efforts to review and respond promptly to all consumer complaints. All marketplace lenders should have an established procedure to ensure that appropriate changes are made if they identify enterprise-wide issues that require correction as part of their complaint response process. Finally, marketplace lenders should update their policies and procedures for document retention and the handling of consumer complaints to ensure that they have access to adequate records in order to comply with the CFPB’s consumer complaint requirements.

Larger Participant Rule. Later in 2016, it is anticipated that the CFPB will issue a rule defining “larger participants” in the installment lending market. The CFPB has the authority to regulate non-bank entities that it defines to be larger participants in specified financial markets. In the past, the agency has defined this term to include certain debt collectors, credit bureaus and auto finance companies. It is not
known whether any marketplace lender will be included in the list of companies that the CFPB will place under its supervisory jurisdiction.

**Arbitration.** Also on the radar screen of the CFPB is arbitration. Many consumer credit contracts include arbitration clauses. The CFPB has been quite critical of the use of arbitration in consumer contracts, has issued a study and held hearings. It is anticipated that it will promulgate a rule, likely to be controversial, that will either prohibit or restrict the use of arbitration in consumer credit contracts. Such a move could of course affect consumer lenders, including marketplace lenders. Because the CFPB has a large number of issues it is considering, it is not known if action will be taken during 2016 or whether it will come later. Lenders should remain alert to developments related to this issue.

**Enforcement Action.** On August 4, 2015, the CFPB filed an enforcement action against an Internet payday lender based in Canada and Malta alleging that the lender had engaged in unfair and deceptive practices. The online lender, in response, claimed that it did not have to adhere to U.S. laws since the loans were originated from non-U.S. offices and the loan documents were governed by non-U.S. laws. The CFPB not surprisingly rejected that argument and stated that any lender making loans in or into the United States must comply with U.S. laws and regulations. In this case, while the CFPB said the lender made loans in violation of usury and licensing laws, the actual violations cited were for misrepresentations to borrowers and loan collections that were not legal. This suggests that the CFPB will bring actions against online lenders where it sees actions, policies, procedures or practices that it views as unfair and deceptive. As of this writing, we are not aware of any CFPB enforcement actions currently underway against any U.S.-based marketplace lender.

6. **California Department of Business Oversight Inquiry**

As we discuss elsewhere herein, see “Lending Laws and Lender Registration/Licensing — State Licensing Requirements”, state licensing requirements have a significant impact on marketplace lending since each lender must either obtain any required licenses, qualify for federal preemption or identify state-specific exemptions. In this regard, state licensing authorities are taking an increased interest in marketplace lending as the sector grows. On December 11, 2015, the California Department of Business Oversight (the “DBO”) launched an inquiry into online programs. While recognizing the importance of innovation, the DBO also stressed its duty to protect California businesses and consumers. It labeled its initiative as an assessment of the effectiveness and proper scope of its licensing and regulatory structure as it relates to these businesses. It 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 has indicated that the inquiry may expand further to cover other participants. As a state regulator, the DBO has the ability to change licensing requirements and regulate licensees in California. 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.
Background

A number of Internet-based lenders are currently in operation in the United States. Most of these lenders focus on a single market segment, e.g., consumer loans, small business loans, student loans, real estate loans or 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.\(^\text{12}\)

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.\(^\text{13}\) 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.\(^\text{14}\) 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, 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

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\(^{12}\) 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 notes program.

\(^{13}\) 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 are currently engaged.

\(^{14}\) 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.
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.15 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%) 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 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 non-recourse 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

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15 Operators have increasingly come to rely upon institutional rather than retail investors to finance their lending operations and most Operators (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 Operators have established “whole loan” programs through which institutional investors may acquire the entire beneficial interest in specific loans selected by them. 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 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.
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.16

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 the risk-adjusted returns on a well-diversified portfolio of Platform Notes can substantially exceed the returns available through alternative investment vehicles such as money market funds and certificates of deposit.

16 The servicing fee deducted from each Borrower Loan payment is typically in the range of one percent of the payment amount.
Regulatory Issues

A. Securities Laws

Perhaps the single greatest regulatory challenge 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 federal Securities Act of 1933 (the “Securities Act”) requires any issuer engaged in a public offering of its securities to register the securities with the Securities and Exchange Commission (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 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 the LendingClub and Prosper 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

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17 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.

18 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.

19 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.
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 at 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 non-convertible debt securities in the prior three years.

An Operator that registers its securities will need to use 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 literally thousands of prospectus supplements. 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 SEC filings to access the terms of their Platform Notes.
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 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

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

21 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.
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). It would, until relatively recently, 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 $1,000,000 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.\footnote{22}{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} An
Operator that intends to sell Platform Notes to individuals may not use Rule 506 unless it excludes non-accredited 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 non-accredited 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 non-exclusive 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

An issuer technically may sell its securities to not more than 35 non-accredited 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 pre-existing relationship would likely be deemed to be engaged in “general solicitation” and therefore subject to the verification requirement.

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23 An issuer technically may sell its securities to not more than 35 non-accredited investors and continue to rely upon Rule 506.

24 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 pre-existing relationship would likely be deemed to be engaged in “general solicitation” and therefore subject to the verification requirement.
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.

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% 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.

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. New 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 pre-sale 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+”) will no doubt be very useful to many privately held operating companies that are seeking to raise equity capital from both accredited and non-accredited 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.\(^{25}\) 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 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.\(^{26}\) Regulation A+ will not 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 ten 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 non-natural 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

\(^{25}\) 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.

\(^{26}\) 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 adopting a rule which defines “qualified purchaser” to include all purchasers of Tier 2 securities. The states of Massachusetts and Montana have sued the SEC in federal district court to invalidate this rule. These states contend that Congress intended the SEC to restrict its definition of “qualified purchaser” to narrowly-defined classes of sophisticated and/or wealthy individuals who could reasonably be presumed to have the capacity to protect their own interests, and that the SEC exceeded its authority in granting a blanket exemption for all sales to Tier 2 purchasers. This proceeding remains unresolved at the time of this survey.
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 non-accredited investors, and/or (ii) exempt their Platform Notes from Securities Act resale restrictions.27

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 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, non-exempt securities. In view of the fact that most Blue

27 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 non-accredited 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 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.
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.

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.28 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 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.29

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

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28 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.

29 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 (i.e., the Operator) and of the Platform Notes (i.e., the subsidiary) will be different companies and Blue Sky preemption definitely will not apply.
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 them in those states in which they have been registered but may 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 the sale.30

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

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30 The Securities Act preempts the application of Blue Sky securities registration requirements to certain nonissuer transactions in the securities of “reporting companies” (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 applies to exempt secondary trading in SEC-registered Platform Notes from all Blue Sky registration 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 note’s original issuance date. 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.
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.

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:

A. **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. Rule 144 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.

B. **Rule 144A.** Rule 144A exempts from registration any sale of securities made by a non-issuer 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.

C. **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

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31 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.
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. In this connection, 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 to 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, both LendingClub and Prosper have arranged for a registered broker-dealer, FOLIOfn, to operate an alternative trading system on which their outstanding Platform Notes may be traded.

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 non-accredited 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” 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.32


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.

32 See the discussion of certain of those factors and the SEC enforcement proceeding in footnotes 17 and 19 above.
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% 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% 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.

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 one-time 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. Section 3(c)(4) 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.

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33 In June 2013 the Ohio Division of Securities initiated enforcement proceedings against an online platform that was facilitating small business lending 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.

34 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.
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.35

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 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 $5,000,000 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.

35 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% 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% of its assets in mortgages and other liens on and interests in real estate and an additional 25% in real estate-related assets.
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.”

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 $100,000,000 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 $100,000,000 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 $150,000,000 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 Certificates 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 five 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. The risk retention requirement is 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.

36 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.
In October 2014 the Agencies approved final regulations implementing the risk retention requirement (the “Final Regulations”). The requirements will 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. The Final Regulations allow securitizers a grace period to bring their transactions into compliance. The Final Regulations will become effective for most asset classes in December 2016.37 Market lenders will 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 will apply), who will be deemed the “sponsor” required to retain the credit risk?38

As to the first of these questions, technical arguments can be made that Platform Notes constitute “asset-backed securities” to which the retention requirement will apply.39 If that were the case, the Funding Bank would likely be deemed the party required to retain the risk.40 At the same time, technical arguments also can be made that the Final Regulations do not extend to Platform Notes.41 It is unnecessary for us to debate the relative merits of these opposing arguments as it appears that the Agencies (although they have

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

38 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.

39 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.

40 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% 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.

41 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 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 21 above.
made no formal pronouncement) do not intend to apply risk retention to Platform Notes and, so far as we know, existing Operators and Funding Banks have no plans to restructure their programs to comply with the Final Regulations. 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 (in fact, in the majority of securitizations to date) 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. 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. 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 a strong argument that only the Aggregator should be viewed as the “sponsor” of any securitizations of the purchased loans. The proper application of risk retention to marketplace loan securitizations is, in fact, an issue that attracted much attention from commenters responding to the Treasury Department’s request for information on marketplace lending. See “Recent Developments — Treasury Department Request for Information” above.

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

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42 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.

43 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% 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.

44 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 which the Aggregator chooses to securitize.
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. Some marketplace lenders and some marketplace loan investors are now broadening that mix by securitizing loans which they hold on balance sheet or as portfolio investments. In so doing, they are helping to create a new asset class collateralized by consumer loans that have credit and payment characteristics quite distinct from those of more established asset classes. Although the first marketplace loan securitizations were completed little more than two 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.

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 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 back-up servicing arrangements under which a pre-approved back-up 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 back-up servicing requirements for marketplace loan securitizations but it is expected that “hot” back-up servicing arrangements will be more common, 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 which the SPE will draw upon 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 foreseeable future investors in marketplace loan ABS will require higher credit enhancement levels than might be expected for similar asset classes.

Rating agencies have 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 have 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. 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 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 back-up 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 will tend to 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).

45 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.

46 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.

47 The challenges that 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 which it had rated within the preceding 12 months. In each case, payment defaults on the securitized loans were higher than expected.
Most securitizations of traditional asset classes are sponsored by the loan originator or one of its affiliates. In contrast, most 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 which 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 Loan Purchase Agreement to impose specific obligations on the marketplace lender in connection with future securitizations. Among other matters, the marketplace lender may agree in the Loan Purchase 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 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 been 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.48

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” which the Committee publishes will be recommendations to the industry, rather than mandates, and will not have the force of law. SFIG

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48 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 does 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.
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. From a broader perspective, initiatives of this type also can help demonstrate to regulators an industry commitment to self-regulation.

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 five percent of the credit risk on each of the securitized loans once the Final Regulations become effective in December 2016. 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. 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 will be particularly important to the Funding Bank in connection with state usury laws.

As previously described under “Background,” lenders who facilitate loans made through Funding Banks will generally purchase each loan from the Funding Bank at the time or soon after the loan is made. Although to our knowledge the use of Funding Banks in consumer marketplace lending programs has not

49 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.

50 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 nonbank 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 non-abusive products and to fair collection practices.

51 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.

52 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.

53 Other purchase arrangements can also occur. Sometimes loans may be sold to investors or into trusts for example.
been challenged by either regulators or private litigants, similar arrangements used in analogous (non-marketplace lending) consumer lending programs have been challenged in court and in at least one instance (discussed below) was found to be ineffective to exempt the program operator from applicable state lending regulations. The use of Funding Banks therefore creates some degree of uncertainty and potential regulatory risk and requires that particular attention be paid to the structure of the program. A lender who does not use a Funding Bank, but makes loans directly, will need to obtain applicable state lending licenses.

This section of our survey and the following section (Section C) briefly discuss some of the principal banking or lending regulations, licensing requirements and consumer protection laws that may apply to the marketplace lender and/or the Funding Bank.54

1. Usury Laws

Most states limit by statute the maximum rate of interest that lenders may charge on consumer loans.55 The maximum permitted interest rate can vary substantially between states.56 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 operating under 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 fix 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.57

Of additional importance, however, is the fact that the lender may often want 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

54 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.

55 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.

56 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.

57 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. March 31, 2014).
their credit scores, considered alone, would suggest. In order to induce lenders to make loans to these individuals, the lender will need to set interest rates high enough to offset expected losses.

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.58 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.59 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.60 Other issues related to use of a Funding Bank, including court challenges to this model, are discussed below.

Lenders not organized as banks will not be subject to direct supervision by federal bank or financial institution prudential regulators such as the FDIC, the OCC or the Federal Reserve Board.61 Each Funding Bank involved in an Internet lending program, however, will remain obligated to comply with applicable laws in originating and funding the Borrower Loans. In this regard, to ensure its own compliance with applicable laws the Funding Bank will likely require the marketplace lender to agree by contract to comply with laws that are binding on banks but may not be directly applicable to the lender.62 The Funding Bank may also require the lender to have policies and procedures addressing these areas and require the lender to

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58 National banks rely on 12 U.S.C. § 85 in order to export the interest rate allowed by the laws of the state, territory or district where such bank is located. Until the passage of the Dodd-Frank Act, an operating subsidiary of a national bank could also utilize rate exportation in reliance on OCC Chief Counsel interpretative opinions. However, those subsidiaries may no longer take advantage of such federal preemption of state law. The corresponding provision applicable to state banks is Section 27 of the Federal Deposit Insurance Act, 12 U.S.C. 1831d. The provisions are nearly identical.

59 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.

60 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.”

61 However, lenders will be subject to possible state licensing and regulation and to possible oversight and regulation by the Federal Trade Commission and/or the Consumer Financial Protection Bureau. 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.

62 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. The makes the marketplace lender, as a service provider to the bank, responsible to comply with applicable laws and regulations and subject to examination by the regulators of the bank.
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. Bank Secrecy Act Regulations

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. However, one example of this type of law is the federal Bank Secrecy Act and related laws that will 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:

- 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;
- 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;
- Report suspicious account activity that meets the thresholds for submitting a Suspicious Activity Report; 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.

The Bank Secrecy Act applies to finance companies, including commercial lenders.

3. Issues Related to 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, vendor management compliance, regulatory issues and the potential of litigation based on who is the “true lender” for the program.

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

a. Availability

At the current time, only a handful of FDIC-insured banks are 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. In addition, if these programs grow inordinately, regulatory considerations might arise such as increased due diligence and compliance requirements (see below). Some Funding Banks may also limit the number of programs they work with.

b. Vendor Management Programs

Third party arrangements with insured depository institutions are subject to the Bank Service Company Act.\(^\text{66}\) Under this law, service providers to financial institutions must comply with laws and regulations applicable to the financial institution and are subject to supervision and examination by the institution's primary federal banking regulator as if the functions were being performed by the bank itself.\(^\text{67}\) This provides an additional layer of protection to consumers when loans are made through a Funding Bank.

Federally insured institutions have been subject to new and expanded guidance on programs they have with third-party providers of services.\(^\text{68}\) Banks that enter into arrangements with marketplace lenders will be subject to these rules for their programs. In short, bank regulators require banks to conduct due diligence on proposed third-party arrangements, enter into agreements that protect the bank from risk (or effectively manage or mitigate identified risks), monitor the third-party service provider and mandate that the service provider take corrective action where gaps or deficiencies occur.

This means that marketplace lenders will undergo scrutiny from the financial institution and that start-ups or entities without a track record may not meet the standards of the institution or may have to agree to additional burdens or restrictions in order for the bank to justify the third-party relationship. Some banks are already stiffening their due diligence to comply with these requirements and requiring up-front policies and procedures with respect to legal and regulatory compliance. Banks will be more likely to embrace contractual and other protections in the structuring of 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. In addition, the regulatory guidelines require financial institutions to take corrective action if necessary. As a result, 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 banks.

c. Regulatory Issues

Bank regulatory agencies seem to permit banks to contract with third parties to provide origination services to bank customers. Such arrangements may give banks a competitive advantage by allowing them to enhance product offerings and diversify assets, among other benefits. Just recently, some small community

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\(^\text{67}\) 12 U.S.C. 1867. The institution must also provide notice to its federal banking regulator of the third party arrangement and provider.

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 the 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 programs based on safety and soundness concerns.

Similar funding arrangements — when employed by payday loan marketers and debit card issuers — have sometimes been characterized (and criticized) as “renting-a-bank charter.” The perceived improper use of a bank charter by these entities has been challenged, by both governmental authorities and private litigants. The impetus in part relates to high rates and fees charged to consumers in those particular programs. In 2001, the OCC issued a bulletin warning that certain payday lending relationships with third parties may expose a national bank to “substantial financial loss and damage to its reputation” and “may constitute an abuse of the national bank charter.” The OCC also warned 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 party directly.” Bank regulators have in fact required banks to exit third-party programs they determined to be unsafe and unsound practices. However, most of these have been when high rate payday loans have been at issue.

d. True Lender Litigation

Some recent litigation has focused on third-party programs where banks fund payday loans. Claims in these cases assert that payday loan marketers use bank lenders solely to evade compliance with state usury limitations and consumer protection laws imposed by the states where such payday loan marketers do business. In some cases, the litigation has sought to characterize the payday loan marketer as the “lender” for purposes of state consumer protection law restrictions, which in some states, in addition to penalties, would render certain payday loans voidable or unenforceable.

Cash Call Decision-West Virginia. Of particular note is a 2014 decision out of West Virginia where the Attorney General sued CashCall, Inc. under these theories. CashCall was an 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. The court ruled in favor of the State, finding that CashCall was the de facto lender and had the predominant economic interest in the loans and, as a result, CashCall should have followed applicable restrictions of West Virginia regulations.

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69 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.

70 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 dollars 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%.


72 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 response was based on CashCall’s failure to adequately describe the program. The program worked like most third-party arrangements, with a marketing agreement in place where the bank kept origination fees and accrued interest on the loans until sold to CashCall soon after they were made. CashCall indemnified the bank, and its owners provided personal guarantees.
law, including its usury rate. 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. The West Virginia Supreme Court upheld the decision on appeal.\textsuperscript{73} The United States Supreme Court declined to review this decision.\textsuperscript{74} As a result, the industry will likely be subject to some degree of uncertainty and additional litigation surrounding the use of Funding Banks, which could be costly to defend and result in differing decisions in different jurisdictions, further complicating the operation of such programs.

CashCall based its unsuccessful appeal on several premises. First, it claimed that the West Virginia decision contravenes federal banking law and existing precedent that a loan is made by the entity setting the credit terms and disbursing funds and thereby extending credit.\textsuperscript{75} Second, it stated that the prior decision ignored the substance of the transaction and the contract between the parties. CashCall also argued that the decision could effectively prevent lenders from selling loans to third parties, as banks commonly do, since tremendous uncertainty would exist if a loan could become usurious solely by virtue of it being sold.\textsuperscript{76}

\textit{Utah Case Supports Bank as True Lender.} In contrast, a federal court in Utah in May 2014 dismissed a consumer class action against an online payment processor (Bill Me Later), finding that the originating bank, not the processor, was the true lender, thereby preempting allegations of violations of state usury law. The court provided some guidance for the proper structuring of third-party relationships, including that the bank 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.\textsuperscript{77} The Court stated that even accepting as true the allegation that the loans were designed to circumvent state usury laws more protective than Utah’s, that the case had to be dismissed as these claims were preempted by federal law. The Court based its decision in part on the fact that the non-bank participant in the program was a service provider to the bank, and that when a bank contracts with a third party service provider for services, under the provisions of the Bank Service Company Act, the performances 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.”\textsuperscript{78} This law provides potent defenses to true lender

\textsuperscript{73} See \textit{CashCall v. Morrissey}, 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 1% or 100% above the applicable usury rate. At a minimum, Internet programs using a Funding Bank making loans to West Virginia residents should either follow the usury limits or exclude the state from their loan programs.

\textsuperscript{74} Typically the Supreme Court hears less than one percent of those cases appealed.

\textsuperscript{75} Citing \textit{Discover Bank v. Varlen}, 480 F.3d 594 (4th Cir. 2007) and \textit{Krispin v. May Dept’l Stores}, 218 F.3d 919 (8th Cir. 2000).

\textsuperscript{76} Other cases on these theories remain pending in the court system. One is \textit{Ubaldi v. SLM Corp.}, pending in federal court in California. In December 2014, the U.S. District Court for the Northern District of California ruled on a case involving student loans originated and serviced by Sallie Mae but made by Stillwater Bank, an FDIC-insured bank. The court certified the case as a class action and will consider the true lender argument in a more traditional lending context.

\textsuperscript{77} \textit{Sawyer v. Bill Me Later, Inc.}, 23 F.Supp.3d 1359 (D. Utah 2014). Since WebBank is located in Utah, this case may have particular precedential value. In another case, the court again 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. \textit{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.”

\textsuperscript{78} 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.
allegations. The role of non-banks in originating loans subjects the non-banks to regulatory scrutiny and accountability under this law providing both regulation and consumer protection. Rather than evading regulation, this law results in more supervision of the program and examination for compliance with applicable laws. As a result, the Court rejected claims that the non-bank was the true lender.

However, a recent decision of the U.S. District Court for the Eastern District of Pennsylvania has highlighted once again the regulatory risks that the so-called “true lender” doctrine can create for Internet-based lenders who partner with banks to establish exemptions from applicable state consumer protection laws (including usury laws). Although the Court did not reach a final decision on the merits, it declined to accept federal preemption as grounds to dismiss an enforcement action brought by the Commonwealth of Pennsylvania against an Internet-based payday lender who arranged for a state-chartered bank to fund loans at interest rates of over 200%, far exceeding the Pennsylvania usury cap.79 However, this decision was made at an early stage of the proceeding on a motion to dismiss and it may be a long period of time before the case proceeds to a decision on its merits. Again, the case dealt with very high rate loans by a payday lender.

So long as litigation and uncertainty surround the use of a Funding Bank for marketplace lending programs, lenders should use care when structuring arrangements with Funding Banks to establish facts and factors that promote a sound foundation for finding that the Funding Bank is the true lender of the Borrower Loans.80 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, counsel should be consulted to assist in the development of an appropriate strategy and drafting of arrangements between marketplace lenders 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 by those institutions and for such an institution to take an active role in establishing, approving and monitoring the program since the institution remains responsible for its credit policies, loan forms and compliance with applicable law. Accordingly, lenders are 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.

An issue separate from the “true lender” analysis is whether marketplace lenders who purchase bank loans originated at rates in excess of applicable state usury caps are entitled to the benefit of federal preemption (as relied upon by the Funding Bank to originate such loans at such rates) and may enforce the

80 For example, consideration should be given to operations where 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 the federal banking guidance to monitor and supervise the Internet marketer’s performance of its duties as a bank service provider.
loans in accordance with their terms. This issue can exist even when there is no claim that the Funding Bank was not the true lender. See “Recent Developments — Madden v. Midland Funding, LLC” above.

4. State Licensing Requirements

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

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

**Broker Licenses.** For example, certain states require the registration or licensing of persons who assist in the loan origination process under either “loan lender” or “loan broker” 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.81 Under some state lending statutes, persons who “arrange” loans for others are covered by the licensing statute.82 Any participant hosting a website or soliciting loans for a Funding Bank may fall within this broad definition and, absent an exemption, will need to comply with any associated licensing requirements imposed by those applicable states for loan brokers, marketers or originators.83

**Lending 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.84 In some cases, a purchaser of a Borrower Loan may become subject to licensing requirements.85 Some states require licensing of commercial lenders.86

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81 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.

82 For example, the Regulated Lender statute in Texas contains this type of language and the regulator there has indicated that the Internet platforms sourcing loans for a bank located in another state need to be licensed under this law.

83 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.

84 See, e.g., 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.

85 For example, loans made under the Illinois Consumer Installment Loan Act may only be sold to regulated financial institutions or other licensees. Until a recent court case, the same was true of loans made by licensed California finance lenders. Kansas and South Dakota have statutes that impose licensing requirements on purchasers/assignees of loans.

86 See footnote 51 above. 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.
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.

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 it is 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 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 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.87 Some states have subscribed to a national licensing registration service which 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 multi-state 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.

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. 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 (“TILA”) and its implementing Regulation Z88 require lenders to provide borrowers with standardized and understandable information concerning certain terms and

87 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.

conditions of their loans and certain changes in the terms of the loans.\textsuperscript{89} The TILA disclosure requirements will apply to the Funding Bank or licensed entity that is the 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.\textsuperscript{90} 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.\textsuperscript{91} 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. Most important, if certain “triggering” terms are used (such as the term of a loan or interest rate), other disclosures must be made.

Although not related to TILA, many Internet-based loan programs include an arbitration provision or agreement as part of the program. Arbitration clauses or agreements should be disclosed conspicuously and prominently. Such provisions are subject to challenge and litigation. The CFPB recently released its report on mandatory arbitration in the context of consumer credit and could take action to restrict or eliminate its use.\textsuperscript{92}

2. FTC Act, UDAP Laws and the CFPB

Marketplace lenders must comply with Section 5 of the Federal Trade Commission Act (“FTC Act”)\textsuperscript{93}, 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 Federal Trade Commission has adopted thereunder to protect consumers against abusive terms and conditions in credit contracts.\textsuperscript{94} Amongst other requirements, the Credit Practices Rule prohibits loan agreements from including terms that:

\textsuperscript{89} 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”, certain other fees and charges that may be applied, and the repayment terms such as the dollar amount of each payment and the number of payments. Loans secured by real estate are subject to additional disclosure requirements and consumer protections which are beyond the scope of this white paper.

\textsuperscript{90} Generally for violations to accrue to assignees, violations of the TILA must be apparent on the face of the documents, but in the case of some higher priced loans, the liability can be broader.

\textsuperscript{91} 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.


\textsuperscript{93} 15 U.S.C. 45.

\textsuperscript{94} 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) and 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);\(^{95}\)

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 pre-authorized 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. Other marketing or servicing practices could be found to be unfair and deceptive based on the facts and circumstances of the situation. As other sections of this paper indicate, placing important provisions in long documents without calling attention to them rather than placing them in separate, more clear and conspicuous formats (such as an arbitration provision, or an E-Sign or EFTA consent, or a power of attorney granted to the lender to sign documents on behalf of the borrower) could be subject to challenge as an unfair practice. Not providing opt outs or not providing them clearly and conspicuously could also be subject to challenge.

Marketplace lenders and Funding Banks as well as 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 of excessive prepayment penalties and the availability to borrowers of certain causes of action and remedies.\(^{96}\)

As further discussed below, the Dodd-Frank Act also mandated the establishment of the Consumer Financial Protection Bureau ("CFPB") and authorized the CFPB to adopt rules prohibiting unfair, deceptive and abusive acts or practices within the consumer finance market under (amongst other laws) the TILA, the ECOA, the FCRA, the FDCPA and the EFTA (as defined below). The CFPB has not issued regulations regarding unfair, deceptive or abusive practices to date but has articulated certain standards to assist entities in identifying whether an act or practice is unfair, deceptive or abusive.\(^{97}\) The CFPB has also been active in

\(^{95}\) A contractual waiver is not prohibited if it is restricted to property pledged as collateral for the debt.

\(^{96}\) 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.

\(^{97}\) 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.
revising rules applicable to consumer lending (particularly as they relate to credit card issuers), residential mortgage lending and debt collection practices.

In May of 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 the financing of Internet-based purchases by unfair and deceptive practices. One of the practices the CFPB complained of was the pre-filling of drop down boxes by the companies. This resulted in customers being signed up for financing or payments that they did not want or intend. This action should serve as guidance (and a warning) that in documents, forms and disclosures on a website or Internet platform, boxes should not be pre-filled 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 ("ECOA") prohibits lenders from taking any action related to any aspect of a credit transaction, including the making of any credit determination, on the basis of the applicant’s race, color, sex, age (except in limited circumstances), religion, national origin, marital status, or 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"). The ECOA applies during all aspects of the credit transaction including advertising, the application and approval process and servicing and collection activities. For example, credit scoring systems must not be discriminatory. If an applicant is denied credit (or the cost of credit is increased), the lender must 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 or negative impact on the basis of any Prohibited Bases.

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98 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 them use their service rather than their preferred method of payment. The action resulted in $25 million in penalties.


100 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.

101 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 original 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.

102 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 2016 is to enforce fair lending in the small business lending sector. Under Section 1071 of Dodd-Frank, 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, minorities and on any other Prohibited Bases. 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 two-fold. First, systems will need to be developed and implemented to collect the data the CFPB will require. Second, like 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, 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.
The Internet provides access to new sources of information and new types of information on potential customers, including through social media channels. It is widely reported that some lenders are using information obtained from social media channels to determine the creditworthiness of potential customers. Incorporating the use of social media data into underwriting criteria raises compliance issues related to the ECOA. 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 combination of the two. A creditor that desires to use social media in its credit scoring system must establish that the data used is predictive of an applicant’s creditworthiness. A lender must ensure that its credit scoring system is validated and revalidated periodically to ensure that the system does not have a disparate impact on protected classes. If a lender uses social media, it may obtain information about the customer that it is prohibited from acquiring and using as part of its credit decision, thereby impacting its compliance with the ECOA. If social media 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. Lenders using social media data in credit decisions must also confirm that their use of social media data will not result in an unfair, deceptive or abusive act or practice. Since not all consumers utilize social media, lenders should ensure that unfair treatment does not occur for applicants who do not use social media.

When reviewing a loan application, a marketplace lender will typically rely on a “consumer report” as defined in the federal Fair Credit Reporting Act (“FCRA”). Often, this will be a report or score from a credit reporting agency or credit bureau. The FCRA specifically applies to users of consumer reports and if a lender uses consumer reports, the FCRA will be applicable. Lenders must review the FCRA requirements and should consult legal counsel as to what obligations under the FCRA may 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 also (i) 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, and (ii) imposes certain requirements that lenders must observe in reporting loan delinquencies or defaults to credit reporting agencies.

When servicing a delinquent loan, a marketplace lender should also consider the potential application of the Servicemembers Civil Relief Act (“SCRA”). 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.

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103 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.”

104 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.


107 The CFPB has been aggressive in enforcing violations of the SCRA in servicing situations.
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 Act (“FDCPA”)108 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. The lender — if it acts as its own collection agent in respect of 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 also will be directly subject to 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 service members 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.109 In particular, the federal Gramm-Leach-Bliley Act (“GLBA”) limits the disclosure by a financial institution110 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

109 See the previous section on the FCRA which also contains requirements with respect to privacy and information sharing.
110 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 CFR Part 1016.
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 appropriate information security program, the related federal agencies published the Interagency Guidelines Establishing Standards for Safeguarding Customer Information (“Security Guidelines”). 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 the 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. 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 (i.e., paperless) 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") 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.

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 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. 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.


113 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.

114 In an Internet context, additional legal issues 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
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 and prior to the time that any disclosures are received or any contract entered into. The consent should not be buried in a longer document, but preferably 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.\(^{115}\) In another recent case, also dealing with an arbitration, 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.\(^{116}\) 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 be clear in their disclosures and to be sure that they obtain agreement by affirmative action on important documents such as electronic contracting and arbitration.

**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 depository institutions) 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\(^{117}\) 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. They contain disclosure and 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.\(^{118}\)

Under the EFTA, a lender may not require a borrower to make payments by electronic means. However, a lender may provide an incentive for making payments electronically.\(^{119}\) Thus, an appropriate customer authorization and compliance with Regulation E are important to Internet lending programs.\(^{120}\) Recently, the CFPB issued Compliance Bulletin 2015-06 dealing with the EFTA and emphasized the importance of complying with the provisions of the EFTA.\(^{121}\) In order for a lender to obtain payment from a

\(^{115}\) Sgouros v. TransUnion Corp. et al, Case No. 15-1371 (7th Cir. 3/25/2016). The “I Agree” button appeared below a notice that the consumer was agreeing to have their personal information viewed. It said nothing of arbitration. The court said that the site did not sufficiently notify customers that they were signing the agreement.


\(^{118}\) 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.

\(^{119}\) For example, although it would be 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. Pre-filled boxes are likely to be viewed as a potential unfair practice.

\(^{120}\) 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.

\(^{121}\) 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.
borrower’s deposit account, it must have a signed writing from the borrower and must provide a copy to the consumer. The CFPB emphasized that the EFTA authorization must be identified as such, must be clear and understandable and must evidence the consumer’s assent to allow the authorization.\footnote{122}

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. As suggested by the recent cases, placing such an authorization within another document may not be sufficient to show proper assent to the electronic transfer of funds as is required by the EFTA.

7. Other Relevant Laws

a. \textit{Fair Credit Reporting Act (“FCRA”).} \footnote{123} As noted above, 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 pre-screening is utilized. However, where a consumer report is used in connection with a pre-approved offer of credit, a firm offer of credit must be provided and a notice and right to opt out of future pre-screening must be provided. Financial institutions that wish to share customer information (other than transaction and experience information) with affiliates must provide a notice and provide an opt-out right. A notice regarding risk-based pricing must be provided to consumers in certain circumstances. A notice must be provided prior to or within 30 days of submitting negative information to a credit bureau. 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.

b. \textit{Telephone Consumer Protection Act (“TCPA”).} \footnote{124} 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. This law poses compliance challenges and has been a hotbed for current litigation. 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 damages which contain no limit. As a result most actions are filed as class actions. Consumers must also have the ability to revoke their consent. It is recommended that the consent be placed where the consumer’s phone number is requested as a best practice. If consumers are asked to provide phone numbers, and in particular if mobile numbers are requested, the TCPA disclosure should be provided and consent obtained. The Federal Trade Commission also manages the federal 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, pre-recorded messages or calls to cell phones are being made.

\footnotetext{122}{The EFTA contains specific requirements about pre-authorized 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.}
\footnotetext{123}{15 U.S.C. 1681 and Regulation V, 12 CFR Part 1022.}
\footnotetext{124}{47 U.S.C. 227 et seq. and 47 C.F.R. 64.1200 et seq. The Telemarketing and Consumer Fraud and Abuse Prevention Act and the Federal Telemarketing Sales Rule is found at 15 U.S.C. 6101-6108 and 16 CFR Part 310.}
c. **CAN-SPAM.** This law establishes requirements for anyone who sends commercial or transactional messages by email and provides recipients of commercial emails the right to ask to be placed on an opt out list. The statute provides penalties for non-compliance for both the company that sends the email and the company whose products are advertised in a commercial email. The CAN-SPAM Act applies to emails sent to both consumers and business entities. A commercial email is one whose primary purpose is promoting or advertising a commercial product or service while a transaction 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 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.

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 “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 “back-up” servicing agreement with an unaffiliated company pursuant to which the back-up 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 back-up servicer — particularly if it has not been appointed under a “live” back-up 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

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back-up servicer’s assumption of full servicing duties could significantly reduce loan collections and cause related losses on the Platform Notes.

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—notwithstanding 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 pre-existing 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 pre-existing 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.\(^{126}\)

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.

\(^{126}\) 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” (see footnote 17) that constitutes a security that must be separately registered under the Securities Act. 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 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.
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 business 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 a special purpose entity (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.

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 back-up 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 back-up 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 to 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.127

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

127 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.
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) and will otherwise employ procedures intended to provide the creditor with requisite degree of “control.”

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

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128 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 to decide 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.

129 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.
economic income — but it also requires the investor to forego the otherwise potentially tax advantageous income deferral that cash method accounting might allow.\textsuperscript{130}

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 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 non-payment of the related underlying cash), Platform Note prepayment (or extension), Platform Note worthlessness and Platform Note sale.

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 — \textit{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\% withholding tax (\textit{i.e.}, the Operator would be required to withhold 30\% 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.\textsuperscript{131}

\textsuperscript{130} Illustrative discussions of these modifications and other related Platform Note tax consequences (\textit{e.g.}, market discount and premium) may be found in the tax discussions set forth in the disclosure documents for Prosper and LendingClub.

\textsuperscript{131} 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\% (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.
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% U.S. withholding tax on gross payments of interest (and OID) made on any direct investments which 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. 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). Securitization and funding structures also are often designed indirectly to achieve the same result with respect to loans which are not in registered form, by first repackaging the loans in pass-through trusts which issue certificates of beneficial interest which are themselves in registered form. 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 days, but ranging widely from anywhere 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 has long been anticipated by small investors and that will soon become 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 will become effective in May 2016. The remainder of this section summarizes the key provisions of the Rules.

Section 4(a)(6) of the Securities Act (as added by the JOBS Act) will exempt 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 is worth 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 could not 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 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 $1,000,000 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 $1,000,000 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 $1,000,000 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 five 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

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136 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 non-financial “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.
$100,000 or ten 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 Proposed 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 other 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).137 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

137 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 $1,000,000. 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.
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.

1. 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.

2. 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 $10,000,000, 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.

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138 Broker-dealers and funding portals are permitted under the Proposed 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 or Marc Franson of Chapman and Cutler LLP, or contact any other Chapman and Cutler attorney with whom you regularly work.

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About Chapman

Chapman and Cutler 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 (including “peer-to-peer” 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.

Marketplace Lending Team

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