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

May 2023 Update

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Preface

We are pleased to offer once again our update of the principal regulatory and securities issues applicable to marketplace lending and related legal issues. This edition arrives at the waning of the COVID-19 pandemic but in a time of banking uncertainty in light of recent bank failures potentially impacting fintechs and marketplace lending.

As in past updates, we have no shortage of topics to discuss, given both significant court cases and regulatory initiatives that reflect the industry's growing importance in the financial markets. Most notably, true lender litigation continues and federal codification of the "valid when made" legal doctrine was upheld in court but remains potentially subject to judicial interpretation. Buy Now Pay Later has come on the scene and new regulations and state laws continue to impact the industry. We discuss these and other important developments that have occurred since the May 2022 publication in the "Recent Developments" section that immediately follows this Preface. The remainder of this book then describes in greater detail the status of marketplace lending under existing consumer protection, securities, and other applicable laws.

At the outset, it may be helpful for us to discuss briefly the scope of this book 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-related business (other than payday lending) that are not banks or savings associations or otherwise regulated as financial institutions. They may offer a wide variety of financial products, including student loans, small business loans, and real estate loans, in addition to the unsecured installment consumer loans on which the industry initially focused. However, "marketplace lenders" may or may not actually be lenders. This term is a generic term to identify participants in marketing, originating, selling, purchasing, and servicing loans. They also may fund their loans through a variety of means, including equity capital, commercial lines of credit, sales of whole loans to institutional investors, securitizations, and/or pass-through note programs. In this book, we focus on the consumer lenders since they are the most heavily regulated and have the highest loan volumes. However, much of the discussion herein—outside of matters pertaining directly to consumer lending regulation—will also apply to non-consumer lenders.

Some marketplace lenders solicit borrowers to take loans that are actually made and originated by FDIC-insured financial institutions. For these types of programs, we refer to the bank that serves as the originating lender as the "Funding Bank." The marketplace lenders are often service providers to the financial institution. The Funding Bank structure (sometimes called the bank partnership model) has generated legal challenges, as discussed in this book, particularly where the marketplace lender both solicits and then purchases and services the loans that are originated by the Funding Bank. Other marketplace lenders obtain state licenses in order to make loans directly to borrowers under state laws.

The marketplace lending industry originally attracted widespread public attention through the pass-through notes programs operated by LendingClub Corporation and Prosper Marketplace. These so-called peer-to-peer (or *"P2P"*) programs enable retail investors to purchase nonrecourse notes representing fractional interests in specific underlying consumer loans. It was once widely expected that P2P programs would become common. In fact, however, most marketplace lenders do not operate such programs on either a public or private basis, in part because of the availability of funding from other sources, but also in part because of the costs and difficulties of securities law compliance. As marketplace lenders who operate P2P programs therefore face some compliance issues that may not apply to those who don't, herein we refer to lenders who operate such programs as "Operators." In some instances, we refer to marketplace lenders as online lenders or "platforms," since by definition such lenders provide their services through Internet-based platforms.

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

We must caution that this publication is intended only to identify the principal laws and regulations that apply to Internet-based lending and does not provide detailed guidance on the steps required to comply with any particular law or as to the laws that may apply to any particular marketplace lender or program.

Recent Developments

Our last update to this book was in May 2022, during the continuation of the COVID-19 pandemic. As was the case then, the two most discussed subjects related to the marketplace lending industry were and remain “valid when made” and “true lender.” Developments on both fronts are discussed below, along with regulatory and court actions in the interim at both the federal and state level. In particular, activities of or concerning the Consumer Financial Protection Bureau (*“CFPB”*) have taken center stage as both the agency’s status and its actions affect online lending. The market has also seen additional product innovations proliferate, such as Buy Now Pay Later (*“BNPL”*) and earned wage access, both of which are catching the attention of regulators and litigants. While the developments over the last 12 months are depicted below, later sections of this book recount the historical and ongoing developments that have shaped and continue to shape the marketplace lending arena.

I. THE CFPB

At the time of publication, the constitutionality of the CFPB itself is under siege and its fate will be decided by the United States Supreme Court within the next year. In the recent past, the agency has promulgated new rules that will affect commercial online lending programs, has issued proposed rules on a variety of topics and engaged in enforcement activities that have been viewed as controversial.

A. Constitutionality of the CFPB

1. *Fifth Circuit Ruling*

Almost since its inception the CFPB has been no stranger to challenges to its existence. As discussed later in this volume[1] there were earlier challenges to the structure of the CFPB, finding that while the makeup of the agency was invalid, its actions remained effective. However, in October 2022 the Fifth Circuit Court of Appeals ruled that the funding structure of the CFPB violated the Appropriations Clause of the United States Constitution.[2]

The original lawsuit brought by two trade associations challenged certain provisions of a rule promulgated by the CFPB in 2017 related to payday lending. The lower court granted summary judgment to the CFPB on all matters and the two trade associations appealed to the Fifth Circuit. The appeal was based on two theories: that the funding of the CFPB was unconstitutional and that the prior

1 See the “Regulatory Issues” section later in this publication, in Section I.B.4.

2 *Cmty. Fin. Servs. Ass’n of America, Ltd. et al. v. Consumer Fin. Prot. Bureau et al.*, Case No. 21-50826 (5th Cir. Oct. 19, 2022). The lower case was from the Western District of Texas, Case No. 1:18-cv-295. Pursuant to the Dodd-Frank Act, funding occurs through requests made the Director of the CFPB to the Federal Reserve subject only to a cap of 12% of the budget of the Federal Reserve. As a result, it bypasses any appropriations process by the U.S. Congress.

United States Supreme Court ruling that the agency was structured in violation of the Constitution made the rule invalid form inception. The Fifth Circuit denied many of the claims asserted by the trade groups but latched onto the argument to conclude that the funding mechanism contravenes the separation of powers doctrine of the U.S. Constitution.[3] The court reasoned that separation of powers requires Congress to have control over federal disbursements and since the CFPB is not subject to that process and receives funds from the Federal Reserve, it is not valid. In essence, the bureau could not engage in rulemaking because the rule was enacted based upon the use of unappropriated funds. The decision not only reversed the prior opinion but invalidated the entire rule.[4]

2. *Appeal to Be Heard by the Supreme Court*

Rather than seeking an *en banc* rehearing by the entire Fifth Circuit, the CFPB filed a writ of certiorari with the U.S. Supreme Court on November 14, 2022, asking for an expedited appeal. The trade groups opposed the CFPB's position but filed their own cross petition for certiorari in January 2023.[5] On February 27, 2023 the Supreme Court decided that it would hear the appeal of the CFPB, but not on an expedited basis.[6] The court has also set a briefing schedule. The CFPB opening brief is due May 8, 2023, and the trade associations' brief is due on July 3, 2023. The CFPB reply brief would then be due by August 2, 2023. The court will hear the case during the term that begins in October 2023 with a decision to be rendered by the end of that term, which would be no later than June 2024.

The fate of the CFPB is in the hands of the United States Supreme Court.

In the interim, the Second Circuit Court of Appeals ruled that the CFPB's funding structure does not violate the Appropriations Clause of the Constitution.[7] The Second Circuit did not follow the Fifth Circuit's reasoning in a case involving a civil investigative demand issued to a law firm. The panel found the funding authorized by Congress, which had given control over the CFPB budget outside of the appropriations process. The CFPB asked a New York federal judge to restart another case that had been subject to a stay pending resolution of the Fifth Circuit proceeding at the United States Supreme

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3 The court rejected claims that the rule was invalid due to its promulgation by a CFPB director insulated from removal from office by the President of the United States, that the rule was enacted in violation of the procedures set forth in the Administrative Procedure Act and exceeded its authority and was arbitrary and capricious, and that the CFPB in making the rule constituted an unconstitutional delegation of legislative power. The decision followed a concurring opinion in another case challenging the constitutionality of the CFPB where several judges found that the funding action was unconstitutional and that an underlying enforcement action should be dismissed. *Consumer Fin. Prot. Bureau v. All American Check Cashing, Inc. et al.*, Case No. 18-60302 (5th Cir. May 2, 2022).

4 The Fifth Circuit panel did not find anything wrong with the promulgation of the rule itself, but found only that it was enacted based on the invalid funding structure.

5 In separate briefs, 38 attorneys general (22 Democrats on one brief and 16 Republicans on another brief) urged the Court to grant the petition so that "chaos" could be averted. The Democrats argued against dire consequences if the ruling were upheld while Republicans stated that a quick answer was needed, but that the CFPB should not be allowed to act as a rogue agency.

6 The Supreme Court Docket Number is 22-448. The Supreme Court denied the petition of the trade associations.

7 *Consumer Fin. Prot. Bureau v. Law Offices of Crystal Moroney, P.C.*, Case No. 20-3471 (2d Cir. Mar. 23, 2023).

Court as a result of the Second Circuit ruling.[8] The judge ruled in April 2023 that the case would remain paused until the Supreme Court rules on the matter.

3. *Possible Long-Term Implications of the Appeal*

In the simplest of terms, the Supreme Court can uphold the Fifth Circuit finding that indeed the CFPB's funding structure is unconstitutional or it could reverse that decision, finding the agency to be valid. A discussion of the legal theories involved or speculation as to the outcome is beyond the scope of this work. If the agency is invalidated, there would be a healthy dose of uncertainty, if not chaos, around the prior rules and actions of the CFPB. Prior rules, guidance and enforcement or other actions could be invalidated and unwound. If the CFPB is found to be unconstitutional, Congress would have an opportunity to refashion the agency and change its funding structure. It could also provide a basis to impose a board to rule the agency rather than a single director. An even larger consideration is that if upheld, the same precedent could be applied to other banking agencies that currently and on a longstanding basis are funded outside of the appropriation process, including the Office of the Comptroller of the Currency (*"OCC"*), the Federal Deposit Insurance Corporation (*"FDIC"*), the National Credit Union Administration (*"NCUA"*) and the Federal Reserve.

If the highest court of the land upholds the funding structure, then another basis for challenging CFPB actions will be eliminated, making it more difficult to overturn the CFPB's actions on structural grounds. In the interim, the CFPB is acting as it is "business as usual."

4. *Effect on Existing Actions*

Almost immediately after the Fifth Circuit decision, litigants with the CFPB or recipients of civil investigative demands filed for stays of the relevant action pending additional review or filed motions to dismiss or added additional defenses to invalidate the actions of the CFPB based on the funding structure of the agency.[9]

The CFPB brought an action against an online lender for purported violations of the Military Lending Act.[10] The defendant claims that the suit fails to state a claim and offers the defense that the agency is unconstitutional.

The CFPB is strongly asserting that the Fifth Circuit ruling does not affect its ability to issue civil investigative demands or bring enforcement actions. In December 2022 the CFPB denied a petition by

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8 *Consumer Fin. Prot. Bureau v. MoneyGram Int'l, Inc.*, Case No. 1:22-cv-03256 (S.D.N.Y.).

9 For example, Populus Financial Group, Inc., filed a motion to dismiss a CFPB enforcement action against its ACE Cash Express unit in federal district court in Texas. It also filed a motion to stay the proceedings pending the Supreme Court appeal in the Community Financial Services Association case. The stay was granted by the Court in October 2022. *Consumer Fin. Prot. Bureau v. Populus Fin. Grp., Inc.*, Case No. 3:22-cv-01494 (N.D. Tex.). *See also, Consumer Fin. Prot. Bureau et al. v. Commonwealth Equity Grp., LLC et al.*, Case No. 1:20-cv-10991 (D. Mass).

10 *Consumer Fin. Prot. Bureau v. MoneyLion Techs. Inc. et al.*, Case No. 1:22-cv-08308 (S.D.N.Y. filed Sept. 29, 2022).

a debt collection agency to vacate a civil investigative demand issued by the bureau to it. However, in proceedings outside of the agency itself, litigants are requesting stays of proceeding until the Supreme Court rules on the matter.[11]

As a result, many of the enforcement proceedings brought by the CFPB or civil investigative demands issued by the CFPB are being stayed or are not proceeding until resolution of the constitutionality questions surrounding the CFPB.[12]

B. Small Business Lending—Section 1071 of Dodd-Frank

Over twelve years ago Congress enacted the Dodd-Frank Act,[13] which in part amended the Equal Credit Opportunity Act to require lenders to collect and report application data for women-owned, minority-owned and small businesses. This requirement was found in Section 1071 of the law. Rulemaking languished such that the CFPB was sued over its failure to issue regulations and ultimately agreed to a timeframe in which to issue those regulations.[14] Finally, on March 30, 2023, the CFPB issued its final rule implanting Dodd-Frank Section 1071. While affecting all lenders, this final rule will have implications for online commercial lending platforms.[15]

The regulation will apply to lenders originating at least 100 covered originations in each of the two preceding calendar years. The rule requires the lender to collect and report data about applications from a small business. A small business is one that has $5 million or less in gross annual revenues in its preceding fiscal year. Coverage includes loans, lines of credit, credit cards, merchant cash advances and credit products used for agricultural purposes.

Business lenders face new data collection requirements that will impact operations.

The operational impact of the regulation is that the lender is required to collect and report several data points derived from the credit application. Credit denials require reporting of denial reasons. The information must be collected on a calendar-year basis and reported to the CFPB before June 1 of the following year.

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11 For example, in a repeat offender case, a credit reporting agency asked the Court to stay the action. *Consumer Fin. Prot. Bureau v. TransUnion et al.*, Case No. 1:22-01880 (N.D. Ill.). On April 13, 2023, the Court denied the motion to stay, claiming that the potential consumer harm from violations outweighed the wait period in order to receive a decision from the Supreme Court.

12 *See, e.g., Consumer Fin. Prot. Bureau v. Daniel A. Rosen, Inc.*, Case No. 2:22-cv-06432 (D.N.J.), and *Consumer Fin. Prot. Bureau v. Daniel A. Rosen, Inc. d/b/a/Credit Repair Cloud et al.*, Case No. 2:21-cv-07492 (C.D. Cal.) (challenges to CFPB subpoenas).

13 Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, July 21, 2010.

14 *California Reinvestment Coalition et al. v. Kraninger and Consumer Fin. Prot. Bureau*, Case No. 4:19-cv-02572-JSW (N.D. Cal. filed May 14, 2019).

15 A comprehensive discussion of these regulations is beyond the scope of this paper, but we have outlined some of the major provisions of particular interest to online commercial lenders.

The regulation imposes on larger lenders a requirement to report data earlier than smaller lenders. A lender must collect data as of October 1, 2024, if it originated 2,500 or more transactions in 2022 and 2023. Other lenders must comply on or before April 1, 2025. This regulation should only affect commercial and business marketplace lending programs.

C. CFPB Guidance and Issuances

Since the last update there have been changes at the CFPB and, consistent with the CFPB's past history, those changes remain controversial. The 2020 elections brought in a new administration. As a result, the prior director, a Trump appointee, resigned and was replaced by a new CFPB director on October 12, 2021.[16] The politicization of the CFPB has become readily evident with its almost daily issuances of general information, guidance and enforcement actions. Below are some of the more important actions coming out of the CFPB that directly impact the marketplace lending industry.

1. Proposal on Abusive Acts or Practices

On March 16, 2022, the CFPB announced that it had revised its examination manual to identify discrimination as a potential unfair, deceptive or abusive act or practice (*"UDAAP"*) in addition to being a violation of fair lending laws including the ECOA.[17] While this pronouncement reiterated the agency's increased focus on eliminating bias in the granting of credit, this move is seen as expanding the definition of a UDAAP to go beyond what is currently covered under fair lending laws so as to allow similar claims that relate to virtually every aspect of the credit process. For example, this now allows the CFPB to prohibit discrimination it sees in marketing and advertising activities related to credit, including demographic research and analysis. The examination manual again targets algorithms, automated decision-making, and other technological tools for examination for UDAAP risk. Customer service is also mentioned in the revisions, citing a possible UDAAP if representatives either improperly favor or disfavor customers of certain demographics, including responses to calls from consumers with limited English proficiency. Servicing activities appear to be a renewed focus for the agency. Several trade groups have brought suit against the CFPB that this change was not properly authorized by the Administrative Procedure Act and the agency exceeded its statutory authority.[18] Motions for summary judgment (by the trade groups) and a motion to dismiss (by the CFPB) are pending before the court.

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16 Rohit Chopra served at the CFPB from 2010–2015 and prior to this appointment was a commissioner at the Federal Trade Commission.

17 CFPB Press Release, CFPB Targets Unfair Discrimination in Consumer Finance, https://www.consumerfinance.gov/about-us/newsroom/cfpb-targets-unfair-discrimination-in-consumer-finance/ (Mar. 16, 2022).

18 *U.S. Chamber of Commerce et al. v. Consumer Fin. Prot. Bureau*, Case No. 6:22-cv-00381 (E.D. Tex.).

An activist CFPB targets nonbanks, emphasizing UDAAP, and returns to regulation by enforcement.

On April 3, 2023 the CFPB issued a Policy Statement on Abusive Acts or Practices. This guidance is to provide information and hopefully clarification on how the CFPB will interpret what is abusive under the Consumer Financial Protection Act, which has been a source of confusion and disagreement since the law's enactment.[19] Until this time, the CFPB had failed to define what would constitute an abusive act or practice but would seek to define it through enforcement actions, often criticized as being regulation by enforcement. The proposal provides examples of what might be an abusive act or practice. For example, omissions as well as actions can be deemed to be abusive, such as failing to provide material information to a consumer such that it interferes with the consumer's ability to understand a transaction. The bureau indicates that prices, limitation of benefits or consequences of default are the types of information that consumers need to know and omission from product terms or disclosures could therefore be abusive. Taking advantage or profiting from things such as a gap in understanding, unequal bargaining power or reliance could be abusive. There may also be a violation where a consumer's lack of understanding of risk or cost or conditions of a financial product is unreasonable. The bureau could bring an action if even a small number of consumers lack understanding of a product and as a result they are taken advantage of. Public comment is open on the proposal until July 2, 3022, and even when adopted, it is nonbinding and not legally enforceable, although it will drive the actions that the CFPB will take in this arena. Early critics of the proposal note that the CFPB is acting too broadly and will not require a showing of substantial injury to establish liability so a practice that causes no harm could still be deemed to be abusive. Even if enacted, vagueness and uncertainty will still exist as to the definition and implementation of the abusiveness standard.[20]

2. *Non-Bank Registry for Violations and Contract Terms*

The CFPB has proposed two registries. One is for publishing supervisory orders and one is for contract terms. On December 12, 2022, the CFPB proposed a public listing of non-bank violators of consumer protection laws by regulatory agencies or courts. This "bad boy" list is intended to inform consumers of non-bank companies that have violated consumer protection laws and require those companies to verify compliance on a periodic basis. It was also touted as a means to identify repeat offenders and direct enforcement and public action toward those companies. Among the intended targets identified

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19 While federal banking regulators and the Federal Trade Commission have authority to police unfair and deceptive acts and practices, the Dodd-Frank Act included an additional term, by adding abusiveness into the mix and putting the CFPB in charge of that. In 2020 the CFPB issued a policy aimed at defining abusive behavior as that which was violative of law.

20 We also note that the CFPB updated its examination manual to add discrimination as an unfair, deceptive or abusive act or practice. The U.S. Chamber of Commerce and other trade groups filed a lawsuit against the CFPB, challenging this update as violating the Administrative Procedure Act. The CFPB has filed a motion to dismiss the case, which is pending at the time of this writing. The suit also asserts that the funding structure of the CFPB is unconstitutional and as a result the update should be negated.

by the CFPB were innovative financial products offered by non-bank fintechs. The proposal has been widely criticized as public shaming and creating an unlevel playing field since there is no similar listing proposed for banks and other regulated financial institutions that were made exempt from the proposal.

In January 2023, the CFPB issued a proposed rule that would create another registry of non-banks subject to CFPB supervision and identify contract terms used by those entities which waive or limit consumer rights or legal protections. Non-Bank entities covered by the proposed rule would be payday lenders, private student lenders, mortgage lenders and servicers and large participants in credit reporting, debt collection and remittance transfers. Comments on the proposal were taken until March 2023. The CFPB indicated that several terms in form contracts, fine print or "take it or leave it" provisions would be included in the registry.[21] Critics of the proposal allege that the registry is a backdoor attempt to invalidate arbitration clauses and class action waivers because arbitration provisions would be a part of the registry.[22] The reporting requirement could have a deterrent effect on the use of disfavored provisions, including arbitration, because reporting of disliked terms could be met with possible scrutiny or enforcement actions.

3. *Out with the Old and in with the New*

In May 2022, in an effort to repeal Trump-era practices, the CFPB dismantled its Office of Innovation and replaced it with a new office, the Office of Competition and Innovation. In its issuance the agency stated that rather than focusing on an application-based process to confer special regulatory treatment on individual companies, the new office will support a broader initiative to analyze obstacles to open markets, better understand how big players are squeezing out smaller players, host incubation events and in general make it easier for people to switch financial providers. The agency also eliminated the process for applying for "no action" letters and regulatory sandboxes and instead encouraged startups and the public to file rulemaking petitions to ask for greater clarity on particular rules.[23]

4. *RFI on Data Brokers*

In March 2023, the CFPB issued a Request for Information (*"RFI"*) about entities that collect and sell consumer data, including data brokers, data aggregators and platforms. The intent of the request is to provide the CFPB with knowledge of the industry and its business models in order for the CFPB to

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21 Examples given by the CFPB were waiver of servicemember legal protections, undermining credit reporting rights, and limitation of liability for bank fees caused by repeated debit attempts.

22 The CFPB enacted a rule that would limit or prohibit the use of arbitration clauses in consumer finance agreements. The rule was struck down by Congress under the Congressional Review Act, which restricts the CFPB from enacting a substantially similar rule.

23 Petitions for rulemaking can be filed at https://www.consumerfinance.gov/rules-policy/petitions-rulemaking. Interestingly, the Center for Responsible Lending and the Consumers Bankers Association have petitioned the CFPB to engage in rulemaking to define larger participants in the personal loan market. This is aimed at fintechs and under this new guidance, the petitioners must receive a response from the bureau.

determine if such businesses are covered by the Fair Credit Reporting Act of other federal statutes. The information collected will also help determine whether there is harm being inflicted on consumers and whether regulation needs to occur. The focus is on companies that collect, aggregate, sell, resell, license or otherwise share consumer personal information with others. This is intended to cover those who collect information from consumers directly as well as those who only share previously collected information.[24] Since fintechs and online lenders often use data aggregation services, this RFI and its consequences could have impacts based on what the CFPB ultimately does.

5. *Negative Option Marketing Practices*

In January 2023, the CFPB issued Circular 2023-01 dealing with unlawful negative option marketing practices. In short, negative option practices can violate the UDAAP provisions under the Consumer Financial Protection Act. Violations can occur if there is a misrepresentation or failure to disclose the material terms of the negative option program, failure to obtain a consumer's informed consent or misleading a consumer who wants to cancel, creating unreasonable barriers to cancelation or failing to honor cancellation requests that comply with the disclosed cancellation procedures. The CFPB is concerned with marketing practices where silence or a failure to take affirmative action to reject a product or service exists or where there is a failure to cancel an agreement which is then deemed to constitute acceptance. The CFPB provides some examples such as automatic renewal programs that renew unless affirmatively cancelled, programs to receive products unless they cancel or the charging of a fee on a recurring basis unless there is an affirmative cancellation. The circular indicates that both the FTC and the CFPB have brought enforcement actions including for add-on products such as debt protection and identity theft protection. In order to avoid UDAAP violations, the guidance requires fulsome disclosure including of the material terms of any negative option offer and emphasizes the need to obtain informed consent before charging fees to a consumer and to provide for reasonable cancellation mechanisms that allow cancellation without undue interference.[25] Given the heightened scrutiny of negative option marketing practices, fintechs and online lenders engaging in such practices should review and follow the guidance carefully or risk enforcement proceedings.

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24 We note that in October 2022 the CFPB issued an Advance Notice of Proposed Rulemaking to implement Section 1033 of Dodd-Frank, which requires that consumers be given access to certain financial information and data aggregation services. No rule has been promulgated.

25 In October 2021, the FTC issued a policy statement applicable to non-bank entities on negative option marketing containing similar requirements on disclosure, informed consent and easy cancellation. In addition, some states (*e.g.*, California, Colorado, Delaware and Illinois) have enacted additional restrictions and requirements relative to negative option marketing.

6. *Examination of Non-Banks—CFPB Invokes Dormant Authority to Examine Non-Bank Companies*

In late April 2022, the CFPB announced that it was "invoking a largely unused legal provision to examine non-bank financial companies that pose risks to consumers."[26] This authority has not been used before. The announcement seems to target fintech companies as the CFPB stated that this will allow it to supervise entities that are fast-growing or in markets outside the bureau's existing supervision programs. In essence, any non-bank not currently supervised will be subject to this unspecific and uncertain rule. Critics see this as a return to the mantra of "regulation by enforcement" rather than regulation, given the lack of guidelines the CFPB must follow in assessing risk to consumers or engaging in supervisory activity. While the bureau sees this as leveling the playing field with banks, it proposes to make its actions public, whereas this is not the case with much of the supervisory activities of depository institutions. At least in the short term, fintechs should expect closer scrutiny, examination and enforcement from the CFPB. On May 19, 2022, the CFPB announced that it would assist state enforcement of consumer protection law by working with and supporting state regulatory efforts to enforce the Consumer Financial Protection Act.

The CFPB indicated that it would publicly identify a potential offender under the registry described above. Critics viewed this effort as a way to examine online lenders, payment platforms and "buy now pay later" providers in an effort to expand its supervisory reach. Interestingly banking organizations vocally criticized the plan, particularly public disclosure, and the CFPB indicated that it would back off the disclosure aspects. Some critics saw this as another "regulation by enforcement" move of the activist agency without engaging in proper rulemaking. Other critics noted that it is suspect that the CFPB would be making its determination before any actual inspection of a company had been conducted and that publicizing only a preliminary finding is deeply problematic. This could lead to litigation and reputational damage even if an entity is later given a clean bill of health. As of this writing, the CFPB has not moved forward with either the examination process or public disclosure of any company.

7. *Fair Lending Focus*

On May 6, 2022, the CFPB submitted its annual report on fair lending to Congress. Of note is the agency's prioritization of fair access to credit and also its notation that it will focus on emerging risks of digital redlining and algorithmic bias. The agency has been critical of both artificial intelligence and machine learning, and the report expressed a skepticism that technology can cure bias in credit underwiring and pricing. Credit models remain under review for potential discrimination.

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26 CFPB Press Release, Apr. 25, 2022. Under the Dodd-Frank Act, the CFPB already had broad supervisory authority over all non-bank entities in the mortgage, private student loan, and payday loan industries regardless of size and non-banks that are determined by regulation to be "larger participants" (currently including consumer reporting, debt collection, student loan servicing, international remittances, and auto loan servicing).

On May 9, 2022 the CFPB issued an interpretive rule on the Equal Credit Opportunity Act (*"ECOA"*) and its implementing Regulation B, reminding the industry that the law and regulation not only apply to applications for credit but also continue after a loan has been made, including occasions of credit revocation or imposition of unfavorable terms that would necessitate the provision of a notice of adverse action. While this has been the position for some time of the CFPB and of other federal regulatory agencies, some federal district courts have found that the ECOA and Regulation B only apply to the credit application process.[27] The agency also noted that some creditors have challenged the applicability of the ECOA to events after credit application. The CFPB will look at all aspects of the credit relationship in applying fair lending laws.

8. *Insufficient Data Protection—UDAAP*

On August 11, 2022, the CFPB published a circular stating that persons may violate the prohibition on unfair acts and practices contained in the Consumer Financial Protection Act if they have insufficient data protection or information security practices. The bureau highlighted three data security practices that could result in substantial injury to consumers without counterbalancing benefits and therefore trigger liability for financial institutions or their service providers. Those high-risk areas are inadequate authorization, poor password management, and lax software update policies. In addition to other issues related to electronic communications, this is yet another arena for marketplace lenders and Funding Banks to be aware of and comply with in order to avoid challenge as an unfair practice.

Other pronouncements of the CFPB related to "buy now pay later" products and preemption of commercial loan disclosures are discussed below.

D. Enforcement Actions

In September 2022, the CFPB sued an online lender, alleging the fintech had overcharged military borrowers on its online loans and snared consumers into paid membership programs.[28] Consumers could not obtain loans unless they joined a membership program and paid monthly membership fees. The CFPB alleged that those fees push the cost of credit above the 36% rate cap on loans to military-related borrowers under the Military Lending Act. In addition, the use of an arbitration clause in the loan agreement also violated the law according to the CFPB. The CFPB also alleged that the fintech misled consumers regarding cancellation of their membership because their membership fees could not be cancelled so long as there was an unpaid balance on the loan. The suit seeks unspecified

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27 This issue arises due to the definition of "applicant" in the law and regulation itself. But the banking agencies have determined that an applicant includes borrowers already granted credit. The Federal Reserve made this determination over forty years ago. This issue is on appeal in the Seventh Circuit—*Fralish v. Bank of America, N.A.*, Case Nos. 21-2846(L) and 21-2999. An amicus brief was filed by the CFPB along with the Department of Justice, the Federal Reserve Board, and the Federal Trade Commission to the same effect as stated in the May 9, 2022 advisory opinion of the CFPB.

28 *Consumer Fin. Prot. Bureau v. MoneyLion Techs., Inc. et al.*, Case No. 1:22-cv-08308 (S.D.N.Y. filed Sept. 29, 2022).

redress for consumers, injunctive relief and a civil money penalty. The fintech filed a motion to dismiss the case.[29]

Another online lender issued a statement that it had received additional inquiries from the CFPB which is investigating its loan processing practices pursuant to an earlier civil investigative demand.[30] The company stated that it had disclosed several of the issues on its own and was offering restitution to customers dealing with processing issues. The CFPB is investigating companies that have previous actions with the agency.[31]

II. TRUE LENDER LITIGATION

A. Background of True Lender Litigation

Perhaps the most significant legal risk facing many marketplace lenders is "true lender" litigation. The platforms most at risk are those that (i) market loans via the Internet, (ii) typically enter into contracts with federally insured depository institutions (herein called "*Funding Banks*") who originate and fund the loans the platforms have marketed, (iii) purchase loans from a Funding Bank at or shortly after origination and (iv) continue to service the loans throughout the life of the loans. At the highest risk, and the most likely to be sued, are platforms where the loans are made at higher rates of interest. In a "true lender" action, a borrower or regulator claims that the "true lender" of a loan made by a Funding Bank is the platform—not the Funding Bank—because the platform marketed the loan, has the "predominant economic interest" in the loan (insofar as it has purchased the loan or a large participation therein), and/or is engaged in other related activities such as loan servicing.[32] Some causes of action are brought on the basis that under the "totality of circumstances" the platform should be considered the lender. This question of whether the platform or the Funding Bank is the "true lender" is far from a technicality. Under a principle known as federal preemption, banks whose deposits are insured by the Federal Deposit Insurance Corporation (*"FDIC"*) can lend at rates allowable in the state of the bank's location, which can then be exported to borrowers in other states and preempt conflicting state laws in states where borrowers are located.[33] This principle allows depository institutions to engage in nationwide lending under uniform terms rather than be subject to the rate and fee structure of the individual states where borrowers reside. A marketplace lender that works with a

29 In addition to substantive reasons, MoneyLion also claims that the CFPB is unconstitutional and on that basis the claims should be dismissed.

30 Enova International Inc. 10-Q filed Oct. 28, 2022.

31 Enova International 8-K filed Jan. 25, 2019. Enova entered into a settlement in 2019 with the CFPB and paid a $3.2 million fine.

32 This type of litigation would not apply to lenders who make loans directly under state licenses at allowable rates and fees.

33 Federal preemption entitles national banks and FDIC-insured state banks to export the rates and fees of the state in which a bank is located to borrowers in other states and preempts inconsistent state laws in those other states. National banks are afforded preemption under 12 U.S.C. § 85 and state banks under 12 U.S.C. § 1831d. Thus, a Funding Bank may rely on federal preemption to extend loans at a higher interest rate than applicable state law might otherwise allow. As a result, Funding Banks tend to be located in states with no interest rate limitations, such as Utah or Delaware.

Funding Bank will in turn claim its own exemption from state lender licensing and usury laws on the basis that the Funding Bank (and not the platform itself) is the lender.[34] Claiming these exemptions has obvious benefits for the platform (*e.g.,* a consumer marketplace lender would thereby be able to offer its loans at uniform rates throughout the nation), but at the same time a marketplace lender that extends loans through a Funding Bank can face significant liabilities if the loans don't comply with federal and state requirements and it loses a true lender case. In fact, the enforceability of some or all of its loans may be called into question.[35] Potential consequences of the platform and not the Funding Bank being deemed the true lender include violation of state lending license laws and violation of state usury laws, which could result in a reduction or elimination of interest and/or principal and/or penalties or damages and, in some instances, voiding of the loan under state law. For this reason, true lender litigation is closely followed by market participants, and adverse rulings can have a significant impact on the marketability of loans extended by particular lenders and/or extended to borrowers in particular states.[36]

> The largest regulatory focus remains the issue of determining the true lender, which is being addressed by litigation and state laws.

True lender theories also differ from litigation based on whether an assignee of a loan can enforce the loan terms as to borrowers. The latter theory challenges the "valid when made" doctrine that a loan which is valid when made by a lender can be enforced by a downstream purchaser of the loan, which is discussed later. The true lender theory challenges the validity of the named lender, asserting that someone other than the named lender is the lender in fact. While often asserted in the same proceeding, the two theories are different and distinct, although after the enactment of OCC and FDIC regulations codifying the valid-when-made doctrine, the focus appears to be shifting to true lender causes of action.[37]

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34 However, while avoiding lending licenses, platforms may in some states need licenses to solicit or broker loans to financial institutions, to purchase loans, and/or to service and collect loans. This is discussed later in this book.

35 See "Lending Laws, Licensing, and Related Litigation" below for further discussion of the penalties that may apply to violations of state licensing or usury laws.

36 Many of the true lender cases that have been decided to date have involved payday lenders rather than marketplace lenders. In addition, some of the payday lender decisions have required the court to consider tribal law (which has been the governing law for certain payday loans but would not often be chosen to govern marketplace loans). The analysis of true lender issues undertaken in these cases is nonetheless instructive for marketplace lending structures, although different from notions of statutorily enumerated preemption powers.

37 As detailed below, federal regulations state that a loan valid when made continues valid in the hands of an assignee when it is sold, transferred or assigned. Thus, the rates and fees allowed to be charged by a Funding Bank continue in the hands of an assignee.

> True lender litigation results in uncertainty in the market and challenges the doctrine of federal preemption conferred on insured banks by federal law. Litigation is both lengthy and costly.

B. Recent True Lender Litigation

Most, but not all, of the recent actions filed against marketplace lending programs have been targeted at higher rate, subprime participants. In addition, in order to avoid raising the issue of federal preemption, Funding Banks are usually excluded from such litigation. In many instances, the actions are brought in state court and the defendants remove them to federal court based on the existence of federal questions relating to preemption, and the plaintiffs then seek to remand the case back to state court. If the loan agreement at issue contains an arbitration clause, there is usually an attempt to compel arbitration and avoid a class action proceeding. Some of the recent actions on these issues are discussed in this section. There are several recent actions where arbitration clauses have caused dismissal of the actions and the case sent to arbitration.

On June 23, 2021, a borrower of a Best Egg loan filed a putative class action complaint against Marlette Funding, LLC in state court in Pennsylvania.[38] Marlette subsequently removed the case to federal district court and filed a motion to compel arbitration of the plaintiff's claims.[39] The plaintiff alleged Marlette was the lender of the loan rather than Cross River Bank and that, based on the *Madden* case, Marlette may not rely on the federal preemption of interest rate laws that applies to Cross River Bank after the sale of the loan. A motion to compel arbitration was filed. On January 16, 2023, the plaintiff filed a voluntary notice of settlement. The court dismissed the litigation by stipulation on January 30, 2023.

> The use of arbitration agreements has been successful in obtaining dismissals of purported class action lawsuits.

On July 23, 2021, a consumer filed a putative class action complaint against a non-bank partner that arranged for the origination of loans by WebBank in state court in Pennsylvania.[40] The plaintiff alleges both that the non-bank partner was the lender of the loan rather than WebBank and that, based on the *Madden* case, the non-bank partner may not rely on the federal preemption of interest rate laws that applies to WebBank after the sale of the loan. Based on these theories, the plaintiff claims that the interest rate on the loan exceeded the 6% interest allowed by Pennsylvania law. The complaint raises a claim under the Pennsylvania Loan Interest Protection Law, the Consumer Discount Company Act, and the Unfair Trade Practices and Consumer Protection Law on behalf of a putative class of

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38 *Henry v. Marlette Funding, LLC*, No. GD-21-007229 (Ct. Common Pleas, Allegheny Cty., Pa.).

39 *Henry v. Marlette Funding, LLC*, No. 2:21-cv-00985 (W.D. Pa.).

40 *McDaid v. Avant, LLC*, No. GD-21-008447 (Ct. Common Pleas, Allegheny Cty., Pa.).

Pennsylvania borrowers who paid interest and fees in excess of 6% simple per year, and it seeks actual, statutory, treble and other damages, attorneys' fees and costs, declaratory relief, and other unspecified relief. On August 26, 2021, Avant removed the case to federal court. The court denied plaintiff's motion to remand. On September 23, 2022, the Magistrate Judge issued a report and recommendation to grant Avant's motion to compel arbitration. On November 10, 2022, the federal court granted Avant's motion to compel arbitration and dismissed the case.

In addition, two borrowers commenced putative class actions in the circuit court for Montgomery County, Maryland, against a marketplace lending platform and certain entities that had been trying to collect on the borrowers' loans. The complaint asserts claims for violation of certain Maryland state laws and seeks damages in part on the theory that the platform is the true lender rather than WebBank. The plaintiffs also seek a declaration of requirement for Maryland licensure as a credit services business and alleged that certain defendants did not have the right to collect money from the plaintiffs and the class members on the loan accounts. Defendants removed the actions to federal court and have moved to compel arbitration.[41] Plaintiffs also filed a separate proceeding claiming that the arbitration provisions are unenforceable, which defendants also removed to federal court.[42] The district court consolidated the cases and ruled in favor of the defendants, granting the motion to compel arbitration. The plaintiffs both moved to reconsider and appealed. On April 4, 2023, the motion for reconsideration was denied and on April 10, 2023, the appeal was docketed at the Fourth Circuit Court of Appeals.

On June 1, 2022, a putative class action lawsuit was filed in federal court in the Western District of Texas, alleging that persons received high interest rate loans through Opportunity Financial that exceeded the usury limits in violation of Texas usury laws. The suit asserts statutory claims under Texas law, claims of unjust enrichment, and violation of the federal Racketeer Influenced and Corrupt Organizations Act and also seeks a declaratory judgment that the loans are unconscionable, void and unenforceable.[43] The suit alleges that Opportunity Financial is the true lender with the predominant economic interest in the loans; that the originating bank, FinWise Bank, is not the real party in interest to the loans; and that Opportunity Financial devised a "rent-a-bank scheme" in an attempt to evade Texas law. The complaint alleges that the interest rate on the loans in question is 130% and thus in excess of the 30% usury limit in Texas. The complaint further asserts that the loan's arbitration clause is unconscionable, void and unenforceable. Opportunity Financial has filed a motion to compel arbitration. In January 2023, the motion to compel arbitration was granted and the case was dismissed.

A purported class action complaint was filed at the end of 2021 in California, alleging various claims against a marketplace lending participant.[44] Although the facts allege a true lender scenario, rather

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41 *Jones v. Prosper Marketplace, Inc.*, Case No. 8:21-cv-00893 (GJH) (D. Md.); *Khan v. Crown Asset Mgmt., LLC*, Civil Action No. 8:21-cv-01126 (GJH) (D. Md.).

42 *Khan et al. v. Crown Asset Mgmt., LLC et al.*, Case No. 8:21-cv-01914 (D. Md. filed Jul. 29, 2021).

43 *Michael v. Opportunity Fin., LLC,* Case No. 1:22-cv-00529 (W.D. Tex. (Austin) June 1, 2022).

44 *Crystal Carpenter et al. v. Opportunity Fin., LLC*, Case No. 2:21-cv-09875 (C.D. Cal. filed Dec. 22, 2021).

than making typical claims of true lender or usury, the complaint seeks relief for state law causes of action related to unfair competition, unconscionability, money had and received, and conspiracy and fraudulent concealment. This strategy may be to avoid raising issues or defenses related to federal preemption of state law. A motion to compel arbitration was denied on March 29, 2023. In March 2023, the court denied the motion and a motion to reconsideration has been filed, which will be heard in May 2023.[45]

These recent cases denote the utilization of arbitration clauses, raising the ability of defendants in most instances to plead that the actions should be arbitrated, which generally moots class claims.

C. Attorney General Actions and Challenges

In March 2022, Opportunity Financial (*"OppFi"*), a financial technology platform, undertook an offensive strategy and brought suit for declaratory and injunctive relief against the California Department of Financial Protection and Innovation (*"DFPI"*).[46] The fintech seeks to bar the state regulator from applying state interest rate caps to loans made by a Utah state-chartered bank. The state was intending to bring an action against the company on a true lender theory and thereby apply the state interest rate cap rather than the rate that the bank would be able to charge to loans made to California borrowers. The plaintiff is seeking a ruling to the effect that the state's usury limitations do not apply to loans made by a federally insured bank.[47] In doing so, it is claiming that the bank—not the platform—is the true lender on the loans because it extended the credit, is the named lender on the loan agreements with borrowers, and remains the owner and holder of the loans. As a result, under federal law, the loans made by the Utah bank under rates allowed to be charged by Utah banks would preempt California law.

> Some marketplace lenders are taking offensive action and even bringing actions against regulators.

Not to be outdone, the DFPI filed a cross-complaint against the fintech, seeking to enjoin it from collecting interest in excess of California limits and declaring the loans void. The cross-complaint claimed the company was engaged in a "rent-a-bank ruse" to circumvent state usury laws. The state reiterated its claims that the platform was the true lender based on the primary fact that it has the

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45 California has some unique issues related to arbitration due to case law there (discussed later in this publication).

46 *Opportunity Fin., LLC v. Hewlett*, Case No. 22STCV08163 (Sup. Ct. Los Angeles Cty. filed Mar. 7, 2022).

47 In 2020, a California law took effect limiting the rate of interest that could be charged on loans over $2,500 up to $10,000. Known as AB539, this law capped rates at 36% plus the Fed Funds rate, whereas previously loans made by licensed lenders had been unrestricted. Prior to the law being enacted, OppFi and FinWise Bank in Utah began a loan program. The suit was filed after DFPI told OppFi that the bank loans were subject to California law and violated the restrictions of AB 539.

"predominant economic interest" in each loan transaction.[48] The state[49] also claims that in performing all of the functions of a traditional lending institution, including marketing, servicing, and significant input into credit underwriting criteria, it is the true lender and subject to state law. The state seeks a permanent injunction declaring the loans void and prohibiting collection on the loans, in addition to restitution to borrowers to include removal of negative credit reporting and payment of penalties of at least $100 million.

Soon thereafter, in May 2022, OppFi filed a demurrer asking the court to disregard the state's pleading on the basis that, under California law and prior decisions, a loan made by an out-of-state bank does not fall within the jurisdiction of the DFPI. It called the state's legal position "convoluted" in an attempt to make OppFi the lender on loans made by a bank. The court denied the demurrer in September 2022. In October 2022, OppFi filed a new cross complaint against the state, calling the state's attempt to subject bank loans to state interest rate limitations "underground regulation." The pleading claims proper rulemaking was not engaged in by the state and therefore its actions were invalid. In February 2023 the state filed to obtain a preliminary injunction against OppFi to stop making loans in California, which was subject to a hearing and is awaiting decision.

This case will be watched with interest and, due to the size of the California lending market, the outcome will be of import, although unless settled, that outcome may be years in the making. The reach of the decision may also be limited given that the basis of the action relates to existing provisions of California law, not just determinations of federal preemption of state law generally.

D. Tribal Lending True Lender Case Update

Some years ago the CFPB sued a tribal lender, CashCall, a case that has taken several twists and turns and is pending at the Ninth Circuit Court of Appeals.[50] CashCall made high-rate loans online through tribal bodies based on tribal law, claiming that such loans were not subject to federal or state law due to sovereign immunity given to Native American enterprises.[51] It was sued by the CFPB on various theories and the district court found that that CashCall, not the tribal entities, was the true lender on

48 There is no definition of what constitutes predominant economic interest but DFPI claims in support of that allegation that OppFi meets that standard in that it purchases almost 100% of the loan receivables within three days after funding, insulating the bank from credit risk. The state also claims OppFi pays most of the costs of the arrangement, including a guaranteed monthly fee. The regulator also claims the cash collateral account to support receivables purchases is a prerequisite to funding.

49 The cross-complaint also alleges violations of the state's Consumer Financial Protection Law. While this law does not apply to a state licensee—which OppFi is—the state alleges that OppFi is not conducting activities under its license and so it is therefore subject to the consumer protection law and has violated its provisions. The state also seeks a permanent injunction against using preauthorized electronic payments by OppFi.

50 The history of this case is depicted later in this text. *Consumer Fin. Prot. Bureau v. CashCall Inc. et al.*, Case Nos. 18-55407 and 18-55479 (9th Cir.).

51 Tribal lending programs are fundamentally different from lending programs with federally insured depository institutions; thus, the determinations made with respect to tribal programs may have limited precedential value when related to notions of federal preemption. Tribal programs are almost wholly unregulated while programs with a Funding Bank are highly regulated, including the service providers to the banks involved.

the loans; restitution damages were determined to be over $200 million. CashCall appealed the award and the court imposed only a $10.3 million penalty, noting that the high rates were fully disclosed and consumers received what they had bargained for. Both parties appealed the damages award and the case was dormant while other cases were being decided primarily related to the constitutionality of the CFPB. Finally, in September 2021, the Ninth Circuit heard arguments on the damages issue. In February 2023, the district court awarded damages of $167 million against CashCall ($134 million in restitution and $33 million as a civil money penalty). In March 2023, CashCall asked the court to stay the action pending the United States Supreme Court's ruling on the constitutionality of the funding structure of the CFPB. Also in March 2023, the motion to stay was denied and CashCall has appealed that decision to the Ninth Circuit Court of Appeals.

E. State Developments

1. Nebraska

Some states have enacted legislation aimed at fintechs working with Funding Banks. Licensing and usury considerations are being placed upon bank service providers or entities with the predominant economic interest. Later in this book laws in Hawaii, Illinois, Maine and New Mexico are detailed. One other state should be highlighted. In 2021, Nebraska passed legislation that requires entities holding, servicing or otherwise participating in consumer loans made to Nebraska residents with an interest rate greater than 16% per annum, a principal balance of less than $25,000 and a duration of 145 months or less to have a physical location in the state. However, the physical presence requirement does not apply to owners, servicers or purchasers of installment loans if they are not making the loans. The state has taken an enforcement posture with respect to online programs requiring compliance with these requirements.

2. Washington

In early 2023, the Department of Financial Institutions of the State of Washington announced that it was gathering information about fintech companies and their lending activity and relationships with out-of-state banks and credit unions. While acknowledging the right of banks and credit unions in other states to export their home-state interest rate to other states, including Washington, this may result in higher interest rates being charged to consumers in the state due to these fintech relationships. According to the state, it can be difficult to determine which entity in these relationships is the "true lender." The state issued "requests for information" from ten fintech companies working with out-of-state banks and credit unions, many of them subprime or higher-rate lenders. The state regulators indicated that such information would help them better understand these relationships, the terms of the financial products offered, whether such arrangements needed a Washington license, and how the products affect Washingtonians.

III. FEDERAL REGULATORY DEVELOPMENTS

A. Update on Regulatory Agencies

Bank regulatory agencies continue to be interested in bank relationships with fintechs and innovative products and services offered by or in conjunction with regulated financial institutions. Several of the agencies in the past year have beefed up their regulatory posture in this area and in particular have addressed the emerging cryptocurrency field and its intersection with banking. In particular, the CFPB has been issuing pronouncements on newer products and services being offered in the public marketplace, often by fintech companies. The following section recaps some of these actions.

1. OCC

In October 2022, the Office of the Comptroller of the Currency released its bank supervision operating plan for the next year. It listed third-party relationships as one area called out for increased examiner scrutiny. In particular, the agency highlighted relationships with financial technology companies and new products and services. As a result, fintech relationships with OCC-supervised banks will receive heightened focus and increased regulatory oversight.[52] The Acting Comptroller has raised questions about the complex arrangements between banks and fintechs. The OCC said the focus will be to assess that there is proper oversight of these relationships commensurate with the risk posed. The OCC said that it will assess whether both the bank and the fintech have sufficient and qualified personnel to meet contractual obligations.

On March 30, 2023, the Office of the Comptroller of the Currency announced the establishment of an Office of Financial Technology. Earlier, in October 2022, the OCC announced that it would be expanding upon its Office of Innovation with this move designed to increase the agency's expertise and ability to adapt and respond to the pace of technological change in the banking industry. The regulator intends that this focus will provide for high quality supervision of bank-fintech relationships by expanding its knowledge of fintech platforms and applications to better achieve its goal of monitoring compliance by national banks and federal savings associations with applicable law and regulation. Like other regulators, the office will analyze, evaluate and discuss trends in financial technology, emerging and potential risks and implications for supervision. Emphasis will be placed on digital assets, fintech partnerships and emerging products and business models at or affecting OCC-chartered institutions.

52 A proposed interagency guidance on third-party relationships has not been enacted. The subject priority is consistent with prior OCC guidance on third-party relationships. The OCC has frequently asked questions on its website regarding third-party relationships and in 2021, the OCC along with the FDIC and Federal Reserve released a guide on conducting due diligence on fintech companies. We note that third-party service providers to banks are subject to examination and regulation by the federal banking agencies under the provisions of the Bank Service Company Act, 12 U.S.C. § 1867(c).

2. *FDIC*

a. Crypto and Deposit Insurance

The FDIC has warned fintechs and banks about proper disclosure of deposit insurance, particularly when dealing with cryptocurrency arrangements. In July 2022, the FDIC and the Federal Reserve ordered a bankrupt cryptocurrency company to stop making false or misleading statements about deposit insurance.[53] The agencies in a cease and desist letter stated that customers were being misled that the company and their funds were protected by FDIC insurance or that customers would be insured if the company failed.

While some cryptocurrency arrangements have both a crypto and a cash component, only the cash component would be subject to insurability if held at an FDIC-insured institution. Those funds are insured only in the event of a failure of the financial institution, not the cryptocurrency company. Digital assets not held at a bank would not be subject to FDIC insurance coverage and in the event of a bankruptcy could be part of the bankruptcy estate and proceeding.

> Bank regulators are paying attention to bank relationships with crypto companies and statements made about deposit insurance.

On July 29, 2022, the FDIC issued FIL 35-2022 to all banks, advising them of the importance of clear and correct guidance on FDIC insurance where cryptocurrency companies and accounts are involved. The letter reiterates that FDIC insurance only covers deposits held in insured banks in the event of a bank failure and that the FDIC does not insure assets of non-bank entities such as crypto companies. It also asks banks to confirm and monitor that those crypto companies are not misrepresenting the availability of deposit insurance.[54]

In March 2023 the FDIC addressed another cryptocurrency situation and demanded that the company cease making false or misleading representations about deposit insurance regarding protecting customers' cryptocurrency.[55] The company, not an insured depository institution, claimed that it was insured by the FDIC. It did not identify any insured institution with whom it had a relationship with respect to deposits and was a material omission.

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53 The company involved was Voyager Digital. Like other cryptocurrency companies, it sought Chapter 11 bankruptcy protection when customers withdrew funds from its platform.

54 The FDIC also issued a Fact Sheet for the public to clarify these points, primarily that deposit insurance does not cover non-deposit products including crypto assets.

55 F.D.I.C. P.R. 24-23, 2023 WL 2645029 (Mar. 27, 2023).

b. ILC Charter

In September 2022, a bipartisan group of U.S. Senators sent a letter to the acting FDIC Chairman expressing support for the industrial loan company (ILC) charter and that the FDIC needs to consider new deposit insurance applications from ILCs as well as other applicants under uniform federal standards. The senators extolled the virtues of the charter, including its historical success, providing additional expansion opportunities and performing niche lending in areas ignored by larger institutions. The letter concluded by asking that the FDIC not act disadvantageously toward ILCs.[56]

3. Department of the Treasury

In November 2022, the United States Department of the Treasury issued a report on banks and fintechs. The report concluded that partnerships between banks and financial technology companies are positive for consumers when conducted responsibly. Of importance was the observation by Treasury Secretary Janet Yellen that under existing law and regulation, regulators can both encourage competition and protect consumers. The report recommended that regulators finalize proposed guidance on how banks should manage third-party relationships and service providers. This includes bank oversight and protective contractual provisions with service providers including fintechs.

4. Federal Reserve

Following other bank regulators, the Board of Governors of the Federal Reserve System issued a policy statement in February 2023 concerning cryptocurrency assets. The activities of state member banks and their subsidiaries are limited to cryptocurrency activities that are permissible for national banks.[57] This aligns what state Fed member banks can do in this arena with guidance issued by the OCC for national banks, including all terms, conditions and limitations placed on national banks by that activity.[58] As with other banking agency guidance, crypto assets may only be held as principal. Any bank seeking to issue a stablecoin would need approval (*i.e.,* a supervisory nonobjection) and be required to follow all restrictions placed on national banks by the OCC. State member banks may offer traditional banking services such as deposit or lending products to crypto companies. Custodial safekeeping for crypto assets is allowed if conducted in a safe and sound manner and in compliance with applicable

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56 Some charter applications have been pending at the FDIC for long periods of time or have been withdrawn. As discussed elsewhere, in 2022 the FDIC issued a rule concerning commitments to be obtained where the parent company is not a regulated financial institution. Since those companies are exempt from bank holding company regulations that restrict banking organizations, the ILC charter has been viewed as a way for non-banks to enter the financial field and has resulted in some degree of controversy about the ILC charter.

57 The Policy Statement also applies to non-insured state member banks such as trust companies.

58 If a proposed activity is not permissible for a national bank, a bank must obtain the Federal Reserve Board's prior permission under Regulation H.

anti-money laundering and consumer protection laws. However, the policy statement cautioned against having business models or exposures concentrated in the crypto asset industry.[59]

5. CFPB and Other Regulators Target New and Innovative Products

a. Buy Now Pay Later

Buy now pay later (*"BNPL"*) programs have proliferated since the last publication, reaching almost $100 billion in 2021. In its December 16, 2021, press release announcing an inquiry directed at five companies,[60] the CFPB described BNPL as follows:

> Buy now, pay later credit is a type of deferred payment option that generally allows the consumer to split a purchase into smaller installments, typically four or less, often with a down payment of 25 percent due at checkout. The application process is quick, involving relatively little information from the consumer, and the product often comes with no interest. Lenders have touted BNPL as a safer alternative to credit card debt, along with its ability to serve consumers with scant or subprime credit histories.
>
> Merchants are adopting BNPL programs and are willing to typically pay 3 percent to 6 percent of the purchase price to the companies, similar to credit card interchange fees, because consumers often buy more and spend more with BNPL. Indeed, BNPL's use has spiked during the COVID-19 pandemic and throughout the holiday shopping season. More and more Americans are using it, and the most recent Black Friday and Cyber Monday shopping weekend saw massive growth in BNPL. This explosive growth has caught the eye of many investors, including significant venture capital money. Big tech companies are also entering the arena.

The CFPB inquiry collected information on the risks and benefits of BNPL. The bureau expressed concerns as to the ease with which consumers can accumulate debt, regulatory arbitrage due to a lack of consumer protections such as disclosures, and data harvesting.[61] In January 2022, the CFPB invited any interested person to submit comments regarding BNPL products. In March 2022, the Attorneys

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59 The timing of the guidance is interesting given that within a month of its issuance, Silvergate Bank, a primary lender to the crypto industry, ceased operations. This was in conjunction with the withdrawal of funds from crypto products and services and dislocation in the industry. Not long after, Silicon Valley Bank and Signature Bank, significant providers of financial services to the fintech sector, failed and were placed into receivership with the FDIC. Hence the warning on overexposure to a market segment was timely if not foreshadowing.

60 The five companies to which the CFPB sent inquiries were Affirm, Afterpay, Klarna, PayPal, and Zip.

61 For example, because BNPL products do not charge interest and are paid in four or fewer installments, the federal Truth in Lending Act does not apply. Its protections only apply when interest is charged or a transaction is payable in more than four installments. A BNPL product not meeting this requirement would not have to provide disclosures or be subject to other protections under the rule.

General of 21 states submitted a comment letter expressing concern about the product, while others requested that the CFPB provide more consumer protections and disclosures with respect to BNPL products.[62]

> Buy Now Pay Later and other new products are facing regulatory scrutiny, which may result in future regulation.

In September 2022, the CFPB issued a report on BNPL. The report discussed some of the harm and risk that arise from BNPL products. One concern is overextension—that consumers are spending more than they otherwise would and perhaps are not able to afford. This can happen through sustained usage as consumers put more payments on BNPL and thereby impede their ability to repay non-BNPL obligations. The other overextension risk is "loan stacking"—that consumers take out concurrent BNPL loans with different lenders and become unable to pay some or all of them. This situation is exacerbated by the ability to make multiple transactions in a short period of time and by lenders not furnishing performance data to consumer reporting agencies. The bureau also stated that the BNPL companies collect consumer data, which they termed "data harvesting," that could result in risk or harm to consumers in the areas of privacy and security. The agency also theorized that there could be market power with data concentration and that data could be used to benefit some consumers and not others, resulting in consumers paying different prices for the same product with the same seller.

The CFPB Report also cited the lack of adequate disclosure being made to BNPL customers. Usually an up-front disclosure is not made nor are there periodic statements given to consumers because most BNPL transactions are structured so that the disclosure requirements of the federal Truth in Lending Act do not apply. The bureau raises a concern that this lack of disclosure may result in consumers not understanding the product terms, fees and payment requirements. The CFPB also noted that there is no uniform complaint resolution process for BNPL products or for billing error resolution as exists with other credit products. The report also noted that most BNPL programs require the use of "autopay" and make it difficult or impossible to change that feature, which could be a violation of Regulation E that prohibits loan payments to be made by electronic transfer as a condition of receiving the loan. There is also a tacit criticism of BNPL companies making several re-presentments of failed payments and charging multiple late fees on a missed payment.

At about the same time, the Federal Trade Commission (*"FTC"*) reminded non-bank BNPL companies that they can be liable for violations of Section 5 of the FTC Act based on misrepresentations or omissions made about BNPL products. The FTC cautioned market participants not to misrepresent the costs of a BNPL product or its terms. Advertising claims may be deceptive if not true for the typical borrower and must be supported by reliable evidence. The agency also warned against in effect hiding

62 Several consumer advocacy groups urged the CFPB to treat BNPL products just like credit cards covered by Truth in Lending. Even some creditor trade groups urged more robust information be provided to consumers.

the ball from consumers with having to go through a number of screens, using small icons or "hiding" information in long terms of service documents. The FTC stated that both retailers and BNPL players may be held liable for unfair or deceptive practices.

CFPB studies show both risk and benefit from BNPL.

In March 2023, the CFPB issued a new report based on its survey of consumers.[63] Somewhat of a surprise to the CFPB, BNPL is used by people who have other available means or access to credit, including those more expensive than BNPL and, as a result, BNPL can be beneficial as it is a lower-cost option. The CFPB also noted the many BNPL customers use the product without evidence of financial distress but that the average BNPL borrower was more likely to have high amounts of debt, to revolve on credit cards and to have suffered one or more delinquencies on a traditional loan or credit card. The survey also found that BNPL customers had less liquidity and not as much in savings as did non-BNPL borrowers. The CFPB results showed that BNPL users had lower credit scores than non-users. If those customers would normally have higher-rate traditional loan products, BNPL would be advantageous to them. While the CFPB concluded that BNPL borrowers have higher levels of financial distress, the bureau also indicates that these levels could have existed prior to the advent of BNPL products. The CFPB could not conclude whether BNPL moves consumers away from higher interest products or leads them to increase borrowing and cites the need for further research.

Although the earlier CFPB study implied that interpretive guidance or rules under its UDAAP authority would likely occur as to BNPL products, the later report recognizing the beneficial aspects of BNPL and the need for further study may indicate that this will not occur soon. It is not known when the CFPB will provide further guidance or regulation of BNPL products, but some action is expected.[64]

In July 2022, a public company announced that its BNPL product was being investigated by the CFPB.[65]

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63 The Report was titled: "Consumer Use of Buy Now, Pay Later: Insights from the CFPB Making Ends Meet Survey." The survey encompassed over 2,000 consumers.

64 It should also be noted that BNPL providers are also becoming subject to class action litigation primarily on the basis of undisclosed fees (late fees and NSF bank fees) or misrepresentation of the service as being free or containing no hidden fees. In many of these actions, the defendants have filed a motion to compel arbitration due to arbitration provisions in the terms of service or BNPL agreement, which have resulted in dismissals. *See Edmundson v. Klarna, Inc.*, Case No. 3:21-cv-00758 (D. Conn. filed June 2, 2021) (Motion to Compel Arbitration denied and on appeal; action stayed pending appeal), and *Hale v. Klarna, Inc.*, Case No. 3:22-cv-00598-DMS-AHG (S.D. Cal. filed Apr. 28, 2022) (asserting violations of California's unfair competition and false advertising law) (Motion to Compel Arbitration pending). Another BNPL company, Sezzle. was hit with a proposed class action based on similar theories that it deceived consumers by not disclosing the risk of incurring bank overdraft fees. *Sliwa v. Sezzle, Inc.*, Case No. 2:22-cv-03055 (C.D. Cal. filed May 6, 2022) (Stipulation to Dismiss filed). Sezzle previously paid penalties to California for operating without a finance lender's license. *See also Amanda Edwards v. AfterPay US, Inc.*, Case No. 2:22-cv-00118-JDL (D. Maine) (Dismissal filed), and *Miller v. AfterPay US*, Case No. 3:21-cv-04032 (N.D. Cal. filed May 27, 2021) (Dismissal filed).

65 Apple Pay Later, the BNPL product of Apple, made the announcement. The CFPB stated that the product raised several issues including antitrust and data privacy concerns. It appears that some if not most of this inquiry centers on use of customer data such as browsing history, geolocation history and health data.

New and innovative products like earned wage access and income sharing agreements are attracting regulatory attention.

b. Earned Wage Access Products

Also becoming popular are Earned Wage Access (*"EWA"*) products. In essence, these products allow an employee to access wages that have been earned, but prior to the time they are paid by the employer. From a legal standpoint, there has been much confusion about EWAs, as they are structured in different ways. Adding to the confusion is a regulatory interpretation made at the latter stages of the Trump era which is being reconsidered by the current administration.

On November 30, 2020, the Trump-led CFPB issued an advisory opinion that certain EWA products did not constitute credit for purposes of the federal Truth in Lending Act.[66] Then, on December 30, 2020, the same CFPB issued a compliance assistance sandbox approval to Payactiv, Inc., regarding its EWA product.[67] Payactiv sought confirmation that its EWA product was not an extension of credit based on how its program operated through employers. The program provided access to wages earned but unpaid and recovered the funds via payroll deduction through the employer. No interest or fees are charged and other attributes associated with credit products are not involved, such as debt collection or credit reporting. The CFPB agreed, finding that the program was not based on creditworthiness and relied on employer information and involvement, including employer-facilitated deductions and the lack of fees or interest, along with the fact that there is no right to collect against the employee.[68]

It should be noted that many EWA programs operate differently than the program described in the CFPB approval letter. The approval letter states that it only applies to the recipient's program, so another program with different features may not receive the same treatment or have assurance that the program does not constitute credit. However, on June 30, 2020 the Biden-led CFPB terminated the Payactiv approval order, claiming that it had been requested by Payactiv, who was changing its business model.

In March 2023, the Government Accountability Office (*"GAO"*) issued a report relating to fintech products including EWA.[69] The GAO recommended that the CFPB should clarify the applicability of

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66 *See* https://files.consumerfinance.gov/f/documents/cfpb_advisory-opinion_policy_2020-11.pdf

67 This was the first CFPB opinion issued under that policy (*see* 84 Fed. Reg. 48246), which was to provide more regulatory certainty for new and innovative consumer products. Approvals assure compliance with specified laws, are good for two years, and are subject to extensions.

68 The CFPB relied on a comment to 12 C.F.R. 1026.2(a)(14) which states that borrowing against the accrued cash value of a pension account without an obligation to repay is not credit under Regulation Z. Important to this determination is the employee having no obligation to repay if the payroll deduction is insufficient.

69 "Financial Technology: Products Have Benefits and Risks to Underserved Consumers, and Regulatory Clarity is Needed." In addition to EWA the report covered digital deposit products offered by fintechs and banks, credit builder products to develop better credit files and scores, and small dollar loans using alternative data.

the Truth in Lending Act's definition of credit for EWA products not covered in the November 2020 CFPB issuance, recognizing that it is unclear how direct-to-consumer EWA models are treated under the prior guidance, which only dealt with employer-to-employee models.

In fact, the current CFPB has been urged to re-examine its position on EWA products and regulate them, and the CFPB has indicated that further guidance on these programs is forthcoming.[70]

Each year, the U.S. Department of Treasury issues its General Explanations of the Administration's Revenue Proposals, commonly known as the "Green Book." The Green Book issued in March 2022 for fiscal year 2023 contains a proposal related to EWA. Specifically, the Treasury Department recommends amending the Internal Revenue Code to expressly clarify that on-demand pay arrangements such as EWA are not loans. Whether or not this proposal will be adopted is unknown, but it does show a difference of opinion between two divisions in the Biden administration.

c. Income Sharing Agreements

Another new and popular product is the Income Sharing Agreement (*"ISA"*). Oftentimes IWAs are used in connection with education or training programs where an individual is provided with an amount to pay tuition or other education-related expenses. Repayment of the amounts so provided is made only if the individual has subsequently (after the educational program has ended) obtained employment and then remits a specified amount or percentage (usually dependent on some calculation or income and/or expenses and perhaps subject to a floor or cap) until the original amount is repaid. Hence, if the individual never obtains employment, there is no obligation of repayment. These types of agreements were largely unregulated and touted as being an alternative to a loan.

However, on September 1, 2021, the CFPB issued a consent order against Better Future Forward, an ISA provider.[71] The CFPB found that ISAs are extensions of credit for purposes of the federal Truth in Lending Act and subject to the provisions of the law and regulations as a private education loan. As a result, Better Future Forward had failed to make the required disclosures and violated those provisions of law. Because the company had marketed its product as not being a loan, the agency found that Better Future Forward had engaged in deceptive practices.[72] As a result, it appears that ISAs need to comply with the applicable provisions of the federal Truth in Lending Act.[73]

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70 It is noted that states are also involved in the regulation of EWA products. In general, California treats EWA as a loan requiring licensing and compliance with the state's lending law.

71 CFPB Admin. Proc. 2021-CFPB-0005 (Sept. 1, 2021).

72 The CFPB also found a Truth in Lending violation for charging prepayment penalties, which are prohibited on private education loans.

73 In January 2022, the CFPB updated its examination procedures manual for private student loans to specifically cover ISAs. The U.S. Department of Education's Office of Postsecondary Education issued an advisory to postsecondary schools about ISAs and compliance with private education loan laws and regulations.

6. *CFPB Jurisdiction over Securitization Vehicles on Appeal*

In 2017, the CFPB brought suit against 15 student loan trusts holding some $12 billion in private student loans.[74] After considering a motion to dismiss based on whether the CFPB could bring an action against a passive investment vehicle, the court ruled in December 2021 that the CFPB could proceed against the trusts, determining that each of the trusts constituted a "covered person" under the Consumer Financial Protection Act and therefore was subject to the bureau's enforcement authority.[75]

> **On Appeal:** Special purpose entities could become subject to liability even though they are only passive investment vehicles.

The CFPB alleged that to collect on defaulted student loans the trusts, through their servicers, used deceptive and unfair tactics, such as filing thousands of lawsuits with allegedly false supporting affidavits. The trusts argued that they do not qualify as "covered persons" under the law because they are just passive investment vehicles and don't themselves engage in debt collection or otherwise control what their servicers do. The judge disagreed, saying that the trusts couldn't disclaim involvement in a "key part of their business just because they contracted it out."

However, the judge recognized that this is a case of first impression, considering novel issues, and was of significance and subject to room for reasonable disagreement. In February 2022, the judge granted a motion for an interlocutory appeal to the Third Circuit Court of Appeals, which the Third Circuit accepted and docketed on May 11, 2022.[76] The case is of tremendous importance to the secondary and securitization markets. If the CFPB is allowed to bring actions directly against special purpose vehicles it could expose those passive investment entities to potential liability, which could lessen investor appetite for marketplace loans and create market volatility and uncertainty. As a result, state attorneys general, industry, securitization and consumer groups are filing amici briefs in the action. Oral argument is schedule for May 17, 2023.

C. Other Federal Regulatory Actions

1. *FDIC and OCC Notices on Crypto Assets*

The FDIC issued notices of possible import to the marketplace lending industry most applicable to Funding Banks whose deposits are insured by the FDIC. In April 2022, the FDIC announced that FDIC-supervised institutions must notify the FDIC if they intend to engage in or are already engaged in activities related to crypto assets.[77] This includes providing the FDIC with information necessary to

74 *Consumer Fin. Prot. Bureau v. Nat'l Collegiate Master Student Loan Trs.*, Case No. 1:17-cv-01323 (D. Del.).

75 The court also found that the CFPB could bring the action despite the U.S. Supreme Court's ruling that the agency was not constitutionally structured.

76 *Consumer Fin. Prot. Bureau v. Nat'l Coll. Master Student Loan Tr. et al.*, Case No. 22-1864 (3d Cir.).

77 FIL 16-2022 (Apr. 7, 2022).

allow the FDIC to evaluate risk from this activity to the institution. The FDIC may then provide supervisory feedback to the institution.

Regulators are looking to understand and regulate digital assets such as cryptocurrency.

The OCC has issued four interpretive letters on crypto-related matters.[78] These letters allow banks to engage in custodial services related to crypto assets as custody is a traditional banking activity performed electronically. They also allow banks to hold deposits serving as reserves for stablecoins on a one-to-one basis, based on banks' authority to receive deposits. Banks may use distributed ledgers and stablecoins to facilitate and engage in payment activities, as it is a modern form of traditional payment services. In connection with payment activities, banks may buy and sell electronically stored value to complete or facilitate payments. The OCC cautions that banks must be able to conduct these activities in a safe and sound manner satisfactory to the OCC. Like the FDIC, the OCC requires banks to notify the regulator of the proposed activity and receive regulatory notification of non-objection.[79]

Given that cryptocurrency assets and programs are proliferating that could affect banks, Funding Banks and their service providers should be aware of these notice requirements.[80] These requirements also signal that not only are banking agencies aware of new innovations but they balance innovation with regulation and will engage in regulatory inquiry and scrutiny of new technological advances that affect safety and soundness, financial stability, and consumer protection.[81]

2. *Small Business Administration Opens Door to Fintech Lending*

On May 12, 2023 a Final Rule will go into effect for certain SBA loans and lenders. The SBA is eliminating its forty-year-old policy limiting the number of nondepository institutions that may participate in its loan guarantee programs under Section 7(a) of the SBA Act. It is a move designed to allow more fintech lenders into SBA lending in order to provide more capital to small businesses, particularly underserved borrowers. The Section 7(a) loans come with an SBA guarantee up to 85% of the loan. Banks and credit unions, the largest SBA lenders, were critical of the rule on the basis that fintechs were responsible for some of the fraud incurred in the PPP (Payment Protection Plan) loan

78 OCC Int. Ltr. 1170 (July 2020) (custody of crypto assets); OCC Int. Ltr. 1172 (Sept. 2020) (deposit reserves); OCC Int. Ltr. 1174 (Jan. 2021); and OCC Int. Ltr. 1179 (Nov. 2021).

79 On March 9, 2022 the President issued an executive order asking government agencies to examine the risks and benefits of digital assets such as cryptocurrency. Given market imbalance in the spring of 2022, regulators are seeking authority over these types of assets and legislation has been introduced in Congress to establish a new regulator that would focus on digital assets.

80 Similarly, the OCC issued an Interpretive Letter applicable to national banks and federal savings associations to notify the OCC of intention to engage in cryptocurrency, distributed ledger, and stablecoin activities. OCC Int. Ltr. 1179 (Nov. 2021).

81 States are also looking to address this issue. For example, on April 11, 2022, Virginia enacted H.B. 263 (effective July 1, 2022), allowing a bank to provide virtual currency custody services if it can effectively manage associated risks and comply with law.

programs during the pandemic. The SBA has indicated that it can monitor the additional nondepository lenders in an adequate manner.

3. *Federal Trade Commission—U.S. Supreme Court Ruling*

On April 14, 2023, the Supreme Court decided cases involving both the FTC and Securities Exchange Commission, finding that claims regarding constitutionality do not have to go through agency in-house administrative procedures prior to bringing a claim in federal court.[82] In essence, a litigant does not have to go through the administrative process they are challenging on constitutional grounds, such as the structure or existence of the agency itself. This may make it easier for litigants to challenge actions prior to a full-blown administrative proceeding being conducted.[83]

IV. STATE DEVELOPMENTS OF INTEREST

In last year's update, a few states were passing laws that impose usury limitations and licensing requirements seemingly directed at non-banks in the marketplace lending arena, states have focused increased attention and scrutiny on online lending programs and practices.[84] More states are enacting licensing, servicing and related laws for student loan lenders and servicers. Some of the more important developments from a state law perspective on usury and licensing are discussed below. Individual states enacting comprehensive privacy laws may impact marketplace programs. In particular, in the past year, there has been a trend toward states enacting laws requiring that consumer-like disclosures be made for commercial loans.

A. State Laws on Commercial Loan Disclosures

As of this writing, four states have passed laws relating to some form of disclosure on commercial financing transactions: California, New York, Utah and Virginia. Georgia has passed legislation that could become effective if signed into law and at least eight other states have considered or are considering legislation of this nature.[85] While these laws have many similarities, they are different in scope and coverage, which will make operational compliance difficult for entities covered by those laws. The CFPB has determined that the Truth in Lending Act does not preempt these state disclosure laws.

It all began in 2018 when **California** enacted a law mandating consumer-like disclosures for commercial financing transactions. After several rounds of proposals, final regulations were issued in

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82 *Axon Enter., Inc. v. Fed. Trade Comm'n. et al.*, Case No. 21-86 (Apr. 14, 2023).

83 This decision may provide some insight as to how the Supreme Court may decide the constitutionality of the CFPB discussed above. The decision was unanimous. The corresponding decision as to the SEC is *Securities Exchange Comm'n et al. v. Cochran*, Case No. 21-1239 (Apr. 14, 2023).

84 Those laws are discussed later in this book.

85 Legislation was defeated in Mississippi. One house of the legislature has passed bills in Maryland and Missouri. Bills are pending in Connecticut, Florida, Illinois, Kansas and New Jersey.

June 2022 and the disclosure requirements became effective on December 9, 2022.[86] The California regime covers a wide variety of transactions—loans, financing leases, open-end credit, factoring, merchant cash advances (sales based financing) and asset-based lending—up to $500,000. The law covers providers, brokers and financiers. While depository institutions are exempt from the law, nondepository subsidiaries and affiliates of those institutions are covered, as are service providers to exempt entities, which would cover marketplace platforms. Disclosures include consumer-type information such as annual percentage rates and finance charges, payments, amount financed and monthly cost. A signed copy of the disclosure is required.[87]

Four states have enacted and other states are considering consumer-like disclosures for commercial financing products.

In December 2020, **New York** enacted its Commercial Financing Disclosure Law. Final regulations became effective on February 1, 2023, with compliance mandatory on August 1, 2023. While disclosure requirements are similar to those in California, unlike California's law, New York's law covers transactions up to $2.5 million and exempts bank subsidiaries. Like California's law, the New York law broadly covers open and closed-end financings, lease financings, sales-based financing and general asset-based lending. Requests to exempt factoring transactions were explicitly rejected. Technology service providers are exempted from the law if providing software or support services but are not exempt if they have an interest, arrangement or agreement to purchase any of the commercial financing transaction.

A **Utah** law became effective on January 1, 2023, requiring commercial financing disclosures. Unlike California or New York, however, Utah's law has a registration requirement in addition to disclosure obligations. The Utah law regulates non-real-estate-secured commercial financing transactions of $1 million or less, including merchant cash advance and factoring transactions. The legislation includes online financing platforms that work in conjunction with a Funding Bank model. Utah exempts a wider range of entities than other states do. At the time of this writing, regulations have not been promulgated. The Utah law explicitly provides that noncompliance does not affect the enforceability of the underlying transaction and does not create a private right of action but creates liability for civil penalties.

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86 The regulations are being challenged in court. *Small Bus. Fin. Ass'n v. Hewlett*, Case No. 2:22-cv-08775 (C.D. Cal. Complaint for Declaratory and Injunctive Relief filed Dec. 2, 2022). The state's motion to dismiss was denied on March 30, 2023. A scheduling conference will be held with a trial set for November 2023.

87 A complete review of these laws is beyond the scope of this work. Entities subject to these laws should consult with professionals to ensure compliance. Disclosures are fashioned after consumer requirements in the federal Truth in Lending Act to allow for credit comparison.

The **Virginia** law only applies to sales-based financings (*i.e.*, merchant cash advances) up to $500,000.[88] There is also a registration requirement that became effective on November 1, 2022, with annual renewals, also applicable to brokers. The Virginia law places restrictions on certain practices such as taking confessions of judgments. The law also requires a Virginia forum selection for disputes with Virginia businesses, including arbitration. Violations of the law render the transaction unenforceable.

In March 2023, based upon a request from a trade association, the CFPB issued a determination that the federal Truth in Lending Act does not preempt the above-described disclosure laws in those four states.

B. Usury and Licensing

Usury and licensing issues remain a focal point of regulators and litigants. It also resulted in legislative proposals to cap interest rates.

A recent study examined the effects of the rate cap imposed by the Illinois Predatory Loan Prevention Act (PLPA) some two years after it became law.[89] The law mandated a usury cap of the Military Annual Percentage Rate of 36% on consumer loans made or offered by any person or entity, excluding banks and credit unions, to a consumer in Illinois. The study found that the 36% cap significantly decreased the availability of small-dollar credit in Illinois and worsened the financial well-being of many consumers. The study showed that loans to subprime borrowers decreased by 44% and that the average loan size increased. The number of state-licensed lenders dropped by more than 50% to 900. This has resulted in a decreased access to credit.

There is legislation pending in South Carolina and Colorado that would create interest rate caps. The Colorado legislation purports to opt out of federal preemption for loans made in that state, which could impact lending into that state and access to credit if enacted.

Many of the court cases have targeted tribal lending programs, which tend to be higher-rate programs and claim exemption from usury laws based on the doctrine of sovereign immunity afforded to Native

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88 Traditionally, this publication has not covered merchant cash advance transactions as in many instances they are considered not to be loans but rather sales of future receivables. There is a body of law that deals with this area, primarily upholding transactions as sales not loans if certain requirements are met, such as no obligation to repay other than future sales and assumption of risk by the purchaser. The merchant cash advance area has been subject to litigation. Merchant cash advances have been criticized as being the payday lending of commercial entities, but until the enactment of disclosure laws referenced above have not been subject to regulation or disclosure requirements. In January 2023 the New Jersey Attorney General entered into a settlement against Yellowstone Capital LLC, a merchant cash advance provider, for over $27 million including forbearance of outstanding balances. The allegations included charging usurious interest rates on small business loans that were disguised as purchases of receivables.

89 Bolen, J. Brandon and Elliehausen, Gregory and Miller, Thomas, Effects of Illinois' 36% Interest Rate Cap on Small-Dollar Credit Availability and Financial Well-being (Dec. 29, 2022), available at SSRN: https://ssrn.com/abstract=4315919.

American tribes. As a result, many of the cases allege that the links to the tribal underpinnings are a sham.[90]

Regulators and litigants are also taking notice of licensing issues. In particular, states have been expanding licensing requirements for student loan lenders and servicers. Within the past year, Kentucky and Louisiana have required licensing requirements for student loan servicers. Private litigants are also suing companies for damages for engaging in business without holding the appropriate licenses.[91]

C. Privacy Laws

Although affecting many entities, privacy laws enacted in several states will also affect online lending programs. On January 1, 2023, laws in Virginia and California became effective. On July 1, 2023, Connecticut's Data Privacy Act and Colorado's Privacy Act went into effect and on December 31, 2023, Utah's Consumer Privacy Act goes into effect. All of these laws will give consumers the right to access, delete and request their personal information. Consumers will also have the right to opt out of targeted advertising and disclosures that may qualify as sales of personal information. Operationally, lenders will be required to provide notices about information practices such as a privacy policy and will be prohibited from discriminating on the basis of exercising their privacy rights. As with commercial disclosure laws, while these laws are similar, they are not the same, so compliance will become more complicated for multistate programs.[92]

V. OTHER CASE DECISIONS OF SIGNIFICANCE

There are some cases of general applicability not involving marketplace participants directly, but nonetheless that may impact marketplace lending programs. Some more significant ones are briefly described here.

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90 *See, e.g.*, *Harris et al. v. Credit Cube et al.*, Case No. 1:23-cv-01153 (N.D. Ill.) (alleging unlawful lending using a tribe to avoid state law and interest rates), and, similarly, *Harris v. Eagle Valley Ventures et al.*, Case No. 1:23-cv-01114 (N.D. Ill.). Historically this publication has not attempted to cover tribal lending issues for a variety of reasons other than as it may impact online lending programs generally. Tribal programs are fundamentally different from programs working with Funding Banks and the laws of federal preemption do not apply to tribal lending programs; conversely, sovereign immunity does not affect bank programs. Tribal programs are also more subject to litigation risk due to the high rates charged on such programs.

91 *See, e.g.*, *Washington et al. v. TitleMax of Virginia Inc. et al.*, Case No. 1:23-cv-00246 (M.D.N.C.). This action follows a similar proceeding in Pennsylvania where the Department of Banking issued a subpoena to a lender operating from a location in an adjacent state but marketing to Pennsylvania residents. The state alleged violation of its usury and licensing laws. The lender defended on the basis of the dormant Commerce Clause and due process. The Third Circuit found that the transactions did not occur totally outside the state. *TitleMax of Delaware Inc. v. Weissman*, Case No. 21-1020 (3d Cir. Jan. 24, 2022). The Supreme Court declined to hear an appeal of this decision.

92 Again, a detailed analysis of these laws is beyond the scope of this missive.

A. Arbitration

Many loan programs, including online lending programs, utilize an arbitration provision as the preferred method of resolving disputes. There is a case pending at the United States Supreme Court dealing with arbitration.[93] The issue to be decided due to a split of decisions in the federal circuits is whether litigation should be automatically stayed during the appeal of a court denial of a motion to compel arbitration. In part the rationale is that a stay would avoid steep costs on defendants in class action litigation. Conversely, plaintiffs claim that they are disadvantaged if they have to wait months or years to proceed with their case. In the oral argument before the Supreme Court, the justices appeared divided over the possible outcome in the case brought by a cryptocurrency exchange.

Another case saw the issue of electronic contracting intersect with arbitration. A federal magistrate recommended that a class action concerning a data breach be sent to arbitration because users agreed to arbitrate claims against the online lending marketplace. The court agreed and granted a motion to compel arbitration and stay the action.[94] The plaintiff stated that he never saw the user agreement containing the arbitration provision because it was concealed on the platform's website. But the website fully informed users that they were agreeing to abide by the terms of use by creating an account, which information was in a reasonable font and had a noticeable hyperlink. Users also had to agree to the terms in order to submit a loan request. The substantive claims related to a data breach.

B. Debt Collection

The debt collection industry was put into a tizzy when a circuit court of appeals ruled that a debt collector violated the Fair Debt Collection Practices Act when it provided its third-party mail letter vendor with customers' personal information in order to print collection letters for purposes of collecting a debt. Lenders have used mail vendors for years to send out notification letters to debtors. The plaintiff alleged that this practice was a communication about a debt to a third party, which violated the law. Numerous suits were filed as a result of this decision and some debt collection was ceased in the Eleventh Circuit states of Alabama, Georgia and Florida. That decision was later vacated and the Eleventh Circuit ruled in favor of the debt collector and dismissed the lawsuit.[95] The decision was based on the legal doctrine of standing that in order to bring a suit, a plaintiff must show a concrete injury to establish an alleged intangible harm. In this instance, there was no harm by the dissemination of information to the service provider. The Tenth Circuit similarly affirmed a dismissal of similar claims

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93 *Coinbase Inc. v. Bielski*, Case No. 22-105 (U.S. Sup. Ct). The crypto customer alleged that a scammer stole money from his Coinbase account and sued the company for failure to investigate or recredit his account under the Electronic Funds Transfer Act.

94 *Granados v. Lending Tree, LLC*, Case No. 3:22-cv-504-MOC (D.N.C. Mar. 1, 2023).

95 *Huntstein v. Preferred Collection, Inc.*, Case No. 19-14434 (11th Cir. Sept. 8, 2022).

for lack of standing find that the use of an outside mail vendor does not violate the Fair Debt Collection Practices Act as there is not concrete injury.[96]

C. Telephone Consumer Protection Act

Among other things, the Telephone Consumer Protection Act (*"TCPA"*) makes it unlawful to send automated phone calls with prerecorded voice messages without prior express consent. Damages can potentially be steep, with a $500 penalty per violation. Since marketing, servicing and collection of online loans may involve telephone contact, compliance with the TCPA is important.

In 2022, the Ninth Circuit vacated a jury verdict of $925 million in statutory damages for over 1.8 million prerecorded calls without prior consent under the TCPA as violating the defendants' constitutional due process rights.[97] The court stated that due process is violated where statutory damages are so severe and oppressive to be wholly disproportionate to the offense and therefore unreasonable. Thus, while the per-violation amount was constitutional, it resulted in excessive damages. This decision has implications for class actions where statutes like the TCPA that permit large aggregate awards create unreasonable verdicts.

D. Auto Lending—Military Lending Act Decision

An issue facing the auto lending industry was whether a loan to purchase a car that also financed ancillary or add-on products and services such as guaranteed asset protection (GAP) insurance was subject to the Military Lending Act (*"MLA"*) or not. Actions under the MLA are attractive to plaintiff lawyers because the penalty for a violation is voiding of the loan. Regulatory agencies including the CFPB also target MLA violations on an ongoing basis. The MLA exempts loans with the express purpose to purchase the property that will serve as collateral for the loan (like an automobile), but there has not been clarity about the situations where add-on products and services are part of the loan. In April 2023, the Fourth Circuit Court of Appeals weighed in on the issue.[98] The court found that add-on products could be financed without losing the exemption from MLA compliance. The court reasoned that the statute's language speaks of the exemption in terms of where the express purpose of the loan—not the sole purpose of the loan—is to purchase the property being financed and acting as collateral security.

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96 *Shields v. Prof'l Bureau of Collections of Md., Inc.*, 55 F.4th 823 (10th Cir. 2022). Both cases follow the Supreme Court holdings in *Spokeo, Inc. v. Robins*, 578 US 330 (2016), and *TransUnion, LLC v. Ramirez*, 141 S.Ct. 2190 (2021).

97 *Wakefield v. ViSalus, Inc.*, 51 F.4th 1109 (9th Cir. 2022).

98 *Davidson v. United Auto Credit Corp.*, Case No. 21-1697 (4th Cir. Apr. 12, 2023).

VI. Marketplace Lending and the Recent Bank Failures

At the writing of this update toward the end of April 2023, the failure of three banks only a few weeks prior remains in the forefront of the public and of great interest to the fintech world. In March 2023 Silvergate Bank, a niche institution serving the cryptocurrency market, shut its doors amid continuing problems of crypto businesses that were its primary customers. Soon thereafter, the FDIC placed Silicon Valley Bank into receivership and then Signature Bank, both banks with significant connections and customers in the fintech industry.[99] When depositors withdrew more funds than liquidity could handle, the institutions failed. Other banks also rescued another bank in the fintech space.[100] The failures created a great deal of concern related to deposits, loans, security and other related issues.

> Recent bank failures underscore the need for contingency planning for both fintechs and Funding Banks.

We deal with only some of the legal and regulatory aspects of a bank failure. When a bank fails, the FDIC is appointed receiver and either is charged with selling the assets and finding a place for the deposits to be assumed, or engages in liquidation of the bank. The FDIC is given "super powers" to resolve these troubled situations, including the ability to void contracts of the failed institution, which creates uncertainty in the short term. There is also possible delay involved in getting access to deposits, draws on loans or foreclosing on collateral held at the distressed institution. One of the looming issues in the recent failures was the large amount of uninsured deposits being held at each institution. The FDIC only insures each depositor for up to $250,000 for specified categories of accounts. Where operating accounts, servicing collection accounts or collateral accounts are held at a bank, amounts above the deposit insurance maximum are uninsured and subject to possible loss if the institution's assets cannot cover depositor liabilities.[101] In the case of one bank failure, the FDIC utilized the uncommon structure of placing assets and liabilities in a bridge bank and due to the large size of the institution provided insurance coverage to all uninsured deposits transferred to the bridge bank. As is the case in most bank failures, the FDIC places the assets and liabilities of the failed institution with a healthy institution.

However, these events raise the question of the potential impact of bank failures on fintech and conversely the effects of failures of fintechs on Funding Banks.

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99 There is plenty of finger pointing as to what went wrong at these institutions: mismatch of assets and liabilities due to investment in long-term Treasury bonds, mismanagement, an unhealthy percentage of uninsured deposits, failure of regulatory oversight and being too heavily concentrated in fintech, to name a few. We do not address these matters but provide an overview of some of the legal issues resulting from bank failures.

100 A consortium of large banks invested in First Republic Bank. The Federal Reserve also set up a fund that banks could draw on. Some of the effects were worldwide with the failure of Credit Suisse, which was taken over by UBS.

101 Our website offers additional information about bank failures and their aftermath at www.chapman.com.

A. Issues for Fintechs and Their Funding Bank

For fintechs, a primary question is the insurability of their deposits. Many Funding Banks require collateral accounts in conjunction with the loan programs associated with a fintech. If those deposits are in one account, they will only be insured up to $250,000 by the FDIC, and excess amounts could be at risk in the event of the bank's failure. Additional insurance could be possible through opening an account in a different insurable category (such as a trust account) that would allow for additional coverage, having accounts held by different corporate entities or requiring the bank to arrange excess amounts to be placed in another institution to provide additional insurance coverage.

Fintechs should also become more diligent in their ongoing review and monitoring of the bank, similar to the way the Funding Bank monitors the financial condition of the fintech. This may include greater diligence at the outset of a program to assess the bank's risk and compliance structure and its history and relationship with its regulators. In addition, while some of these situations occur rapidly, others develop over time and the fintech should explore representations of the Funding Bank as to financial condition, such as adverse changes in condition, maintaining an adequate level of capitalization or liquidity, and related notification of any breach of those conditions and the ability to invoke remedies if the breach is not cured.

Since the regulators of the Funding Banks may scrutinize program relationships based on the recent dislocation related to fintechs, fintechs need to be in a position to respond to the institution and to be sure that its policies, procedures and compliance structure are not only up to date, but are working well. Some fintechs offer their customers deposit capabilities at a bank typically through an umbrella account at the bank for the benefit of (FBO) the fintech customers.[102] In situations where deposit insurance is being provided to those customers, the fintech is usually responsible for keeping the records of the beneficiaries of the account that would allow the FDIC to determine how much insurance coverage would accrue to each customer. Fintechs in this role should be sure that their records comply with applicable FDIC requirements so that customers receive the benefit of any promised FDIC insurance.[103]

Fintechs should also provide with a Funding Bank an exit strategy in the event of regulatory problems or a bank failure. While this may have a potential impact on any contractual agreements with a Funding Bank as to the exclusivity of the relationship, there also needs to be a plan in place for movement or

102 The current situation has also called into sight sweep arrangements. If accounts are subject to a sweep arrangement, FDIC insurance may only cover the amounts when at the bank. If the amounts are swept into non-bank or securities accounts, FDIC insurance may not be applicable. These should also be reviewed in light of what disclosures are being made to depositors.

103 As earlier discussed in this section, the FDIC is concerned that statements about deposit insurance are correct and do not mislead consumers. Disclosures concerning insurance should be reviewed since the FDIC is likely to review and examine these statements.

transition of the program in the event of a receivership or if the FDIC voids the contract for the program. This may include having in place a backup or multiple Funding Banks.

Fintechs should be prepared to deal with financial instability or failure of their Funding Bank.

B. Funding Bank Issues for Fintech Distress

Also in recent days there have been reports of layoffs at fintechs, even large and well-known fintechs, and with higher interest rates and a slower economy additional pressure is being placed on marketplace programs and pullback of investor appetite for these types of assets. As a result, Funding Banks also need to prepare for situations where the bank's service provider is subject to adverse financial conditions, is insolvent or declares bankruptcy. The Acting Comptroller of the Currency has publicly stated that the OCC expects Funding Banks to have robust contingency plans in place in the event of fintech failure. This means that Funding Banks need to make sure that they have contingency plans in place to provide for these types of events and to minimize the risk associated with potential impacts on customers and the reputation of the institution.

As part of a bank's vendor management and onboarding process, there should be appropriate diligence of the financial condition and prospects of the fintech. The program agreement should address appropriate financial covenants, collateral security and reporting and notification obligations. If the fintech has relationships with other service providers including processors, there should be planning and consideration given to the ability to assume important servicing contracts or relationships while protecting the bank from the liability of obligations incurred by the fintech. The bank should also have access to the fintech's systems and be able to view and review customer accounts and, if necessary, have the ability to step into the shoes of the fintech if needed.

Ongoing communication with the fintech and monitoring of the program are crucial. While these require additional effort and cost, the Funding Bank needs to be able to assume, wind down or transfer program responsibilities and assure its regulators that it can be nimble and quick in protecting the bank and program customers.

VII. LOOKING AHEAD

As the foregoing pages illustrate, since the last version of this book, there have been many legal and regulatory developments affecting marketplace lending. While each and every event cannot be captured and disseminated, nor the full impact fully explored, we have tried to present some of the more important issues and happenings over the past several months. There will be more to come as innovation and regulation evolve. The fate of the CFPB may be decided by the next edition. True lender litigation continues to breed uncertainty. The intersection and conflict between federal and state law continue to take center stage in many of the issues confronting marketplace lending participants including licensing, usury and commercial disclosures. Newer products such as BNPL, EWA, and ISAs and the digital assets discussed in this section will continue to draw attention and potentially lead to increased regulation. The political winds that swept in changes in Washington and at the CFPB are blowing in a different direction. Macroeconomic issues, increased delinquencies, and banking failures have created additional stress on marketplace lending. All of this will generate additional fodder to feed the next update of this book.

Regulatory Issues

I. Regulatory Matters

Given either the true lender challenges facing marketplace lenders that work with Funding Banks or the licensing and compliance burden of being a multistate-licensed lender, it is no surprise that these entities are looking at the possibility of banking type charters as a business model. Options include starting or purchasing a bank, the OCC special purpose national bank charter or an industrial bank state charter. The "full-service" bank charters would encompass compliance with all regulatory requirements that come with a full-purpose bank charter. These options and their history as related to marketplace lending are discussed below.

A. Charters for Marketplace Lenders

1. OCC Proposes Special Purpose Charter for Fintech Firms

On December 2, 2016, the OCC announced that it was considering issuing special purpose bank charters to qualified fintech companies.[104] In its press release, the OCC took the position that applying a bank regulatory framework to fintech companies will (i) benefit customers, businesses, and communities and will help ensure that these companies operate in a safe and sound manner; (ii) result in the OCC's uniform supervision of fintech companies, promoting consistency in the application of laws and ensuring that consumers are treated fairly; and (iii) make the federal banking system stronger by including these companies. Many within the industry viewed the OCC's announcement as a victory for fintech companies that have argued for a national charter so that they can establish a uniform national program and avoid obtaining various state licenses and facing different laws and restrictions in each state.

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

104 This development came almost simultaneously with the OCC promulgating a final rule addressing the receivership of banks not insured by the FDIC, which would presumably apply to fintech companies that obtain a national bank charter but are not insured by the FDIC. In September 2016, the OCC also revised the "Charters" booklet of its Licensing Manual, which describes the process of applying for and obtaining a national bank charter, presumably with revisions contemplating the limited-purpose aspects of a charter applicable to fintech companies. Almost immediately, some state regulators both questioned and opposed the ability of the OCC to grant a limited-purpose charter.

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

> **Key Consideration:** We note that in the past the OCC has not said that there will be a "FinTech charter." Rather, the OCC will consider granting a special purpose national bank charter to fintech companies engaging in non-deposit taking banking activities: lending or payments.[105]

The obvious benefits of a national bank charter include preemption of state usury laws, exemption from state licensing requirements, operationally being able to maintain a uniform national program, and autonomy and control by the marketplace lender, a feature not present in a Funding Bank arrangement as the regulated institution needs to control the loan program.[106] Since all national banks are members of the Federal Reserve System, there is also access to the Fed's payment system. Conversely, obtaining a national bank charter is complex, costly, and often subject to regulatory conditions. The chartering process usually takes at least several months and often a year or more. Public comment and field investigations are part of the process. Charter applicants must submit a three-year business plan and cannot deviate from it without OCC approval. This may inhibit the nimbleness that fintech companies utilize as a competitive advantage. Often the OCC will require a minimum level of capital and the ratio of capital to total assets must always be 8% or greater.

It is not known how the OCC might impose financial inclusion requirements on marketplace lenders seeking a charter, whether retention of some portion of loans will be required, or how off-balance sheet items such as loan sales will be treated for capital purposes. Federal law also limits transactions with affiliated companies and absent a change in law, and depending on how the interplay of regulators comes out, a parent company might become a bank holding company, subject to not only additional regulation but also a restriction on being engaged in activities constituting banking or being closely related to banking.[107]

It remains to be seen whether a special purpose bank charter will come into being, let alone be an appealing alternative for fintech companies and what conditions the OCC may impose on granting

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105 Whether and when the OCC might issue the first such charter is unknown. No applications have been made to date, in part due to pending litigation as to the status of this charter.

106 One possible alternative is an industrial bank or industrial loan charter. This charter is discussed below and provides many of the same benefits as would an OCC charter.

107 If however, the special-purpose national bank is not required to accept deposits (and not be FDIC insured), it may not meet the definition of a bank under the Bank Holding Company Act and the parent would not be a bank holding company.

such a charter.[108] All but the largest marketplace lenders may find certain of the requirements, such as the capital and compliance risk management requirements, sufficiently burdensome to outweigh the benefits of obtaining a national bank charter. It is also a long-term business strategy, not one that can be deployed in a short time frame. The availability of a national bank charter to qualified marketplace lenders could also have an impact on the competitive balance of the industry if investors come to view chartered lenders as "safer" or "more sound" than those that do not obtain charters, and the latter companies, as a result, are put at a competitive disadvantage in raising lending capital. The "Recent Developments" section highlights some marketplace lenders that have opted for a full-service national charter.

Fintech Charter Proposal Brings Lawsuits. The OCC's announcement that it would explore the possibility of a special purpose charter led to two lawsuits being filed against the agency. In May 2017, the New York Department of Financial Services (*"NYDFS"*) brought an action claiming that granting such special purpose charters would exceed the authority of the OCC.[109] The OCC sought to dismiss the suit on the grounds that the NYDFS's claim was not "ripe" because the OCC had not yet made a final determination about whether to grant such charters. On December 12, 2017, the court granted the OCC's motion to dismiss. The Conference of State Bank Supervisors (*"CSBS"*) had filed a similar action in April 2017, arguing that the OCC did not have the authority to grant a limited-purpose bank charter to a non-bank entity.[110] The OCC also sought to dismiss this action as premature since the OCC had not taken any formal action with respect to such a charter. The motion to dismiss was granted by the court on April 30, 2018.

When the OCC announced that it would accept applications for this charter, both the CSBS and NYDFS again filed suit against the OCC. While the CSBS action was dismissed, the NYDFS action ruled against the OCC, finding that being a bank required the acceptance of deposits. On appeal, the Second Circuit Court of Appeals dismissed the suit for lack of standing without deciding the issue of whether a national bank charter required the taking of deposits.

The New York regulator filed suit against the OCC, claiming that a special purpose charter to entities that would not take deposits went beyond the OCC's statutory authority, which is limited to institutions engaged in the business of banking.[111] The OCC filed a motion to dismiss the action, which was denied by the district court which ruled that national banks must accept deposits. The OCC appealed and in June 2021 the Second Circuit reversed the lower court and directed the lower court to dismiss the action. The appellate court found that the claims were not ripe for decision and the

108 One fintech, Varo Bank N.A., has obtained a full-service national bank charter, and another fintech, Social Finance, Inc., was approved to acquire and now operate a national bank, SoFi Bank, N.A. Other fintechs have been rumored to be interested in a full-purpose national bank charter. LendingClub Corporation acquired a bank holding company and its subsidiary bank headquartered in Massachusetts, and now operates as LendingClub Bank, N.A.

109 *Vullo v. Office of the Comptroller of the Currency,* 17 Civ. 3574 (S.D.N.Y. filed May 17, 2017).

110 *Conference of State Bank Supervisors v. Office of the Comptroller of the Currency,* Civ. Act. No. 17-CV-0763 (D.D.C.).

111 *Lacewell v. Office of the Comptroller of the Currency*, Case No. 1:18-cv-08377 (S.D.N.Y.), Case No. 19-4271 (2d Cir.).

regulator failed to allege the required element of suffering an injury. Thus the basic question of whether the business of banking requires the taking of deposits is left to another day or likely to be litigated if there is an application for a special purpose charter.

> While there have been no takers on the OCC "fintech" charter, marketplace lenders are seeking full-service national bank charters.

The OCC is no stranger to litigation. In December 2020, the Conference of State Bank Supervisors filed an action challenging the OCC's approval of a special purpose charter application to a non-bank based on the New York district court decision discussed above.[112] The plaintiffs desired that the court rule that the OCC could not grant charters to entities without them taking deposits and obtaining FDIC insurance. In January 2022, the Conference withdrew its complaint after the bank charter applicant changed its application to seek FDIC deposit insurance, which would moot the claims made in the complaint.

Given the litigation surrounding non-depository charters, fintechs attempting to obtain a bank charter have opted to buy existing banks or apply for a full-service charter that would include the taking of deposits rather than apply for the special purpose charter.[113]

2. *Federal Deposit Insurance Corporation*

Industrial Bank Charters. Attention has been given to the possibility that fintech companies could apply for industrial bank charters (also called industrial loan companies, or ILCs) under state law.[114] There are some 25 ILCs in existence, most of them chartered under Utah law.

Industrial loan companies must also apply for FDIC insurance. While they can take savings or time deposits, the implementing laws do not allow them to take demand deposits. The allure of an ILC is that they can provide most types of financial products and services except for demand deposit accounts, obtain the benefits of federal preemption from state usury laws as an FDIC insured institution, and they may be owned by non-bank companies. ILCs, even though insured by the FDIC, are exempt from the definition of "bank" under the federal Bank Holding Company Act, and therefore an ILC may be owned by a commercial company without becoming subject to that law's extensive

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112 *Conference of State Bank Supervisors v. Office of the Comptroller of the Currency*, Case No. 1:20-cv-03797-DLF (D.D.C.). The case dealt with the application of Figure Technologies.

113 LendingClub Corporation purchased Radius Bancorp and its subsidiary bank on February 1, 2021. On July 30, 2020 the OCC also approved the application of Varo Bank, N.A., which became the first fintech to receive a full-service charter. In January 2022 the OCC approved conditionally an application from Social Finance, Inc. to purchase Golden Pacific Bank, N.A. and rename it SoFi Bank, N.A., which is also a full-service national bank.

114 Utah, California and Nevada are the only states that currently have industrial banks, with the majority in Utah. Although other states have a statutory framework that allow for industrial bank charters, they are not currently active according to the National Association of Industrial Banks (*"NAIB"*) http://industrialbankers.org/.

regulations and supervision by the Federal Reserve of bank holding companies.[115] Utah requires an ILC and its management to have an in-state presence and the FDIC requires a level of capital commensurate with the ILC's assets and the risks posed by its business plan. ILCs are subject to regulation and examination by their state chartering authority and the FDIC.

Until recently, no company had received an ILC charter since 2009, in part because of a federal moratorium on granting deposit insurance. The FDIC indicated a willingness to consider new deposit insurance applications, a development which could pave the way for marketplace lenders and other fintech companies to apply for an ILC charter with FDIC insurance. In June 2017, Social Finance, Inc. (Sofi) applied for an industrial loan company charter in Utah, but later withdrew its application due to issues and changes in the top management of the company.[116] In addition, payment processor Square, Inc. filed an application to become a Utah ILC to offer small business additional financial products and their applications for deposit insurance with the FDIC. The FDIC approved both applications in March 2020. Thus, the industrial bank charter became a viable alternative for fintech companies. However, after the change in federal administrations following the 2020 elections and change in leadership at the federal banking agencies, including the FDIC, pending applications have either stalled or been withdrawn, making the ILC charter's future for fintechs and marketplace lenders uncertain.

Worth Noting: A marketplace lender chartered as an ILC could undertake a uniform national lending program since as an FDIC-insured state bank, it would qualify for federal preemption of state interest rate caps and exemption from most state licensing requirements. As a trade-off, the marketplace lender should be subject to direct and potentially greater supervision by the state regulator that grants its charter and the FDIC. The ILC charter could become a preferred way for marketplace participants to offer Internet-based products and services.[117]

Originally stylized for industrial loan companies or ILCs, this charter has been around since the early 1900s.[118] As stated above, these institutions make loans and can accept savings and time deposits, but cannot accept demand deposits such as checking accounts. They are insured by the Federal Deposit Insurance Corporation (*"FDIC"*), which provides the benefit of federal preemption of usury laws and

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115 The Bank Holding Company Act requires a bank holding company limit its commercial activities to banking and activities that are closely related to banking. The Act also limits the nature and amount of transactions of the holding company with its bank affiliates, imposes capital requirements and subjects the holding company to regulation and examination by the Federal Reserve. Since an ILC is not a bank, these limitations do not apply. Many ILCs are owned by commercial companies as a means of conducting their financial activities. When Walmart attempted to acquire an ILC, however, it resulted in a moratorium on the granting of ILC charters.

116 Clozel, Lalita, "SoFi Withdraws Bank Application in Wake of Scandal," American Banker, Oct. 13, 2017. Later, Social Finance, Inc. purchased a national bank.

117 Marketplace lenders holding an industrial bank charter would be making their own loans under that authority rather than through a Funding Bank, so the risks and uncertainty of true lender challenges would likely be avoided.

118 Seven states have a regulatory regime that allows for industrial banks, but most industrial banks are chartered in Utah. There are about 25 in existence today.

exemption from state lending licensing laws in most states.[119] Also of importance, they are not banks for purposes of federal law and therefore their owners are not deemed to be bank holding companies that are subject to various restrictions and prohibitions.[120] This means that non-bank companies including commercial entities may own industrial banks without being subject to regulation by the Federal Reserve. Unlike bank holding companies that are restricted to conducting business activities closely related to banking, owners of industrial banks are not so constrained. As a result, ILCs have been a source of continuing interest and controversy.[121]

> The industrial bank charter may be a feasible alternative if FDIC insurance can be obtained. The FDIC approved deposit insurance for an industrial bank, but recent applications have languished.

Prior to 2020, the last industrial bank charter had been issued in 2009. No new applications for FDIC insurance for ILC charters were filed until 2017 when a marketplace lender applied for insurance; later, two other applications from fintech companies were filed. However, all three applications for deposit insurance were initially withdrawn, and two were refiled and subsequently approved by the FDIC.[122] The FDIC previously indicated that the agency is open to *de novo* charter applications and the agency published new guidance on applying for deposit insurance, signaling a "green light" for receiving new applications, including those with different business models.[123] However, the agency has indicated that with respect to fintech companies, the FDIC needs to be very careful about allowing non-traditional entities into the banking system.[124]

In late 2018, following the leads of the OCC and CFPB, the FDIC also set up an Office of Innovation but with the focus on banks and working to help those regulated institutions innovate and compete with

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119 Like a national bank, the institution would be making its own loans under principles of federal preemption rather than through a Funding Bank. The risks and uncertainty of true lender challenges would therefore be avoided.

120 See Bank Holding Company Act, 12 U.S.C. § 1842(c)(2)(H). In addition to being subject to Federal Reserve supervision and being permitted to engage only in financial activities and activities closely related to banking, bank holding companies are subject to a number of other rules including restrictions on transactions with affiliates and capital requirements.

121 Utah placed a moratorium on new charters between 1986 and 1997 due to financial difficulties incurred by some institutions. Later, Walmart applied for a charter and the FDIC imposed a moratorium on approving FDIC insurance for industrial banks. In 2010, Congress also implemented a three-year moratorium on the granting of deposit insurance. All of this meant that new charters could not be issued for much of the recent past.

122 Social Finance, Square and Nelnet applied for ILC charters. All initially withdrew their applications. Square, along with Varo (discussed above) and Nelnet, refiled its application. Community groups filed letters in opposition to applications, in particular as to compliance with the Community Reinvestment Act. The key concern seems to be how to apply that law to an online lender. As stated above, the FDIC has approved the insurance applications of Square and Nelnet. Social Finance has since acquired a national bank and Varo received an OCC national bank charter.

123 *See FDIC FIL 83-2018*, Handbook and Procedures Manual for Application for Deposit Insurance. Five ILC charter applications are pending in Utah.

124 The Independent Community Bankers of America, a trade association representing community banks, is lobbying against the ILC charter. It distributed a policy paper calling for a moratorium on providing deposit insurance to industrial loan companies as they are not subject to Federal Reserve supervision. The group may also oppose applications filed for deposit insurance by an ILC.

other financial technology companies. The FDIC indicated that it will look at innovation through the use of the ILC charter, regulation of third-party vendor relationships and working with technology companies to obtain better services and efficiencies for banks.

Another charter potentially attractive to fintechs is that of the industrial loan company. The charter is desirable because it allows a non-financial company to engage in financial services without becoming a bank holding company. In early 2021, the FDIC adopted a final rule dealing with non-financial companies acquiring an industrial loan company and will require the non-financial company to provide certain commitments to the financial entity primarily related to capital and liquidity and enter into written agreements with the FDIC. The rule became effective on April 1, 2021. Promulgation of the rule may have been prompted at least in part due to fintechs exploring the industrial loan charter, which the FDIC stated in the preamble to the final rule. The regulation applies to companies that are or become subsidiaries of companies not subject to supervision by the Federal Reserve. The non-supervised company must also comply with reporting and record-keeping requirements. The company may not hold more than 50% of the board of directors of the financial institution and must agree to maintain capital and liquidity at FDIC-prescribed levels. The FDIC may also require the development of a contingency plan to address financial or operational stress. However, the industrial loan charter remains controversial and legislation has been introduced in Congress that would ban this charter.[125]

B. Other Regulatory Promulgations

For several years, the federal banking regulators did not make many public comments about marketplace lending. Perhaps this was because banks play a variety of roles in this space and the regulators primarily are in the business of regulating what banks do. Banks can be competitors to online lenders and potential purchasers of them. Banks are lenders to platforms and are also 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. Some banks are offering bank loans directly through an online platform as an alternative to partnering with a marketplace lender. Bank regulators have supervised and examined banks that serve as Funding Banks for online lending programs for some time, but largely without any public comment.[126]

However, this has changed dramatically as the marketplace lending industry and the involvement of banks in this space continue to expand and grow. In the last few years, banking regulators have made some significant pronouncements, both directly and indirectly, regarding marketplace lending, some of which are described below.[127]

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125 H.R. 5912 – The Close the ILC Loophole Act was introduced in 2021 but failed to come to a vote.

126 However, see the section below related to the FDIC for discussion of an enforcement action taken by the FDIC against a bank that funded loans (not marketplace loans) originated by a third-party service provider.

127 In response, the marketplace lending industry is forming groups to study and advocate regulatory issues. In April 2016, the Marketplace Lending Association was formed as a lobbying group. The Online Lending Policy Institute was also formed

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

Federal consumer protection laws apply to all aspects of consumer credit from the origination of loans to the servicing of loans and attendant matters such as the protection of sensitive borrower data. Federal consumer protection laws are made by Congress and enforced by various regulatory agencies that may seek administrative penalties as well as civil, and in some cases criminal, liability resulting from violations of consumer protection laws. These laws and their corresponding regulations apply to online lending transactions. This section depicts recent federal regulatory supervisory and enforcement actions, highlights policy considerations being undertaken or discussed at the federal level and surveys recent Congressional initiatives affecting marketplace lending.

All of the federal agencies regulating banks and non-bank lenders have focused on financial technology companies and innovation. Each has an office dedicated to innovation and, over the last several months, the agencies have issued guidance that affects marketplace lending. Below are some of the more important pronouncements from federal regulators.

1. Office of the Comptroller of the Currency (OCC)

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

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

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and conducted summits since 2016 related to policy matters in the industry. Both groups merged in March 2021 to form the American Fintech Council.

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

OCC Fintech White Paper. On March 31, 2016, the OCC published a white paper on the fintech industry. While the paper is generally supportive of innovation and the improvements it brings, the OCC cautions that it must be accomplished in a safe and sound manner, consistent with principles of consumer protection. The OCC also announced that it had created a working group within the agency to monitor developments related to marketplace lending. On October 26, 2016, the OCC announced its decision to establish an Office of Innovation and to implement a regulatory framework supporting "responsible innovation." The Office of Innovation became operational in 2017. This is similar to the CFPB's original Project Catalyst and now its Office of Innovation to allow development of financial fintech in tandem with compliance with consumer protection laws.[128] This is indicative of the overall general interest of regulators in the space.[129]

OCC Fintech Charter. As described elsewhere in this white paper, the OCC has proposed a special-purpose "fintech" charter. This action was challenged by one lawsuit by the Conference of State Bank Supervisors which was dismissed in federal court in the District of Columbia. However, the New York Department of Financial Services also sued to block the issuance of this special purpose charter in New York and, in May 2019, the federal district court denied the OCC's motion to dismiss the case, finding that a national bank requires the receiving of deposits in order to be a bank. The ruling is significant as the court stated that its decision would have nationwide effect so that the OCC could not issue any charter to any fintech company, not just one from New York. Upon the agreement of the parties, the court entered the decision as a final judgment in October 2019, thus allowing the OCC to appeal the ruling, which it did to the Second Circuit Court of Appeals.[130]

The OCC filed a brief based upon three tenets. First, the OCC maintains that New York lacks standing to bring the suit, as no one has applied for this charter and therefore any action is speculative. Second, the OCC states that its interpretation to allow a non-depository charter from a fintech company is both

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128 The CFPB announced changes that would promote innovation and expressed an appetite to allow a regulatory "sandbox" to allow market participants to experiment broadly as has occurred in the UK.

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

130 *Lacewell v. Off. of the Comptroller of the Currency*, Case No. 19-4271 (Second Circuit Court of Appeals).

reasonable and entitled to deference. Third, the OCC asserts that any decision should not be entitled to nationwide application. New York filed its brief and the OCC filed a reply brief in August 2020. Given the litigation, there have been no applications for this charter. The Second Circuit ultimately dismissed the action as not being ripe, hence the uncertainty of this charter's future, if any, remains in flux. The outcome of this case is also significant because the OCC has indicated that it would like to issue a special purpose payments charter to preempt state money transmitter laws and allow for a national payments and servicing platform.[131]

OCC Seeking to Modernize Digital Activities Regulation. On June 4, 2020 the OCC issued an Advance Notice of Proposed Rulemaking related to the digital activities of national banks and federal savings associations.[132] This promulgation seeks input on revising and modernizing the existing provisions of the Code of Federal Regulations related to electronic and technological aspects of banking. It is part of the OCC's push to foster the use of innovation and technology in banking. The public comment period was short, ending on August 3, 2020.

The eleven questions posed by the OCC ask commenters to address new aspects of digital activities and whether regulation would be beneficial or burdensome to things such as digital finder activities, sale of software, cryptocurrency, distributive ledger technology, use of artificial intelligence and machine learning, payment technologies, regtech, other activities and changes due to the COVID-19 pandemic. However, the OCC stated that this initiative is not to comment on special purpose national banks related to fintech.

OCC Proposes True Lender Regulation. On July 22, 2020, the OCC issued a Notice of Proposed Rulemaking related to who is the true lender on a loan.[133] In short, simple and succinct fashion, the OCC states that as of the date of loan origination the true lender is either the party named as lender on the loan agreement or the entity that funds the loan. The agency indicated that this rulemaking is being made in the context of bank partnerships with third parties, including marketplace lending. The OCC emphasized the piecemeal and divergent court decisions on the subject which, are neither clear or dispositive, have created uncertainty and discouraged third-party lending relationships and limited competition. The OCC emphasized the need for predictable and stable markets that will allow for the continued availability of credit. If enacted, this bright-line test would provide a clear path to resolving

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131 The OCC may have other avenues to allow fintech companies to pursue a national charter. For example in September 2020, the OCC approved the acquisition of an existing national bank based in Minnesota by a fintech company with plans to make the bank a digital bank. The Federal Reserve also approved the application of the parent, Jiko Group, Inc., to become a bank holding company. Rather than offering traditional demand deposit accounts, deposits will be invested in Treasury bills until the customer makes a withdrawal when the Treasuries will be converted into cash.

132 85 Fed. Reg. 40827 (July 7, 2020) to be codified at 12 C.F.R. Parts 7 and 155. On the same day, the OCC also issued a notice of proposed rulemaking related to bank operations which, although not directly related to financial technology, would help facilitate innovative technologies and digital activities.

133 85 Fed. Reg. 44223 (July 22, 2020) to be codified as 12 C.F.R. 7.1031.

the current existing ambiguities and confusing precedent.[134] The proposal was subject to a public comment period that ended September 3, 2020.[135] The OCC issued a final rule that was overturned by Congress and is of no force and effect. The FDIC did not propose a similar rule.

2. *Federal Deposit Insurance Corporation*

FDIC Draft Guidance Concerning Purchased Loans, Third-Party Lending Relationships. In November 2015, the Federal Deposit Insurance Corporation issued a Financial Institutions Letter (*"FIL"*) dealing with effective risk management practices for purchased loans and participations.[136] 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."[137] 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.

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134 The OCC correctly notes that divergent standards have emerged in true lender cases and that there is no predictable standard, as different factors are considered and not given the same weight, result in subjective determinations and undermine the certainty and stability needed in financial markets.

135 As would be expected, consumer advocates and groups tended to oppose the proposal while industry trade groups supported the proposal. Twenty-four state Attorneys General filed comments in opposition to the proposal.

136 FIL-49-2015 (Nov. 6, 2015).

137 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

Then, on July 29, 2016, the FDIC published FIL-50-2016, seeking comment on its proposed Guidance for Third-Party Lending applicable to FDIC-supervised institutions lending through a business relationship with a third party, including loan originator activities.[138] The guidance focuses on identification and assessment of risk commensurate with the third-party lending relationship. It would require due diligence, appropriate contract protections, ongoing monitoring, and remediation. Institutions with significant third-party lending relationships may be subject to increased supervisory attention and examination and review of the third parties.

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

FDIC Enforcement Action Against Funding Bank, Third-Party Service Provider. On March 28, 2018, the FDIC entered into two related settlements, one with a Funding Bank and the other with a third-party marketer/servicer of one of the Funding Bank's loan products, with facts analogous to many marketplace lending programs.[139] The loan product at issue was a debt consolidation loan where the service provider negotiated debt settlements on the borrower's behalf for a fee. The FDIC found that the Funding Bank and its third-party service provider had engaged in unfair and deceptive practices related to the marketing and origination of the loans and had violated the Electronic Funds Transfer Act by requiring borrowers to pay by preauthorized ACH.[140] In addition, the FDIC determined that the loan disclosures violated the Truth in Lending Act because they failed to clearly and conspicuously state the terms of the loans by using estimates which were significantly different than the actual loan terms. The FDIC also found that the Funding Bank had failed to provide adequate oversight of its third-party service provider and did not have an adequate compliance management system to manage these

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138 FDIC FIL-50-2016, "FDIC Seeking Comment on Proposed Guidance for Third-Party Lending" (July 29, 2016).

139 *In the Matter of Cross River Bank*, FDIC -17-0123b, FDIC-17-0121b and FDIC-17-0122k and *In the Matter of Freedom Fin. Asset Mgmt., LLC*, FDIC-17-0126b, FDIC-17-0125b and FDIC-17-0124k (both titled "Consent Order, Order for Restitution and Order to Pay Civil Money Penalty"), Mar. 28, 2018.

140 See the later discussion of EFTA and Regulation E under "Electronic Commerce Laws." Lenders cannot compel borrowers to pay loans by electronic means and whether authorizations for pre-authorized transfers meet this requirement or are valid has been the subject of litigation. In this case, the bank is being required to clearly and conspicuously explain that preauthorized electronic payments are optional and that a loan cannot be conditioned on the borrower repaying the loan in this manner.

relationships, including engaging in appropriate due diligence prior to entering into a relationship with a third-party service provider.

The FDIC exercised jurisdiction over the third-party service provider as an "institution-affiliated party" of the Funding Bank under the Federal Deposit Insurance Act.[141] Because the service provider was the primary actor in the program, the FDIC required restitution and required the service provider to deposit $20 million in a segregated account for consumer reimbursement purposes.[142] The service provider was also tagged with a civil money penalty close to $500,000.[143]

> **Key Point:** Marketplace lenders should remember that they too are subject to the jurisdiction of federal banking regulators when they partner with a Funding Bank and need to be vigilant in complying with the consumer protection laws applicable to their programs.

There are at least three important takeaways from this FDIC enforcement action for Funding Banks that have relationships with marketplace lenders: (1) federal regulators will hold the bank responsible for the products and services it originates, including those originated through a third-party relationship, and may impose civil money penalties for compliance deficiencies,[144] (2) banks are expected to have robust third-party risk management programs as required by federal regulatory guidance including appropriate risk assessment, initial and ongoing due diligence and oversight and correction of deficiencies, and (3) banks must maintain a strong compliance program to manage third-party risk including adequate policies, training, monitoring and audits of consumer protection laws as well as a consumer complaints process that timely identifies, reviews, investigates, responds to and resolves consumer complaints.[145]

Deposit Insurance. After a long drought of granting few approvals for applications for deposit insurance, the FDIC had been approving applications for deposit insurance, including to companies in

141 12 U.S.C. §§ 1813(q) and 1813(u).

142 The FDIC orders require the service provider to pay all reimbursement amounts due to consumers, even if they exceed the deposited amount. In addition, the bank is also responsible for restitution if the service provider fails to make payments to borrowers. Even if reimbursed, consumers retain any rights they may have against the bank and the service provider. Therefore both the bank and the service provider could be subject to additional actions.

143 In November 2017, the CFPB filed suit against the service provider's affiliate debt relief company for the same actions. *See CFPB v. Freedom Debt Relief, LLC et al.*, Case No. 3:17-cv-064843 (N.D. Cal.). The CFPB settled this action in 2019 for a fine of $5 million and restitution of $20 million.

144 In this case, the FDIC imposed a penalty of $641,750 and stated that the bank is prohibited from being indemnified for that penalty.

145 This strong action by the FDIC is in contrast to statements made by regulators from the Federal Reserve, OCC and CFPB at a banking conference in early 2018 that they would be more "flexible" in applying third-party risk management guidance to partnerships between banks and fintech firms. Interestingly, the FDIC did not make such a statement. The FDIC is the primary regulator of Funding Banks engaged in marketplace lending programs.

the fintech space and to proposed industrial banks.[146] Recent applications have lingered, however. As discussed elsewhere in this book, the industrial bank is a viable option for marketplace platforms to obtain a banking charter. Recognizing this, the FDIC proposed a rule relating to the safety and soundness of industrial banks where the parent company is not subject to supervision by the Federal Reserve. The proposal would require a parent company to enter into written agreements with the FDIC and the industrial bank concerning the relationship of the parent company to the industrial bank, require capital and liquidity support from the parent to the industrial bank and establish appropriate recordkeeping and reporting requirements. The rule serves to codify existing supervisory processes and policies.[147]

FDIC RFI Relating to Standards and Voluntary Certification. On July 20, 2020, the FDIC put out a Request for Information (*"RFI"*) as part of its efforts to promote new technology in banking.[148] The RFI poses 26 questions, asking for comments on the use of a standard setting organization (*"SSO"*) and voluntary certification of credit models and third-party service providers. The RFI is aimed at making it easier for smaller community banks the FDIC supervises to utilize modern technology in their banking operations. Smaller banks face high startup costs and barriers to entry that could be mitigated by use of models or service providers that meet certain standards or achieve certification. These standards and certifications would not replace existing guidance but instead would provide short cuts to vendor management and due diligence processes.[149]

FDIC Publications Promote Innovation. The FDIC established FDiTech, its technology lab that partners with banks, private companies, regulators and others to bring about new technologies that enhance the operations of financial institutions and encourage innovation that meets consumer demand. In February 2020, the FDiTech issued its first publication, "Conducting Business With Banks—A Guide for Fintechs and Third Parties," to help fintechs partner with banks.[150] The FDIC also published guidelines to assist non-banks in understanding the de novo application process for

146 Approval was granted to Varo Bank N.A. in February 2020. The OCC also approved the application to become a national bank and the bank officially opened in August 2020. In March 2020, the FDIC approved the deposit insurance application of Square, Inc. to create a de novo Utah-based industrial bank primarily serving merchants that process card transactions through Square. Also in March 2020, the FDIC granted a deposit insurance application of Nelnet, Inc. to create a Utah-based de novo industrial bank to originate and service student loans and other consumer loans. However, other fintech companies such as Robinhood and Rakuten have withdrawn their applications for deposit insurance. Other platforms desire to become a financial institution by purchasing an existing bank. In March 2020, LendingClub agreed to acquire Radius Bancorp, a $1.4 billion company based in Boston, Massachusetts.

147 The FDIC Statement indicates that industrial banks have operated for more than a century. In 1982 they became eligible for deposit insurance and parent companies were excluded from Federal Reserve regulation in 1987. Industrial banks are state chartered and supervised by the FDIC.

148 85 Fed. Reg. 44890 (July 24, 2020).

149 Chapman partner Marc Franson discussed the RFI with two senior officials at the FDIC. This discussion, sponsored by the Online Lending Policy Institute, is available on our website: www.chapman.com. Discussion with Brandon Milhorn, Chief of Staff to the FDIC Chairman, and Leonard Chanin, Deputy to the Chairman of the FDIC.

150 The Guide reaffirms portions of vendor and risk management guidelines of the FDIC and indicates that a financial institution will review a fintech's compliance, financial condition, management structure, risk management and controls.

nontraditional bank organizers. The FDIC in these documents indicated a commitment to work with any group interested in starting a financial institution and that given "sound business plans, experienced leadership … and appropriate capital support" they can "play a vital role in serving the deposit and credit needs of their communities."

3. *Department of the Treasury*

Treasury White Paper. On May 10, 2016, the U.S. Department of the Treasury (the "*Department*") published a white paper entitled "Opportunities and Challenges in Online Marketplace Lending" (the "*White Paper*").[151] The White Paper states that marketplace lending can provide both consumer and small business borrowers with expanded access to credit but may also create risks that existing regulatory structures do not adequately address.

The White Paper follows the "Request for Information," or RFI, the Department published in July 2015 to solicit public input on various topics concerning marketplace lending. The Department received approximately 100 responses from marketplace lenders, trade associations, consumer and small business advocates, academics, investors, and financial institutions. Building on the RFI comments and its own market research, the Department makes a number of recommendations in the White Paper for regulatory and/or industry actions. The Department stated that its recommendations are intended to facilitate the safe growth of marketplace lending while fostering affordable access to credit for consumers and businesses. The Department's recommendations include the following:

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

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

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

151 The White Paper is available at https://www.treasury.gov/connect/blog/Pages/Opportunities-and-Challenges-in-Online-Marketplace-Lending.aspx

creation of a private sector registry that is available to the public for tracking data on transactions, including the issuance of notes and securitizations, and loan-level performance.

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

- *Working Group for Interagency Cooperation.* Various aspects of marketplace lending and related financing activities by lenders are subject to regulation by a number of different federal and state agencies. The Department therefore recommended that regulators organize an interagency working group consisting of representatives of the Department, the CFPB, the FTC, the SEC, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Small Business Administration, and a representative of a state banking regulator, to consider the applicability of existing regulations to marketplace lenders, whether there are any gaps in the current regulatory structure, and the impact of nontraditional data on credit scoring models.

U. S. Treasury Report on Financial Innovation. In February 2017, President Trump signed Executive Order 13772 outlining core principles for the regulation of the financial system of the United States. The thrust of the order was to simplify and reform laws and regulations inconsistent with the smooth operation of the financial system and to seek to streamline and reform those laws and regulations. In response to President Trump's administration establishing these principles for a regulatory framework to foster financial growth and stability by making regulation more efficient, the U.S. Department of the Treasury undertook a review of the financial system in an effort to determine what laws and regulations either enhanced or inhibited the provision of financial services. This process generated several reports, including one focusing on fintech issued in July 2018.[152] The report as it related to non-bank financial and fintech companies was generally supportive of establishing a more flexible regulatory framework that promotes innovation.

The report contained some 80 recommendations affecting the current regulatory framework relating to non-bank financial entities and innovation. These can be summarized in four general areas as follows: (1) adopting regulatory approaches that support the development of competitive technologies, (2) aligning or harmonizing the existing regulatory framework to combat fragmentation and allow for new business models enabled by financial technology, (3) updating outdated regulations affecting the products and services of non-bank financial institutions and (4) advocating regulation that embraces

152 *See* U.S. Department of the Treasury, *A Financial System that Creates Economic Opportunities—Nonbank Financials, Fintech and Innovation*, available at https://home.treasury.gov/sites/default/files/2018-07/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financi....pdf

responsible experimentation and regulatory agility and that promotes American interests abroad while maintaining consumer protections and safeguarding the financial system.

In particular, and relevant to marketplace lending, the study endorsed several concepts including (1) the establishment of a regulatory sandbox to promote innovation, (2) updating the rules affecting partnerships between banks and non-bank firms to accommodate technological advances, (3) codifying the "valid when made" doctrine and the role of a bank as the true lender of loans it makes, (4) providing regulatory clarity for the use of data and algorithms in the underwriting process and (5) supporting the OCC's special purpose charter that could be attractive to fintech companies. The report also recommended that Congress enact a federal data security and breach notification law to protect consumer information and provide notification when a breach occurs.

Since the Treasury Department is not itself a regulator of marketplace lenders or banks, it does not have specific authority to cause its recommendations in this report to be enacted. Whether and how these recommendations will be pursued is unclear, although each federal agency seems to be pursuing its own course in these areas. Since the issuance of this report, the change of administrations in Washington is likely to impact the priorities and objectives of these and similar initiatives.

4. Consumer Financial Protection Bureau

The last several months have brought many changes to the CFPB. The most significant actions that may impact marketplace lending programs are discussed below and in the "Recent Developments" section of this book. As stated previously, the structure of the CFPB was found to be unconstitutional in 2020, but its actions nonetheless remain valid. In 2023, the United States Supreme Court will hear another challenge to the constitutionality of the agency due to a Fifth Circuit ruling finding the funding structure to violate the U.S. Constitution. This has led to continued uncertainties and challenges to CFPB enforcement actions. Prior important activities of the CFPB particularly as they are related to marketplace lending are discussed in this section.

Arbitration Rule Thwarted. After years of study, receiving comments and holding hearings, on July 10, 2017, the CFPB promulgated its Arbitration Agreements Rule (the "*Arbitration Rule*"), which prohibited the inclusion of class action waivers in arbitration clauses in agreements for consumer financial products and services and imposed related disclosure and reporting requirements.[153] Compliance with the Arbitration Rule would have been required by March 19, 2018. However, a joint resolution was passed by both houses of Congress overturning the Arbitration Rule pursuant to the Congressional Review Act.[154] On November 1, 2017, President Trump signed the joint resolution, effectively

153 Prior to issuing the Arbitration Rule, the CFPB conducted an arbitration study and published a lengthy report of its findings in March 2015. Then on May 5, 2016 the CFPB issued its proposed arbitration rule for public notice and comment. The CFPB received nearly 13,000 comments on the proposed rule, with one of the main criticisms being that the proposed rule was not justified based on the CFPB's own arbitration study.

154 The vote in the United States Senate was 50-50 for and against disapproval, requiring Vice President Pence to cast the tie-breaking vote for disapproval. The law provides Congress within a certain time parameter to overturn agency regulations.

nullifying the Arbitration Rule and preventing the CFPB from issuing any similar rule in the future. Many lenders, including marketplace loan programs, utilize arbitration agreements or clauses in their loan agreements, and this action has been viewed as a victory that will allow these lenders to retain the ability to use and enforce arbitration agreements and potentially avoid class action litigation. However, it is possible for Congress to pass legislation that could impact this result.

Project Catalyst Issues First No-Action Letter. On September 14, 2017, the CFPB issued its first "no-action" letter to a marketplace lender.[155] The letter was part of the CFPB's Project Catalyst, which reviews requests from companies seeking to develop consumer-friendly innovations or products in areas where there is regulatory uncertainty.[156] The marketplace lender who requested the letter was using alternative data such as education and employment history in its credit underwriting and pricing decision models, and sought the CFPB's agreement that it would not take supervisory or enforcement action under the Equal Credit Opportunity Act in connection with the marketplace lender's use of such data.[157] The CFPB agreed, recognizing that the use of alternative data could potentially make credit more accessible and affordable to some segments of the population. The CFPB did, however, require the marketplace lender to agree to ongoing reporting to the CFPB concerning its practices to allow the bureau to understand the impact of alternative data on credit decision-making and to mitigate risk to consumers.[158] We note that the no-action letter is specific to the facts and circumstances of this particular company and should not be viewed as permission to utilize alternative data in other lending models without an appropriate evaluation of fair lending risks or a similar determination being made by the CFPB. This no-action letter nonetheless showed the willingness of the CFPB to consider emerging technologies in a manner favorable to their development while providing a degree of regulatory certainty for technological innovations in the financial services industry. In June 2022, the CFPB terminated this no-action letter despite its reported success in providing lower rates and higher acceptance. The CFPB has abandoned its no-action letter posture.[159] The initial analysis of data shows that increased access to credit and lower rates resulted from the use of alternative data as opposed to traditional means.

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5 U.S.C. 801 *et seq.* This law was later used as a means of overturning the "true lender" regulation enacted by the OCC in 2020. Legislation has been introduced in Congress that would prohibit arbitration clauses.

155 The letter was issued to Upstart Network, Inc. on Sept. 14, 2017. The letter is available at: http://files.consumerfinance.gov/f/documents/201709_cfpb_upstart-no-action-letter.pdf

156 The agency has dropped the name Project Catalyst, but the CFPB's Office of Innovation entertains requests for no-action letters under a streamlined process.

157 The use of alternative data in credit underwriting is discussed further below under "Consumer Protection Laws—Fair Lending and Related Laws."

158 The legal concern is that use of alternative data, newly derived algorithms and automated machine decision making can have the effect of circumventing fair lending laws and unintentionally result in discrimination against persons protected by the ECOA and other similar laws. The data which the CFPB will receive from the marketplace lender in connection with the no-action letter will help the bureau evaluate whether new modeling techniques potentially result in discrimination.

159 The CFPB is revamping its processes to encourage further experimentation with innovation in disclosures and other matters. The U.S. Treasury Report of July 2018 supports clarifying and establishing a federal regulatory approach to the use of alternative data.

However, the CFPB has indicated that it will scrutinize utilization of technology for potential discriminatory effects.

PHH and Constitutional Challenges to the CFPB Structure—2016 Decision. The much-anticipated decision in *PHH Corporation v. Consumer Financial Protection Bureau* was handed down by the U.S. Court of Appeals for the D.C. Circuit, *en banc*, on January 31, 2018. This case originated in 2014 with an administrative enforcement action brought by the CFPB against PHH, a New Jersey-based mortgage lender, alleging violations of the Real Estate Settlement Procedures Act (*"RESPA"*). The CFPB alleged that despite relying on prior regulatory guidance, which was widespread industry practice, PHH violated Section 8 of RESPA by referring customers to mortgage insurers, who in turn bought reinsurance from one of PHH's affiliates. In the initial administrative enforcement action, the CFPB imposed a $6.4 million penalty for PHH's RESPA violations. PHH appealed the decision to the CFPB's director, Richard Cordray, who increased the penalty to $109 million (primarily related to extending relief beyond RESPA's statute of limitations period). PHH then appealed directly to the Court of Appeals for the D.C. Circuit.

The court's 2016 decision[160] analyzed three questions and ruled against the CFPB on each one: (1) whether the CFPB's structure is constitutional, (2) whether the CFPB properly applied RESPA in finding a violation, and (3) whether the statute of limitations in RESPA applies in administrative actions as well as court proceedings. As expected, following the court's decision the CFPB petitioned for a rehearing *en banc* by the full D.C. Circuit and the court granted the bureau's request, effectively vacating its 2016 decision.

CFPB Structure Found Constitutional by Appeals Court. The subsequent decision in *PHH Corporation v. Consumer Financial Protection Bureau* was issued on January 31, 2018,[161] almost a year after the CFPB petitioned for a rehearing by the Court of Appeals for the D.C. Circuit, *en banc*. The court issued a 250-page opinion finding that the single-director structure of the CFPB was constitutional and that its director could only be fired for inefficiency, neglect of duty or malfeasance in office, and not at the will of the President of the United States. This, the court stated, allowed the CFPB to remain one step removed from political winds and the President's will. The court also threw out the $109 million penalty previously awarded against PHH, returning the case to the CFPB for further consideration. The court found that this penalty, which was calculated based on the CFPB's retroactive application of certain federal laws beyond the statute of limitations, violated PHH's due process rights—thus confirming that the CFPB is subject to the statutes of limitation prescribed by federal law in its enforcement actions.[162] The CFPB dismissed the case against PHH. However, there are other lawsuits

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160 *PHH Corp. v. Consumer Fin. Prot. Bureau*, 839 F.3d 1 (D.C. Cir. 2016).

161 *PHH Corp. v. Consumer Fin. Prot. Bureau*, 881 F.3d 75 (D.C. Cir. 2018).

162 By law, the CFPB cannot appeal the decision, and PHH did not appeal the decision. The CFPB subsequently dismissed the action.

pending that challenge the constitutionality of the CFPB which ultimately required the United States Supreme Court to decide the issue.[163]

Constitutionality of the Consumer Financial Protection Bureau (CFPB). The CFPB has been a source of controversy since its inception. Its saga is recounted in this book. However, the culmination of the brouhaha was a decision by the United States Supreme Court in June of 2020.[164] In 2017, a debt collection law firm, Seila Law, was issued a civil investigative demand by the CFPB. The firm refused to comply, based on the argument that placing the agency's authority in a single director who could only be removed for cause violated the separation of powers doctrine and was therefore unconstitutional. The CFPB went to federal court to enforce its demand. Both the district court and the Ninth Circuit Court of Appeals sided with the CFPB. Despite the fact that there was no split in authority in the circuits, the United States Supreme Court nonetheless agreed to hear the case.[165] This fact signaled a potential reversal.

The Supreme Court held that the structure of the CFPB—one director who could only be removed for cause—violated the Constitution's separation of powers doctrine. However, the court took "a scalpel rather than a bulldozer" to the CFPB, finding that this in and of itself did not make the agency unconstitutional. This was based on a provision in the law that created the CFPB that allowed severability, allowing the court to invalidate the issue of the director's removal from the unconstitutionality of the entire agency. Thus, the court reined in the power of the director without invalidating the agency, leaving the CFPB and its powers in place.[166]

The Supreme Court did not address how its holding affects prior agency regulations and actions. The court noted that individual actions should be handled by the lower courts on a case-by-case basis. Thus, the court left open the potential for continued uncertainty and litigation in those matters. On July 7, 2020 the CFPB did provide a ratification of all of its past actions, which might make those challenges more difficult.[167] In August, 2020, the CFPB also filed a brief in the *Seila Law* remand at the Ninth Circuit, asking it to enforce the civil investigative demand.[168] At least one other case has already been

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163 In a case pending at the Second Circuit Court of Appeals, the structure of the CFPB was found to be unconstitutional by the lower court. It is on appeal to the Second Circuit. *CFPB v. RD Legal Funding LLC,* Case No. 18-2743 (2nd Cir.) Other cases have raised this issue in the Fifth (*CFPB v. All American Check Cashing,* Case No. 18-60302) and Ninth Circuits (*CFPB v. Seila Law,* Case No. 17-56324), and it is included as an issue to be decided in the *CFPB v. CashCall* case in California discussed in the "Recent Developments" section and below. The constitutional issue is being raised by defendants in enforcement actions.

164 *Seila Law LLC v. Consumer Fin. Prot. Bureau*, No 19-7 (U.S. Sup. Ct. June 29, 2020), 591 U.S. ____ (2020), 140 S. Ct. 2183 (2020).

165 As discussed later, the D.C. Circuit agreed with the Ninth Circuit. *See, PHH Corp. v. Consumer Fin. Prot. Bureau,* 881 F.3d 75 (D.C. 2019).

166 Because a U.S. president can then remove the Director of the CFPB at will, if there is a change in administrations as a result of the November 2020 elections, the existing director could be removed at any time by the new president. This could mean changes in how the CFPB operates or alter its enforcement objectives.

167 https://files.consumerfinance.gov/f/documents/cfpb_ratification_bureau-actions_2020-07.pdf

168 *Seila Law v. CFPB,* Case No. 17-56324 (9th Cir.). Case decided Dec. 29, 2020.

stayed subject to the Ninth Circuit's determination of the remand proceeding.[169] The appeal was decided in favor of the CFPB and the case was not appealed.

Leadership Changes at CFPB Brings Lawsuit, New Focus. The agency has never been free from controversy. One such saga involves the changes of director of the body. On November 24, 2017, CFPB Director Richard Cordray resigned to run for Governor of Ohio, an election he subsequently lost. Cordray had aggressively led the CFPB as its first director, and critics assailed him for engaging in "regulation by enforcement," *i.e.,* using enforcement actions as a means to circumvent the administrative process of issuing regulations. Cordray left on a contentious note, appointing Deputy Director Leandra English as acting director of the agency. Meanwhile, President Trump named his own interim director of the agency, Mick Mulvaney, who was serving as Director of the Office of Management and Budget and had been a harsh critic of the CFPB.

This jockeying for position led to English filing a lawsuit asking that she be declared the CFPB Director pursuant to the provision of the Dodd-Frank Act that states that the Deputy Director serves as Acting Director in the absence or unavailability of the Director.[170] The Trump administration defended the lawsuit, arguing that the President has the right to fill executive positions, including the CFPB directorship, under the Federal Vacancies Reform Act.[171] On November 28, 2017, the court denied English's request for a temporary restraining order to keep Mulvaney from exercising power as CFPB Director. The court also denied English's request for a preliminary injunction, which was appealed to the Court of Appeals for the D.C. Circuit. The case was dismissed after a new director of the CFPB, Kathy Kraninger, was confirmed by the U.S. Senate.[172]

In the interim, Acting Director Mulvaney effected a significant restructuring of the CFPB. In the CFPB's semi-annual report to Congress issued April 2, 2018, Mulvaney recommended statutory changes to the Dodd-Frank Act including legislative approval of major CFPB rules. He indicated that the enforcement activities of the bureau will be curtailed, leaving enforcement to the federal banking agencies or the states, while rulemaking will take a higher priority.[173] The CFPB's fair lending office was relegated to

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169 *CFPB v. CashCall et al.*, Case No. 18-55407 (9th Cir. Order issued Aug. 2, 2020). This case is discussed in detail later in this book.

170 *English v. Trump and Mulvaney*, C.A. No. 1:17-cv-02534 (D.D.C. 2017).

171 In addition, a federal credit union sought to block Mulvaney's appointment by filing suit in federal court in New York. *Lower East Side People's Fed. Credit Union v. Trump et al.*, No. 17-09536 (S.D.N.Y. Feb. 1, 2018). The court dismissed this case because it found that the credit union lacked authority to bring it.

172 Kraninger was confirmed on December 6, 2018. Legislation had been introduced during the prior Congress in the U.S. House of Representatives with bipartisan support to put the CFPB under a five-member commission rather than a single director. H.R. 5266—Financial Product Safety Commission Act of 2018. However, it was not acted upon and died with the end of the 115th Congress in January 2019.

173 In a January 24, 2018 staff memo, Mulvaney stated: "On regulation, it seems that the people we regulate should have the right to know what the rules are before being charged with breaking them. This means more formal rule making and less regulation by enforcement."

an administrative function rather than an enforcement one.[174] Under Mulvaney, the CFPB issued a series of Requests for Information seeking industry and public input on a variety of subjects including its civil investigative demands, consumer complaint portal and how to improve the rulemaking process.[175]

Only recently, on March 30, 2023, has the CFPB promulgated final regulations with respect to data gathering for small business lending under Section 1071 of the Dodd-Frank Act, as discussed further below under "Consumer Protection Laws—Fair Lending and Related Laws," and in the "Recent Developments" section. After a suit was brought against the CFPB for not acting on this issue, in September 2020, the agency issued an outline of proposals that it was considering, convened a panel to provide input and issued a proposal and received comments on the proposal and proposed regulations before finalizing the rule.

Enforcement Action Against Lead Aggregator. On September 6, 2017, the CFPB issued a Consent Order against an online lead aggregator imposing a $100,000 penalty for selling leads to lenders where the resulting loan was either made by an unlicensed lender, imposed interest rates in excess of applicable usury limits, or was void. [176] The CFPB cited these activities as an abusive practice and required the lead aggregator to engage in efforts to ensure that its leads do not result in void loans and monitor the lenders to whom it sells leads and obtain copies of their lending licenses. The use of lead generation and aggregation is coming under increasing regulatory scrutiny, including with respect to state licensing, unfair or deceptive practices claims, and sharing of consumer information.

CFPB on Marketplace Lenders. On March 7, 2016, the Consumer Financial Protection Bureau announced that it was accepting consumer complaints about online marketplace lenders, giving consumers "a greater voice in these markets and a place to turn to when they encounter problems." The CFPB also issued a bulletin to provide consumers with information on marketplace lending, including guidance on shopping for a loan. Significantly, the CFPB noted in its bulletin that while marketplace lending is relatively new, marketplace lenders are subject to the same state and federal laws as other lenders.

Although consumers have been able to file complaints regarding marketplace lenders with the CFPB since July 2011, it seems the CFPB issued this press release to raise awareness in the industry and among consumers that the bureau might seek to expand its oversight in this area. The CFPB has used complaint data to identify areas that require additional regulatory guidance and rulemaking and to

174 The Office of Fair Lending was created by Section 1013 of the Dodd-Frank Act. Mulvaney's action stripped the Office of its supervisory responsibilities and replaced them with advocacy and education efforts.

175 These RFIs are characterized on the CFPB website as "Calls for Evidence" that the CFPB is fulfilling its proper function. See https://www.consumerfinance.gov/policy-compliance/notice-opportunities-comment/open-notices/call-for-evidence/.

176 The full text of the CFPB's consent order entered against Zero Parallel, LLC is available at: http://files.consumerfinance.gov/f/documents/201709_cfpb_zero-parallel-llc_consent-order.pdf. In a related action, the CFPB proposed to fine the owner of Zero Parallel $250,000 for similar illegal actions. *See* https://files.consumerfinance.gov/f/ documents/201709_cfpb_gasparyan_proposed-stipulated-final-judgment.pdf

direct its investigations and enforcement actions. Marketplace lending has not generated an inordinate amount of complaints. However, with the change in leadership at the agency, it seems likely that the CFPB may be less focused on using complaint data in this manner, particularly since the CFPB issued Requests for Information on the efficiency and effectiveness of its consumer complaint reporting and enforcement processes.[177] However, the agency is still pursuing enforcement actions.

> The CFPB is still prosecuting enforcement actions against online lenders.

Although actions of the bureau remain provocative, during the Trump administration the agency moved away from regulation by enforcement to supervision but now appears to have returned to a more aggressive enforcement posture. Nonetheless, the CFPB still undertakes enforcement actions when it deems them warranted. Some relevant ones are outlined below.

Enforcement Action Against Online Foreign Lender. In February 2019, the CFPB lodged a complaint and settlement agreement with the Southern District of New York against a non-U.S. online payday lender based in Canada and Malta.[178] The lender and its related entities were cited for making misrepresentations to borrowers, claiming that they had to repay loans even though those loans violated U.S. state laws on lender licensing and usury.[179] The lender also falsely stated that the loans were not subject to U.S. laws and used a foreign governing law provision. In addition, the lender took wage assignments and made misrepresentations about punishments that allegedly would result from nonpayment. The entities were barred from doing business in the United States in any manner, including collection of any outstanding loan made to a U.S. resident. Consumer groups were disappointed that the CFPB action did not require payments to affected customers or any type of restitution. However, this proceeding is a lesson to foreign-based Internet lenders that lending to U.S. citizens requires compliance with U.S. law, including state licensing and usury laws. Nor can the use of a foreign jurisdictional clause circumvent consumer protection laws that are applicable to lending to U.S. residents.

> Any lending to U.S. residents over the Internet, even from foreign countries, requires compliance with U.S. legal requirements including any applicable licensing and usury laws.

Enforcement Actions on Electronic Transfers. Online lenders often utilize electronic fund transfers to collect the payments due on their loans. Electronic fund transfers are subject to the Electronic Fund

177 *Request for Information Regarding Bureau Public Reporting Practices of Consumer Complaint Information*, 83 Fed. Reg. 9499 (Mar. 6, 2018); *Request for Information Regarding Bureau Enforcement Processes*, 83 Fed. Reg. 5999 (Feb. 12, 2018).

178 *Consumer Fin. Prot. Bureau v. NDG Fin. Corp. et al.*, Case No. 15-cv-05211 (S.D.N.Y. filed Feb. 4, 2019).

179 Since the CFPB cannot enforce state laws dealing with licensing and usury, the fact that the online lender made loans in violation of those laws provided the basis of the CFPB claims relating to misrepresentation of the applicability of state law to those loans.

Transfer Act and its implementing Regulation E. Generally, the law and regulation require the lender to obtain the consumer's consent before debiting the consumer's deposit account, and special requirements apply to recurring transfers. In January 2019, the CFPB entered into a consent order with an online marketplace lender.[180] The CFPB found that the platform had debited borrowers' bank accounts without proper authorization. While borrowers may have provided an authorization as to one account, the platform was debiting payments from different accounts that had not been authorized for withdrawals. The CFPB also found that the lender failed to honor loan extensions that had been given to borrowers. In addition to prohibiting the debiting of consumer bank accounts without prior authorization, the consent order required payment of a $3.2 million penalty. It appears that electronic fund transfers are an area of focus by the CFPB.[181] In an unrelated action against a bank, the CFPB settled a complaint for failure to implement stop-payment requests on preauthorized fund transfers and for failure to conduct proper error-resolution investigations. The settlement resulted in $12 million in restitution and a $3.5 million civil penalty.[182]

> The CFPB is closely watching online lender practices relating to electronic funds transfers from borrower accounts.

Office of Innovation and Regulatory Sandbox. The CFPB issued only one no-action letter under its originally named Project Catalyst (which the bureau had designed to promote innovation in financial products and services). In 2018, the CFPB announced that it would be revising its policies and established an Office of Innovation to promote financial innovation. It focused on revising its no-action letter policy to increase participation by entities wanting to offer new and innovative products and services in the marketplace and streamline its application and review process, focusing on potential benefits to consumers and the control of potential risks. The agency also proposed a "regulatory sandbox" to give companies the opportunity to test new financial products, while receiving relief from certain regulatory requirements. The CFPB also established a trial disclosure program to encourage the use of alternate disclosures on a trial basis, which the bureau terms a "disclosure sandbox." The Office of Innovation was to work with the Global Financial Innovation Network (*"GFIN"*) to work with regulators in other countries with respect to innovation and new ideas on a cooperative basis. In May 2022, the CFPB replaced the Office of Innovation with the Office of Competition and Innovation.

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180 *In re Enova Int'l, Inc.*, CFPB File No. 2019-BCFP-0003 (Jan. 25, 2019).

181 In 2015, the CFPB brought an enforcement action against an online payday lender. *In re Integrity Advance LLC et al.*, Adm. Proc. File No. 2015-CFPB-0029 (Nov. 18, 2015). Although there were allegations of failure to accurately disclose the costs of the loan, the agency also alleged violations of Regulation E for conditioning the loan on electronic payment and continuing to debit borrower accounts after revocation of the debit authorization by borrowers. The recommended decision includes over $13 million in penalties and remains pending before the CFPB.

182 *In re USAA Fed. Sav. Bank*, CFPB File No. 2019-BCFP-0001 (Jan. 3, 2019).

Use of Alternative Data. The first "no-action" letter issued by the CFPB related to the use of alternative data and artificial intelligence.[183] The letter required monitoring by the CFPB and reporting from the non-bank fintech. In August, 2019, the CFPB released performance metrics indicating that 30% more loans were approved when using alternative data. The CFPB stated this expanded access to credit when compared with traditional models. In addition, annual percentage rates on approved loans were lowered by 16% using alternative data when compared to traditional models. The CFPB also indicated that the alternative data benefited multiple demographic groups. More recently, leadership at the CFPB has been critical of machine learning and the use of artificial intelligence and alternative data as being potentially discriminatory.

Abusive Practices. In early 2020, the CFPB outlined how it defines abusive practices when overseeing companies.[184] The CFPB said it would challenge conduct as "abusive" only when the harm to consumers outweighs the benefit. It stated that duplicative charges would not be issued against companies as being both abusive and unfair or deceptive. The agency also said it will seek monetary relief where there has been a lack of good faith effort to comply with applicable law. With new leadership at the CFPB, this view will likely be disregarded.

a. Civil Investigative Demands

The CFPB has started investigations against some fintechs. In February 2021, PayPal told investors that the CFPB was investigating the collection practices of Venmo, a mobile money transfer service. In March 2021, it was also disclosed in an SEC filing that an online consumer lender, Oportun, Inc., was being investigated for debt collection practices and pandemic-related dealings with borrowers. Also publicly disclosed in March 2021 was that the CFPB issued a civil investigative demand to Opportunity Financial, LLC, an online lender, investigating its compliance with the Military Lending Act. That proceeding was based on a consumer complaint.[185] The CFPB continues to use civil investigative demands to investigate consumer complaints and other perceived compliance issues both generally and as to fintechs.

b. Enforcement Against Point-of-Sale Platform

In July 2021, the CFPB entered a Consent Order against GreenSky, LLC.[186] GreenSky is a fintech lending platform that originates consumer loans through a point-of-sale merchant network. The CFPB alleged that contractors and merchants were able to facilitate and benefit from loans from consumers who did not request or authorize the loans, making it an unfair practice and violating the law. In addition, the platform received over 6,000 complaints from consumers concerning unauthorized loans,

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183 The no-action letter was issued to Upstart, a California fintech firm.

184 The Dodd-Frank Act added the concept of abusive conduct to what the CFPB could enforce, including the more common and better defined unfair or deceptive practices. Prior CFPB actions used this to prohibit a variety of practices.

185 At the time of writing, no formal actions have been filed as to any of these companies under investigation.

186 2021-CFPB-0004 (July 12, 2021).

some becoming aware of them from credit reports, billing statements, or collection activity. The order requires refunding or canceling some $9 million in loans and the company was hit with a $2.5 million civil money penalty. The company must also implement a complaint management program to prevent a recurrence of the situation. The action highlights the challenge of programs that work with third-party merchants and that require appropriate controls, merchant training and oversight, and a robust compliance management program.

c. Fintech Halts Lending Due to CFPB Action

In December 2021, the CFPB announced that an online fintech agreed to halt new lending activity and collection of some outstanding loans in order to resolve a pending lawsuit alleging that it continued to engage in the deceptive marketing practices that were the subject of a 2016 CFPB order.[187] The CFPB also cited the company for violation of fair lending regulations. The bureau claimed that the company misrepresented to consumers that paying off loans would result in lower interest rates and larger loan amounts, which often did not materialize. The agency also claimed that thousands of adverse action notices failed to accurately describe the main reasons why loan applications were denied, as required by the ECOA and Regulation B. The CFPB imposed a $100,000 penalty based on the company's inability to pay the fine. However, the CFPB press release noted that the company was "backed by some of the biggest names in venture capital."

> Marketplace lenders should expect more enforcement actions, particularly from the CFPB.

5. Federal Trade Commission (FTC)

In June 2016, the Federal Trade Commission (*"FTC"*) held a FinTech Forum addressing marketplace lending.[188] The forum focused on consumers and consumer protection. The FTC's Director of Consumer Protection, who has since left the agency, identified several areas that concern the FTC, including preauthorized transfers to repay loans, transparency of loan terms, privacy and data security, and potential discrimination arising from using nontraditional data to make credit decisions.

> The FTC has become a potent force in enforcing consumer protection laws with online lenders.

187 *Bureau of Consumer Fin. Prot. v. LendUp Loans, LLC*, Case No. 4:20-cv-08583-JSW (N.D. Cal. filed Jan. 20, 2021). The CFPB also sued LendUp in 2020 for violations of the Military Lending Act and was awarded a judgment in that action.

188 This was the first such forum. A second forum was held in October 2016 on crowdfunding and peer-to-peer payments and a third was held in March 2017 on blockchain technology and artificial intelligence.

Federal Trade Commission Actions. The Federal Trade Commission has broad authority to prevent unfair competition and unfair or deceptive acts and practices affecting commerce.[189] While the federal banking agencies supervise and regulate insured depository institutions, the FTC's enforcement posture focuses on non-bank entities. Recently, the FTC has prioritized fintech as an area of priority.

Lawsuit Against Online Lender on Marketing Practices. On April 25, 2018, the FTC filed a complaint in federal court in California against a large marketplace lending platform.[190] The FTC claimed that the platform engaged in various deceptive practices including (1) telling customers that they would receive a loan with "no hidden fees," (2) telling customers that they were approved for loans when they were not, (3) that funds were withdrawn from customer bank accounts without authorization and (4) the required privacy notices were not provided to borrowers. The FTC further claimed that origination fees were charged without proper disclosure. The complaint seeks injunctive relief and other relief, including rescission or reformation of contracts, restitution, refund of monies paid and disgorgement. The marketplace lender challenged all of the allegations and filed a motion to dismiss the proceeding, which was granted in part and denied in part. On October 22, 2018, the FTC filed an amended complaint to add further details concerning the alleged harm and providing additional examples of the platform's alleged misconduct. The platform filed an answer, portions of which the FTC moved to strike. Subsequently, some of the challenged practices have been stopped and the court urged the parties to settle the proceeding if appropriate consumer disclosures can be made.[191] In June of 2020, the court addressed motions for summary judgment from each side.[192] In this case, the court in large part denied the summary judgment motions of the FTC, meaning that the case would go to trial on the "no hidden fees" claims. The judge ruled in favor of the FTC on the claim that loan approval communications to customers were misleading. However, in August 2020, the court stayed the proceeding until a case was decided by the United States Supreme Court dealing with whether the FTC has authority to order restitution for consumers harmed by conduct enforced by the FTC.[193] Since that issue was central to the remedy that the FTC is seeking, the California action was paused. The Supreme Court held that the FTC does not have the power to impose restitution. This case was settled around

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189 Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45.

190 *Fed. Trade Comm'n v. LendingClub Corp.*, Case No. 3:18-cv-02454 (N.D. Cal. filed Apr. 25, 2018).

191 The FTC action also precipitated a shareholder suit, *Veal v. LendingClub Corp. et al.*, Case No. 5:18-cv-02599 (N.D. Cal.). A motion to dismiss has been filed by the platform, which was granted in November 2019 with leave to amend. A second amended complaint was filed and again the platform moved to dismiss, which was granted in June 2020, with leave to amend certain portions of the action. 2020 WL 3128909. The appeal of that decision was unsuccessful (Case No. 20-16603 Sept. 21, 2021, 9th Cir.).

192 A motion for summary judgment is a pleading asking the court to rule in favor of the moving party based on the pleadings and materials before the court, without additional proceedings or a trial. If a party is successful in a motion in its entirety, the case is resolved. Partial success on such motions serves to throw out certain allegations or causes of action and narrow the scope of the remaining proceeding.

193 On July 9, 2020 the U.S. Supreme Court agreed to hear two appeals on this issue. *FTC v. Credit Bureau Ctr.* (No. 19-825) and *AMG Capital Mgt., LLC v. FTC* (No. 19-508). Supreme Court decision at 593 US ___, 141 S. Ct. 1341 (2021).

the time the United States Supreme Court determined that the FTC did not have the authority to impose damages and restitution.[194]

> The FTC is taking a more active role in enforcement and is focusing on the marketing practices of online lenders.

Settlement with Lending Platform. The FTC filed litigation against a prominent lending platform in 2018.[195] The FTC alleged that the platform violated Section 5 of the FTC Act[196] by engaging in deceptive and unfair acts and practices in connection with its online lending program, in part by alleging that there were "no hidden fees." Earlier in the proceeding the court granted in part and denied in part a motion to dismiss the action, and the judge urged the parties to settle the action.[197] In July 2021, the action was settled by the platform paying $18 million to the FTC for consumer redress, but neither admitting nor denying the allegations in the complaint. In addition, the platform was prohibited and enjoined from misrepresenting the amount of loan fees, the amount of loan proceeds, the status of any application, the timing of when consumers would receive their funds, or any other material fact concerning the loan. The platform also agreed to clearly and conspicuously state the dollar amount of any up-front fee whether financed or paid in cash and the total amount of funds to be disbursed to the consumer or on the consumer's behalf. Given that, like the CFPB, the FTC remains in an activist posture, non-bank marketplace participants subject to FTC jurisdiction should remain vigilant as to their compliance posture and practices.[198]

6. Supreme Court Limits FTC Ability to Order Consumer Restitution

In April 2021, the United States Supreme Court ruled that the FTC does not have the authority to obtain equitable monetary relief such as restitution for consumer harm under Section 13 of the FTC Act.[199] While this ruling does not eliminate the FTC's ability to obtain damages for consumer harm, it makes it more difficult. Other provisions of the law allow for consumer redress, but they are also more complicated and impose additional legal requirements beyond what Section 13 required.[200]

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194 The majority of circuit courts allow the FTC to impose monetary damages and restitution; however, the Seventh Circuit issued a decision to the contrary, resulting in a split of authority. The Supreme Court decided the case, against the FTC.

195 *Fed. Trade Comm'n v. LendingClub Corp.*, Case No. 3:18-cv-02454 (N.D. Cal) (settlement filed July 14, 2021).

196 15 U.S.C. 45.

197 There is an additional description of this action later in this book in the "Regulatory Issues" section.

198 Until May 2022 when a new FTC Commissioner was named to replace Rohit Chopra, who went to the CFPB, the FTC was deadlocked 2-2 politically and thus little action was taken during this interim period. With a full commission with a Democratic majority, the FTC (like the CFPB) is expected to become more activist in its enforcement posture.

199 *AMG Capital Mgt., LLC v. Fed. Trade Comm'n*, 141 S. Ct. 1341 (2021). The FTC filed the action alleging deceptive payday lending practices in violation of Section 5 of the FTC Act. The district court granted an injunction and ordered $1.27 billion in restitution and disgorgement. The Ninth Circuit affirmed, rejecting the argument that Section 13(b) of the FTC Act does not authorize the award of equitable monetary relief. The Supreme Court reversed.

200 Legislation is pending in the current Congress that would give the FTC the authority to impose restitution under Section 13 of the FTC Act. H.R. 2668 has passed the House as of this writing.

Prior to this decision, the FTC used Section 13 for years to obtain monetary damages and it was deemed to be a well-established principle. However this section of the FTC Act allows only for injunctive relief and not for money damages. The Supreme Court agreed and found the Commission's use of Section 13 unlawful.[201] In the future, to obtain monetary relief, the FTC will need to navigate more cumbersome processes. For example, Section 19 may require the FTC to issue a final cease-and-desist order before seeking money damages. In addition, the proof required in order to obtain the requested damages is that a reasonable person would have known that the conduct was improper.

7. FTC Amends and Updates Safeguards Rule

On October 27, 2021, the FTC issued a Final Rule clarifying and updating the Safeguards Rule promulgated under the Gramm-Leach-Bliley Act.[202] In addition to being applicable to depository institutions such as Funding Banks, the rule also applies to non-banks that are significantly engaged in providing products or services, covering most service providers and marketplace lending platforms. The rule requires these participants to develop and implement adequate security measures to keep customer data safe and mitigate the risk of cyberattacks or data security breaches. The clarifications in the new codification deal with how information security programs should be developed, requirements for employee training, and requiring risk assessment to be in writing. The update also provides guidance on increasing safeguards through the utilization of data encryption and authentication. One new change will require the designation of one key individual to be responsible for overseeing the information security program and also assuring internal compliance with the program. The final rule also requires periodic reporting to the governing body of the entity. This promulgation also extends coverage under the rule to include finders such as brokers or lead generators. Marketplace lending participants should be aware of these new changes and adapt policies, procedures, and operations to be in line with the changes.

Student Loan Advertising. An online student lender settled charges brought by the FTC in connection with the agency's allegations that the marketplace lender was making false claims about the savings that would accrue in connection with a refinancing of the student loan.[203] The FTC claimed that advertising the lender used to solicit student loan refinancings was misleading because savings calculations were inflated or incorrect. The consent order entered into by the parties prohibits the platform from misrepresenting any savings from refinancings unless backed by proof. The FTC complaint stated that the claims of inflated savings began in April 2016 and appeared in television, print and Internet advertising. The FTC also alleged that when disclosures were made, they were buried in the fine print. In its public statement on the settlement, the FTC specified that it is putting other lenders making savings claims similar to those addressed in the proceeding on notice and is

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201 The Supreme Court stated that Section 19's more difficult approach to receive monetary relief would not make sense if the legislature had intended Section 13 to allow monetary damages.

202 The Safeguards Rule is codified at 16 C.F.R. Part 314.

203 *In re Soc. Fin., Inc. and SOFI Lending Corp.*, Docket C-4673 (Fed. Trade Comm'n Feb. 25, 2019).

recommending that all advertising be reviewed to ensure that false or unsubstantiated statements are not being made.

Loan Servicing Practices. In April 2019, an online lending company agreed to settle FTC claims that it had engaged in deceptive and unfair loan servicing practices.[204] The online lender paid a $3.85 million penalty. Allegations included that the platform imposed unauthorized charges on consumer accounts and had violated the Electronic Fund Transfer Act by requiring consumers to agree to recurring automatic debits from their bank accounts as a condition of obtaining a loan.[205] In addition, the company told borrowers that it would accept debit or credit cards for payment when it in fact did not accept those types of payments. The platform allegedly withdrew payments from consumer accounts without authorization and in some cases took duplicate payments. Charges also encompassed failing to timely credit payments, providing inaccurate payoff quotes, and collecting additional amounts even after payoff. The FTC asserted that it views servicing just as important as loan marketing and origination and will hold online lenders accountable for their servicing practices.

Electronic Fund Transfers. Regulators continue to focus on the practices of lenders when it comes to taking funds out of consumer accounts by electronic means. The Electronic Fund Transfer Act and Regulation E make it illegal to require payment of a loan by electronic means. The law and regulation also require consumer consent to withdraw funds from deposit accounts, and authorizations for recurring transfers require specific information and disclosures to consumers.[206] In May 2020, the FTC filed a Complaint against several related entities for various violations of federal law, including Regulation E.[207] Although this was a payday lender using a tribal business model, the Regulation E allegations included making withdrawals without having a proper customer authorization, making duplicate withdrawals for the same payment and making withdrawals without crediting the customer's account. The court entered a temporary restraining order and injunction against the companies, froze their assets and prohibited ongoing operations. Although other issues were involved in this action, it is clear that regulators are serious about enforcing Regulation E. Practices involving electronic transfers from customer deposit accounts should be reviewed routinely to ensure compliance.

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204 *Fed. Trade Comm'n v. Avant, LLC*, Case No. 1:19-cv-02517 (N.D. Ill. 2019).

205 This is a violation of the law's implementing Regulation E, 12 C.F.R. 205.10. A creditor may offer an incentive in order for a borrower to agree to payment by recurring electronic transfers. Certain notifications and requirements apply to pre-authorized transfers under the law and regulation.

206 12 C.F.R. 1005.10.

207 *Fed. Trade Comm'n v. Lead Express, Inc. et al.*, Case No. 2:20-cv-00840-JAD-NJK (D. Nev. filed May 11, 2020).

8. *Board of Governors of the Federal Reserve System (Federal Reserve)*

The Federal Reserve has conducted studies and issued reports that are supportive of marketplace lending.[208] In March 2018, the Federal Reserve Bank of Philadelphia published a research study using live lending data from LendingClub, titled "Do Fintech Lenders Penetrate Areas that are Underserved by Traditional Banks?"[209] The study concluded that fintech lending has expanded consumer access to credit, penetrated areas that have lost traditional bank branches, and allowed consumers to obtain credit at lower rates than through a bank-issued credit card. In addition, the paper found that the use of alternative credit data has enhanced financial inclusion. The study indicated that these borrowers were on average more risky than traditional borrowers with similar characteristics, such as FICO scores, and that online lenders were providing additional access to credit based on the use of alternative underwriting standards and data.

A staff report issued in February 2018 by the Federal Reserve Bank of New York concluded that the technological innovations implemented by fintech mortgage lenders have been beneficial to consumers and have improved the efficiency of the mortgage lending market.[210] This study looked at mortgage lending in particular, finding that fintech mortgage lenders provided more timely processing and quicker responses to fluctuations in demand as compared to traditional mortgage lenders. The study found that online lenders reduced mortgage processing time by 20% and online loans experienced lower levels of overall delinquency.

Federal Reserve Study: Online Small Business Lending. On June 28, 2018, the Federal Reserve Board and the Federal Reserve Bank of Cleveland released a report concerning online small business lending.[211] The study encompassed only small businesses with fewer than 20 employees and less than $2 million in annual revenue that had shopped for credit in the last year. The study found that small business owners preferred traditional lenders to online lenders, although they expressed frustration concerning loan approval and underwriting processes and the requirements of those traditional lenders. When considering online lenders, the small businesses preferred platforms that provided more information about their products and pricing prior to beginning the application process. Small businesses found additional and repeated marketing by online lenders to be annoying. On balance, the report showed that more robust disclosure was preferred, particularly related to pricing. Similarly, small business owners were concerned with the lack of full information or the use of undefined terms.

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208 We note, however, that in November 2017 the Federal Reserve Bank of Cleveland published a study of peer-to-peer lending that claimed the perceived benefits of that type of lending were overrated and that it resembled predatory lending. The study was widely discredited as using flawed methodology and within days of its posting, the Reserve Bank removed the study from its website.

209 Jagtiani, Julapa and Lemieux, Catherine: *"Do FinTech Lenders Penetrate Areas that Are Underserved by Traditional Banks?"* Fed. Res. Bank of Philadelphia (Mar. 13, 2018).

210 Fuster, Andreas; Plosser, Matthew; Schnabl, Philipp; and Vickery, James, "The Role of Technology in Mortgage Lending" Fed. Res. Bank of New York Staff Report No. 836, February 2018.

211 "Browsing to Borrow: 'Mom and Pop' Small Business Perspectives on Online Lenders" available at www.federalreserve.gov/publications/default.htm.

The survey respondents were also presented with sample disclosures. Small business owners were overwhelmingly desirous of receiving additional information (similar to what consumers receive on consumer loans) such as loan amount, repayment amount, term and APR.

Fintech Risk Management Guidance. The Federal Reserve published guidelines for banks engaging in innovation.[212] The guidance focuses on risk management and stresses that banks identify and mitigate risks before entering into fintech relationships. This involves board and senior management oversight, policies and procedures, training, monitoring and oversight. It also emphasizes vendor management and fair lending compliance for online and Internet-based programs, as well as monitoring complaints.

Small-Dollar Loans. The Federal Reserve along with all of the other federal banking agencies issued an "Interagency Lending Principles for Offering Small-Dollar Loans" in May 2020. This promulgation encouraged financial institutions to offer responsible small-dollar loans to consumers and small business owners. It stated core lending principles and that products offered through effectively managed third-party relationships should reflect core lending principles including returns reasonably related to the institution's risks and costs.

However, a Federal Reserve study indicated that small-dollar loans require high interest rates in order to break even.[213] For example, a $600 loan needs a 103.5% APR to break even while a loan of near $1,200 needs an APR of about 61%. The study found that with substantial fixed costs, high interest rates are necessary to provide sufficient revenues to cover the costs of providing such loans. The study also stated that if small loan revenue is constrained by rate ceilings, institutions would only provide large loans, and consumers who need a small loan would not be served by the interest rate ceiling.

9. Federal Reserve Publication on Bank-Fintech Partnership

On September 9, 2021, the Federal Reserve Board published a guide on relationships between community banks and fintech companies.[214] The paper discussed three types of partnerships that community banks might use to leverage the benefits of fintechs. These include operational technology partnerships that enhance the bank's infrastructure or processes; customer-oriented partnerships such as assistance with account opening, where the bank retains customer contact; and front-end partnerships where the fintech interacts with the bank customer. The Federal Reserve notes that for a relationship to be successful strategically and operationally, the bank must have an ongoing commitment to innovation, congruent priorities with the fintech, and integrated connections between the two parties. This public dissemination is another example of federal banking regulators paying attention to bank-fintech relationships.

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212 Published in the December 2019 issue of the Consumer Compliance Supervision Bulletin.

213 Chen, Lisa, and Elliehausen, Gregory, "The Cost Structure of Consumer Finance Companies and Its Implications for Interest Rates: Evidence from the Federal Reserve Board's 2015 Survey of Finance Companies," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, Aug. 03, 2020, https://doi.org/10.17016/2380-7172.2610.

214 "Community Bank Access to Innovation through Partnerships" (Sept. 2021).

10. *Interagency Guidance on Risk Management in Third-Party Relationships*

In July 2021, the Federal Reserve, the OCC, and the FDIC proposed interagency guidance for banks dealing with managing risk related to third-party relationships. This guidance includes bank arrangements with fintechs, including bank/fintech programs. While each agency has risk guidelines, this was the first instance where all three agencies have worked together to propose this on an interagency basis. The guidance derives from the OCC's existing guidance from 2013 and makes changes to encompass the other banks supervised by the other agencies.[215]

Building on existing promulgations including vendor management guidance, the proposal deals with managing risk at each juncture of a third-party arrangement, including (1) planning, (2) due diligence and selection, (3) contract terms and negotiation, (4) oversight and monitoring, and (5) termination. Each area is general and does not discuss specific types of relationships. Both existing guidance and this proposal reiterate the importance of banks paying attention to third-party relationships and managing risk appropriately. This has not yet become effective.

Interagency Guidance on Security Incidents. It should also be noted that on November 23, 2021, the FDIC, the OCC, and the Federal Reserve issued a joint final rule that established computer security incident notification requirements for banking organizations and their bank service providers effective May 1, 2022. While banking institutions such as Funding Banks must report security incidents directly to the FDIC, service providers to the institutions must notify the affected bank as soon as possible when the service provider determines that there has been an incident that has materially disrupted or degraded or is reasonably likely to materially disrupt or degrade services provided to the banking organization for four or more hours. Therefore, the servicers to Funding Banks must comply with this rule.

C. U.S. Congress Fintech Hearing

On January 30, 2018, the Financial Institutions and Consumer Credit Subcommittee of the United States House of Representatives held a hearing entitled "Examining Opportunities and Challenges in the Financial Technology ('FinTech') Marketplace."[216] Five witnesses submitted written testimony and responded to questions asked by members of Congress. Industry as well as consumer proponents participated in the proceeding. While some questions were raised, there was positive commentary on fintech and bank partnerships as well as the benefits of innovation and the work being done to enhance consumer protection and regulatory compliance. Congress also has a Task Force on Financial Technology and conducts hearings periodically on issues such as a November 2021 hearing on "buy now pay later" products.

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215 In March 2020, the OCC supplemented its 2013 guidance with a set of revised FAQs to update and clarify it to take into account industry evolution.

216 Committee Memorandum available at: https://financialservices.house.gov/uploadedfiles/013018_fi_memo.pdf

D. Basel Committee on Banking Supervision

On February 19, 2018, the Basel Committee on Banking Supervision released a report entitled "Sound Practices: Implications of Fintech Developments for Banks and Bank Supervisors."[217] This report focused on how technology-driven innovation may affect the banking industry as well as the activities of banking supervisors. The study suggests that banks will find it increasingly difficult to maintain their current operating models given technological change and customer expectations and will undertake more third-party relationships and outsourcing to unaffiliated service providers. In addition, fintech has the potential to lower barriers of entry to financial services, and elevating the role of data will drive the emergence of new business models, presenting both opportunities and risks for banks and the banking system. Likely issues cited in the report include safeguarding data, privacy, cybersecurity, consumer protection, competition and AML compliance. As traditional banking business models change, the report concludes that bank supervisors will need to improve supervisory efficiency and effectiveness, including through the use of technology. The report also stresses the need for bank supervisors to promote interaction with each other and with innovative financial participants.

E. General Accounting Office

On March 22, 2018, the Government Accountability Office (*"GAO"*) issued a report titled "Financial Technology: Additional Steps by Regulators Could Better Protect Consumers and Aid Regulatory Oversight."[218] The report states that fintech provides benefits to consumers and poses similar risks to traditional products. It further states that while the extent to which fintech is subject to federal oversight varies, consumer harm appears to be limited. The GAO acknowledges that the U.S. regulatory structure poses challenges to fintech firms and that such firms have expressed that it can be difficult for them to identify the applicable laws and ascertain how their activities will be regulated. The report also emphasizes that complying with fragmented state requirements is costly and time consuming. The report recommends that federal regulators engage in more collaboration and coordination, develop offices of innovation (to the extent they have not already done so) and engage in knowledge building initiatives including consideration of what is being done in other countries such as regulatory sandboxes. These recommendations are consistent with the GAO's framework calling for regulatory systems to be flexible and forward-looking, which will help regulators adapt to market innovations.

In December 2018, the General Accounting Office published a report on the use of alternative data by fintech lenders in order to determine creditworthiness of borrowers. The GAO indicated that while there are potential benefits of using such data—such as greater access to credit—risks also exist from that use, including the potential for fair lending issues such as disparate impact. While the CFPB and other federal financial regulators have monitored the use of alternative data by fintech companies, the

217 The report is available at: https://www.bis.org/bcbs/publ/d431.pdf

218 GAO-18-254 (Mar. 22, 2018). The 132-page report was issued as a "Response to Congressional Requestors" and addresses fintech payment, lending, wealth management and other products. Many of the report's recommendations deal with the issue of account aggregation data.

agencies have not provided specific guidance on how such data can be utilized in the underwriting process. The GAO recognized the bank partner model and indicated in the report that clarification of this issue would help those banks manage their relationships with marketplace lenders. The GAO recommended that the federal agencies provide guidance on the appropriate use of alternative data in the underwriting process both to marketplace lenders and Funding Banks.

In January 2019, the GAO published a report on federal oversight of Internet privacy. In part, this study was conducted after several incidents of misuse of consumer personal information derived from the Internet. The GAO recommended that Congress develop comprehensive legislation to deal with Internet privacy with the stated objective of enhancing consumer protections and providing flexibility to address changes in a rapidly evolving space.

In March 2019, the GAO publicly released a report on consumer data protection.[219] The GAO noted there were several FTC and CFPB enforcement actions and called for action by the federal agencies to strengthen oversight of consumer data and consumer reporting agencies. The report recommends that the FTC be given civil penalty authority to enforce the safeguarding of personal information and urged the CFPB to prioritize examinations to address data security at reporting agencies.

F. COVID-19

As is true of other areas of the economy and life in general, marketplace lending has been affected by the pandemic in many respects. From a legal and regulatory perspective, however, the changes have been few.

H.R. 748, better known as the CARES Act or more informally as the $2 trillion stimulus bill signed by President Trump on March 27, 2020, contained one important provision for all consumer lenders, including those making or servicing marketplace loans. With the expectation that economic activity would be decreasing and unemployment would be increasing, it was anticipated that loan payments may not be made or that borrowers would ask for relief from their payment obligations. A part of the legislation deals with this issue as it relates to credit reporting.

Credit Reporting. Section 4021 of the CARES Act revises Section 623(a)(1) of the Fair Credit Reporting Act (15 U.S.C. 1681s-2(a)(1)) and affects any consumer lender or servicer who furnishes credit reporting information due to an accommodation for hardships resulting from the COVID-19 virus. Accommodation is defined very broadly to include any deferral of payments, partial payments, forbearances, or any modification of a consumer loan.

Since federal banking agencies recommended that financial institutions work with borrowers during the time of national emergency, this law was particularly important as lenders try to assist borrowers.

219 GAO-19-469T (pub. Mar. 26, 2019).

The new provision applies from January 31, 2020 until the later of 120 days after March 27 or 120 days after the date the national emergency is terminated.

When an accommodation is made and the borrower makes payments or is not required to make payments, the creditor must report the loan obligation as current. If the loan was delinquent before the accommodation period began, the creditor can continue to report the obligation as delinquent. On the other hand, if the borrower brings the account current, the creditor must report the obligation as current. The exception is a charge-off, which may continue to be reported as a charge-off.

Creditors and servicers reporting credit information need to follow the new requirements when a loan modification or accommodation is made. However, it is left up to creditors to determine if and what kind of an accommodation is made, if any.

Payment Protection Program (PPP). A primary provision of the CARES Act was the PPP for small businesses. Small businesses were eligible to apply for loans which, if certain conditions were met, would be forgiven. The program reached over 5 million small businesses for loans totaling over $525 billion. While the requirements of the PPP program affect all lenders the same, the significance for the marketplace lending industry was that several marketplace lenders either made PPP loans or worked with banks to assist in the making of PPP loans.

II. LENDING LAWS, LICENSING, AND RELATED LITIGATION

The extension of consumer credit in the United States is heavily regulated at both the federal and state levels.[220] A marketplace lender that conducts a nationwide business therefore may be subject to regulation under various laws and, potentially, by multiple jurisdictions. Generally, an Internet-based consumer lending program will utilize a Funding Bank because a lender who makes loans directly and does not use a Funding Bank will need to obtain applicable state lending licenses. The Funding Bank will be subject to both federal and state regulation as well, but may in certain instances be able to rely upon federal law to preempt state laws that would otherwise apply. As discussed further below,

220 The extension of commercial credit, while less regulated than consumer credit, is still subject to some federal and state laws including usury limitations and licensing requirements in some states, most notably in California, and in New York for loans less than $50,000 to sole proprietors. Several other states also have licensing requirements that might be applicable to some forms of business lending. Business lenders also rely on choice of law provisions in their loan agreements. Such provisions are generally enforceable in commercial transactions so long as the state whose laws are stated to apply has a reasonable relationship to the transaction. Governing law provisions may not supersede licensing and usury laws in some states. Also, some state laws limit how business borrowers can complain about alleged usury violations. For example, in some states corporate entities may not plead usury as a defense. *See, e.g.*, *Klein v. OnDeck Capital, Inc.*, No. 62996-2014 (S. Ct. N.Y. 2015). OnDeck, an online business marketplace lender made a business loan at an almost 37% interest rate to a New York corporate borrower based on Virginia law where OnDeck is located. The court upheld OnDeck's position that Virginia and not New York law governed the agreement and that the loan was not usurious under the law of Virginia. The court also stated that even if New York law applied, corporations only have a defense to payment based on usury and cannot bring an action for usury offensively. The borrower alleged that the loan was for consumer purposes, but the court found otherwise based on the loan documents stating that the loan was for business purposes. States are also enacting statutes requiring disclosure to be made on some commercial loans and related financing products, notably California and New York.

federal preemption is particularly important to the Funding Bank in connection with state usury laws.[221] Lenders who facilitate loans made through Funding Banks will often purchase each loan from the Funding Bank at the time or soon after the loan is made.[222]

Non-bank lenders making loans directly to borrowers will not be subject to direct supervision by federal banking or financial institution prudential regulators such as the FDIC, the OCC or the Federal Reserve Board.[223] However, they may be subject to state licensing and regulation as well as oversight and regulation by the FTC and/or the CFPB. Each Funding Bank involved in an Internet lending program will remain obligated to comply with applicable laws in originating and funding the Borrower Loans. Marketplace lenders working with Funding Banks are also subject to supervision and oversight by the Funding Bank's regulators.[224]

> **Worth Remembering:** Due to the amount of attention that marketplace lending is receiving from state regulators, federal banking agencies and continued litigation challenging the structure whereby a Funding Bank is used, the use of Funding Banks creates some degree of uncertainty and potential regulatory and litigation risk and requires that particular attention be paid to the structuring of the program.

A full discussion of the financial institution regulations that will affect Internet lending businesses and the extent to which specific regulations will apply to specific persons is beyond the scope of this book. In this Part II, we briefly discuss some of the main banking or lending regulations, state licensing requirements, and consumer protection laws that may apply to the marketplace lender and/or the Funding Bank as well as relevant litigation in this space.[225]

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221 It cannot be assumed that federal laws governing consumer lending activities will preempt all 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.

222 Other purchase arrangements can also occur. Sometimes loans may be sold to investors or into trusts, for example. Loan participation structures may also be used where the Funding Bank retains title to the loan but sells economic interests.

223 We note that there is a difference between being subject to direct supervision and examination by regulatory authorities and the need to comply with the applicable regulations of those authorities.

224 Marketplace lenders that provide services to banks may be subject to examination and regulation by federal banking regulators under the Bank Service Company Act (12 U.S.C. § 1867(c)).

225 This book 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.

A. Usury Laws

Most states limit by statute the maximum rate of interest that lenders may charge on consumer loans.[226] The maximum permitted interest rate can vary substantially between states.[227] Some states impose a fixed maximum rate of interest while others link the maximum rate to a floating rate index. Absent an exemption, these laws would be binding on the lender making the Borrower Loans (whether making loans directly under a state license or utilizing a Funding Bank) and would have to be observed in setting the interest rate for each loan. Given the nature of an Internet platform, it could be difficult for a marketplace lender conducting business in multiple states to set different maximum rates for the Borrower Loans based on the borrower's state of residence. Doing so would prevent the lender from conducting its business on a uniform basis across jurisdictions. State laws may also prohibit or limit the amount of fees that can be charged to consumers for delinquency or returned payments, presenting another compliance burden for lenders who conduct a multistate business. Violations of usury laws can result in various penalties from state to state, including voiding the entire loan in some states.[228]

In addition, the lender may want the ability to set interest rates that exceed the maximum rate that the applicable state usury laws would permit. One of the stated goals of Internet-based lending is to provide broader access to credit to certain borrowers who are unable to obtain bank loans. Although the lender may require each borrower to have a specified minimum credit score (and may set the minimum score at a relatively high level), many of these borrowers—despite having acceptable credit scores—may have other attributes indicating that they are less creditworthy than their credit scores, considered alone, would suggest. In order to make loans to these individuals, the lender will need to set interest rates high enough to offset expected losses.[229]

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,

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226 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 borrower, or the amount of the loan.

227 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. Lenders may also use choice-of-law provisions in a commercial lending context, particularly in states where no licensing requirements exist as the basis for usury purposes. Choice of law is often given effect in a commercial lending context where the jurisdiction has a reasonable relationship to the parties or the transaction. Some states also restrict the ability of business entities to utilize usury as a defense.

228 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 consumer 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 ex rel. Swanson v. Integrity Advance, LLC,* 846 N.W.2d 435, 444 (Minn. Ct. App. 2014), *aff'd sub nom. Swanson v. Integrity Advance, LLC*, 870 N.W.2d 90 (Minn. 2015).

229 A 2020 study by the Federal Reserve found that the break-even point for small-dollar loans resulted in high annual percentage rates (APR). See the "Recent Developments" section.

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.[230] For example, in many programs the Funding Bank is an FDIC-insured, Utah-chartered bank or 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, boards rely on DIDA to fund Borrower Loans at interest rates that are not limited by the state usury laws of other states.[231] 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.[232]

Usury—New York Case. Usury is a subject that continues to pervade marketplace lending law. Recently there was a clarification of New York usury law that is of import.[233] In considering the application of state usury laws, the Second Circuit Court of Appeals certified a question to the state court inquiring whether a loan that was criminally usurious was also void. While the statute dealing with civil usury specifically states that a loan in excess of civil usury (16% in New York) is void and unenforceable, the

230 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. The United States Supreme Court has upheld the rate exportation theory in a case involving a national bank. *See, Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp.*, 439 U.S. 299 (1978). *Accord*, as to state banks, *Greenwood Tr. Co. v. Massachusetts*, 971 F.2d 818 (1st Cir. 1992), *cert. denied*, 506 U.S. 1052 (1993). Codified for national banks at 12 C.F.R. 7.4001(a) and for state banks in FDIC General Counsel Opinion No. 10.

231 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.

232 Loans made by state-chartered institutions in states that opt out of the federal rate exportation rules will remain subject to that 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." This may involve consideration of federal law, applicable state law and governing law provisions of loan agreements. The FDIC takes the view that a loan is made where certain non-ministerial acts are performed, such as credit decisioning and loan funding. The analysis is complicated in states that have enacted the Uniform Consumer Credit Code that indicates loans are made where the borrower is a resident.

233 *Adar Bays, LLC v. GeneSys ID, Inc.*, Case No. 18-3023 (2d Cir. Mar. 15, 2022).

statute dealing with criminal usury (25% in New York) does not contain such a provision.[234] New York cases were also divided on whether a usurious loan to a corporation was void or subject to reformation given that corporations are not allowed to plead the defense of usury under the civil usury statute. The court determined that a loan in violation of the criminal usury statute is void.[235]

Interstate Lending. In January 2022, the Third Circuit Court of Appeals found that applying Pennsylvania law to activities occurring out of the Commonwealth but to residents of the Commonwealth did not violate the commerce clause of the U.S. Constitution.[236] This case centered on a motor vehicle loan with a high interest rate to Pennsylvania residents from the lender's office located outside of Pennsylvania and included the entire lending process, from application to disbursement of funds. Pennsylvania issued a subpoena to the lender who stopped making the loans to Pennsylvania residents and sued the state regulator for lost revenue. The lower court found that Pennsylvania could not apply its usury laws outside of the state, as that would be in violation of the commerce clause. The appeals court overturned the decision, finding that the relationship existed beyond the making of the loan and that the state had an interest in protecting its residents even when conducting business out of state. Titlemax is requesting that the Supreme Court hear the case. If allowed to stand, this law presents a host of potential issues to interstate lenders.

B. "Valid When Made" Litigation—Background of *Madden* Decision

1. *Madden v. Midland Funding, LLC*

In 2015, the Second Circuit Court of Appeals issued an opinion finding that under the doctrine of federal preemption, a non-bank assignee of a bank loan could not charge and collect the rates and fees that the lending bank could charge and was therefore subject to state usury law limitations.[237] This ruling was somewhat surprising in that its finding was in opposition to decades of precedent establishing the concept of "valid when made," meaning that the terms of a loan that are valid at the inception of the loan do not change or become invalid when the loan is subsequently sold or transferred to another party. The decision was widely criticized and created uncertainty for marketplace lending programs that utilized loan or purchase arrangements involving banks, funds, investors, lenders, or, in connection with securitizations, asset-backed transactions or warehouse loans. As a result, some lending programs were either curtailed, suspended, or limited in the Second Circuit states of New

234 The civil usury statute is found at N.Y. GEN. OBLIG. LAW 5-511 and the criminal usury statute is at N.Y. Penal Law 190.40.

235 The opinions relating to this case can be found at 962 F.3d 86 (2d Cir. 2020) and 341 F. Supp. 3d 339 (S.D.N.Y. 2018). The court also found that a stock conversion option permitting a lender to convert a loan to shares of stock at a fixed discount should be treated as interest for determining usury.

236 *Titlemax of Delaware, Inc. v. Weissman*, Case No. 21-1020 (3d Cir. Jan. 24, 2022).

237 *Madden v. Midland Funding, LLC,* 786 F.3d 246 (2d Cir. 2015), *cert. denied,* 136 S. Ct. 2505 (2016). The procedural and case decision history of this case, referred to as "*Madden,*" are discussed at length in the main portion of the "Regulatory Issues" section of this book. The doctrine of federal preemption allows federally insured depository institutions to charge the rates and fees allowed in the state where they are located, export those rates and fees to other states, and preempt any conflicting state laws. This doctrine and its associated case law are also discussed later in this book.

York, Connecticut, and Vermont. Federal Reserve economists determined that consumer access to credit was reduced in those states as a result.[238] The May 2015 decision of the Second Circuit in *Madden v. Midland Funding, LLC*[239] sent shockwaves through the marketplace lending industry, and for years later many of the questions generated by this case remained unanswered. Midland Funding's request for rehearing by the full Second Circuit and subsequent petition for review by the U.S. Supreme Court were both denied, and the February 2017 remand decision by the district court further muddied the waters. Even though the case was ultimately settled and the OCC and FDIC have issued regulations to address the effects of this decision, those regulations are only subject to court deference and so this decision continues to predicate uncertainty for the marketplace lending market.

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

> **Key Consideration:** *Madden* did not involve a marketplace lender or loan, but if the *Madden* holding were applied to a marketplace lender as a non-bank purchaser of an existing bank loan, the marketplace lender might be unable to enforce the loans in accordance with their terms or may be subject to claims of damages for charging excess interest.[240] *Madden* therefore has raised significant questions for the marketplace lending industry.

Procedural History. In 2005, Saliha Madden, a New York resident, opened a credit card account with a national bank that was governed by Delaware law. Madden defaulted on the account and after it was charged off by the bank, it 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 York alleging that this rate violated New York's usury limitations. Midland

238 Julapa Jagtiani and Catharine Lemieux, "Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information" (June 16, 2017) available at: https://www.fdic.gov/analysis/cfr/bank-research-conference/annual-17th/papers/14-jagtiani.pdf

239 786 F.3d 246 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

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

constructed its defense on the principles of federal preemption based on the bank's contract and its ability to charge this rate under the NBA. Since the loans purchased were lawfully made, Midland argued that, as an assignee of the loan, it was exempt from compliance with the New York usury law. The federal district court agreed with Midland, and Madden appealed to the Second Circuit.

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

Scope of Decision: Although *Madden* is binding only in the states included in the Second Circuit (Connecticut, New York, and Vermont), there remains the risk that other jurisdictions will adopt the Second Circuit's analysis.[241] Some marketplace lenders and their Funding Banks have revised their business relationship to address *Madden* concerns.[242] In addition, some purchases and/or securitizations of marketplace loans have limited eligibility criteria to loans that comply with applicable usury rates in the states located in the Second Circuit or not included loans from those states in the loan pool. Some platforms have ceased operations in those states.

Requests for Review. Following the Second Circuit's decision, Midland requested that the entire Second Circuit Court of Appeals rehear the case, but this petition was denied. In November 2015, Midland asked the U.S. Supreme Court to grant certiorari to hear the case. In its brief to the Supreme

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

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

Court, Midland argued that the Second Circuit's decision violates the long-standing doctrine that loans are "valid when made" and do not change character or become invalid when they are sold or transferred.[243] 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.[244]

In its brief to the Supreme Court, the Solicitor General strongly criticized the Second Circuit's analysis and called its holding incorrect.[245] The Solicitor General said that the "valid when made" doctrine was incorporated into Section 85 of the NBA, which provides banks with their preemptive powers. The brief also stated that the Second Circuit failed to consider the effect of its decision on the marketability of loans. The Solicitor General's brief is of particular significance because it was joined by the OCC, the federal regulator of national banks. However, the Solicitor General ultimately recommended that the Supreme Court *deny* certiorari for three reasons: (1) there was no circuit split on the question raised, (2) the parties did not present significant aspects of the preemption analysis to the lower courts, and (3) there was a possibility that Midland Funding could still prevail on remand.[246] In June 2016, after considering all of the briefing, the Supreme Court declined to hear the case.[247]

Remand Decision. On February 27, 2017, the U.S. District Court for the Southern District of New York issued its remand decision. The district court held that applying Delaware law per the account agreement would violate a fundamental public policy of New York—namely, its criminal usury statute, which limits interest to 25% per year. [248] Broadly interpreted, this decision could prevent the enforcement of choice of law provisions in credit agreements against New York consumers when the interest rate exceeds 25%, as is the case for many credit cards and other consumer loans.

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

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243 *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).

244 This request shows that the Supreme Court was interested in the potential effect of this case on the financial services industry and capital markets.

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

246 *Id*.

247 *Midland Funding, LLC v. Madden,* 136 S. Ct. 2505, 195 L. Ed. 2d 839 (2016) (cert. denied). Interestingly, Madden's brief explicitly stated that this case is limited to the sale of defaulted debt and does not apply to marketplace lending.

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

The case proceeded upon theories related to debt collection claims. After notice and a fairness hearing, the case was settled and dismissed in September 2019. The settlement included a payment of $550,000 and a $9 million fund to provide credits to the accounts of borrowers, and payment of $550,000 in attorneys' fees.

Thoughts. The district court's holding compounds the uncertainty created by the Second Circuit's decision in *Madden* by further undermining common law principles that are routinely relied upon by creditors and their assignees. While the Second Circuit's decision undercuts the doctrine that loans are "valid when made" and do not become invalid when they are assigned to a third party, the district court called into question the enforceability of a choice of law provision in a credit contract against New York consumers where the interest rate exceeds the state law usury limits. However, the court did not directly address what happens when federal preemption and state public policy conflict. How similar cases in the Second Circuit (New York, Vermont and Connecticut) will be decided remains to be seen. Interestingly, a New York district court found the *Madden* analysis not applicable in a case involving state law claims brought by a consumer against a non-bank service provider to a national bank.[249]

Illinois Court Cites Madden*.* In March 2017, an Illinois federal court denied a motion to dismiss state usury claims against a non-bank assignee of loans originated by a national bank on the basis of federal law preemption, determining that it was not clear which entity had made the loans.[250] In its decision, the court made the assertion in dicta (without any briefing) that *Madden* was the only appellate court decision addressing the issue of federal preemption as it applies to assignees.[251] Although it is not a finding on the merits of the *Madden* position taken with respect to assignees, this is at least one court outside the Second Circuit that has referenced the *Madden* decision approvingly and *Madden*-type claims will remain an area to watch. This case has subsequently settled on other grounds.

Madden "Fix" Legislation Not Enacted*.* Various proposals referred to as Madden "fix" legislation have been made to invalidate the Second Circuit's decision in *Madden* and codify in federal statutes the "valid when made" doctrine that has served as court precedent for decades. The valid when made doctrine provides that a loan which is valid when originally made does not become invalid when it changes hands to an assignee. Specifically, the Madden "fix" legislation would invalidate the Second Circuit's decision in *Madden* finding that a non-bank loan assignee cannot enforce the terms of a loan made by a bank where (i) the term to be enforced violates applicable state law, and (ii) the bank no

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

250 *See, Euls v. Transworld Sys., Inc.*, 15 C 7755, 2017 WL 1178537 (N.D. Ill. Mar. 30, 2017). This case was settled on other grounds.

251 This statement is incorrect, as many of the cases cited in the *Madden* litigation have addressed the issue of loan assignees being able to take assignment based on the terms of the original loan made by the assignor.

longer has any interest in the loan.[252] The Madden "fix" was contained in the CHOICE Act,[253] which was passed by the U.S. House of Representatives on June 8, 2017 but stalled in the Senate. On February 14, 2018, the House of Representatives passed H.R. 3299,[254] a stand-alone bill that would codify the valid when made doctrine for loans made under various federal laws by regulated financial institutions. However, this bill died in the Senate, which never took a vote on the measure. While there was bipartisan support for the bill, consumer groups rallied in opposition claiming that this legislation would advance predatory payday lending. Therefore, uncertainty around the assignment of loans in the Second Circuit states of New York, Connecticut, and Vermont still remains.[255] This uncertainty became even greater when in 2019 two putative class action lawsuits were filed in two New York federal courts alleging that securitization trusts as non-bank assignees of credit card receivables received interest in violation of New York usury laws. These suits were ultimately dismissed. The import of such cases is significant given that the penalty in New York for usurious loans is voiding of the entire loan-principal and interest.

2. *Suits Filed Against Credit Card Trusts Dismissed*

Few cases were filed on *Madden v. Midland* theories until June 2019 when two cases were filed against securitization trusts in two federal courts in New York.[256] In both cases, class action status was sought against defendants affiliated with two national banks that have acted as special purpose entities in credit card receivables securitization transactions sponsored by the banks. The actions sought to expand on the *Madden* decision by alleging that the defendants' acquisition, collection and enforcement of the banks' credit card receivables violate New York usury laws and that the securitization vehicles as non-bank entities are not entitled to the benefits of federal preemption and must be limited to collecting interest under state usury limits. The defendants filed motions to dismiss each action. In one of the cases, a federal magistrate judge recommended that the action be dismissed because it would interfere with banks' ability to exercise their federally granted powers. On September 21, 2020, the judge in this case (the *Petersen* case referred to in the footnote) granted the defendants' motion to dismiss. On September 28, 2020, the judge in the *Cohen* case granted the defendants' motion to dismiss

252 There is some expectation that the 2020 regulations of the OCC and FDIC will have the effect of overruling *Madden* to the extent that a court would give deference to the federal agency's interpretation. See the "Recent Developments" section regarding how one court has already done so while state Attorneys General are challenging the rules.

253 H.R. 10, Financial CHOICE Act of 2017.

254 H.R. 3299, Protecting Consumers' Access to Credit Act of 2017.

255 The *Madden* decision has had both practical and operational consequences for marketplace lending programs and the broader financial markets. Some marketplace lenders have ceased to do business in the three affected states, while others only make loans in those states up to the applicable state's usury limit. Investors have shunned and securitizations have excluded loans from those states in an effort to reduce risk, and studies have indicated that *Madden* has to some extent limited access to credit in the Second Circuit region. *See* Honigsberg, Colleen; Jackson, Robert J.; and Squire, Richard, *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment*, J. OF L. AND ECON. (Aug. 2, 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2780215.

256 *Petersen et al. v. Chase Card Funding, LLC et al.*, Case 1:19-cv-00741-LJV (W.D.N.Y. filed June 6, 2019) and *Cohen et al. v. Capital One Funding, LLC et al.*, No. 19-03479 (E.D.N.Y. filed June 12, 2019). Decision at 489 F. Supp. 33 (E.D.N.Y. 2020). *See* Petersen order at 2020 WL 5628935 (Sept. 21, 2020).

with prejudice. These dismissals are an important development in that the cases, while not overruling *Madden,* found that different facts required a different result. Both courts distinguished the facts from the *Madden* decision, finding that unlike the *Madden* case where the bank had no continuing interest in the loan because the bank had sold the loan, in these cases the two national banks held a continuing interest in the loans including retention of the account and the continuing right to change interest rates. Both courts noted that the securitization situation was more like a case cited approvingly by the *Madden* court.[257] The courts found that the federal preemption applicable to the two national banks preempted New York usury laws. One court did not rely on the newly minted OCC rules on this topic, but approvingly alluded to the OCC's rationale in enacting the rule in its decision. The other court stated that it did not need to rule on that as it was moot under its analysis. The decisions also found that application of New York usury laws would significantly interfere with each national bank's right to sell and securitize loans. Appeals of both decisions were voluntarily withdrawn, depriving the Second Circuit of the opportunity to reconsider or clarify its *Madden* decision.

These filings created additional uncertainty in the investor and securitization markets.[258] The filing of these cases accelerated the momentum to act, prompting members of Congress to ask the federal banking agencies to address the issue. The FDIC and the Office of the Comptroller of the Currency (*"OCC"*) also filed an amicus brief in a bankruptcy action in Colorado as discussed below, stating that the court should honor the "valid when made" doctrine.

C. Agencies Propose Rules

In November 2019, both the OCC and the FDIC issued proposed regulations that would codify the long-standing legal principle that a loan that is "valid when made" does not become invalid when sold, transferred or assigned. After a public comment period, both agencies adopted as a final regulation a substantially similar rule clarifying that interest permissible on a loan at the time it is made is not affected by the sale, assignment or transfer of the loan, even if to a non-bank assignee. As a result, both nationally chartered institutions and state-chartered institutions are covered by the newly promulgated and effective regulations.

D. Final Rules Issued

On May 29, 2020, the OCC issued its final rule codifying as a regulation that the interest charged on loans that is permissible before the loan is transferred remains in effect after the loan is transferred. The

257 *Krispin v May Dep't Stores*, 218 F.3d 919 (8th Cir. 2000) (finding federal preemption applicable to a bank's sale of 100% of its receivables on a daily basis to its department store affiliate).

258 Both cases, filed by the same attorneys, and having some overlapping plaintiffs, are somewhat curious in that the *Madden* decision favorably discusses a case where a bank retains the customer account but sells receivables generated, the precise situation involved in the securitization of credit card receivables. The Magistrate decision in the *Petersen* case was a recommendation to the trial judge and was opposed. However, in December 2019, the trial judge issued an order stating that he would consider the proposed regulations of the OCC related to the issue. Several amicus briefs were filed on both sides.

one sentence regulation: "Interest on a loan that is permissible under 12 USC 85 shall not be affected by the sale, assignment or other transfer of the loan" will be codified for national banks at 12 C.F.R. 7.4001(e) and a similar regulation for federal savings associations will be codified at 12 C.F.R. 160.10(a). These regulations became effective August 3, 2020.[259] While these regulations are intended to clarify the agency's position relative to the Second Circuit decision, the promulgation also states that this rulemaking does not address which entity is the true lender of a loan.

The FDIC issued a similar rule applicable to state-chartered banks that became effective August 21, 2020.[260] The OCC has indicated that although adopted first, its rule is intended to function in the same way as the FDIC rule. The FDIC stated that its final rule is to clarify the ambiguity it perceived that a bank has the right to both make and transfer loans, and the rule protects the right of a bank to assign loans it makes according to its terms. It does not purport to allow state banks to assign their ability to preempt state law interest rate limits as allowed under federal law. Rather, the rule merely allows state banks to assign loans at their contractually agreed-upon interest rate.

Both agencies expressed the view that the interest statutes for national and state banks were ambiguous and created uncertainty that was fueled by the appellate court decision in *Madden v. Midland*.[261] The rules would alleviate such uncertainty and provide market stability. Both agencies went to great lengths to explain their rulemaking and why it was not subject to the Administrative Procedure Act,[262] or a pre-emption determination, or that the rule would result in predatory lending. Rather, each agency expressed displeasure with entities that attempted to use banks to evade interest rate restrictions.

While this OCC regulation and the FDIC regulation will not prohibit litigants from alleging *Madden* types of claims, the regulations should provide a potent defense to such claims and at minimum would knock out claims that a non-bank assignee is not entitled to enforce the interest rate terms of a loan made by a federally insured depository institution. Under the *Chevron* doctrine[263] courts must consider giving deference to the interpretations of federal agencies with jurisdiction over certain entities or subject matter. Under this principle, courts should give weight to the opinions of the banking regulators and find that interest made at loan inception carries through to assignees.

Both agencies stated in their Final Rules that a bank is entitled to charge interest at rates allowed in the state(s) where it is located and also has authority to assign loans. The OCC also stated that its regulation is designed to encourage responsible lending and provide better access to credit, citing studies indicating that access to credit declined after the *Madden* decision in the three states located in the Second Circuit. The FDIC cited similar studies and stressed that the rule reduces uncertainty in the

259 85 Fed. Reg. 33530 (June 2, 2020).

260 85 Fed. Reg. 44146 (July 22, 2020), to be codified as 12 C.F.R. 33.4(e).

261 786 F.3d 246 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016).

262 5 U.S.C. 551 *et seq.*

263 *Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

secondary markets needed for capital and liquidity of banks, which in turn promotes the safety and soundness of depository institutions.

The OCC spent a large portion of its analysis of the regulation on rejecting claims made by public comments in opposition to the proposed rule, most importantly, that the OCC did not have the authority to issue the regulation. Under existing law, a statute must be ambiguous in order for the agency to issue a regulation. In this case, the statute was silent concerning interest terms when loan terms are assigned. Opponents said this was not an ambiguity, but the OCC stated that due to uncertainty presumably caused by the *Madden* decision, express interpretation was necessary to resolve the silence of the statute.

The OCC made several persuasive arguments in this regard. The first is that under federal law national banks have the right to enter into contracts and assign contracts, and the character and terms of a contract endure its assignment. In other words, interest terms shouldn't be treated differently based upon the status of an assignee; rather, the assignee steps into the shoes of the assignor. As the OCC stated, a contract should not be usurious depending on who is enforcing it, rather than who made it. Significantly, assignment should not alter a borrower's original obligation to repay the original terms that were agreed upon. While there is significant precedent on these points, the OCC was careful to state that these common law tenets served to inform the OCC's decision, but were not the sole basis of that decision. The agency gave short shrift to opponents who claimed the *Madden* decision foreclosed the OCC's rulemaking by stating that *Madden* neither considered nor decided the scope of Section 85 as to a national bank. It also disagreed with commenters who claimed the agency had exceeded its authority and didn't follow the provisions of the Administrative Procedures Act.

The OCC also made it clear that this regulation is not one dealing with preemption of state law; rather it is narrowly construing a statute that is rooted in and relies on state law. Some opponents contended that this rule would facilitate predatory lending. The OCC again disagreed and addressed the issue by stating that appropriate third-party relationships play an important role in the operations of banks and the economy and are better addressed in already-issued OCC guidance on third-party relationships rather than in a regulation dealing with interest rates.

The FDIC made similar observations in its promulgation. Both agencies strongly endorsed the rule as needed for clarifying what happens to interest rates on loans when they are sold, transferred or assigned as being consistent with the underlying statutes that allow for nationwide uniformity in lending and promoting safety and soundness precepts for liquidity management that were undermined by *Madden*. It would be illogical to apply the statutes to loans only held to maturity by a bank, as banks need to sell loans for liquidity purposes. To have uncertainty on the terms of the loans when they are sold negatively affects both the primary and secondary markets for loan sales.

For banks selling or securitizing loans, these regulations provide both clarity and certainty. If challenged by *Madden*-type theories, the federal regulations will assist banks and credit markets in feeling comfortable that loans made upon terms at the loan's inception should carry through until payment or maturity, no matter who holds the loan. It remains to be seen if litigation based on *Madden* theories will be deterred or dismissed. The OCC and FDIC rules are consistent with precedent dealing with contractual rules of assignment and will promote less volatility in the secondary markets dealing with loan sales.[264]

> Since both agencies state that these valid when made rules do not determine who is the true lender of a loan, the focus of challenges is likely to shift to true lender issues.

E. Court Challenges to Regulations

Soon after the regulations became effective, the attorney generals of some states brought two lawsuits challenging the regulations, one against the OCC and the other against the FDIC.[265] The states claimed that enactment of the rules violated the federal Administrative Procedure Act and that the agencies did not have the authority to issue those rules. At the heart of the matter was the states' view that the rules promote "rent-a-bank schemes" and allow entities that are not banks effectively to ignore state usury limitations and interest rate caps. After procedural posturing and the submission of amici briefs from multiple sources, the parties in each case filed motions for summary judgment.

On February 8, 2022, the federal court issued decisions in both cases ruling on the cross motions for summary judgment and rejecting the plaintiffs' challenge and finding in favor of both the OCC and the FDIC. The court found that the regulators were reasonably interpreting the banking laws under their jurisdiction. In addition, the court reasoned that the regulations did not regulate the conduct of non-banks, as they only provide a basis for regulated institutions to sell a loan "without altering the interest rate upon which [the bank] and the borrower initially agreed." The rules were within the agencies' regulatory purview and were neither arbitrary nor capricious. The court recognized that banks need to have the ability to sell loans for liquidity purposes and the regulations provided greater certainty to banks and the capital markets that promote safety and soundness considerations. This is in contrast to the *Madden* decision, which created a great deal of uncertainty. These regulations serve to counter *Madden* although that decision remains precedential in the Second Circuit until overturned.

The states did not appeal the district court decision; therefore, the regulations remain in force. However, the regulations did not consider the issue of who is the "true lender" on a loan for purposes of determining the proper interest rate on a loan. That doctrine is discussed later in this book. But with

264 It is also significant that this final rule was one of the first official acts of Brian P. Brooks, acting Comptroller of the Currency.

265 *People of the State of California et al. v. The Office of the Comptroller of the Currency et al.*, Case No. 4:20-cv-05200 (N.D. Cal. filed July 29, 2020); *State of California et al. v. Federal Deposit Insurance Corporation*, Case No. 4:20-cv-05860 (N.D. Cal. filed Aug. 20, 2020). The OCC plaintiffs included Illinois and New York and the plaintiff states in the FDIC case included those states, Massachusetts, Minnesota, New Jersey, North Carolina, and the District of Columbia.

the "valid when made" rules in effect, the focus of regulatory scrutiny and litigation appears to be on the true lender issue.

> The "valid when made" regulations adopted by the OCC and FDIC diminish but do not eliminate *Madden* risk in the marketplace.

F. Court Decision Upholds Agency Rules

However, at least one court case has already found that it must follow the OCC "valid when made" regulation and ruled that the bank's rates apply to a non-bank assignee, even though it appeared that the judge was inclined to rule otherwise had the rule not been in effect.[266]

That decision came from an appeal of a bankruptcy proceeding in Colorado. In the underlying action, a federal judge found that the interest rate on a promissory note made by a national bank remained valid in the hands of an assignee after the assignment of the loan.[267] The debtor appealed the decision to the district court including theories based on the *Madden* decision. The FDIC and the OCC filed an Amicus Brief in this action calling the *Madden* opinion "unfathomable" because it failed to consider the long-standing legal principle that a loan "valid when made" does not become usurious when assigned and under contractual principles of assignment. A college professor filed an amicus brief in opposition to the position of the federal banking agencies. The debtor also opposed the position of the agencies.

On appeal, even though the court found itself bound by the new federal regulations, the judge remanded the action for consideration of the true lender issues that might exist. The judge stated that if the bank is found to be the true lender, then the assignment upon the original terms is valid. But if the bank is not the true lender, the regulations would not be applicable.

This decision and the agencies' statements that the "valid when made" rule does not answer the question of who is the true lender on a loan mean that the focus of legal and regulation actions will center on true lender theories.

G. Courts Are Giving Deference to "Valid When Made" Regulations

Courts must take into consideration and give deference to (but not necessarily follow) the interpretations of federal agencies with jurisdiction over certain entities or subject matter. This is called the *Chevron* doctrine.[268] Court decisions have followed the guidance found in the "valid when made" regulations.

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266 *See, Rent-Rite Super Kegs West Ltd. v. World Bus. Lender, LLC*, Case No. 1:19-cv-01552-RBJ (D. Colo. Aug. 12, 2020).

267 *In re: Rent-Rite Super Kegs West Ltd.*, Adversary Proceeding No. 18-1099-TBM, 603 B.R. 41 (Bankr. D. Colo. 2019).

268 *Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

In April 2021, a federal court in Massachusetts also gave deference to the newly minted rules.[269] There, a bank service provider designed and marketed a student loan program where the loans were funded by a national bank and then sold to a trust established by the service provider. A borrower and co-signer sued the trust on the grounds that the loan exceeded the 6% usury rate set by Pennsylvania law. The defendant filed a motion to dismiss. The court dismissed the action against the trust on the basis of the loan being valid when made. The court also found the bank to be the true lender on the loan. The decision stated that the interest rate on the original loan was not usurious and therefore it could not become usurious when assigned, giving deference to the OCC regulation.

The policy implications of *Madden* were outlined in a Ninth Circuit opinion in late 2020.[270] The opinion noted the importance of the ability of financial institutions to sell loans into the secondary market and obtain liquidity in order to make more loans. The court stated: "Allowing states to impose a panoply of requirements on loans originated by savings associations impedes the securitization of those loans by (1) creating substantial uncertainty for buyers in the secondary market about the applicable law governing the loans they are purchasing and (2) imposing substantial compliance costs on secondary buyers." The court went on to describe what happened in the wake of the *Madden* decision:

> In the wake of *Madden*, the secondary market "significantly reduced the price of notes backed by above-usury loans to borrowers in Connecticut and New York." Colleen Honigsberg et al., *How Does Legal Enforceability Affect Consumer Lending? Evidence from A Natural Experiment*, 60 J.L. & Econ. 673, 675 (2017). Lenders also extended "relatively less credit to borrowers" and "discount[ed] notes backed by above-usury loans to borrowers in Connecticut and New York." *Id*. at 675, 691. "Not only did lenders make smaller loans in these states after *Madden*, but they also declined to issue loans to the higher-risk borrowers most likely to borrow above usury rates." *Id*. at 675; *see also* Piotr Danisewicz & Ilaf Elard, *The Real Effects of Financial Technology: Marketplace Lending and Personal Bankruptcy 22* (2018), https://tinyurl.com/y5s3s7oh (noting a 64% decrease in the volume of lending to low-income households in the wake of *Madden*.)

Madden remains precedent in the Second Circuit and it is not known if or when the decision will be reconsidered or overturned.

Since the regulations have been enacted, it appears that the trend is for courts to give deference to those agency determinations, providing a modicum of certainty in the midst of the storm that occurred after

269 *Robinson and Spears v. Nat'l Collegiate Student Loan Trust 2006-2*, 2021 WL 1293707 (D. Mass. Apr. 7, 2021). The case also found the bank to be the true lender on the loan. The case is currently on appeal to the First Circuit.

270 *McShannock v. JP Morgan Chase Bank, N.A.*, 976 F.3d 881 (9th Cir. 2020).

the *Madden* decision. However, because courts are not required to give that deference, the shadow of *Madden* still hangs over the marketplace lending industry and remains a risk factor, albeit likely diminished. Hence, the shift of focus of both regulation and litigation has been toward true lender issues which are discussed below.

H. Issues Related to the Funding Bank Structure

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

Availability. Although the marketplace lending industry has grown exponentially in the last few years, only a handful of FDIC-insured banks are currently operating as Funding Banks. Most of them are smaller institutions. Trade publications indicate that these banks are receiving scores of inquiries related to serving as a Funding Bank for marketplace lenders. This demand is likely to increase the fees charged by Funding Banks to provide origination and funding for Borrower Loans. Some Funding Banks may also limit the number of marketplace lenders they work with. In addition, the rapid growth of these programs and increased scrutiny by their regulators has led to increased due diligence and compliance requirements for their marketplace lender partners.[271] As might be expected, some banks are emulating marketplace lenders by offering bank loans through an online platform, often branded differently from the bank's main website. This eliminates the third-party service provider aspect of the relationship and makes the bank directly responsible for the program. Direct lending by banks also alleviates the risk of litigation under "true lender" theories.

Bank Vendor Management Requirements. In recent years, federally insured institutions have been subject to new and expanded guidance on programs they have with third-party service providers.[272] In short, this guidance requires banks to conduct due diligence on proposed third-party arrangements, enter into agreements that protect the bank from risk (or effectively manage or mitigate identified risks), and monitor the third-party service provider, and it mandates that the service provider take corrective action where gaps or deficiencies occur. This guidance is in addition to the existing legal framework provided by the Bank Service Company Act,[273] which requires service providers to comply with laws and regulations applicable to the bank and subjects them to supervision and examination by

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271 Funding Banks will require their third-party service providers to have extensive policies and procedures to promote compliance with applicable laws and regulations. Funding Banks may also require ongoing audits of those service providers in areas such as Bank Secrecy/Anti-Money Laundering, compliance management systems, technology systems/information security and complaint resolution processes.

272 *See, e.g.*, OCC Bulletin 2013-29, FDIC FIL-44-2008, and CFPB Bulletin 2012-03.

273 12 U.S.C. §§ 1861—1867.

the bank's primary federal banking regulator.[274] Banks that enter into arrangements with marketplace lenders will be subject to these rules for their programs. This means that a marketplace lender will undergo scrutiny from its Funding Bank, and startup companies or other entities without a track record may not meet the Funding Bank's standards or may have to agree to additional burdens or restrictions in order for the bank to justify the third-party relationship.

In response to the increased regulatory scrutiny on third-party arrangements, some Funding Banks are tightening their due diligence requirements and demanding up-front policies and procedures from marketplace lenders with respect to legal and regulatory compliance. Funding Banks are likely to seek contractual and other protections in structuring their third-party relationships to minimize risk of loss. Funding Banks will also be required to monitor the activities of their service providers and subject them to audit, and bind their service providers to strict compliance and information security requirements.[275]

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

"Rent-A-Bank" Criticism. Funding arrangements where a bank contracts with a third party to provide origination services to bank customers have sometimes been criticized as "renting a bank charter," particularly in the context of payday loan marketers.[276] The perceived improper use of a bank charter by these entities has been challenged by both governmental authorities and private litigants, in part because of the high rates and fees charged to consumers in those payday lending programs which are fundamentally different from marketplace loans that are lower rate, longer term and do not renew. Bank regulators have even required banks to exit third-party programs that the regulators determined involved unsafe and unsound practices. However, most of these programs have involved high-rate

274 12 U.S.C. § 1867. The institution must also provide notice to its federal banking regulator of the third-party arrangement and provider.

275 Funding Banks also usually seek to have control over all aspects of the loan program including setting the underwriting criteria for the program, approval of all consumer facing and marketing material, and adherence to bank's collection policies. The program will require regular reporting to the Funding Bank by the marketplace lender. Often the marketplace lender is required to pay for the Funding Bank's costs of compliance and audit. Typically the marketplace lender will fully indemnify the Funding Bank as well. Most of these types of operational requirements are part of the August 2020 settlement of the Colorado Attorney General with two online programs discussed in the "Recent Developments" section in order to provide loans to Colorado residents.

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

payday loans. Both the OCC and FDIC have stated that bank charters should not be used as a means to evade state law requirements.

However, some banks may legitimately seek a competitive advantage by contracting with marketplace lenders to enhance the bank's product offerings, extend the area in which it makes loans and diversify assets. For example, some small community banks have entered into arrangements with marketplace lenders to originate consumer loans to their customers. Even larger banks have engaged in these types of programs, including for business and commercial loans.[277] These programs offer Funding Banks additional fee income generally at acceptable levels of risk, which arguably enhances the safety and soundness of the institution. However, regulators may become concerned if a bank concentrates too much of its portfolio in one area. Thus, it is possible that regulators could limit the number or size of these third-party marketplace lending programs based on safety and soundness concerns.

Worth Remembering: To ensure its own compliance with applicable laws, the Funding Bank will likely require the marketplace lender to implement policies and procedures demonstrating regulatory compliance and agree by contract to comply with laws that are binding on banks but may not be directly applicable to the lender.[278] The Funding Bank may also require the lender to submit to compliance protocols or audits and to take corrective action if deficiencies are found. Accordingly, financial institution laws and regulations—in addition to the consumer protection laws discussed below—will have a significant impact on the platform structure and operations where a Funding Bank is involved.

I. True Lender Litigation

Litigation continues to arise challenging third-party programs, particularly where banks fund high-rate loans or payday loans.[279] However, true lender litigation has also begun to expand further into the marketplace lending sector. The claims made in these cases assert that the payday loan marketers or marketplace lenders are actually the "true lenders," and that they are using banks as the named lender solely to evade compliance with state usury limitations, licensing regimes, and consumer protection laws imposed by the states where such payday loan marketers or marketplace lenders do business. Several earlier cases are summarized below.

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277 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. OnDeck also works with PNC Bank. Similar arrangements exist with others in the marketplace, including an arrangement between Kabbage and Santander Bank. Avant works with HSBC. However, some of these programs are no longer in existence.

278 As discussed herein, marketplace lenders may also be considered to be vendors of the bank and subject to the Bank Service Company Act and vendor management requirements. This makes the marketplace lender, as a service provider to the bank, responsible for complying with applicable laws and regulations and subject to examination by the regulators of the bank.

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

CashCall Decision—West Virginia. One of the first recent "true lender" cases is a 2014 decision from West Virginia where the Attorney General sued CashCall, Inc., the operator of an Internet loan program that used a South Dakota bank to fund consumer loans. CashCall was not licensed under West Virginia law and the loans made by the bank were made at interest rates in excess of the usury rate in West Virginia.[280] The state's position was that CashCall was the "true lender" under this arrangement because it had the predominant economic interest in the loans, and therefore CashCall should have followed applicable restrictions of West Virginia law, including its usury rate.[281] The court ruled in favor of the state, finding that CashCall was the de facto lender under this program. The court enjoined CashCall from making new loans in the state, voided the existing loans (thereby cancelling the debt of the borrowers), and awarded $1.5 million in civil penalties and $10 million in punitive damages against CashCall, in addition to attorneys' fees and costs. On appeal, the West Virginia Supreme Court upheld the decision.[282] CashCall sought review by the U.S. Supreme Court, but it declined to review this decision.[283] The decision in *CashCall* created some degree of uncertainty in the industry and spawned additional litigation surrounding the use of Funding Banks. Such suits are costly to defend.[284]

Utah Case Supports Funding Bank as True Lender. In contrast to the *CashCall* decision, a federal court in Utah dismissed a consumer class action against an online payment processor, Bill Me Later, Inc., alleging that the originating bank was not the true lender in that arrangement.[285] The court stated in its decision that even accepting as true the allegation that the loans were designed to circumvent state usury laws more protective than Utah's, the case had to be dismissed because the claims were preempted by federal law.

The court based its decision in part on the fact that Bill Me Later, Inc. was a service provider to the bank. Under the provisions of the Bank Service Company Act, when a bank contracts with a third-party service provider for services, the performance of those services is "subject to examination and

280 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 in some respects 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. Other facts, however diverge from typical programs such as CashCall funding the loans.

281 The court never defined what constitutes the "predominant economic interest," although this term has been used in other litigation.

282 *See CashCall v. Morrisey*, No. 12-1274, 2014 WL 2404300 (W. Va. May 30, 2014). Although some see this case as an aberration primarily because of the excessive interest rates being charged, the legal principles involved are the same whether the rates are 1% or 100% above the applicable usury rate.

283 Typically, the Supreme Court hears less than 1% of those cases appealed.

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

285 *Sawyer v. Bill Me Later, Inc.*, 23 F. Supp. 3d 1359 (D. Utah 2014). Since many funding banks are located in Utah, this case may have particular precedential value.

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."[286]

> **Worth Remembering:** The Bank Service Company Act provides a potent defense to true lender allegations because it subjects bank service providers to regulatory scrutiny and accountability, providing both regulation and consumer protection. The court's opinion in *Bill Me Later* also provided some guidance for the proper structuring of lending arrangements between banks and third-party service providers, including that the bank (not the service provider) was the party to the loan agreement, the bank funded the loans and owned the accounts and held them for at least two days, and the bank received interest on the loans until they were sold.[287] Sale of a participation interest rather than the sale of a whole loan may also be beneficial. Some marketplace lenders using a Funding Bank have sought to replicate this structure to combat potential "true lender" claims.

CashCall Decision—California. CashCall was again embroiled in litigation even after a change in strategy following the West Virginia litigation. In March 2014, the CFPB filed a lawsuit against CashCall in California.[288] The complaint alleged that CashCall ran a loan program using a "tribal model" whereby the loans were made by Western Sky, a Cheyenne River Sioux Tribe entity. All loans issued under this model were governed by tribal law, such that no state usury laws would apply. The CFPB alleged that this was an abusive practice where CashCall was the true lender, not Western Sky, and that the laws of the borrowers' home states should determine what usury law applies, despite the tribal choice-of-law provision contained in the loan documents.[289] The court ultimately sided with the

286 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.

287 *Sawyer v. Bill Me Later, Inc.*, 23 F. Supp. 3d 1359 (D. Utah 2014). In an earlier case, a court similarly placed greater emphasis on the bank's role as the named loan originator and held that preemption applied even though the website operator marketed and serviced the loans and had the predominant economic interest in the loans. *Hudson v. ACE Cash Express, Inc.*, No. IP 01-1336-C H/S, 2002 WL 1205060 (S.D. Ind. May 30, 2002). In that case, the court accepted as true the claims that a state-chartered bank played an insignificant role in a lending program that a non-bank had "designed for the sole purpose of circumventing Indiana usury law." But the court held that the bank was still the true lender based on federal law principles, noting that "concerns about protection of state usury laws present questions of legislative policy better addressed by Congress." In the *Hudson* case, the bank retained a 5% participation interest in the loan, while selling a 95% participation interest. The court determined that a participation does not destroy the debtor-creditor relationship and does not create privity between the loan participant and the borrower. Participations in loan have been common place for decades, although they have been related primarily to commercial loans. The legal principles related to participations are fairly well established as set forth in the *Hudson* case. As a result, one way to potentially avoid true lender claims is to have the Funding Bank sell participation interests in the loan, rather than sell the whole loan. The bank would retain the status of the creditor and also be able to thwart *Madden* claims as well since there is no assignee. However, not holding the entire loan could present potential issues in further selling or securitizing the asset.

288 *Consumer Fin. Prot. Bureau v. CashCall, Inc. et al.*, Case No. 15-cv-07522 (C.D. Cal. Aug. 31, 2016).

289 Additionally, the CFPB alleged that the debt-collection arm of the enterprise, Delbert Services, violated the law by collecting on accounts that did not have amounts due and owing. There are, of course, obvious differences between this case utilizing tribal law and marketplace loans. However, the case may help to define the parameters of a true lender analysis.

CFPB, finding CashCall to be the "true lender" and holding that courts should look to the substance and not the form of the loan transaction. The court further noted that there was no substantial relationship between the loans and the Cheyenne River Sioux Tribe. As such, tribal law did not govern these loans.

In December 2016, CashCall asked that the decision be certified for interlocutory appeal to the Ninth Circuit and in early January 2017, the court granted CashCall's request. One of the questions identified for review was whether the proper test for determining the true lender under a loan agreement allows the court to look past the documentation and its parties to investigate related transactions. Many in the industry were hopeful that the Ninth Circuit would hear the case because the decision could provide an important precedent in true lender litigation; however, the Ninth Circuit ultimately declined to hear the appeal.

Although the court found that CashCall was the true lender of certain loans it had marketed even though the loans were made by a Native American tribal entity and the loan agreements between the tribal entity and the borrower specified tribal law as the governing law. Those issues are different and distinguishable from those related to an FDIC insured Funding Bank, where there is statutory authorization for exportation of interest rates and preemption of federal loans.

The CFPB requested that the court void the CashCall loans and order restitution in the amount of almost $300 million to borrowers, but in January 2018 the court denied the CFPB's request and levied a fine of only $10 million against CashCall.[290] The CFPB had argued that restitution should be required because under various state laws, the loans were either void or carried excessive fees and/or interest. In denying the CFPB's request, the court found that the borrowers were not misled about the amounts they were required to pay for the loans and had received the loan funds and the benefit of their bargain.[291] The court's decision that the loans remained enforceable because their terms had been fully disclosed is significant because it shows that even when a true lender claim succeeds, the loans at issue will not necessarily be voided and reimbursement to borrowers may not be required depending on the facts. After stays enacted due to other pending litigation, the CFPB and CashCall both appealed the decision on damages to the Ninth Circuit Court of Appeals. The current status of this case is discussed in the "Recent Developments" section.

California Case Finds That Funding Bank Is the True Lender. Shortly after the California decision finding that CashCall was the true lender under its tribal model loan program, a judge in the same district issued a decision supporting the Funding Bank as the true lender for certain student loans.[292] In this case, class action plaintiffs that had obtained private student loans made by a national bank alleged that the "actual lenders" in the transactions were the companies that ended up buying and

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290 *Consumer Fin. Prot. Bureau v. CashCall, Inc. et al.*, Case No. 2:15-cv-07522 (C. D. Cal. Jan. 26, 2018).

291 *Id.* The court noted, "Defendants plainly and clearly disclosed the material terms of the loans to consumers—including fees and interest rates—before the loans were funded. Accordingly, the court cannot conclude that the defendants acted in bad faith, resorted to trickery or deception or have been guilty of fraud in connection with the origination of the loans that are at issue in this case."

292 *Beechum et al. v. Navient Sols., Inc. et al.*, No 15-cv-8239-JGB-KKx (C.D. Cal. Sept. 20, 2016).

servicing the loans, in part because the national bank was required to sell all the student loans it made during the course of the program to these companies.

> **Noteworthy:** The plaintiffs argued that the court should review the substance of the transaction rather than the form and find that these companies were not authorized to charge rates in excess of the California usury limit. The court declined to do so, explaining that while there are cases where courts have considered the substance of a transaction when assessing whether it satisfies the elements of usury or falls under a common-law exemption to the usury prohibition, that analysis does not apply when a transaction falls under a constitutional or statutory exemption to the usury limit.[293]

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

LendingClub True Lender Class Action Settled in Arbitration. In April 2016, LendingClub was sued by borrowers in a class action for alleged violations of usury laws, RICO, and New York state consumer protection laws.[294] LendingClub originated loans through a state-chartered bank; the borrowers alleged that the loan program was a "pretext and a sham" and that the company was trying to avoid state usury laws by structuring its loan transactions through the bank. The plaintiffs relied on both *Madden* and true lender theories. Instead of answering the complaint, LendingClub moved to compel arbitration and stay the district court case pending that arbitration. On January 30, 2017, the court ruled in favor of LendingClub, granting the motion to compel arbitration.

The decision is significant because it finds that the arbitrator determines the question of whether the case is subject to arbitration or not. Under the Federal Arbitration Act, the decision is subject to immediate appeal to the Second Circuit. The decision is also significant because it compelled the arbitration on an individual—and not class—basis, potentially reducing the impact of any adverse decision. The court's ruling on LendingClub's motion to compel arbitration also provides support for the use of arbitration clauses in consumer loan agreements. Ultimately, the case was settled with a small settlement payment and no admission of liability or wrongdoing by LendingClub.[295]

J. OCC True Lender Rule Invalidated

On July 20, 2020, the OCC published a rule defining who is the true lender on a loan.[296] In short, simple, and succinct fashion, the OCC stated that as of the date of loan origination the true lender is either the

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

294 *Bethune v. LendingClub Corp.*, No. 1:16-cv-02578 (S.D.N.Y. Apr. 6, 2016).

295 Confidential Settlement Agreement and General Release, *Bethune v. LendingClub Corp.*, No. 1:16-cv-02578 (filed Mar. 2, 2018).

296 85 Fed. Reg. 44223 (July 20, 2020), to have been codified as 12 C.F.R. 7.1031.

party named as lender on the loan agreement or the entity that funds the loan. The agency indicated that this rulemaking was being determined in the context of bank partnerships with third parties, including marketplace lending. The OCC emphasized the piecemeal and divergent court decisions on the subject, which are neither clear nor dispositive, have created uncertainty and discouraged third-party lending relationships and limited competition. The OCC emphasized the need for predictable and stable markets that will allow for the continued availability of credit.[297] The proposal was subject to a public comment period that ended September 3, 2020, and a final rule was published in the Federal Register on October 30, 2020.[298] The OCC issued the final rule that ostensibly became effective in December; however, the rule was invalidated under the Congressional Review Act, which gives Congress the power to overrule agency rulemaking.[299] On June 30, 2021, the President signed a joint resolution of Congress to disapprove the OCC true lender rule. As a result, it is as if the rule had never been put into effect and, in addition, a new rule that is substantially the same cannot be enacted unless authorized by a law passed by Congress.[300]

K. True Lender Litigation in Colorado

1. Background on the Colorado True Lender Litigation

The Colorado Attorney General serves as the Administrator of the state's Uniform Consumer Credit Code (*"UCCC"*), the statute that governs extensions of consumer credit to Colorado residents.[301] Colorado's version of the UCCC contains an "extraterritoriality" provision which purports to apply the UCCC to any consumer credit transaction with a Colorado resident, even those made by out-of-state lenders, and prohibits the parties from choosing any law to govern the transaction other than that of Colorado. The UCCC also limits allowable interest rates and fees that may be charged in consumer credit transactions.

In early 2017, the Administrator brought legal actions against two marketplace lenders that are licensees under the UCCC. In Colorado, licensing is required to take assignment of and service consumer loans. Since both platforms purchased and serviced loans, they became licensed. As licensees, they were subject to examination by the Colorado Administrator. The targeted marketplace lenders were sued when they did not correct deficiencies cited by the Administrator for

297 The OCC correctly notes that divergent standards have emerged in true lender cases and that there is no predictable standard, as different factors are considered and not given the same weight, result in subjective determinations, and undermine the certainty and stability needed in financial markets.

298 85 Fed. Reg. 68742 (Oct. 30, 2020). The FDIC never promulgated a similar rule.

299 *See* 5 U.S.C. 801. The House passed its joint resolution on June 24, 2021 and the Senate on May 11, 2021.

300 The meaning of the repeal is open to debate. Most likely the result is a return to the status quo prior to the rule being proposed, which means that the conflicting and ambiguous standards from court decisions will be used as guidance for future true lender determinations. Hence, the risk for marketplace lenders should not appreciably change.

301 The significance of the Colorado litigation is heightened by the fact that a number of states have enacted similar versions of the UCCC which could be impacted by the decision. Those states include Idaho, Indiana, Iowa, Kansas, Maine, Oklahoma, South Carolina, Utah, Wisconsin, and Wyoming.

charging and collecting interest rates and fees to Colorado borrowers above those allowed by the UCCC and not having a Colorado choice-of-law provision governing the loan agreement.[302] At the heart of the complaints were allegations that the marketplace lenders were the "true lenders" on the loans to Colorado residents because of how their arrangements were structured and because they held the predominant economic interest in the loans.[303]

2. *Procedural Posturing: Removal and Remand*

Soon after the Administrator filed the suits in state court in Denver, both platforms removed the cases to federal court, claiming that the actions were completely preempted by federal law, specifically the Federal Deposit Insurance Act, because the loans at issue were made by FDIC-insured banks.[304] The Administrator filed motions to remand (*i.e.*, to send back) both cases to state court.[305] In March 2018, the federal court in Colorado hearing both actions determined that the federal court did not have jurisdiction of the matter and, in fact, remanded both cases back to state court. The basis of the decisions was that the complaints on their face did not raise a federal question despite the claims of the marketplace lenders that the loans were made by a federally insured bank and federal law completely preempted the Administrator's claims. The determination was made in large part because the Administrator made no direct claims against either of the Funding Banks. The decisions to remand are procedural in nature and while the cases proceeded in state court, rather than federal court, the platforms could still pursue their federal preemption arguments in the state court actions.[306]

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302 The actions were titled *Fulford et al. vs. Marlette Funding, LLC et al.*, No. 2017-cv-30376 (Dist. Denver Cty.), and *Fulford et al. vs. Avant of Colorado, LLC et al.*, No. 2017-cv-30377 (Dist. Denver Cty.).

303 As to structuring, the Administrator alleged that the platforms pay implementation fees to start the programs, pay the Funding Banks' legal fees, bear the costs of marketing the program and evaluating loan applications, are responsible for ensuring compliance with applicable laws and assume responsibility for the servicing and administration of the loans even before they have purchased the loans from the Funding Banks. The Administrator also alleged that the marketplace lenders assume all risk of default and indemnify the Funding Banks for claims arising from the lending programs. Because the bank only holds the loan for a short period of time, the allegations also claim the platforms to be the true lender because they hold the predominant economic interest in the loans. Taken at face value, the predominant economic interest theory would potentially hold any purchaser of any loan from a bank at risk for these types of claims, impeding the ability of banks to obtain liquidity by selling loans in the secondary market, a practice that most financial institutions have engaged in for decades. The facts raised in the lawsuit would seemingly be more difficult to assert in a situation utilizing a loan participation structure rather than a loan sale. Participations have long been used by banks. In a participation, the originating bank continues to hold title to the loan and account relationship but sells percentages of the economic benefits and risk in the loan to others. This provides liquidity to the bank. Borrowers are usually not aware that participations have been made in their loans. Since the bank retains title to the loan throughout its life, it would be more difficult to assert that the bank is not the true lender. This would be even more difficult in the case of open-end credit, such as credit cards where the originating bank continues to hold the account and makes future advances on the account.

304 Certain state court actions may be removed to federal court within 30 days under 28 U.S.C. § 1446. In this case, the platforms believed that the action raised a federal question, allowing for removal pursuant to 28 U.S.C. § 1331. In the initial complaint, the Administrator's allegations did not mention the fact that the loans at issue were made by FDIC-insured state banks, possibly in an attempt to avoid removal to federal court.

305 The procedure for remanding a case back to state court is found in 28 U.S.C. § 1447.

306 *See Meade v. Avant of Colorado LLC d/b/a Avant and Avant, Inc.*, No. 17-cv-0620, 2018 WL 1101672 (D. Colo. Mar. 1, 2018) and *Meade v. Marlette Funding LLC d/b/a Best Egg*, No. 17-cv-00575, 2018 WL 1417706 (D. Colo. Mar. 12, 2018).

> The Colorado actions were litigating primarily procedural matters for more than two years. The parties engaged in discovery and several motions were filed and pending, so any court resolution would not happen quickly. The settlement also avoids what was sure to have been a lengthy appeals process.

3. *Banks File Declaratory Judgment Actions in Federal Court*

The two Funding Banks making the loans that were subject of the Administrator's lawsuits each filed a declaratory judgment action in Colorado federal court.[307] The Funding Banks asked the court to declare that the loans at issue were validly made by a federally insured depository institution and therefore, under the federal preemption doctrine, the permissible rates and fees on any loans made by the banks to Colorado residents were governed by the laws of the Funding Banks' home states and not by the laws of Colorado. Several trade groups filed briefs in these actions.[308] The Funding Banks also sought to enjoin the Administrator from taking further action against the two marketplace lenders. The Administrator in each action filed a motion to dismiss, claiming that the banks lacked standing to bring the suit. In March 2018, about a year after the actions were filed, the federal court dismissed both actions based on the legal doctrine of abstention. Under this doctrine, federal courts will not interfere with state court proceedings that can deal with the subject matter of the claims and, as a result, must abstain from exercising federal jurisdiction. One of the cases was appealed to the Tenth Circuit Court of Appeals, but the appeal was subsequently dismissed.

> Colorado also filed suit to implicate investors and securitization trusts in its litigation on true lender theories.

4. *Colorado Sues Securitization Trusts*

Both marketplace lenders filed motions to dismiss the Colorado action, which the court denied in the summer of 2018. However, both banks were given the right to intervene and participate in the actions, and each bank joined its respective case.

On November 30, 2018, the Administrator filed a Second Amended Complaint containing allegations similar to those in the prior complaint, but naming as additional defendants the trustees of certain securitization trusts and certain special purpose vehicles that acquired loans originated through the platforms to borrowers who were residents of Colorado at the time of their loan applications.[309]

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307 *See WebBank v. Meade*, Civil Action No. 17-cv-00786-PAB-MLC (D. Colo. filed Mar. 28, 2017) (Funding Bank for the Avant platform) and *Cross River Bank v. Meade*, Civil Action No. 17-cv-00832-PAB-KMT (D. Colo. filed Apr. 3, 2017) (Funding Bank for the Marlette/Best Egg platform).

308 These included the Independent Community Bankers of America, New Jersey Bankers Association, The Clearing House Association L.L.C., American Bankers Association, Loan Syndications and Trading Association and The Marketplace Lending Association.

309 The trustees were sued in their fiduciary capacity as a trustee, and not in their individual capacity.

The Administrator claimed that the trusts meet the definition of a creditor under the UCCC and are receiving compensation greater than that allowed by the UCCC, and therefore have the predominant economic interest in the loans. The newly-named defendants filed motions to dismiss on the grounds that the Colorado state court lacks personal jurisdiction over them. On February 20, 2019, the Administrator responded in opposition to the motions. After briefing on the motions, in May 2019 the Colorado court denied the motions to dismiss, finding that it could exercise jurisdiction over the securitization trusts and that, by receiving payments, the trust could be considered to be a creditor under the UCCC.

Motions for summary judgment were filed by each side in both cases and the state filed a "Motion for Determination of Law" asking the court to determine, if in fact the banks were found to be the true lender for the loans made to Colorado residents, whether the rates and fees charged by the banks could be enforced by non-bank assignees of the loans. In June 2020, the court answered in the negative. It found that even if the banks were the true lenders on the loans, that the platforms, as assignees of the loans, could not as a non-bank entity, take advantage of the federal preemption that the banks enjoyed and stand in the shoes of the banks with respect to the loan terms. Thus the platforms, as assignees, could not charge the rates and fees that the banks were allowed to charge, according to the court.[310]

5. *The August 2020 Settlement*

On August 18, 2020, the parties to the litigation agreed to settle the matter. The implications of the settlement should allow platforms to work with Funding Banks to make loans to Colorado residents so long as loans do not exceed a maximum 36% APR. While the settlement relates only to the parties involved in the litigation and extends to all programs of the two Funding Banks involved, the implication is that other bank programs that follow the parameters of the settlement should be entitled to the same deference.

Maximum Rate and State Licensing. There are several requirements that comprise the settlement. First, loans to Colorado residents must not exceed a maximum APR of 36%. This was the maximum being charged by one of the banks in the lawsuit (the other limited loans to 30% APR) but is greater than the 21% maximum rate specified in the Colorado UCCC. Second, any platform that takes assignment of loans or receivables in any manner and engages in direct collection or enforcement of those loans must become licensed as a supervised lender under the Colorado UCCC.[311] This will allow the state to monitor and supervise the non-bank that is involved with the financial institution and, thereby, the entire program. Third, loan programs must meet certain operational and compliance

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310 This decision was made within the contours of this particular case, so it may not have true precedential value. However, it is anticipated that similar claims in other litigation will cite this decision for support. The decision also came at the same time as federal banking regulators issued regulations contrary to the court's decision. No doubt the alignment of both actions made it advantageous for both sides to enter into a settlement.

311 There will be additional reporting requirements for loans carrying an APR in excess of 21%.

standards. The programs must be subject to federal or state oversight. The bank must control the program and review, approve and oversee (with audit rights) origination activities, marketing materials, website content, credit terms and credit models, and it must approve or deny all applicants. The bank must be the named lender on loan documents, fund the loans from its own funds, and approve third-party subcontractors. The platforms must have a compliance management system, including a system for tracking and resolving complaints. The parties must comply with applicable regulatory guidance for third-party arrangements, and be subject to audit and corrective action.[312]

Banks Must Have "Skin in the Game." One goal of the state was to see that the banks had an economic stake in the loans. For the loans that exceed Colorado usury limits of 21%, which the settlement called "Specified Loans," there are three options to ensure that the lending banks have "skin in the game" as to the sale of those loans. There are no limitations generally placed on loans with an APR up to 21%. The following three options outlined by the settlement deal with the sale of the Specified Loans and arguably provide a "safe harbor" for sale of loans to non-banks.

- *Option 1: Uncommitted Forward Flow Arrangements.* Under this option, there is no commitment by the platform to purchase the Specified Loans from the bank. The bank will provide a notice of loans it wants the platform to purchase, but the platform is under no obligation to purchase all of the loans in the notice and only needs to purchase those loans it specifies. The bank may retain, sell, or securitize loans that the platform does not choose to purchase. Under this option, indemnification by the platform to the bank can only cover services not performed by the platform to the bank but not for either the performance of the loans or any failure to purchase loans offered (unless a commitment has been made to purchase the loans). The program can be collateralized, but not for Specified Loans, unless there has been a commitment to purchase those loans, and then only up to certain limits.

- *Option 2: Maximum Transfer of Specified Loans in Forward Flow Commitment.* Under this option, the bank can transfer up to 49% of the economic interest in the Specified Loans in a committed forward flow arrangement or sell 25% of the Specified Loans on a committed basis, with the rest being on an uncommitted basis. This includes whole loans, participations or sale of receivables. There would be no restrictions on collateral or indemnification on committed loans. The banks may also sell loans to others, including to securitizations.

- *Option 3: Program Loans.* Under this option, the banks can sell 85% of all program loans to the platform, but no more than 35% can be Specified Loans.

312 The two banks involved in the litigation generally adhere to these requirements.

Other Provisions of the Settlement. The settlement provides for the payment of certain monetary amounts to the Administrator and to a fund for economic literacy education. There is no admission of liability on behalf of the defendants.[313]

The settlement also provides for a "safe harbor" for the litigants. The state will not pursue claims, past or future, for violations of Colorado law based on matters of federal preemption of state law or true lender theories or related to the assignment of the loans. In addition, all other programs of the litigating lending banks that comply with the terms of the settlement will be subject to the safe harbor. The court will dismiss the litigation with prejudice; any administrative actions pending will be withdrawn and any expired licenses will be renewed.

The terms of the settlement apply for five years, but a conflicting change of law or regulation could reduce this period to two years. Actions in other states could reduce the 36% APR cap in certain circumstances. In addition, certain loan modifications and forbearances will be made to Colorado borrowers in respect of the pandemic.

Significance of the Settlement. The settlement of these two cases is significant for several reasons.

First, this is a scenario in which a state regulator was challenging the bank funding model widely used in the marketplace lending industry. If these challenges had proved successful, other states would likely follow.

Second, if the actions were successful, the penalties could have been severe. Violations of the Colorado UCCC result in voiding of the finance charge, a possible penalty (as determined by the court) of up to three times the finance charge, the recovery of excess charges and a separate penalty equal to the greater of the finance charge or ten times the excess charge plus attorneys' fees.[314]

Third, since several states have enacted various forms of the UCCC, a decision in favor of the Administrator could have spawned actions in those other UCCC states and in other states as well.

Fourth, the addition of purchasers of loans as defendants is attempting to subject financing vehicles and investors to the ambit of the UCCC and its attendant penalties could have inhibited investment in marketplace loans. The litigation itself had already spawned significant impacts on the financing of loans made through online platforms in Colorado.[315] But the August 2020 settlement has likely changed this.

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313 $1,050,000 will be paid to the State of Colorado for consumer protection efforts and $500,000 in contributions will be made to a fund for financial education programs.

314 The statute does state, however, that no violation impairs the right to collect the underlying principal amount of the debt.

315 Some lenders, loan purchasers and securitizations have either excluded or limited the amount of Colorado-based loans included in a borrowing base, determination of eligible receivables or securitization loan pool. This has the effect of limiting the amount of credit ultimately available to borrowers in Colorado.

The settlement provides a sigh of relief for the marketplace lending industry, which has been watching this litigation with interest. Protracted litigation and imminent appeals—which would have resulted in prolonged uncertainty in the industry—have now been avoided.

The terms of the settlement are consistent with most mainstream MPL programs, although some re-structuring may be necessary in terms of the purchase of Specified Loans. But marketplace lending will again be alive and well in Colorado, at least for loans up to 36%, ending a drought created when many platforms avoided Colorado due to this litigation. This will increase the access to credit for Colorado residents.

The fate of other programs remains in some doubt. However, it would seem that programs that adhere to the parameters of the settlement should not come into the Administrator's sights, particularly when these might be addressed as part of the licensing process that would be required, although high rate programs would still remain on the radar screen of the Administrator and subject to the types of claims brought in this litigation.

This settlement may serve to chill efforts of other state regulators on similar marketplace lending issues or serve as a basis for similar settlements in other jurisdictions. But because this settlement is limited to Colorado, its ultimate effect may be limited. It may also serve as impetus for renewed discussion of the imposition of a national usury rate.

However, states may face a more difficult time pursuing claims against marketplace lending platforms due to the recent actions of federal banking regulators codifying as federal regulations that the interest rates made on a loan originated by a federally-insured bank at inception do not change when the loan is sold or assigned. Arguably, courts must give deference to these regulations.

The settlement should provide a level of certainty and comfort for investors in Colorado-based marketplace loans and for the securitization of Colorado loans. In any event, this settlement in Colorado is a significant development in the marketplace lending arena.

L. Other Cases

Small Business Marketplace Lender Sued in Massachusetts. In October 2017, a small business owner filed suit against a small business marketplace lender and its Funding Bank in federal court in Massachusetts.[316] As in other true lender cases, the main allegation was that the marketplace lender used the Funding Bank's charter to originate loans that were usurious under state law and that the marketplace lender was the true lender because it bore the risk of loss for the loans. However, this Massachusetts case is noteworthy for several additional reasons. First, it was brought against a small business marketplace lender rather than a consumer lender. Second, the suit also named the Funding Bank as a defendant rather than omitting the Funding Bank like the Colorado Administrator in the

316 *NRO Boston, LLC and Alice Indelicato v. Kabbage, Inc. and Celtic Bank Corp.*, Case 1:17-cv-11976 (D. Mass. filed Oct. 12, 2017).

cases described above. And third, it alleged violations of federal marketing and racketeering laws. Specifically, the plaintiff asserted causes of action under the Lanham Act[317] for false advertising and under the federal Racketeer Influenced and Corrupt Organizations Act ("*RICO*")[318] for conspiring to violate usury and consumer protection laws. The RICO cause of action is attractive for plaintiff lawyers as it provides for treble damages and the potential recovery of attorney's fees and costs.

The marketplace lender's loan agreement contained an arbitration provision and the defendants filed a motion to compel arbitration, which was opposed. However, on March 16, 2018 the court entered an order staying the proceedings pending the outcome of arbitration. As we've seen in other cases,[319] the fact that the loan agreement contained an arbitration clause proved helpful in sending the case to arbitration rather than proceeding in court. After a five-day arbitration was held the arbitrator rejected the true lender theories, found the bank to be the true lender and the commercial note valid and entered an over $3 million judgment in favor of the bank. In a somewhat bizarre pattern of events, the plaintiff filed an entirely new lawsuit based on the same facts while the defendants filed to enforce the arbitration awards. The action ended with an acknowledgment of the debt, payment and dismissal.

In another case, on March 22, 2018, a small business owner filed a putative class action lawsuit against the same marketplace lender and bank in state court in California. On April 24, 2018, defendants removed the case to federal court.[320] The complaint alleges that Kabbage's partnership with Utah bank Celtic Bank is a "rent-a-bank" scheme the purpose of which was to evade criminal usury laws. The suit asserts violation of California usury and consumer protection laws for false advertising and unfair competition, and violations of federal RICO laws. The defendants moved to compel arbitration based on a provision in the loan agreement, and the action was stayed pending the outcome of arbitration. In December 2018, the case was dismissed.

Yet another complaint was filed in federal court in New York in October 2019 against the same marketplace lender and two of its principals, seeking to represent a class of merchant borrowers in California, Colorado, Massachusetts and New York.[321] The claims in this suit are also based on true lender theories. Kabbage filed a motion to compel arbitration; however, before the motion was ruled upon the case was dismissed voluntarily by the plaintiff without the ability to bring the suit again.

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317 15 U.S.C. 1125(a).

318 18 U.S.C. 1962.

319 *See, e.g., Bethune v. LendingClub Corp.*, No. 16-cv-02578 (S.D.N.Y. Apr. 6, 2016), which is discussed further below under "Issues Related to the Funding Bank Structure."

320 *Barnabas Clothing, Inc. et al. v. Kabbage, Inc. & Celtic Bank Corp.* (C.D. Cal.) (No. 2:18-cv-03414).

321 *Bright Kids NYC, Inc. et al. v. Kabbage, Inc. et al.* (No. 19 Civ. 9221 S.D.N.Y.).

M. True Lender Case Resolved in Massachusetts

In 2017, an action was filed against an online business lender and its funding bank.[322] The basis of the allegations was that the non-bank was the true lender of the loan. Based upon an arbitration provision in the loan agreement, the matter was sent to arbitration where a five-day arbitration commenced. The arbitrator gave no credence to the allegations that the non-bank was the true lender and awarded a judgment in favor of the bank for over $3 million. While the bank moved to enforce the arbitration award, the original plaintiff brought another action in federal court again raising true lender claims.[323]

In May 2020, both actions were settled and dismissed by granting the bank's motion to confirm the arbitration award in the amount of $3,299,621.97, which court filings indicate was satisfied. The use of an arbitration clause appeared to be helpful to the cause of the lender and fintech involved in the lending program.

N. Pennsylvania *Think Finance* Litigation

Investors Sued. The *Think Finance* litigation started in 2014 when the Pennsylvania Attorney General brought an action against an Internet payday lender who first used a Funding Bank, and then later a Native American tribe, to extend loans to Pennsylvania residents.[324] Think Finance initially sought to have the case dismissed on the basis of federal preemption, but in January 2016, the court denied this motion and allowed the Attorney General's claims to proceed on a true lender theory. Subsequently, Think Finance filed for bankruptcy protection. The Attorney General then filed an amended complaint, adding as defendants certain investors who were providing funding to Think Finance. The investors filed a motion to dismiss the claims as they related to Think Finance's Funding Bank program. On January 26, 2018, the court dismissed the claims made against the investors under Pennsylvania's Corrupt Organizations Act (a state statute similar to the federal RICO laws), finding that an investor who merely funds an alleged unlawful enterprise would not have liability under that Act absent allegations that the investor had knowledge of being a part of an unlawful activity, which the Attorney General had not pled. However, the investors remained subject to claims for their participation in Think Finance's tribal lending program.

Think Finance declared bankruptcy and as part of a global settlement of several pieces of litigation, the Pennsylvania Attorney General reached a settlement as part of the bankruptcy proceeding that forgave outstanding loan balances and submitted $2 million to the state for customer refunds. Funding of the settlement included participation of the major investor of the company.[325]

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322 *NRO Boston LLC and Indelicato v. Kabbage, Inc. and Celtic Bank Corp.*, Civ. Act. No. 1:17-cv-11976-GAO (D. Mass.).

323 *NRO Boston, LLC et al. v. Kabbage, Inc. et al.*, Civ. Act No. 1:19-cv-11901-GAO (D. Mass.).

324 *Commonwealth of Pennsylvania v. Think Finance, Inc. et al.*, Civil Action No. 14-cv-7139 (E.D. Pa).

325 The bankruptcy was in the Northern District of Texas. *In re Think Finance LLC et al.*, Case No. 17-33964. The overall settlement also included settlement of claims brought by the CFPB against Think Finance. It obtained a mere $7 recovery ($1 for each of seven companies) in order to maximize recovery to borrowers. The CFPB action, like the Pennsylvania action, alleged

Litigation Settled. In 2014, the Pennsylvania Attorney General brought suit against Think Finance and its affiliates who partnered with banks and then tribal entities to offer loans to consumers. The Commonwealth alleged that this was an attempt to avoid state licensing and usury laws.[326] In July 2019, the Commonwealth reach a multimillion-dollar settlement with the entities that involved forgiveness of loan balances and a $2 million dollar payment to the state and offered refunds to other consumers. The settlement was part of a Chapter 11 bankruptcy reorganization.[327]

Caution: This case suggests that investors should proceed with some caution when dealing with higher-risk programs such as those involving high rate payday loans or tribal law, particularly if the investors are involved in decisions affecting the operations of the loan program.

Action in North Carolina. In another action involving the Think Finance tribal lending program, a lawsuit was filed in federal court in North Carolina.[328] Similar to the approach taken by the Pennsylvania Attorney General after Think Finance filed for bankruptcy, the plaintiffs in this case brought claims against various persons associated with the tribal lending program, including lenders, investors and even banks which processed ACH transactions for the program, since (because of the Think Finance bankruptcy) it was unable to sue Think Finance itself. Interestingly, the complaint states that the rates charged under the tribal lending program actually violated usury provisions of the tribal law that purportedly governed the program. The complaint also alleges violations of the Electronic Funds Transfer Act, the Federal Trade Commission Act and RICO. Specifically, it was alleged that collection of an unlawful debt alone violates RICO. The remedies sought include voiding of the loans including the governing law, forum selection and arbitration provisions of the loan agreements, disgorgement of profits, treble damages, an injunction and attorney's fees and costs. The case was stayed pending settlement.

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claims of avoiding state licensing laws and exceeding state usury limits. Think Finance did not admit any liability and maintained that it was acting as a technology service provider for valid lending relationships.

326 *Commonwealth v. Think Finance et al.*, Case No. 2:14-cv-07139. This case is discussed later in this book. A motion to dismiss was filed and the court denied adherence to federal preemption with respect to bank-made loans. Think Finance continued to make loans but not with banks (rather, with tribal entities) and sought exemption from state usury laws based on the doctrine of sovereign immunity.

327 *In re Think Finance LLC et al.*, Case. No. 17-33964 (Bkcy. N.D. Tex.). Under the terms of the settlement, Think Finance did not admit any liability and contended that the loans were legal and that it was acting as a technology service provider to the tribal lenders. The CFPB also settled its actions with Think Finance for a nominal amount as part of the bankruptcy proceeding. Individual defendants also entered into settlements, as did a debt collection agency.

328 *Granger et al. v. Great Plains Lending LLC et al.*, No: 1:18-cv-00112 (M.D.N.C.).

"True Lender" Takeaways: Two points can be taken from these true lender cases. First, it appears that claims under RICO are becoming more common, likely due to the potential for treble damage recovery. Second, while most of these cases are still being brought against payday lenders and tribal lending programs, the range of defendants is being expanded to include Funding Banks, investors, marketplace lenders and, as in the North Carolina case, banks providing services to the program such as ACH processing.[329] It appears likely that true lender litigation will continue to create uncertainty and risk in the marketplace lending space.

O. D.C. Files True Lender Action

DC Attorney General Settlements. The Attorney General in the District of Columbia brought two actions against online lending programs, resulting in settlement in both instances. In 2020, the Attorney General filed a complaint in the District of Columbia Superior Court alleging that a company deceptively marketed loans to consumers with rates into the triple digits, far in excess of the DC usury rate of 24%, and was a sham "rent-a-bank" arrangement.[330] The company removed the action to federal court on the basis that under federal law, the district's usury caps would be preempted for the out-of-state bank that made the loans marketed by the company.[331] In a lengthy opinion, the federal court remanded the action back to state court. The court's reasoning indicated that while preemption applies to banks—not non-bank entities—and the complaint alleged a cause of action, the company was the true lender and the claims are factual, not legal, in nature, which was within the ambit of the Superior Court to decide. Ultimately, in February 2022, the parties settled the action by the online platform agreeing to pay some $3.8 million and comply with the District's interest rate limitation.[332] This settlement followed another settlement with another online lending program sponsor in November 2021.[333] This entity paid some $1.5 million to settle claims of predatory lending as being the true lender on loans made to District of Columbia borrowers.[334]

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329 Cases involving payday lenders and/or tribal programs will often raise different issues and considerations than would apply to claims brought against marketplace lenders, assuming that the marketplace lenders extend their loans at interest rates significantly lower than payday rates and partner with Funding Banks under arrangements intended to ensure that federal preemption applies. As part of their defense against true lender claims, marketplace lenders should also be able to assert reliance upon common law "valid when made" and assignment principles, although these principles have been called into question by the *Madden* decision as discussed further in this book under "Usury Law."

330 *District of Columbia v. Elevate Credit, Inc.*, Case No. 2020 CA 002697 (Sup. Ct. D.C.).

331 *District of Columbia v. Elevate Credit, Inc.*, Civ. Action No. 20-1809 (EGS) (Dist. D.C.).

332 $3.3 million was for alleged overcharges of interest to District borrowers. Some $300,000 of interest is waived, and it made a $450,000 payment to the District.

333 *District of Columbia v. Opportunity Fin., LLC*, 2021 CA 001072B.

334 The Consent Judgment and Order provided for reimbursement of excess interest, waiver of other interest, and payment of a $250,000 fine.

Litigation has centered on higher rate loan programs when challenging federal preemption under a true lender theory.

1. *Federal Decisions and Cases*

Massachusetts Student Loan Case. An April 2021 decision from Massachusetts found that a bank was the true lender on a loan that was subsequently transferred to a trust comprised of student loans.[335] The bank service provider designed and marketed a student loan program where the student loans were funded by a national bank and subsequently sold to a trust established by the service provider. The plaintiffs, a borrower and co-signer of a student loan, sued the trust primarily on the allegation that the loan exceeded the 6% usury rate set by Pennsylvania law and that the service provider and not the bank was the true lender on the loan. The plaintiffs sued 13 trusts originally. The defendant filed a motion to dismiss the action. The court dismissed the action against 12 of the trusts, as the loan was not a part of those trusts, but considered the allegations as they related to the one trust into which the plaintiffs' loan was sold. The court dismissed the action against the trust.[336]

The court upheld the concept of "valid when made" and found the bank to be the true lender on the loan. The court found that Section 85 of the National Bank Act preempts conflicting state law and that national banks have the power to purchase and sell loans (citing 12 C.F.R. 7.4008(a)). The court ruled that the interest rate on the original loan was non-usurious and therefore could not become usurious upon assignment. The court gave deference to the OCC's recently enacted "valid when made" regulation. As to the true lender theory, the court stated that the plaintiffs had not identified any binding authority that would require the court to apply the true lender doctrine.[337] In addition, the court looked to the transaction documents, finding that the national bank was the named lender on the loan, funded the loan, and could be required to hold the loan for an extended period of time. The court did not deem it necessary to address the OCC's true lender rule that is being challenged in court and in Congress. Therefore, the court concluded that the bank did have economic risk as to the loan. The court also dismissed state law claims related to breach of contract and unfair practices.

California Challenge to Funding Bank Program. On April 13, 2021, a case was decided in the Northern District of California involving FinWise Bank, a Funding Bank, and its non-bank service provider, Opportunity Financial, LLC, challenging the validity of loans and business practices associated with a Funding Bank program.[338] The defendants removed the action, which had originally been filed in state court, to federal court and filed a motion to dismiss. The plaintiff, a California consumer, alleged that

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335 *Robinson and Spears v. Nat'l Collegiate Student Loan Trust 2006-2*, 2021 WL 1293707 (D. Mass. Apr. 7, 2021), on appeal to the First Circuit Court of Appeals.

336 As stated in the prior section, the court upheld the concept of valid when made based on the OCC regulation.

337 In a prior Massachusetts action, the court declined to deal with the true lender doctrine because it could decide the case on the basis of usury. The court dismissed the usury claims. *Kaur v. World Bus. Lenders, LLC et al.*, 440 F. Supp. 3d 111 (D. Mass. 2020).

338 *Sims v. Opportunity Fin., LLC et al.*, 2021 U.S. Dist. LEXIS 71360 (N.D. Cal. Apr. 13, 2021).

the defendants operated a "rent-a-bank" scheme to issue high cost loans although the bank was listed as the lender on the loans. The plaintiffs claimed the bank was lender in name only, with the service provider marketing the loans, purchasing the loans, and then servicing and collecting the loans, which actions the plaintiffs alleged were designed to evade California interest rate restrictions. The plaintiff made several claims against the defendants under both California and Utah law for unfair and unconscionable conduct and requested reformation of the loan contract and refunds for excessive charges. The defendants challenged all claims based on the doctrine of federal preemption and alternatively that if preemption failed, the action failed to state a cognizable claim under either state's law.

The court found that all of the plaintiffs' claims failed on the merits and, as a result, the court did not need to address or resolve the issue of federal preemption. In part, the court held that the plaintiffs failed to show that the defendants were subject to the California Financial Code, which contains wording to the effect that the California statute does not apply to any person doing business under any law of any state relating to banks. In that regard, the court upheld existing precedent that, as to usury, the court may look only to the face of the transaction and not to the intent of the parties.[339] On the face of the loan agreement, it was not subject to California law. The court noted that arguments as to evasion of California law are irrelevant since the bank is the lender on the documents. The court also reviewed the service provider's website and found that it was not misleading as to who was the lender on the loans. The court also dismissed claims under Utah law for unconscionability in that Utah law allows any rate of interest to be charged on a loan. A claim was also made under the Electronic Funds Transfer Act that a preauthorized transfer was required as a condition of the loan, and therefore the loan violated EFTA and Regulation E. The court found this claim to be insufficient based on language in the loan agreement allowing for alternative payment methods.

> There are no established judicial standards for making a true lender determination, which creates uncertainty.

P. State Statutes Take Aim at Marketplace Lending Programs on True Lender Basis

1. Illinois

In addition to federal laws and regulatory oversight, some states have recently enacted legislation that potentially will impact marketplace programs and is related to licensing and usury. On March 23, 2021, the Illinois Predatory Loan Prevention Act (the *"PLPA"*) was signed into law.[340] The PLPA imposes a

339 *Beechum v. Navient Sols., Inc.*, 2016 WL 5340454 (C.D. Cal. 2016).

340 815 ILCS 123/15-1-1 *et seq*. The legislation was crafted without the knowledge of the state regulator and passed in record time without input from the industry or the regulator.

36% military annual percentage rate (*"MAPR"*) cap on all loans made to Illinois consumers.[341] It applies to all consumer loans made or renewed on or after the effective date of the PLPA. Failure to comply with the interest rate cap may result in the consumer loan becoming null and void. The PLPA applies to any person or entity that offers or makes a loan to a consumer in Illinois. While there is an exemption for banks, credit unions, and insurance companies that are chartered by the United States or any state, the PLPA has a sweeping "anti-evasion" provision to the effect that a person may be a covered lender by purporting to act as an agent of a bank or other exempt party and engaging in marketing, arranging, or brokering loans made by the exempt party, or holding or acquiring the predominant economic interest in the loans generated by the exempt party.[342] The anti-evasion provision of the PLPA appears to have been designed, in part, to limit the use of Funding Bank and service provider relationships commonly seen between banks and non-banks, such as fintech companies, marketplace lenders, and loan servicers, to operate loan programs with interest rates in excess of 36% MAPR.

2. *Maine*

In 2021, Maine also updated its Consumer Credit Code to include a statutory "true lender" test, providing that an entity which is a purported agent or service provider is a "lender" subject to certain requirements of the Consumer Credit Code if the entity, among other things: (i) has the predominant economic interest in a loan; (ii) brokers, arranges, or facilitates a loan and has the right to purchase the loan; or (iii) based on the totality of the circumstances, appears to be the lender, and the transaction is structured to evade certain statutory requirements.[343] Under the new statute, if the deemed lender violates the provisions and lends in excess of the permissible state rate, the borrower is not obligated to pay the debt and may recover amounts previously paid on it.

3. *Wyoming*

Wyoming amended its Consumer Credit Code effective July 1, 2021.[344] Under the new provisions, Wyoming changed its licensing statute to provide that, "[u]nless a person is a supervised financial organization or has first obtained a license from the administrator, no person shall engage in the business of making consumer loans or taking assignments of non-servicing rights relating to consumer loans that are not in default." The statute applies to all consumer loans that do not exceed $75,000. Thus, non-bank persons (such as the marketplace lending platform or a non-bank trust or special

341 Note that the MAPR is calculated under the provisions and definitions of the Military Lending Act (*see* 10 U.S.C. 987) and is NOT the same as the Annual Percentage Rate or APR calculation under the provisions and definitions of the Truth in Lending Act (*see* 15 U.S.C. 1601 *et seq*.). The MAPR includes additional amounts related to credit insurance fees or premium, debt cancellation or suspension fees, ancillary products sold in conjunction with the credit, and, in the case of credit card, application fees and some participation fees.

342 The law does not define the term "predominant economic interest." Regulations were proposed and become effective August 1, 2022, including a separate disclosure informing consumers of the MAPR limitation and the fact that a loan above that rate is void.

343 ME. REV. STAT. Art. 9-A: § 2-702 (effective Oct. 18, 2021).

344 WYO. STAT. 40-14-302.

purpose entity) that take assignments of non-defaulted consumer loans may need to be licensed. The penalty for a non-bank taking an assignment of a consumer loan without a license is that the loan is void and the borrower is entitled to repayment of any principal and interest paid on such loan.[345] The Wyoming regulator has indicated that servicers are not required to be licensed if they do not take assignment of loans and that only an entity that takes assignment and services loans is required to be licensed. Further, the Wyoming regulator has indicated that an assignee such as a special purpose entity or trust not engaging in servicing does not require a license in Wyoming.

> States are enacting laws that target marketplace lending programs, limiting interest rates and requiring licensing.

4. *Hawaii*

Effective January 1, 2022, there is a new Hawaii licensing requirement for those engaging in business as an "installment lender" with respect to loans under $1,500.[346] The penalty for engaging in business without a license is that the loan is "void," and "no person shall have the right to collect, receive, or retain any principal, interest, fees, or other charges in connection with the loan." In addition to this licensing requirement, the new law contains requirements for installment loan transactions and renewals.

5. *New Mexico*

On March 1, 2022, the governor of New Mexico signed into law HB 132, which caps interest rates at 36% for loans up to $10,000. The rates became effective on January 1, 2023.[347] The law also contains strong anti-evasion provisions aimed at Funding Bank-type programs as they apply to any agent or service provider of a bank where it holds the predominant economic interest or has the right to purchase the loan. The statute also provides that it applies where the "totality of the circumstances" indicate that the person is the lender and the transaction is structured to evade the requirements of the law.[348]

There can be no assurance as to how these new laws will be applied in those states, but it is clear that they are intended to reach higher rate marketplace programs. In addition, it is possible that other states may follow suit, instituting similar statutory "true lender" tests, which may impact the ability to

345 WYO. STAT. 4-14-521.

346 H.B. 1192.

347 The law amends the Small Loan Act and the Bank Installment Loan Act. Previously, loans up to $5,000 could charge rates up to 175%. The "all-in" rate includes fees to obtain the credit, credit insurance premiums, and ancillary products.

348 In deciding whether the totality of the circumstances indicate that a person is the lender and a transaction is structured to evade the law, all relevant factors may be considered, including whether the person (1) indemnifies, insures, or protects an exempt entity for any costs or risks related to the loan, (2) predominantly designs, controls, or operates the loan program, or (3) purports to act as an agent, as a service provider, or in another capacity for an exempt entity while acting directly as a lender in other states.

operate in those jurisdictions. Such statutes also raise the risk of true lender litigation as well as the tests applied by courts and regulators in determining who is the true lender of a loan. While such provisions provide additional clarity with respect to jurisdictional requirements, they may also result in increased usury and licensing risk and impact operations. Further, other states may take different paths to promulgate similar "true lender" restrictions, creating a patchwork of rules that federal preemption seeks to avoid; if not through a legislative path, impacted parties may have little to no advance notice of new restrictions and compliance obligations. These laws may also impair the ability to sell or securitize loans into the secondary market, reducing access to credit—often to those in need of it. Such laws may also be subject to challenge based on being an impediment to interstate commerce.

6. Maryland

One regulator has taken another approach to derail marketplace programs based on licensing. In 2021, The Office of the Commissioner of Financial Regulation sued an out-of-state bank and its fintech service provider engaged in a Funding Bank program.[349] The state alleged that the parties were not licensed under applicable Maryland laws and therefore their loans were void. The bank and its service provider removed the matter to federal court based on preemption principles. In April 2022, the federal district court sent the parties back to the state administrative proceeding because the matter was based on issues of state licensing, not federal preemption of interest rates.[350] Accordingly, removal was not proper and the state proceeding was the appropriate place for the hearing. The case raises at least two important issues. First, while state banks are exempt from licensing in most places, this may not be the case in Maryland. Second, the state has long held the view that service providers to banks must be licensed under the state's Credit Services Business Act. In addition, the state claims that a collection agency license is needed to engage in collection activities. A decision in favor of the state on these issues could create additional requirements for Funding Banks as well as service providers. The court also found that the state administrative proceeding cannot be removed as it is not a court action, and only court proceedings can be removed; and even with an adverse determination, the state proceeding can be appealed to a court. The defendants attempted to certify the decision for appeal, but that motion was denied on July 8, 2022.

Final Thoughts—Structuring Funding Bank Relationships. So long as litigation and uncertainty surround the use of a Funding Bank for marketplace lending programs, when structuring arrangements with Funding Banks, lenders should use care to establish facts and factors that promote a sound foundation for finding that the Funding Bank is the true lender of the Borrower Loans.[351] Possible criteria to be considered include whether the Funding Bank distributes loan proceeds from its

349 *Salazar v. Fortiva Fin., LLC, Atlanticus Servs. Corp. and The Bank of Missouri s/b/m Mid-America Bank and Trust Co.*

350 Civil Action No. 21-cv-00866-LKG (Dist. Md. Apr. 28, 2022).

351 For example, the parties should ensure that the bank has substantive duties and/or an economic interest in the program or loans. Banks should also take care to fulfill their obligations under applicable federal banking guidance to monitor and supervise the Internet marketer's performance of its duties as a bank service provider.

own funds; 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, and indemnifications 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 marketplace lender; and the compliance requirements imposed by the Funding Bank on the marketplace lender. Funding Banks need to exercise control over the program, including credit criteria and underwriting and program fees, and have the ability to audit the program and direct program changes. Funding Banks also need to have oversight over the services provided by the marketplace lenders and be sure that as service providers they follow vendor management protocol. Some Funding Banks are moving toward programs where the bank retains ownership of the loan and customer relationship and merely participates an economic interest to the marketplace lender based on long-standing precedent dealing with loan participations. Banks may also retain the right to keep loans rather than sell them. Collateral arrangements should also be undertaken with care so as not to appear to mitigate economic risk to the Funding Bank. True lender risk may be diminished by different entities being involved in the program and by a separation of origination functions from servicing functions from loan purchasers. Courts have looked to loan documentation and other communications with borrowers to determine the intent of the parties and also whether the Funding Bank is the true lender. Fundamental is that the Funding Bank is named as the lender on loan documentation and in related documents. Due to the complex issues involved, experienced counsel should be consulted to assist in the development of an appropriate strategy and drafting of arrangements between marketplace participants and Funding Banks.

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

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

Q. California Focus on Arbitration

In mid-2019 a mobile lending startup was sued by a consumer alleging that it would not let her pay off her loan while her membership fees remained unpaid.[352] Allegations in the case included violation of usury laws as well as violations of the federal Truth in Lending Act. The defendant filed a Motion to Compel Arbitration based on arbitration provisions in the customer agreements, which the court granted in December 2019. The plaintiff has appealed that decision to the Ninth Circuit Court of Appeals.[353] In a 2021 ruling, the court upheld the use of arbitration.[354] California courts remain skeptical of arbitration provisions that attempt to curtail the availability of public injunctive relief. The decision, however, clarified that consumers can obtain "public" injunctive relief in "individual" lawsuits. Thus, arbitration agreements containing class action waivers, joinder waivers, and/or private attorney general waivers are likely to be found valid, so long as the agreements provide an individual with a right to public injunctive relief in an individual arbitration proceeding.

Unlike other states that have freely allowed arbitration under the Federal Arbitration Act,[355] California takes a contrary view and restricts the use of arbitration when the arbitration clause would prohibit the bringing of a public injunction.[356] As a result, efforts to move court actions to arbitration face a battle in California. Even the use of an arbitration agreement may not be honored in California. But structuring of arbitration provisions to follow recent case law decisions provides a possible alternative to allowing arbitration if there is the ability of the individual to arbitrate the issue of bringing a public injunction.

This same online lending entity and its funding bank were sued in an action in North Carolina where the allegations included saddling borrowers with short-term loans with high interest rates without a license to lend in the state.[357] In December of 2019, the court granted a Motion to Compel Arbitration and stayed the actions. Objections to the ruling were denied. As stated elsewhere, the use of arbitration clauses in loan agreements can be beneficial.

Arbitration in California. Arbitration in California forums has been up in the air since the decision of *McGill v. Citibank, N.A.*[358] In short, an arbitration provision that deprives a consumer of the ability to bring an action for a public injunction violates California law and denies the ability to arbitrate. Litigation has resulted from this decision and lenders' changes to arbitration provisions to address this

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352 *DiCarlo v. MoneyLion Inc. et al.*, Case No. 5:19-cv-01374 (N.D. Cal.).

353 *DiCarlo v. MoneyLion, Inc. et al.*, Case No. 20-55058 (9th Cir.).

354 Decision at 988 F.3d 1148 (9th Cir. 2021).

355 9 U.S.C. 1 *et seq.*

356 *McGill v. Citibank*, 393 P.3d 85 (Cal. 2017).

357 *Corpening v. MoneyLion Inc. et al.*, Case No. 3:19-cv000282 (W.D.N.C.). The Funding Bank defendant is First Electronic Bank.

358 393 P.3d 85 (Cal. 2017).

issue. A recent decision denied a motion to compel arbitration.[359] The argument that the litigant was not seeking a public injunction should allow arbitration was rejected. As a result, California arbitration provisions remain in a state of flux.

R. State Licensing Requirements

Depending on how a program or platform is structured, various state licensing requirements could potentially apply. Even when a Funding Bank is utilized, participants may need state licenses in order to perform certain functions in the origination, funding, purchasing or servicing of loans.

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

The role and functions that an entity performs will determine whether licenses are required or not, and what licenses may be required. The general types of state licenses are described below. In some instances, more than one state license may be required.

Conference of State Banking Supervisors. The Conference of State Banking Supervisors ("*CSBS*") consists of the banking regulators from the various states. Given the development of technology and innovation, the state regulators began considering ways to promote innovation for companies subject to multistate licensing. In February 2019, the CSBS adopted several recommendations from its FinTech Industry Advisory Panel. These include development of a model law for all states to license money services businesses, creation of a standardized call report for consumer finance businesses and providing an online database of state licensing and fintech guidance. The CSBS agreed to develop an examination system to simplify examinations of state-licensed entities operating in multiple jurisdictions. The CSBS would also work to streamline state licensing application processes by expanding the use of the Nationwide Multistate Licensing System ("*NMLS*") to all state regulators and entities supervised at the state level. NMLS is already used by several states to submit and process applications for state licenses.

State Licensing Generally. 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

359 *Snarr v. HRB Tax Grp., Inc.,* Case No. 19-17441 (9th Cir. Dec. 9, 2020). But see the "Regulatory Issues" section of this book for a California decision to the contrary.

(*e.g.*, California and New York) the process can take several months. In addition to filing fees, license applicants may be subject to background checks and fingerprinting and may be required to submit business plans and financial statements. A marketplace lender subject to state licensing requirements must also comply with any associated recordkeeping, financial reporting, disclosure, minimum net worth, surety bond, 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.[360] Some states have subscribed to the NMLS, a national licensing registration service that allows use of submitted information in multiple jurisdictions for licensing purposes. At least one state, Nevada, has a requirement of an in-state office for brokers and lenders of consumer and commercial loans, although online commercial lenders may meet the requirement to be exempt from the in-state office requirement. Accordingly, state licensing requirements may create significant compliance burdens and the need for a compliance infrastructure. This multistate compliance burden for lenders generally impedes having a uniform national program, which is one reason why the Funding Bank approach has been utilized for marketplace lending programs. However, to reiterate, even when working with a Funding Bank, marketplace lenders may need to obtain other state licenses to provide services to the Funding Bank or to acquire, service and collect loans.

State licensing authorities are taking an increased interest in marketplace lending as the sector grows. The California Department of Financial Protection and Innovation (formerly the Department of Business Oversight) launched an inquiry into online programs in December 2015 with the objective of determining whether market participants are fully complying with the state lending and securities laws. The department 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 department published a summary report of the aggregate transaction data on April 8, 2016. It is still not known whether the regulator intends to propose any changes in California law. More recently, the New York Department of Financial Services (*"NYDFS"*) circulated a similar survey to online lenders to gather information for a report issued in 2018 suggesting that additional licensing requirements should be considered for online lenders and recommended a lower usury rate. In general, though, state regulators are starting to focus more attention on marketplace lending and the need for licensing depending upon how such businesses are conducted.[361]

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360 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.

361 However, a recent California enforcement action decision appears to expand entities that need to be licensed under the California Financing Law. The decision upheld a cease and desist order against an entity that did not fund loans to borrowers but solicited borrowers, evaluated the credit, proposed loan terms, and made or participated in credit advances. The DBO rejected the argument that a license was needed only if the entity made loans. Lending-related activities may also require licensing. *In the Matter of the Desist and Refrain Order Against Financial Services Enterprises dba Pioneer Capital*, OAH No. 2016040551 (Nov. 29, 2016). California has taken a more aggressive posture on licensing enforcement actions.

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

Broker and Lead Generation Licenses. Certain states require the registration or licensing of persons who assist in the loan marketing and origination process under "loan broker" or "credit service organization" statutes. Some states, such as Connecticut and New Hampshire, 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.[362] Any participant hosting a website or soliciting loans for a Funding Bank may fall within one or more of these broad definitions and, absent an exemption, will need to comply with any associated licensing requirements imposed by those applicable states for loan brokers, marketers, or originators.[363] Even lead generators and aggregators may be subject to these laws. At least one state, Vermont, requires a license for lead generators/aggregators.

Lending and Assignee Licenses. Consumer marketplace lenders that do not utilize a Funding Bank are subject to lending license requirements in virtually all states. State regulators take the position that Internet lenders must be licensed by the state to make loans to residents of that state.[364] Persons who "arrange" loans for others are also covered by the lending license statute in some states.[365] In some

362 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.

363 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. Some impose disclosure requirements that are inappropriate to marketplace lenders. In some states, money transmitter licenses could be a consideration.

364 *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. In October 2016, the Georgia Supreme Court ruled that out-of-state Internet lenders are subject to the state's payday lending law, which prohibits making loans of $3,000 or less without a license. *Western Sky Fin., LLC v. State of Georgia*, No. S16A1011 (Oct. 31, 2016).

365 For example, the Regulated Lender statute in Texas contains this type of language and the regulator there has indicated that Internet platforms sourcing loans for a bank located in another state need to be licensed under this law. In addition, in late 2016 the California regulator took action against a company that arranged commercial loans, finding that a license was required under the California Finance Lenders Law (as of October 2017, renamed the California Financing Law) because the company was engaged in the business of making commercial loans even though it did not actually lend money or take security. We note that merchant cash advance businesses conduct business over the Internet. A discussion of the laws applicable to that arena are beyond the scope of this book; however, if structured correctly, such advances are in the nature of receivables purchases or factoring and not loans and should fall outside of typical lending requirements. Litigation has occurred over this issue, most prevalently in California, and some merchant cash advance businesses obtain licenses.

cases, a purchaser or assignee of a Borrower Loan may become subject to licensing requirements.[366] Some states require licensing of commercial lenders.[367]

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. Even if a marketplace lender outsources collection activities to a licensed third party, in some states, it too may be subject to collection licensing requirements.[368] This could apply to an entity that sells loans to a third party and retains servicing of the loans, including marketplace lenders that sell loans to investors and then service the loans on behalf of the purchaser. Additional state-level requirements that may be applicable to lenders that service Borrower Loans are described in "Debt Collection Practices" below.

Money Transmitter Licenses. Most states also have statutes that deal with money transmission. If one meets the state's definition of engaging in a business that transmits money, then a state money transmitter license may be required. If a marketplace lender handles funds directly, then inquiry about the applicability of money transmitter laws should be undertaken.

Credit Services Organizations Licenses—Maryland Decision. Several states have credit service organization, or CSO, statutes. While aimed at persons who try to improve a person's credit standing or credit record, many of these statutes also apply to entities that assist a borrower or a lender in obtaining a loan. Some states require borrowers to compensate the entity, while others define compensation more broadly. A decision of the Maryland Court of Appeals demonstrates the need for marketplace lenders to review state licensing requirements carefully since non-uniform requirements can prove a trap for the unwary. On June 23, 2016, the court filed a decision in *CashCall, Inc., et al. v. Maryland Commissioner of Financial Regulation*, upholding the $5.6 million in sanctions imposed by the Commissioner against CashCall.

In this case, CashCall was utilizing 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

366 Any loan assignee (even a passive investor) is subject to licensing in Kansas (Supervised Lender License required with respect to loans over 12%; see KAN. STAT. § 16a-2-301(1)(6)) and South Dakota (Money Lender License, S.D. STAT. § 54-4-52) and potentially in other states (*e.g.*, installment loans of $6,000 or less in Massachusetts—M.G.L. Ch. 140 Sec. 96) and perhaps other states. Assignees who also service and collect consumer loans are potentially subject to licensing in several states including Colorado, Connecticut, Idaho, Iowa, Louisiana, Maine, Oklahoma, South Carolina, Utah (notification), and Wyoming. In addition, certain types of loans may be subject to restrictions on assignment. Loans made under the Illinois Consumer Installment Loan Act may only be sold to regulated financial institutions or other licensees. Loans made under the Massachusetts Small Loan Act may only be assigned to other licensees or exempt entities. The same is true for Ohio Small Loans (loans under $5,000). Some states such as Texas impose licensing on any entity that charges, contracts for or receives interest greater than 10%.

367 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. Legislation is pending in some states that would expand the number of state licensing commercial lenders.

368 *Barbato v. Greystone Alliance, LLC*, Case No. 18-1042 (3rd Cir. Feb. 22, 2019).

maximum rate allowed under Maryland's usury laws. Soon after the banks made the loans, CashCall purchased the loans and serviced and collected them. The regulator in Maryland cited CashCall for failure to obtain a license under the Maryland Credit Services Business Act (the *"CSBA"*). In addition to requiring a license for any credit services business, the CSBA contains a provision that prohibits a person from arranging loans for banks that would be in excess of allowable Maryland rates. The regulator claimed CashCall was a credit services business and fined it $1,000 for each loan it arranged for the banks with Maryland residents that exceeded Maryland's applicable usury rate.

CashCall argued on appeal that it was not engaged in a "credit services business" and therefore had not violated the CSBA. The CSBA defines a "credit services business" as one in which a person obtains or assists a consumer in obtaining an extension of credit "in return for the payment of money or other valuable consideration."[369] In an earlier decision the Court of Appeals had held that under the quoted language, a business is a "credit services business" only if the payment it receives for arranging an extension of credit comes "*directly from the consumer*."[370] CashCall argued that it received no compensation from borrowers, but only royalty fees paid by the Funding Banks; thus, it had not received any payments "directly from the consumer" and was not subject to the CSBA. The court rejected CashCall's argument, clarifying that the direct payment requirement only applies to companies that are primarily engaged in providing goods or services to consumers other than arranging extensions of credit, and does not extend to a company that is exclusively engaged in assisting Maryland consumers in obtaining loans. The court further stated that the Maryland legislature had intended the CSBA to prohibit payday lenders from partnering with non-Maryland banks to extend loans at rates exceeding the Maryland usury caps, and that it would undercut the purpose of the legislation to limit its application to loan marketers who receive direct payments from the borrowers beyond the payments made on the loan. In fact, the court said that CashCall's activities were exactly what the Maryland legislature had intended the CSBA to prohibit.

The court did, however, acknowledge that the CSBA only applies to loan marketers who provide their services "in return for the payment of money or other valuable consideration." In this regard, the court held that CashCall's right to receive principal, interest, and fees on the loans it purchased from the Funding Banks constituted adequate "consideration" for purposes of the statute. In fact, said the court, the overall arrangements between CashCall and the Funding Banks (under which the latter retained no economic interest in the loans) appeared to constitute a "rent-a-bank scheme" that "rendered CashCall the *de facto* lender." This latter statement is interesting to the extent it suggests that the Maryland courts may be willing, at least in some circumstances, to apply the "true lender" doctrine to loan marketers if the originating bank has no continuing economic interest in the loans.[371]

369 MD. COM. LAW § 14-1901(e).

370 *Gomez v. Jackson Hewitt, Inc.*, 427 Md. 128, 154 (2012) (emphasis added).

371 The practical reality is that a marketplace lender may not be able to solicit loans for a Funding Bank in excess of Maryland usury rates. The penalties may not affect the enforceability of the loan, but could impose the statutory penalties on the marketplace lender. The "Recent Developments" section discusses ongoing litigation in Maryland on these issues.

Takeaway: The court's decision potentially creates significant issues for marketplace lenders who partner with non-Maryland banks to offer consumer loans to Maryland consumers. First, the decision impacts licensing as it could require non-bank marketplace lenders to obtain credit services business licenses to market loans originated by a financial institution. The decision may also indicate that marketplace lenders need to adhere to the substantive provisions of the CSBA, including the prohibition on soliciting Maryland residents for loans at interest rates exceeding the applicable usury caps permitted under Maryland law (24%). Accordingly, the decision has implications for unlicensed entities that are marketing loans and/or for entities who solicit loans for others in excess of Maryland permissible rates.[372]

The licensing issues raised in the Maryland case have been renewed in a proceeding brought by the Maryland regulator against an out-of-state bank and its fintech partners. Claiming that the entities needed to be licensed under Maryland law, the regulator is seeking to void the loans. This case is discussed in the "Recent Developments" section.

Massachusetts—License Violations Yield $2 Million Penalty and Customer Reimbursement. On March 12, 2018, the Massachusetts Division of Banks entered a Consent Order against LendingClub and its subsidiary Springstone Financial, LLC based on failure to be properly licensed. The state regulator alleged that the marketplace lender was engaging in the business of being a third-party loan servicer and arranger of small loans for a fee without holding a servicer registration or small loan license.[373] As part of the Consent Order, LendingClub paid an administrative penalty of $2 million and agreed not to engage in licensable activities without having the necessary license.[374] In addition, LendingClub was required to reimburse consumers for any interest or fees on small loans arranged or serviced by LendingClub since August 1, 2011 that were in excess of the amount permitted under the state's small loan law. Some marketplace lenders only engage in activities related to loans greater than $6,000 in Massachusetts to avoid the small loan licensing requirement.

Caution: This enforcement action is a reminder that marketplace lending participants may be subject to various state licensing regimes and failure to obtain necessary licenses can result in fines and penalties and even, as in this case, customer reimbursement.

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

373 A small loan license is required under M.G.L. Ch. 140 Sect. 96 to arrange, negotiate, aid or assist a borrower or lender in procuring or making loans of $6,000 or less at a rate greater than 12% APR. That law applies to closed-end credit, but not open-end credit. Persons must register prior to acting as a third-party loan servicer in Massachusetts pursuant to M.G.L. Ch. 93 Sect. 24A.

374 As part of the proceeding, the marketplace lender obtained both a Massachusetts third-party loan servicer registration and small loan license.

New Hampshire—License Violations. Similar to the Massachusetts state regulator action above, the New Hampshire Department of Banking has recently entered into a number of consent orders with marketplace lenders for their failure to have a small loan license.[375] Under New Hampshire law, the definition of a small loan lender includes any person acting as a finder or agent for a lender or a borrower who assists in the arranging, finding or procurement of a loan.[376] The state regulator takes the position that making a website available to New Hampshire residents for the purpose of finding a loan implicates the licensing requirement. The consent orders have required marketplace lenders to either become licensed or cease and desist from small lending activity in the state, and has imposed fines and penalties for violations.

Activist Attorney General in Virginia. The Attorney General in Virginia has been active in pursuing online lenders, although most of this activity has been focused on predatory lending tactics. For example, in October 2017 the Attorney General reached a settlement with an online lender that advertised on its website that it was licensed by the state of Virginia and its Bureau of Financial Institutions, when it was not so licensed.[377] In addition to this misrepresentation, the lender was charging borrowers rates in excess of Virginia's general usury limit of 12%, which applies to unlicensed lenders. In November 2017, the Attorney General reached a settlement with a high-rate online payday lender charging triple-digit interest rates, imposing a $3 million penalty.[378] In February 2018, the State recovered $2.7 million from another online lender that claimed it was licensed by the state when it was not and was charging unlawful fees.[379] Also in February 2018, a six-figure settlement was reached with eight affiliated online lenders and debt collectors regarding an open-end credit program.[380]

Legislation Affecting Lead Generators—Vermont. In what could become a growing trend, Vermont enacted a law requiring various entities to obtain a loan solicitation license, including lead generators and others who engage in online marketing, loan comparison and making referrals to others.[381] It appears that the law applies to both consumer and commercial loans. The license is obtained through Vermont's Department of Financial Regulation. In addition to licensing, the law requires loan solicitors to make certain disclosures including that they are not the lender and that consumer information will be shared with others.[382] Many states' broker licensing laws are unclear as to whether technology firms such as lead aggregators or loan comparison websites must be licensed; however, Vermont has taken action to clarify its position with this new law, which took effect May 4, 2017.

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375 *See, e.g.*, N.H. Banking Department Consent Orders against Klarna Inc. d/b/a Klarna Credit (Nov. 8, 2017), Career Bridge Inc. d/b/a Career Bridge (Dec. 27, 2017).

376 N.H. R.S.A. 399-A-1. Small loans are loans of $10,000 or less with an APR of more than 10%.

377 *Commonwealth of Virginia v. Mr. Amazing Loans, Assurance of Voluntary Compliance* (Oct. 13, 2017).

378 *Commonwealth of Virginia v. Opportunity Financial, LLC, Assurance of Voluntary Compliance* (Nov. 30, 2017).

379 *Commonwealth of Virginia v. MoneyLion of Virginia LLC, Assurance of Voluntary Compliance* (Feb. 5, 2018).

380 *Commonwealth of Virginia v. Field Asset Service Team, LLC et al., Assurance of Voluntary Compliance* (Feb. 5, 2018).

381 H.182 (Act 22).

382 8 V.S.A. § 2220a.

Vermont Licensing Exemption for Business Lending. Vermont has enacted a broad law pertaining to loan solicitation which requires licensing of any loan solicitation or lead generation activity.[383] The law also allows the Commissioner of the Department of Financial Regulation to exempt from licensing certain categories of loans or service providers.[384] In September 2018, the Commissioner entered an order exempting from the statutory licensing requirements loan solicitation companies that partner with an FDIC-insured bank in making commercial loans.[385]

The state regulator noted that when loan solicitation activities are conducted online and in conjunction with an FDIC-insured bank, the loan solicitation company and activities are subject to supervision, oversight, regulation and examination by the bank's state and federal regulators.[386] As a result, the loan solicitation activities are monitored and managed by the bank, including regulatory guidance on third-party providers, and therefore sufficient protection is provided for commercial borrowers. Accordingly, the Commissioner exempted from licensing companies that partner with FDIC-insured banks to solicit commercial borrowers and where the bank extends the loan. However, the order noted that an exemption for consumer loans might not be appropriate due to greater restrictions and protections afforded to consumers.

More Sandboxes—Arizona, Wyoming, and D.C. In March 2018, Arizona became the first state in the country to enact legislation to establish a regulatory "sandbox" designed to help fintech companies test innovative products and services in a limited manner without total compliance with licensing or other applicable requirements.[387] Arizona has publicly announced that it is taking applications for this program.

On February 19, 2019, the Governor of Wyoming signed into law an act creating a financial technology sandbox for financial products and services in the state.[388] Upon application and receipt of a bond, specified statutes or rules may be waived to provide for the testing of new products and services. The program is limited to new innovations that cannot be made under current law.[389]

On January 23, 2019, the District of Columbia established a Financial Services Regulatory Sandbox and Innovation Council. The body will issue a report within six months concerning the feasibility of having a regulatory sandbox in the District of Columbia for financial products and services. The scope of the

383 8 V.S.A. § 2200(14). This law requires that persons who provide any assistance to lenders in connection with the making of loans (including through the Internet) obtain a loan solicitation license. Marketplace lending platforms would therefore be required to obtain a license in order to provide services to a Funding Bank for loans made to Vermont residents. In addition, the statute requires licensing for lead generation activities including the referral of Vermont borrowers to others for loans.

384 8 V.S.A. § 2200(17)(B)(vi).

385 Order of State of Vermont Department of Financial Regulation, *In Re: Licensing Exemption for Loan Solicitation Companies that Partner with FDIC Insured Banks to Extend Commercial Loans*, Docket No. 18-041-B (Sept. 18, 2018).

386 Citing, among others, the Bank Service Company Act, 12 U.S.C. § 1867(c).

387 H.B. 2434, codified at ARIZ. REV. STAT. § 41-5601–5612.

388 H.B. 57 (Financial Technology Sandbox Act), effective Jan. 1, 2020.

389 In September 2020, Wyoming chartered a new type of digital bank to engage in cryptocurrency transactions.

report includes blockchain and smart contract technology as well as financial, insurance and regulatory technology products and businesses.

S. State Business Loan Disclosure Laws

At least four states (California, New York, Utah, and Virginia) have enacted some form of consumer-like disclosures for commercial loan products, and each one of them is different. Congress and some other states are considering similar types of disclosure.[390] These laws will likely impact some marketplace lenders, making operations more difficult, and are a move toward patchwork regulation of business lending.

> Several states have enacted or are considering consumer-like disclosures for business loans and financings, sometimes including factoring and merchant cash advances.

1. California

In 2018 California was the first state to enact a business loan disclosure law.[391] Final regulations became effective December 9, 2022. Unique to the California provisions, the borrower would need to sign the disclosure, which requires disclosure of several things including total funds advanced, the total cost, the term, payments, and prepayment penalties. The law affects loans to $500,000 and exempts banks and real estate secured loans but applies to non-bank partners of exempt entities. The law reaches not just open-end and closed-end loans but also merchant cash advances, factoring arrangements, and asset-based lending transactions.[392]

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390 Other states considering legislation are Connecticut (S.B. 272), Maryland (S.B. 825), Missouri (S.B. 963), New Jersey (S.B. 819), New York (S. 1061-B), North Carolina (H.B. 969), and Pennsylvania (H.B. 1793). A proposal in Mississippi did not make it out of committee. On the federal level, legislation has been introduced to require APR disclosures on small business loans. H.R. 6054 and S. 3235, titled the Small Business Lending Disclosure Act of 2021 (Introduced 11/18/2021), is in committee at this writing.

391 S.B. 1235 enacted Sept. 30, 2018.

392 Some lenders are located in California and use a California governing law provision in their loan agreements. That fact could impose the disclosure requirements in all states using a California governing law provision. The law applies to Financing Law licensees, so out-of-state lenders holding a California license will at a minimum be subject to the requirements for their California portfolio of loans.

Merchant cash advances are contractual arrangements whereby merchants sell some portion of their future sales (accounts receivable) to the cash advance provider. A discussion of this type of financing is beyond the scope of this book but much of this business is conducted online and a separate body of law has developed in connection with these arrangements, largely in connection with litigation claiming such arrangements are loans rather than purchases and courts finding that they are valid sales where typically there is no credit recourse back to the merchant. *See, e.g., LG Funding v. United Senior Props. of Olathe*, 181 A.D.3d 664, 666 (N.Y. 2d Dep't 2020).

2. *New York*

The New York legislature passed a law requiring disclosures on a broad set of commercial-related financings up to $2.5 million.[393] Final Regulations were published, and compliance became mandatory, on August 1, 2023. Unlike California's law, the Empire State's provisions apply to brokers, but, similarly, the law also covers merchant cash advances and factoring. While banks are exempt, bank subsidiaries and affiliates are not. The disclosure requirements are similar to, but not the same as, those in California.[394] Unlike California, the New York law does not apply to technology service providers to exempt institutions.

3. *Utah*

In March 2022, Utah enacted the Commercial Financing Registration and Disclosure Act, effective January 1, 2023.[395] Unlike New York and California, Utah has imposed no APR disclosure requirement.[396] The law applies to loans up to $1 million. In addition to disclosures required to be made in other states, Utah requires disclosure of any costs or discounts associated with prepayments and disclosures of payment made to brokers. The law also contains a registration requirement and focuses on accounts receivable purchase transactions, commonly known as merchant cash advances. Specifically, the law covers a "provider," which exempts depository institutions and their subsidiaries or service corporations but includes a person with a written agreement with a depository institution that offers commercial financing products of that institution via an online platform. Given that several Funding Banks are located in Utah, this law affects online commercial lending programs made with a Utah-located Funding Bank. While the law places limits on the amount of civil penalties that can be imposed and does not appear to create a private right of action, it does specify that violations of the law will not affect the enforceability of the loan.

4. *Virginia*

In April 2022, Virginia enacted a law limited in scope to merchant cash advances or "sales based financing."[397] The law contains both disclosure provisions and registration requirements. The disclosures become effective on July 1, 2022 and registration is required by November 1, 2022 for existing providers. Apparently recognizing the difficulty in determining an annual percentage rate on

393 Codified at NY CLS Fin. Serv. Sec. 801-812.

394 New York requires disclosure of the amount of the loan as well as the amount disbursed to the borrower, finance charges including an APR, repayment terms, other fees, and any collateral securing the loan. Each state's law in complicated and there are some differing requirements for different kinds of financing products. A discussion of the specifics of those laws and the pending regulations is beyond the scope of this book, but business lending programs should carefully consider these laws and their potential implications.

395 Codified at UTAH CODE 7-27-101 *et seq*. (S.B. 183 enacted Mar. 24, 2022).

396 Interestingly, some fintech platforms testified at a hearing in Utah on the measure and asked lawmakers to include APR disclosures so that businesses would adequately compare loan terms.

397 H.B. 1027, enacted April 11, 2022.

merchant cash advance transactions, the law does not require disclosure of an APR but contains disclosure requirements of other terms, similar in content to those required under the New York law discussed above. In addition, the law prohibits the use of confession-of-judgment clauses, requires all actions to be in Virginia, and limits arbitration to the venue of the principal place of business of the merchant.

> California imposes disclosure requirements on commercial loans, including online platforms using a Funding Bank arrangement. So does New York and Utah. Virginia has requirements for merchant cash advance programs.

Attorneys General. Although several state attorneys general indicated that they would fill the gap if the CFPB slowed down its enforcement posture, making good on that pledge has not been obvious. Only a few states, including Pennsylvania and New Jersey, have announced plans to establish "mini-CFPBs" to focus on consumer protection issues. Maryland has created a Financial Consumer Protection Commission. Virginia has created a special unit targeting predatory lenders and has been active in enforcement, including actions against online unlicensed lenders.[398] Massachusetts is investigating the advertising and disclosure practices of a marketplace lender.[399] California enacted legislation to establish a mini-CFPB.

New York—Online Lending Report. In July 2018, the New York Department of Financial Services (*"NYDFS"*) issued its report on online lending, based in part on responses that the NYDFS received from questions it had posed to participants in the online lending industry. The report takes the position that the state's consumer protection laws and regulations should apply to all consumer and small business lending. This would mean that small business lending would be subject to consumer disclosure standards and other consumer-oriented laws. The report also took the position that the state's usury limits should apply to all lending in New York. The NYDFS stated that a borrower deserves to get the benefit of New York's protections whether they borrow from a bank, a credit union or an online lender. This appears to be a challenge to the federal preemption and rate exportations that many banks and marketplace lenders use for their programs. In fact, the NYDFS suggested that the usury rate be reduced from the current 16% to 7%, which would require more entities to become licensed (*i.e.*, loans at rates in excess of 7% would still be permitted, but only by licensed lenders). The NYDFS took aim at online lenders, asserting that the licensing of online lenders is needed, which would

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398 *See, e.g.*, *Commonwealth of Virginia v. NC Fin. Sols. of Utah, LLC* (Cir. Ct. Fairfax Co.), Civil Action No. 2018-06258 (filed Apr. 23, 2018) (action against out-of-state online lender not licensed in Virginia and using a Utah choice of law with no Utah connection).

399 In a regulatory filing, LendingClub Corp. disclosed that it had received a civil investigative demand in June 2018 from the Massachusetts Attorney General and is cooperating with the investigation.

allow for the state to supervise and provide oversight as to safety and soundness and consumer compliance of those entities.[400] Future legislative sessions may consider these proposals.

California Targets Lead Generators. The California Department of Financial Protection and Innovation has been aggressive in targeting lead generators for operating in the state without obtaining a broker license under the California Financing Law. That law requires a license to broker loans to a lender who is also licensed under the California Financing Law.[401] The state regulator has taken the position that websites offering loans that are sourced to California licensees or taking application information either directly or from other websites and relaying it on to other lenders for a fee should be required to obtain a broker license under that California statute.[402] The state specifically declared that collecting consumer loan applications or application data and forwarding it to a licensed lender for the purposes of making a loan is acting as a broker. Furthermore, under the California Financing Law, it is unlawful for a licensed lender to pay a fee to an unlicensed person for broker services. The state regulator has also brought actions against licensed lenders for paying unlicensed lead generators for leads and referrals.[403] A lender was cited for referring its declined applicants to other lenders for a fee if a loan was made without being licensed as a broker. It is anticipated that California will continue to monitor the activities of lead generators and licensees relative to online websites and loans for compliance with the licensing requirements under the California Financing Law.

The activities of lead generators are becoming subject to more scrutiny by regulators.

Enforcement Actions Target Lead Generators. Lead generators have also been subject to scrutiny in some of the largest states. In California, the former Department of Business Oversight (*"DBO"*) recently brought a number of actions against licensees under the California Financing Law[404] for paying unlicensed lead generators for referrals in violation of California regulations.[405] These actions have resulted in penalties and customer refunds. In one case, the DBO revoked a company's license for paying unlicensed entities for leads and loan referrals.[406] In the past, New York has also sanctioned lead generators.[407] Penalties and customer reimbursement were ordered by the NYDFS for

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400 The NYDFS Superintendent, in an October 2018 interview, indicated that the NYDFS was considering whether to impose new licensing requirements for online lenders operating through bank partnerships. That superintendent has subsequently left the NYDFS.

401 CAL. FIN. CODE § 22100.

402 *See, e.g., Desist and Refrain Order* (Zero Parallel, LLC Dec. 7, 2018) (selling of borrower data to lenders by means of a "ping tree").

403 *See, e.g., The Comm'r of Bus. Oversight v. Avant of California, LLC*, Consent Order, CFL File No. 603-K-124 (Jan. 31, 2019).

404 Legislation effective October 4, 2017 changed the name of California's licensing law from the California Finance Lender's Law to the California Financing Law.

405 CAL. CODE REGS, tit. 10, § 1451(c).

406 *The Comm'r of Bus. Oversight v. Wheels Fin. Grp., LLC et al.*, Settlement Agreement (Feb. 22, 2017).

407 *See, e.g., In re Blue Global, LLC et al.*, 2016 WL 1146396.

misrepresentations concerning the safety of personal information and for knowingly advertising and soliciting for loans in violation of New York's usury limits.

T. State Licensing

1. *Nevada—Commercial Lenders*

Nevada licensing rules have proved to be a stumbling block for online lenders. The Installment Loans and Finance Act[408] applies to both consumer and commercial loans and also applies to both lenders and those soliciting loans on behalf of lenders. The statute requires that the licensee have a physical location (brick and mortar) in Nevada.[409] This is, of course, problematic to entities conducting business totally online without any physical locations. However, under a law passed in 2019, some relief has been afforded to commercial brokers and lenders. The law exempted business lenders who only made loans via the Internet exempt from the requirement of having an in-state physical presence.[410] Entities needing licensing related to consumer loans are still subject to the location requirement, which remains problematic for marketplace lenders.

2. *Wyoming—Special Purpose Depository Institution*

Wyoming enacted legislation in 2019 that allowed for the creation of a "special purpose depository institution" targeted at fintech companies and innovation.[411] The state indicated that such banks would focus on digital assets such as virtual currencies, digital securities and utility tokens and resemble custody banks focusing on fiduciary, safekeeping, asset management and servicing. In September 2020, Wyoming granted the first charter for the special=purpose bank to Kraken Financial, which will be involved with cryptocurrency assets. While any deposits are not federally insured by the FDIC, this appears to make the company the first "digital bank" and provides access to the payment systems.

3. *Pennsylvania—Technology Provider Does Not Require License*

In good news for technology service providers, a Pennsylvania court decided that the provider of technology that provided information about the transmission of money but did not actually engage in the transmission of money was not required to have a money transmitter license under the state's Money Transmitter Act.[412] The technology collected payment information and sent it to a processor. While there was transmission of information related to the payment process, that type of transmission

408 NEV. REV. STAT. 675.

409 NEV. REV. STAT. 675.090.

410 The drafting of S.B. 161 was somewhat confusing as it defined the term "Internet Lender" but intended this to cover only those entities subject to licensing relating to commercial loans. This was clarified by an Order of the Department of Business & Industry Financial Institution Division on June 26, 2020, stating that the exemption applied only to commercial loans, not to consumer loans.

411 H.B. 74.

412 *Givelify LLC et al. v. Pennsylvania Dep't of Bkg. and Fin.*, Case No. 329 CD 2018 (Pa. Commw. Ct. 2019).

was not the transmission of the money itself according to the court ruling. The court proceeding was in response to the state regulator's action against the company to obtain a license as being an indispensable part of the money transmission process. But the company never touched any money itself so was found not to be subject to the requirements of the statute.

4. *California—Significant Regulatory Events*

As California is a large, populous state, its regulation affects most marketplace lenders.

In September 2020, California enacted the California Debt Collection Licensing Act.[413] The law became effective January 1, 2022 and requires licensing by the DFPI of any person or entity engaged in debt collection with California residents, including those collecting debt on their own behalf.[414] The scope of the law is quite broad and covers any act or practice in connection with the collection of consumer debt. In addition to fee, reporting, and surety bond requirements, licensees must develop policies and procedures compliant with the law and be subject to examination. It is emphasized that this law requires a license for lenders collecting their own debt (*i.e.,* first-party collection activity).[415] It would also cover entities that are servicing loans for others, including platforms that engage in servicing for Funding Banks, investors, or loan assignees. This law is a reminder that participants in marketplace lending may be subject to various state licensing requirements in order to market, purchase, or service loans.[416]

a. *California Requires Licensing for "Buy Now Pay Later" (BNPL) Programs*

A current "rage" in online shopping is providing the option of "buy now pay later," or BNPL. This was a concept that became quite popular in Australia and has found its way to the United States. In the typical scenario, a purchaser is able to split the purchase price (without incurring any interest charges) into up to four installments. The primary reason for this is that the federal Truth in Lending Act and its disclosure obligations only apply to situations where either a finance charge is imposed or the deferral of payment is incurred in more than four installments.[417] The business model provides for retailers to be paid upfront, which is attractive to them and similarly appealing to consumers who can

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413 S. B. 908, codified at CAL. FIN. CODE 100000 *et seq*.

414 A separate California law remains applicable to the practices of those collecting debt: the California Rosenthal Fair Debt Collection Practices Act. CAL. CIV. CODE 1788 *et seq*.

415 FDIC-insured banks including out-of-state banks and California Financing Law licensees are excluded from the requirement of obtaining a debt collection license. But the law allows the DFPI to take action against exempt entities for violations of the debt collection practices law.

416 There is a discussion of licensing in the "Regulatory Issues" section of this book.

417 12 C.F.R. 1026.1(c).

purchase products without making full payment. While some of the providers claim that these are not loans, California has taken a contrary position.

On December 19, 2019, the Department of Business Oversight (the *"DBO"*), now called the Department of Financial Protection and Innovation, the California regulator, issued a pronouncement in response to a request that BNPL products (referred to as *"deferred payment products"*) were loans requiring a license to conduct a BNPL business under the California Financing Law.[418] The state maintained that the BNPL product consisted of an online contract where a customer is delivered a sum of money and agrees to pay it back at a future time. That meets the definition of a loan under CAL. CIV. CODE 1912. The letter did not find any exemptions that would be applicable.

In September 2019 a BNPL company applied to the DBO for a California Financing Law license. Upon investigation, the DBO found that the company had already been engaging in transactions without a license and initially denied the license application on December 30, 2019. The BNPL company asserted that the transactions constituted credit sales which under California law are not loans. The DBO found otherwise. Where the role of third-party financing parties is extensive, substance trumps form and the credit sale constitutes a loan. The DBO found that the BNPL company marketed financing prior to any shopping and that the credit arrangement was with the BNPL provider not the retail merchant. Therefore it was a loan. However, the state and the BNPL provider came to a settlement where the BNPL company was fined over $28,000 for operating without a license and required it to refund some $282,000 to 17,000 customers representing fees charged in the transactions the DBO deemed to be illegal. In addition, the BNPL company was required to obtain a California Financing Law license.[419]

In March of 2020 the DBO entered into a similar Consent Order with another BNPL company for similar violations, obtaining a fine of over $90,000, exacting customer refund of late fees of over $900,000 and requiring licensing of the company.[420] Similarly, in April 2020, the DBO and another BNPL company entered into a Consent Order.[421] There, a fine of $68,556 was extracted plus 10% of late fees paid by customers and customer refunds were mandated of over $685,000. Again licensing was required.

BNPL companies as well as other financing participants should be aware of these developments by the California DBO. Where third-party involvement with a merchant goes beyond something needed to purchase credit sales, as is generally the case with BNPL programs, California (and perhaps other states as well) will treat these as loans. California will also find a loan if the role of the third party or terms of

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418 Cal. Dep't Bus. Oversight Op. 7667 (Dec. 20, 2019) (Deferred Payment Products), https://dbo.ca.gov/wp-content/uploads/sites/296/2019/12/Deferred-Payment-Products-cfl.pdf

419 *In re Sezzle, Inc.*, No. 60DBO-104155 (Cal. Dep't Bus. Oversight Jan. 6, 2020) (Consent Order), https://dbo.ca.gov/wp-content/uploads/sites/296/2020/01/settlement-sezzle.pdf

420 *In re Afterpay, US Inc.* (Cal. Dep't Bus. Oversight Mar. 16, 2020) (Consent Order), https://dbo.ca.gov/wp-content/uploads/sites/296/2020/03/afterpay-settlement.pdf

421 *In re Quadpay, Inc.* (Cal. Dep't Bus. Oversight Apr. 22, 2020) (Consent Order), https://dbo.ca.gov/wp-content/uploads/sites/296/2020/04/Quadpay-Consent-Order-Final.pdf

the transaction are not fully disclosed to consumers or where the third party does not bear the full risk of non-payment.

b. Disclosure Requirements for Commercial Lending Transactions

In 2018, California passed SB1235, making it the first state to impose disclosure obligations similar to consumer disclosures under the federal Truth in Lending Act, but related to commercial financing transactions. The disclosures became effective after final regulations were issued by the California Department of Business Oversight on December 9, 2020.

The scope of the disclosures not only includes traditional loans and lines of credit but also extends to a broad array of commercial transactions, including factoring, lease financing and merchant cash advances. Disclosures would be required for transactions from $5,000 up to $500,000. Although depository institutions such as banks are excluded from complying with the law, non-banks and fintech companies working with Funding Banks that market loans via an online lending platform would be required to make disclosures. Therefore, companies conducting originations on behalf of banks online are not encompassed with the exemption provided to the bank.[422] Transactions secured by real property are also exempt from the law.

The regulations prescribe formatting and content requirements and set out model forms for six types of commercial transactions. One of the important issues involved in the rulemaking is how the cost of credit is determined. The proposal provides for calculation of an annual percentage rate and would in some cases allow the use of estimates; however, if estimates are used, self-audits would need to be conducted to verify the accuracy of the estimates.

Other states looked to California as a model and already New York, Utah, and Virginia have enacted, and other states are looking to enact, a commercial disclosure law, the importance of the California rules cannot be underestimated. If handled reasonably, they could serve as a model. But if not, the stage would be set for another patchwork of state regulation of disclosures for commercial transactions. While the laws are similar, there are differences.[423]

c. California to Create Mini-CFPB

On the last day of August 2020, the California Legislature passed Assembly Bill 1864. This legislation creates a new consumer protection regime and changes the name of the financial regulator (the DBO,

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422 This is probably not as important in the commercial arena where Funding Bank programs are not as prevalent as they are in consumer lending. In part this is because, as a general rule, there are fewer usury restrictions applicable to commercial lending, which in many states is already deregulated with no rate ceiling. There is also favorable legal precedent allowing commercial transactions to be subject to a governing law provision so long as there is a reasonable relationship to the jurisdiction chosen and it does not violate public policy. Restatement Contracts (Second) Sec. 187.

423 Georgia has enacted a law and legislation is pending in Illinois, Kansas, Mississippi, and Missouri.

or Department of Business Oversight) to the Department of Financial Protection and Innovation (the *"DFPI"*).

It has been dubbed a "mini-CFPB" in part because one of the architects of the law was former CFPB Director Richard Cordray and one of the law's major tenets is giving the new agency UDAAP (unfair, deceptive and abusive acts and practices) authority. The agency could define what is abusive and, unlike its federal counterpart, it has authority over commercial financing transactions such as merchant cash advances, factoring and leasing. The law also expands the enforcement power of the agency and allows additional penalties. Financial institutions and existing licensees would be exempt from the law, but new licensees would not. This sets up a dual system applicable to when one became a California licensee.

Another provision would require registration as prescribed by the agency to companies that are not currently subject to any requirements such as technology service providers, credit reporting agencies, payment processors and providers of ancillary products and services. California enacted a law to require licensing of debt collectors which became effective on January 1, 2022. Since the agency would be funded by fines and settlements or judgments, it is anticipated that an aggressive posture will be taken in order to impose and collect such penalties.

Other Licensing Considerations. The issue of licensing is always relevant to marketplace lenders. As discussed earlier, licensing may be required of marketplace lenders in order to market, service or take assignment of loans. These licensing requirements are imposed regardless of whether the marketplace lender is acting on its own or on behalf of a Funding Bank. Although licensing is based on the laws of the individual states, some recent cases have addressed licensing issues and have sought to expand licensing to other participants in marketplace lending transactions.

> Marketplace lenders must assess their business model in order to adhere to applicable state licensing requirements.

One question that often arises in marketplace lending is whether loan purchasers, investors or securitization trusts need to be licensed under state law. This issue arose in Maryland, where the question was raised whether securitization trusts needed to be licensed as state collection agencies. In August 2018, the Maryland Court of Appeals determined that the state collection agency law does not require a statutory trust acting as a securitization vehicle to obtain a license as a debt collection agency, overturning contrary decisions of the lower courts.[424]

Conversely, a debt collector who purchased defaulted loans moved to dismiss a complaint claiming that it needed to be licensed as a consumer lender under New Jersey law. The New Jersey statute

424 *Blackstone v. Sharma; Shanahan v. Marvastian; O'Sullivan v. Altenburg and Goldberg v. Neviaser*, Case No. 040, Sept. Term 2017 (Md. Ct. App. Aug. 9, 2018) (consolidated cases dealing with mortgage servicing).

contains language stating that one who directly or indirectly engages in the business of buying notes must be licensed as a consumer lender. On that basis, the action was not subject to dismissal.[425]

In yet another action against CashCall, New Hampshire issued a cease and desist order for lending without a license. CashCall filed a motion to dismiss which was denied and appealed to the New Hampshire Supreme Court. The state court found that the Department of Banking had jurisdiction over CashCall. The Department denied a motion to transfer the action to state court and is proceeding against the payday lender for failure to hold a license.[426]

Lending on Digital Asset Collateral. Recently, some digital asset[427] businesses, many of which operate primarily or solely online, have desired, attempted or engaged in lending to their digital asset customers, typically on a secured basis, at some percentage of their digital asset account balance, and secured by the digital asset as collateral.

We note that programs related to lending, even if secured by underlying digital asset accounts, remain subject to all applicable lending laws and regulations. In the consumer realm, such programs are subject to the licensing, usury and consumer protection law requirements described in this book.

Other new and innovative programs are likely to emerge that will raise novel legal issues or require the application of existing law to those new activities.[428]

> Digital asset lending requires compliance with applicable laws including licensing and usury.

III. 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

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425 *Tompkins v. Selip & Stylianou LLP et al.*, Case No. 2:18-cv-12524 (D.N.J. Feb. 11, 2019) (dismissed by Court Order Aug. 14, 2019). *See also, Barbato v. Greystone Alliance, LLC et al.*, 916 F.3d 260 (No. 18-1042) (3rd Cir. Feb. 22, 2019). There the court found that a debt buyer who outsources collection activities to a third party is still a debt collector under federal law. Although not dealing with online lending per se, this case stands for the proposition that one who meets the definition of a debt collector may need to be licensed under state law even if it outsources collection activities to a third party.

426 *In re State of New Hampshire Banking Dep't v. CashCall, Inc. et al.*, 2018 WL 3570104 (N.H. Banking Dept. Case No. 12-308 June 14, 2018). The parties entered into a settlement in March 2019 requiring payment of a fine of over $188,000 and customer restitution to recast loans at a 36% APR.

427 We use the term "digital asset" to describe a broad set of digital representations of value or rights. Generally speaking, we are referring to cryptographically secured assets that include cryptocurrencies, which are mediums of exchange native to a blockchain or similar distributed network, and cryptographically-secured tokens launched on top of such networks. For example, bitcoin is a cryptocurrency network, while the "initial coin offerings" made somewhat popular in 2017 were largely tokens issued through smart contracts on the Ethereum network.

428 For example, a fintech startup claimed that it would offer savings and checking accounts that would be federally insured by the Securities Investor Protection Corp. This was not true as SIPC covers only brokerage accounts and not savings or checking accounts. The program was abandoned as a result.

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 significantly changed the regulation of the consumer credit market by establishing the Consumer Financial Protection Bureau, which can bring enforcement actions for unfair, deceptive, or abusive acts or practices. Since marketplace lending is Internet-based, special consideration must be given to legal requirements that allow for electronic contracting and consent to receive disclosures electronically and requirements related to customer authorization for making payments electronically from their bank accounts. This section discusses some of the principal consumer protection laws that marketplace lenders will need to consider for program regulatory compliance purposes.

A. Truth in Lending Act

The federal Truth in Lending Act (*"TILA"*) and its implementing Regulation Z[429] require lenders to provide borrowers with standardized and understandable information concerning certain terms and conditions of their loans and certain changes in the terms of the loans.[430] The TILA disclosure requirements will apply to the Funding Bank or licensed entity that is the named lender of each Borrower Loan. In addition, borrowers are generally permitted to assert some types of 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.[431] 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 lenders or investors. Each platform 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 TILA requires.

TILA and Regulation Z impose certain substantive restrictions and significant disclosure requirements in relation to certain other categories of loans.[432] TILA also applies to advertising of loans. Most

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429 15 U.S.C. § 1601 *et seq.* and 12 C.F.R. pt. 1026.

430 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 book.

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

432 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

websites are likely to be considered advertising. Thus, marketplace lenders must comply with TILA advertising requirements regardless of whether a Funding Bank is involved or not. Most important, if certain "triggering" terms are used (such as the term of a loan or interest rate), other disclosures must be made. Many Borrower Loans are installment or closed end loans. The disclosure and other requirements applicable to closed end loans are different from those that apply to revolving or open end loans. Special rules apply to private student loans, home equity loans and lines of credit and credit card products under Truth in Lending. Based on the type of loan involved, the disclosure and other requirements may differ.[433]

B. FTC Act, UDAP Laws, and the CFPB's UDAAP Authority

Marketplace lenders must comply with Section 5 of the Federal Trade Commission Act (*"FTC Act"*),[434] which declares as unlawful any unfair or deceptive act or practice in or affecting commerce. The FTC has traditionally undertaken enforcement actions related to advertising and marketing practices. In addition, of particular importance is the Credit Practices Rule that the FTC has adopted thereunder to protect consumers against abusive terms and conditions in credit contracts. Among other requirements, the Credit Practices Rule prohibits loan agreements from including terms that:

- 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);[435]
- Assign to the creditor the borrower's wages or earnings unless (a) the borrower may revoke the assignment at any time, (b) the assignment is a preauthorized payment plan established at the time the debt is incurred, or (c) the assignment applies only to wages or earnings already earned at the time of the assignment; or
- Pyramid late charges (*i.e.,* impose multiple late charges based on a single late payment).

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

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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.

433 A full discussion of the Truth in Lending Act is beyond the scope of this book. However, all online lending programs will be subject to this law and care should be taken to ensure compliance since even technical violations can lead to the imposition of statutory damages, actual damages, attorneys' fees and costs, all of which in the aggregate could be significant.

434 15 U.S.C. § 45.

435 A contractual waiver is not prohibited if it is restricted to property pledged as collateral for the debt.

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

Marketplace lenders, Funding Banks, and loan servicers may also be required to comply with certain state laws that prohibit unfair and deceptive acts and practices (*"UDAP Laws"*). Some provisions of UDAP Laws that may be applicable to marketplace lenders include specific disclosure requirements related to the terms of loans, prohibitions on excessive prepayment penalties, and the availability to borrowers of certain causes of action and remedies.[436]

The Dodd-Frank Act mandated the establishment of the Consumer Financial Protection Bureau and authorized the CFPB to adopt rules prohibiting unfair, deceptive, and abusive acts or practices (*"UDAAP"*) within the consumer finance market under (amongst other laws) TILA, ECOA, FCRA, FDCPA, and EFTA (each as defined below). The CFPB has not issued regulations regarding unfair, deceptive, or abusive practices, but it has articulated certain standards to assist entities in identifying whether an act or practice is unfair, deceptive, or abusive.[437] In addition, the CFPB has used enforcement actions to articulate its UDAAP standards and define the scope of that authority. The CFPB has attempted to characterize the abusive standard as one where consumer harm outweighs consumer benefit, but the current CFPB is embarking on an activist agenda with respect to UDAAP.

Case in Point—<u>Prefilled Drop-Down Box</u>. In May 2015, the CFPB filed a complaint and consent order in the U.S. district court in Maryland against PayPal, Inc., and its subsidiary, Bill Me Later, Inc., related

436 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 TILA, ECOA, and EFTA includes its own standard for preemption of state laws.

437 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.

to unfair and deceptive practices in the financing of Internet-based purchases.[438] One of the practices the CFPB complained of was the prefilling of drop-down boxes by the companies. The use of such prefilled drop-down boxes resulted in customers being signed up for financing or payments that they did not want or intend. This CFPB enforcement action served as guidance that in documents, forms, and disclosures on a website or Internet platform, boxes should not be prefilled or pre-checked but should rather allow the borrower to make an informed and independent choice after full disclosure of the options.

C. Fair Lending and Related Laws

Equal Credit Opportunity Act. The Equal Credit Opportunity Act (*"ECOA"*)[439] prohibits lenders from taking any action related to any aspect of a credit transaction, including making any credit determination, on the basis of the applicant's race, color, sex, age (except in limited circumstances), religion, national origin, or marital status; the fact that all or part of the applicant's income derives from any public assistance program; or the fact that the applicant has in good faith exercised any right under the federal Consumer Credit Protection Act or any applicable state law (*"Prohibited Bases"*).[440] The ECOA applies during all aspects of the credit transaction, including advertising, the application and approval process, and servicing and collection activities. For example, a lender's credit scoring systems must not be discriminatory. When determining whether to approve or deny a loan application, a creditor may use either an empirically derived and demonstrably and statistically sound credit scoring system, a judgmental system, or a combination of the two. The lender must validate and periodically revalidate its credit scoring system to ensure that it does not have a disparate impact on protected classes. In addition, if an applicant is denied credit or the cost of credit is increased, the ECOA requires that the lender provide an adverse action notification to the applicant.

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.[441] In addition, the criteria used to determine creditworthiness must not have a disparate

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

439 15 U.S.C. § 1691. Regulation B implementing the ECOA is found at 12 C.F.R. pt. 1002.

440 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.

441 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. Some state laws expand the scope of a prohibited basis such as to handicapped individuals.

impact on the basis of any Prohibited Basis.[442] Notably, the ECOA applies to commercial as well as consumer lending. Regulators including the CFPB are extensively scrutinizing fair lending practices.

Fair Lending—Loan Purchasers. Although not an action involving marketplace lending, a recent Fifth Circuit decision may have positive implications for purchasers of marketplace loans.[443] Discrimination claims under the Equal Credit Opportunity Act (*"ECOA"*) were brought against Wells Fargo as a purchaser of loans made by AmeriPro Funding, Inc. Wells Fargo would not purchase loans that were made to borrowers receiving public assistance as income, and the plaintiffs alleged that this practice violated the ECOA. The CFPB participated in the case and advocated that the ECOA covers secondary market players such as loan purchasers. However, the Fifth Circuit disagreed. While the plaintiffs could sue AmeriPro Funding as the creditor, the court ruled that they could not bring ECOA claims against a loan purchaser based on an arm's-length transaction in the secondary market. The U.S. Supreme Court declined to hear an appeal of the case. This decision potentially protects secondary market loan purchasers from claims asserted under the ECOA.

An online lender entered into a settlement with the Department of Housing and Urban Development in connection with alleged violations of the Fair Housing Act.[444] The lender was accused of failing to make loans because the real properties at issue were located on Indian reservations and therefore constituted discrimination under fair lending laws based on race. The online lender paid a penalty of $240,000 and agreed to revise policies and practices concerning doing business with property located on Indian reservations.

Fair Credit Reporting Act. When reviewing a loan application, a marketplace lender will typically rely on a "consumer report" as defined in the federal Fair Credit Reporting Act.[445] Often, this will be a

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442 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 stated that one of its goals for 2017 was to enforce fair lending in the small business lending sector. Under Section 1071 of the Dodd-Frank Act, the CFPB is also charged with writing rules on data collection on small business loans. This is potentially similar to the data collection for consumer loans under the Home Mortgage Disclosure Act, ostensibly to identify whether there is discrimination in lending to women and minorities and on any other Prohibited Basis. The CFPB changed consumer rules to enlarge the amount of data collection required under that law. For commercial lenders, including marketplace lenders, the potential impact is at least twofold. First, systems will need to be developed and implemented to collect the data the CFPB will require. Second, as with the consumer data, such data will be publicly available, and in the case of consumer lending such publicly available data has led to litigation. Since the ECOA is designed to be neutral, the collection of data is potentially in conflict with the law. To alleviate this concern, the persons collecting the data must be separate from anyone involved in the underwriting or credit decision process. This rule will undoubtedly pose some compliance challenges for commercial lenders.

443 *Alexander v. AmeriPro Funding, Inc.*, No. 15-20710 (5th Cir. 2017), *cert. denied*, U.S. No. 16-cv-01395 (Nov. 6, 2017).

444 "Conciliation Agreement" in FHEO Title VIII Case Nos. 08-17-5267-8 and 08-18-6949-8.

445 15 U.S.C. § 1681; 12 C.F.R. pt. 1022. Under the law, a person must have a "permissible purpose" to obtain a credit report on a consumer. While typically a loan application provides that permissible purpose, inquiries to credit reporting agencies prior to making an application may be subject to scrutiny or challenge. Typically, lenders are also furnishers of information to the credit bureaus and the FCRA imposes obligations upon the complete and correct furnishing of information. Obligations are also imposed related to inquiries or disputes of credit bureau information and the correction thereof. These issues have become of greater importance as several notable data breaches have occurred which have potentially compromised customer personal or credit information. Issues can also arise when platforms are accessing consumer report

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

Case in Point—"Hard" vs. "Soft" Credit Inquiries. In August 2016, a California federal judge approved a $2.4 million settlement in a class action lawsuit against Social Finance Inc., an online lender.[446] The complaint alleged that the lender claimed only soft credit inquiries (which generally do not affect a credit score) would be made on the applicants, when in fact hard inquiries were made (which can negatively affect credit scores). The action was based on the FCRA and similar California laws.

Use of Alternative Data for Credit Underwriting. Looking beyond more traditional sources of information like consumer reports, the Internet provides access to new sources and types of information on credit applicants, including through social media channels. It has been widely reported that some lenders are using information obtained from social media to determine the creditworthiness of loan applicants.[447]

Incorporating the use of social media data into a lender's underwriting criteria raises fair lending compliance issues. A lender that desires to use social media data in its credit scoring system must establish that the data used is predictive of an applicant's creditworthiness. If social media data is used as a basis to deny an application, the adverse action notification needs to reflect that. Lenders need to ascertain whether the information obtained from social media channels is accurate and reliable since such channels are not consumer reporting agencies subject to FCRA requirements, and confirm that their use of social media data in credit decisions will not result in an unfair, deceptive, or abusive act or practice. Further, lenders should ensure that unfair treatment does not occur for applicants who do not use social media.[448] Finally, a lender that uses social media data may obtain information about an

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information on behalf of Funding Banks requiring authorization for those service providers to obtain that information. A full discussion of this law, as with other consumer protection laws, is beyond the scope of this work.

446 *Heaton v. Soc. Fin., Inc.*, Case No. 14-cv-05191-TEH (N.D. Cal. 2016).

447 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."

448 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.

applicant that it is prohibited from acquiring and using as part of its credit decision under the ECOA, thereby impacting its fair lending compliance.

***Spokeo*, Standing and Actual Harm.** In 2016, the U.S. Supreme Court ruled in the *Spokeo* case that in order to have standing to sue, a plaintiff must have suffered a concrete, particularized injury from the alleged statutory violation.[449] The Supreme Court remanded to the Ninth Circuit to determine if the plaintiff, whose claims were based on violations of the Fair Credit Reporting Act (*"FCRA"*), had suffered such an injury so as to confer standing to sue. In August of 2017, the Ninth Circuit on remand found that the mere placement of incorrect information about a person in a consumer database did in fact constitute a concrete injury and violated the FCRA.[450] Spokeo appealed the Ninth Circuit's decision to the Supreme Court, but the Supreme Court denied the petition without comment.

> **Why It Matters:** The issue of standing is important in the context of consumer protection statutes because many are technical in nature, and clarifying what is required in order to demonstrate a concrete injury could have the effect of limiting the claims that plaintiffs may bring against lenders and other providers of consumer financial products and services.

The doctrine of standing as espoused by the *Spokeo* decisions has been litigated in numerous consumer protection statute cases, even with virtually the same facts resulting in conflicting decisions.[451] The amount of litigation related to standing is staggering and appears in many, if not most, consumer finance cases.[452] Following the Ninth Circuit's remand decision, plaintiffs will continue to assert that a technical statutory violation is injury enough to allow the bringing of the lawsuit. Defendants will continue to claim that something more, *i.e.*, an actual injury to the plaintiff, is required to create standing to sue. The saga will undoubtedly continue until the Supreme Court decides to take up the

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449 *Spokeo, Inc. v. Robins,* 136 S. Ct. 1540 (2016), *as revised* (May 24, 2016).

450 *Robins v. Spokeo, Inc.*, 867 F.3d 1108 (9th Cir. 2017), *cert. denied,* 138 S. Ct. 931 (Jan. 22, 2018).

451 Employers will often ask prospective employees to provide a credit authorization to obtain a credit report. The FCRA requires that such a provision be contained in a separate, stand-alone document. In a situation where an employer provided the authorization along with other information, a technical violation of the FCRA, one circuit court has found the practice permissible and that the technical violation would not convey standing to sue. *See, Groshek v. Time Warner Cable,* 685 F.3d 864 (7th Cir. 2017). Meanwhile, another circuit on virtually identical facts has found that the statutory violation will result in injury and standing. *See, Syed v. M-I, LLC,* 846 F.3d 1034 (9th Cir. 2017). Note: As employers, marketplace lenders should review the FCRA to ensure that the practices they employ to obtain credit authorizations from prospective employees comply with the statute.

452 Standing is often an issue when there has been a data breach, potentially resulting in the compromise of personally identifiable nonpublic information. Again, there are conflicting court opinions. One federal circuit holds that the breach itself results in injury because there is a risk of being subject to identity theft, which is sufficient to bring a claim. *See, In re Horizon Healthcare,* 2017 WL 242554 (3d Cir. 2017). Another circuit has found that there must be allegations or proof that the data is in fact at risk, *i.e.*, the breach itself is not enough to convey standing. *See, Gubala v. Time Warner Cable, Inc.,* 2017 WL 243343 (7th Cir. 2017). Given recent large data breaches, these issues can be of material importance to the companies involved.

question of standing, which it did in a recent decision referenced in the "Recent Developments" section of this book.

***Further Thoughts on* Spokeo*, Standing and Actual Harm under Consumer Protection Statutes*.** As summarized above, the *Spokeo* decision made ripples in the industry—though the ripples were not as large as some may have hoped. The central issue in *Spokeo* was whether the plaintiff had standing for a claim under the Fair Credit Reporting Act if he could not show that any actual harm arose from the alleged statutory violation. While the Supreme Court ultimately answered this question in the negative, its holding was narrow and thus unlikely to have the effect of limiting potential claims under a variety of consumer protection statutes—particularly those that are often the basis of class actions.[453]

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

Because *Spokeo* did not create any new law and simply restated the requirements for standing, it has not been able to be applied in the way many companies had hoped. Courts have been inconsistent in applying *Spokeo* to a number of federal consumer protection statutes. For example, while in some instances TCPA cases have been dismissed on *Spokeo* grounds, many other courts have found sufficient injury based on invasion of privacy, or even *de minimis* costs, like the amount it costs to charge a cell phone battery drained by receiving unwanted telephone calls, or time spent answering unwanted phone calls.[454] Similarly, courts have been split when reviewing Fair Debt Collection Practices Act (*"FDCPA"*) claims, where some courts have asserted that a bare FDCPA violation alone constitutes a violation of a right that Congress sought to raise to the level of a concrete injury.[455] However, many

453 Many of these statutes affect marketplace lenders, including the Truth in Lending Act, the Electronic Funds Transfer Act, the Fair Credit Reporting Act, and the Telephone Consumer Protection Act.

454 *Mey v. Got Warranty, Inc.*, No. 5:15-CV-101, 2016 WL 3645195, at *3 (N.D.W. Va. June 30, 2016).

455 *Church v. Accretive Health, Inc.*, No. 15-15708, 2016 U.S. App. LEXIS 12414 (11th Cir. July 6, 2016).

others have disagreed, requiring an additional showing of some injury.[456] The trend continues with courts reviewing TILA claims.[457]

The Ninth Circuit heard oral arguments in December 2016 on whether the plaintiff had actually alleged the kind of injury that would allow his suit to proceed. In August 2017, the Ninth Circuit issued its decision, finding that the mere placement of wrong information about a person in a consumer database constituted a concrete injury and violated the FCRA. The U.S. Supreme Court refused to hear an appeal. As a result, *Spokeo* ultimately did not bring much clarity to the question of standing in consumer protection statute cases and this issue will likely remain unsettled until further litigation resolves it. Many cases have brought both claims and defenses based on this case and it continues to be a legal issue in many consumer protection-type cases. Nonetheless, the decision provides a potential defense to claims brought under consumer financial protection laws.

Standing. In many consumer finance cases, the question arises as to whether a mere violation of the statute is a sufficient enough injury to create standing to sue. This was considered in a recent Supreme Court decision dealing with the Fair Credit Reporting Act.[458] The plaintiff was denied a loan due to an alert placed on his credit file. The suit alleged a class of persons subject to this alert, which numbered about 8,000; however, only about 1,850 customers had these alerts disseminated outside the credit bureau. The court found that these persons had no basis to assert standing. The court ruled that if there is no concrete harm, there is no standing to sue. The court indicated that the risk of possible future harm was also not enough of an injury to create standing. FCRA actions are oftentimes brough in the context of data breach situations. Therefore, this decision may be an important precedent in either deterring or limiting litigation where there is no evidence of injury or only the potential for future harm.

Servicemembers Civil Relief Act. Another fair lending consideration is the potential application of the Servicemembers Civil Relief Act (*"SCRA"*).[459] The SCRA, applicable to all lenders, 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

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456 *Nokchan v. Lyft, Inc.*, No. 15-cv-03008, 2016 U.S. Dist. LEXIS 138582 (N.D. Cal. Oct. 5, 2016) ("not follow[ing] *Church*"); *Macy v. GC Servs. L.P.*, No. 3:15-cv-819, 2016 U.S. Dist. LEXIS 134421, at *8 n.3 (W.D. Ky. Sept. 29, 2016) (finding that it "does not share the *Church* panel's expansive reading of *Spokeo*"); *Dolan v. Select Portfolio Servicing*, No. 03-CV-3285, 2016 U.S. Dist. LEXIS 101201, at *20 n.7 (E.D.N.Y. Aug. 2, 2016) ("respectfully disagree[ing] with *Church*" and "reject[ing] the view that *Spokeo* established the proposition that every statutory violation of an 'informational' right 'automatically' gives rise to standing").

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

458 *TransUnion v. Ramirez*, 141 S. Ct. 2190 (2021). Decided June 25, 2021.

459 50 U.S.C. § 501 *et seq.*

duty.[460] In the loan servicing context, it is important to have procedures to ensure SCRA compliance so that servicemember benefit requests are properly handled and monitored on an ongoing basis. Regulatory agencies, including the CFPB, continue to enforce the SCRA.

Military Lending Act. The Department of Defense (*"DOD"*) issued a final rule imposing new requirements under the Military Lending Act, which took effect in October 2016 (the *"MLA Rule"*).[461] The MLA Rule is not specific to marketplace lending, but it applies to most unsecured consumer credit transactions and therefore implicates the practices and procedures of many marketplace lenders.

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

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

CFPB Expanded Oversight of Small Business Lending. On May 15, 2017, the CFPB published a Request for Information on the small business lending market.[462] Many had speculated that the CFPB would make moves to expand its jurisdiction to small business lending, as then-Director Richard Cordray had publicly commented that his preference would be for the CFPB to protect both consumers and small businesses since both operate similarly in the marketplace.[463] The CFPB has the ability to exercise jurisdiction over small business lenders through the data collection provision mandated by Dodd-

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

461 80 FR 43560 (Jul. 22, 2015).

462 *Request for Information Regarding the Small Business Lending Market*, 82 Fed. Reg. 22318 (May 15, 2017).

463 The Semi-Annual Report of the Bureau of Consumer Financial Protection: Hearing Before the House Committee on Financial Services, 114th Cong. (2016) (testimony of Richard Cordray, Director, Consumer Financial Protection Bureau).

Frank, which amended the Equal Credit Opportunity Act by adding a requirement for lenders to collect and maintain loan data for women-owned, minority-owned and small business credit applicants.[464] The CFPB is the sole agency responsible for overseeing this requirement for all financial institutions regardless of their size or primary regulator,[465] thus permitting CFPB oversight of smaller lenders including certain marketplace lenders that would otherwise be excluded from its ECOA enforcement authority.

The CFPB could use this data collection requirement as a means to pursue fair lending actions against small business lenders since the data could enable the agency to analyze potential disparate impacts and redlining practices. The CFPB could also use the data to influence the lending practices among small business lenders, similar to its actions in the auto finance market. Cordray never proposed any small business rules and it was not until after a lawsuit was filed that the CFPB publicly announced an outline of proposals it was considering implementing this rule in September 2020. A proposed rule has now been issued but is not yet final.[466]

D. 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"*)[467] and similar laws in the applicable state when attempting to collect overdue payments from delinquent borrowers. Such laws govern how servicers and collection agents can collect overdue amounts and generally prohibit abusive, unfair and harassing debt collection practices, limit certain communications with third parties, and impose notice and debt validation requirements. For example, a servicer communicating with anyone other than the borrower in trying to ascertain the borrower's location must identify themselves (including their employer, if requested), state that they are seeking location information, and not disclose that the borrower owes a debt. Once a consumer debtor is represented by counsel, all collections communications must be with their attorney rather than with the consumer directly. Collection activities must be limited to reasonable times; the FDCPA specifies between 8:00 a.m. and 9:00 p.m. absent actual knowledge of inconvenient times. The FDCPA also requires servicers to cease further collections communications upon the debtor's request, except in very limited circumstances.

Debt collection laws are a compliance complexity and can lead to litigation. Violations of the FDCPA can lead to awards of actual damages, statutory damages of up to $1,000 in an individual action and up to $500,000 or 1% of the defendant's net worth in a class action, plus attorney's fees and costs.

464 Section 1071 of the Dodd-Frank Act, codified at 15 U.S.C. § 1691c-2.

465 Financial institution is defined broadly as "any partnership, company, corporation, association (incorporated or unincorporated), trust, estate, cooperative organization or other entity that engages in any financial activity." 15 U.S.C. § 1691c-2(h)(1). The definition covers both banks and non-banks, including online lenders that lend to applicable businesses.

466 The proposed rules are discussed in the "Recent Developments" section.

467 15 U.S.C. § 1692.

Regulatory agencies can also enforce the law. As a result, marketplace lenders acting as servicers or utilizing third-party servicers need to understand and comply with the applicable debt collection laws for Borrower Loans.

A lender that acts as its own collection agent for any Borrower Loans will not be directly subject to the FDCPA but as a matter of prudence should comply with its substantive provisions and will be subject to mandatory compliance with similar laws in certain states. The lender will be directly subject to the FDCPA if it acts as a collection agent for an affiliated issuer, purchasers of the Borrower Loans, or funds. 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. See Part V, "Bankruptcy Considerations," below. Finally, marketplace lenders must consider provisions of the SCRA that permit courts to stay proceedings and the execution of judgments against servicemembers and reservists who are on active duty.

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

Prior to the passage of the Dodd-Frank Act no federal agency had been tasked with the job of writing regulations for the FDCPA. Dodd-Frank gave that authority to the CFPB. In May 2019, the CFPB issued a notice of proposed rulemaking concerning debt collection to take into effect modern-day communications not in existence at the time the FDCPA was enacted in 1977, such as email. The proposal deals with electronic forms of communication and would prohibit more than seven calls to a debtor in a seven-day period. It would also provide forms of notices to comply with debt collection validation notices. Regulation F incorporating these proposals became effective in November 2021. Although applicable to all third-party collectors, servicers and third-party collectors of marketplace loans should prepare for operational changes resulting from the enactment of this rule. It is hoped that codification of rules will provide additional certainty to debt collection efforts and slow the pace of litigation related to debt collection practices.

Regulation F—Consumer Debt Collection Became Effective in November 2021. Although enacted in the 1970s, no regulations were written for the federal Fair Debt Collection Practices Act (*"FDCPA"*) until the 2020s, with the final regulation becoming effective on November 30, 2021.[468] While the regulations apply to all debt collectors, there are participants in the marketplace lending industry who are debt collectors and will be subject to this law. They could include entities that service loans and collect payments on behalf of a Funding Bank, a loan assignee, an investor, or a securitization vehicle.

468 The regulation is codified at 12 C.F.R. Part 1006.

Some provisions of the regulations are designed to deal with modern technology that is used to collect debts, such as email or text messages. In order to use these methods, consumer consent must be obtained. The regulations also provide language that creditors should use to inform consumers they intend to share their email address with a debt collector, and the debt collector must confirm that the creditor followed the required procedures before using the email address. Consumers are also given the right to opt out of texting or email communication by notifying the creditor or debt collector. As to telephone communications, debt collectors may not call a consumer more than seven times in seven days, or within seven days of their last conversation with that consumer. Collectors may only call during specified hours (8:00 a.m.–9:00 p.m. in the consumer's time zone) and may not call at times known to be inconvenient to the consumer. If leaving a voicemail, there is a specific script that limits the information a collector may say on the voicemail.[469] Regulation F will have a significant impact on how debt collectors operate. Creditors should be sure that their arrangements with servicers and debt collectors reflect adequate coverage and protection given the new regulations. Creditors will also need to provide the prescribed notice if email addresses will be shared with debt collectors.

Debt Buyer Is Not a Debt Collector. Resolving a split of opinion between several circuits, the U.S. Supreme Court ruled that an entity that buys defaulted debts is not a debt collector under the Fair Debt Collection Practices Act and therefore, not subject to compliance with that statute.[470] In newly-appointed Justice Gorsuch's first written opinion expressing the views of a unanimous court, he stated that debt buyers do not meet the FDCPA statutory definition of collecting or attempting to collect debts "owed or due to another."[471] Rather, a debt buyer is collecting on its own behalf because it owns the debt. It is possible, however, that debt buyers may still be subject to the FDCPA under other definitions.

Use of Automatic Dialers. The U.S. Supreme Court unanimously decided a case under the Telephone Consumer Protection Act (*"TCPA"*), narrowing the scope of autodialers subject to the law.[472] The consumer sued under the TCPA after receiving several months of text message for an account that never existed and without consent. In interpreting the definition of an automatic telephone dialing system under the law, the court found that in this instance the technology used could neither store nor produce numbers in a random sequential order as required by the statute and therefore the case was dismissed as not being subject to the TCPA definition. As a result, this effectively narrowed the devices subject to the law.

469 A full discussion of this extensive regulation is beyond the scope of this book. The regulation does prohibit bringing or threatening to bring an action where it is known (or should have been known) that the statute of limitations has expired, and it makes it a strict liability cause of action. Regulation F also prescribes sample debt validation notices that must contain specific and expanded amounts of information. Compliance issues are likely to generate new litigation based on these new regulations.

470 *Henson v. Santander Consumer USA, Inc.*, 137 S. Ct. 1718 (2017).

471 15 U.S.C. 1692a(6).

472 *Facebook, Inc. v. Duguid*, 592 U.S. ____(2021).

E. 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.[473] In particular, the federal Gramm-Leach-Bliley Act (*"GLBA"*) limits the disclosure by a financial institution[474] 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 thereafter. 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.

GLBA also requires financial institutions to establish an information security program to ensure the security and confidentiality of customer records and information, protect against anticipated threats or hazards to the security or integrity of those records, and protect against unauthorized access to or use of those records or information. In order to assist financial institutions in developing an appropriate information security program, the related federal agencies published the Interagency Guidelines Establishing Standards for Safeguarding Customer Information (*"Security Guidelines"*).[475] 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.[476]

Finally, GLBA requires financial institutions to develop and implement a response program designed to address incidents of unauthorized access to customer information maintained by the institution or its service provider. The related federal agencies have also published Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice. In addition, most states have laws that would require a marketplace lender to notify customers of a breach of security in which personal information is reasonably believed to have been acquired or accessed by an unauthorized person. For example, the NYDFS cybersecurity rule imposes requirements that are

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473 See the previous section on the FCRA which also contains requirements with respect to privacy and information sharing.

474 The GLBA governs "financial institutions," which is defined to mean any institution the business of which is engaging in financial activities as described in section 4(k) of the Bank Holding Company Act of 1956 (which includes the lending of money). Marketplace lenders will most likely be deemed "financial institutions" for these purposes. The GLBA is codified at 15 U.S.C. § 6801-3809 and regulations are found at 12 C.F.R. pt. 1016.

475 Interagency Guidelines Establishing Standards for Safeguarding Customer Information (15 U.S.C. § 6801 *et seq.*) and FTC Safeguards Rule (16 C.F.R. pt. 314). The FDIC Regulation is at 12 C.F.R. pt. 364 App. B.

476 In March 2019, the FTC issued notices of proposed rulemaking to amend the GLBA privacy rules and rules related to safeguarding personal information.

more stringent than those imposed under GLBA. 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.

After the massive data breach at a national credit bureau, it has been anticipated that additional privacy restrictions would come into place for all lenders, including marketplace lenders. As stated previously, the U.S. Treasury report recommended that Congress enact a comprehensive data privacy and data breach law. Some legislation has been introduced in Congress to this effect, but the issue of federal preemption of state laws looms as a deterrent to enacting any legislation at the federal level.[477]

Meanwhile, some states are moving forward on these issues. California, for example, passed privacy legislation in June 2018 that took effect in 2020. In Vermont, data brokers must disclose information they collect and allow consumers to opt out. Colorado, Virginia, Utah, and Connecticut have also enacted laws to protect personal identifying information. Additional state legislation on this front is expected to continue creating a patchwork of laws relating to data security, privacy and breach notifications.

F. State Privacy Laws—California

The California Consumer Privacy Act, or CCPA, went into effect in January 2020, final rules were promulgated June 1, 2020 and enforcement by the Attorney General began in July 2020. Although not unique to marketplace lenders, the law imposes obligations on certain commercial entities that collect consumer data including through a website. The law affects a business that either has annual gross revenues more than $25 million or annually buys, receives for commercial purposes, sells or shares personal information of 5,000 or more consumers or derives 50% or more of its annual revenues from selling consumer personal information.[478] If the CCPA is applicable, California consumers have the rights (1) to know what personal information is being collected and where it is from, and whether this is being disclosed or sold, (2) to prevent personal information from being sold, (3) to have personal information deleted and (4) to receive the same pricing and services even if they exercise their rights under the CCPA. Compliance with this law may be difficult and non-compliance could lead to onerous penalties.[479] Proposition 24 was on the California ballot on November 3, 2020 and passed. The Proposition encompasses four major areas: (1) it makes changes to existing privacy laws, (2) it provides for new privacy laws and consumer rights, (3) it changes penalty provisions (most notably the current

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477 The FTC on March 5, 2019, published notices of proposed rulemaking to make extensive changes to the existing standards for the safeguarding of consumer information (12 C.F.R. Part 314) and the GLBA Privacy Rule affecting privacy of consumer financial information (16 C.F.R. Part 313).

478 CAL. CIV. CODE § 1798.100 *et seq*. The law also applies to any entity that controls or is controlled by an entity that meets the applicable thresholds. CAL. CIV. CODE § 1798.140.

479 The Attorney General may seek civil penalties of up to $7500 per violation and consumers may seek the greater of statutory damages of $100 to $750 per incident or actual damages incurred. CAL. CIV. CODE § 1798.150.

ability to correct violations and avoid penalties), and (4) it creates a new state enforcement agency for privacy matters, the California Privacy Protection Agency (CPPA).

Colorado, Virginia, Utah, and Connecticut have also passed privacy legislation. Like the state-by-state commercial disclosure laws discussed above, each of these laws (which become effective in 2023) contains different provisions. Fast becoming another patchwork collection of state laws requiring differences in compliance operationalization, consumer privacy law is another area where federal legislation has been introduced.[480] These laws all have similarities such as when an entity becomes subject to the law, consumer consent, and/or opt-out rights of data sharing, but they take somewhat different approaches in how these issues are handled.[481]

As discussed in the "Recent Developments" section, other states have enacted similar, but differing state laws on privacy protection, and other states are considering them. In addition, Congress is considering a uniform national standard to avoid the patchwork of state laws that appears to be developing.

G. Electronic Commerce Laws

E-Sign Act and UETA. It goes without saying that Internet loan platforms execute borrower/lender registration agreements and process credit transactions in electronic form and that virtually all payments are processed through the Automated Clearing House (*"ACH"*) electronic network. Accordingly, marketplace lenders need to comply with the federal Electronic Signatures in Global and National Commerce Act (*"E-Sign Act"*)[482] and similar state laws (particularly the Uniform Electronic Transactions Act (*"UETA"*)),[483] both of which authorize the creation of legally binding and enforceable agreements utilizing electronic records and electronic signatures and set forth certain disclosure and consent requirements.[484]

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480 S. 1494 Consumer Data Privacy and Security Act of 2021.

481 A discussion of the specifics of the similarities and differences of these laws is beyond the scope of this book. Whether or not the law applies and to what extent compliance is required should be looked at carefully.

482 15 U.S.C. § 7001 *et seq.*

483 Forty-seven states and the District of Columbia have adopted UETA in substantially the form promulgated by the National Conference of Commissioners on Uniform State Laws in 1999. California has adopted UETA, but made significant variations to the model text. *See*, Uniform Electronic Transactions Act: CAL. CIV. CODE § 1633.1 *et seq*. Illinois has adopted the Electronic Commerce Security Act: IL ST Ch. 5, ACT 175, New York has adopted Rules and Regs. Electronic Signatures and Records Act: N.Y. State Tech. Law § App § 540.1 *et seq*. (hereinafter *"ESRA"*), and Washington has adopted the Washington Electronic Authentication Act: WASH. REV. CODE ANN. tit. 19, ch. 19.34. This book assumes that either UETA or the E-Sign Act (which preempts state electronic signature and records laws to the extent inconsistent with UETA) will apply to the electronic transactions discussed herein. Lenders should consult legal counsel if California, Illinois, New York, or Washington law applies to their electronic transactions.

484 However, security interests governed by Article 9 of the Uniform Commercial Code (the *"UCC"*) are not subject to the E-Sign Act or UETA. See 15 U.S.C. § 7003(a)(3) and UETA § 3 (exempting certain transactions governed by the UCC, including Article 9 security interests, from coverage under the E-Sign Act and UETA, respectively). Also see "Bankruptcy Considerations—Security Interests in Electronic Collateral" below for a discussion of related UCC issues.

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.[485] 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.

Worth Remembering: Having a proper form of E-Sign Act authorization and consent to receive disclosures electronically is crucial to the successful operation of an Internet lending platform.[486] As a result, the timing and placement of the customer's consent to electronic disclosures and contracting is important. It is a best practice to put the E-Sign consent first in a transaction as it must be obtained prior to the time that any disclosures are received or any contract is entered into. The consent should not be buried in a longer document but preferably presented as a standalone document requiring an affirmative act to show assent.

Courts are paying attention to these types of matters. For example, 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.[487] In another case also dealing with an arbitration agreement, a federal court held that checking a box to confirm reading of an agreement was not enough to bind the borrower where the online lender held all of the electronic records.[488] These recent cases demonstrate that courts are scrutinizing online programs and documentation in light of consumer protection considerations. This suggests that marketplace lenders need to provide disclosures clearly

485 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.

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

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

488 *Dillon v. BMO Harris Bank N.A.*, 2016 BL 89102 (M.D.N.C. Mar. 25, 2016).

and obtain a consumer's agreement to important documents such as electronic contracts and arbitration agreements by affirmative action to effectively demonstrate their consent.

Electronic Funds Transfers. With respect to electronic payments, since marketplace lenders are not typically organized as banks, they must rely on eligible financial institutions (such as FDIC-insured banks) both to fund the Borrower Loans and to receive payments over the ACH network. The Electronic Funds Transfer Act (*"EFTA"*) and its implementing Regulation E[489] establish the rights, responsibilities, and liability of consumers who use electronic fund transfers and of financial institutions and certain other parties that offer these services. These laws contain disclosure and 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.[490]

> **Key Considerations:** Under the EFTA, a lender cannot require a borrower to make payments by electronic means as a condition of obtaining a loan. However, a lender may provide an incentive for making payments electronically.[491] Thus, an appropriate customer authorization for automatic debits and compliance with Regulation E are essential to Internet lending programs.[492] The authorization must be in writing and signed by the borrower, and a copy of the authorization must be provided to the borrower. As suggested by the recent cases, placing such an authorization within another document may not be sufficient to show proper consent to the electronic transfer of funds as is required by the EFTA. As a result, it is a best practice to have a separate authorization for a preauthorized transfer from a borrower's account for payment of a loan.

Two courts have considered the practice of requiring the borrower to sign an electronic funds transfer (*"EFT"*) authorization for loan payments but allowing the customer to cancel at any time, even before the first loan payment is made. Both courts found this practice to be a violation of Regulation E and the EFTA. In *De La Torre v. CashCall, Inc.*, the lender used a promissory note containing an EFT

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489 15 U.S.C. § 1693 *et seq.*; 12 C.F.R. pt. 1005.

490 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.

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

492 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 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.

authorization which included language allowing cancellation of the authorization at any time.[493] In order to comply with the signed writing requirement, the lender required the borrower to check a box indicating its authorization for EFTs. If the borrower did not check the box, it could not obtain a loan. Once the loan was funded, the borrower could cancel the authorization at any time, including prior to the first loan payment date. The court found that this practice violated the EFTA and Regulation E, which prohibit conditioning an extension of credit on repayment via EFT. The court reasoned that the violation occurs at the time the lender requires the authorization to receive the loan, notwithstanding any later ability to revoke or use another means of payment. This case was decided on a motion for summary judgment, so it was a ruling on the merits and the court ordered a hearing to determine damages on the claim. The court also found that this practice violated the California Unfair Competition Law.

Another court reached the same conclusion on similar facts. In *FTC v. Payday Financial, LLC*, the lender had an EFT authorization in its loan agreement and required borrowers to sign it in order to obtain a loan.[494] As in *De La Torre*, the borrower had the ability to revoke its authorization prior to the first loan payment. However, since the borrower had no choice but to authorize the EFT to obtain a loan, the court found that the lender had violated the EFTA and Regulation E.

Regulators are also enforcing Regulation E violations. Electronic payments and compliance will continue to be an ongoing source of regulatory and judicial action.

Takeaways: Based on these cases, there is a significant risk of violation of law and regulation, and the potential for UDAP/UDAAP-type claims as a result of such a practice. Our experience is that lenders are now providing choices for payment and making loans regardless of what payment option is chosen. Accordingly, any practice that does not provide a choice or payment or that prevents a borrower from obtaining a loan if it does not sign an EFT authorization under current precedent would likely be subject to challenge, litigation, and a finding of a violation.[495]

Cases Relating to Electronic Contracting. Given the online world in which we now live, it is no surprise that more litigation is occurring that deals with entering into contracts electronically. Some of the litigation involves whether or not a contract has been formed, and many cases deal with the enforceability of arbitration clauses. Where there is evidence of a valid electronic signature process, arbitration clauses in electronic notes have been routinely upheld.[496] However, often the person claiming the validity of an electronic contract must provide evidence allowing this determination to be

493 56 F. Supp. 3d 1073 (E.D. Cal. 2014).

494 989 F. Supp. 2d 799 (Dist. S.D. 2013).

495 The CFPB analyzes the EFT practices of creditors for compliance with the EFTA, has issued civil investigative demands (CIDs), and considers enforcement actions related to compliance with EFTA.

496 *See, e.g.*, *Delgado v. Ally Fin., Inc.*, 317CV02189BENJMA, 2018 WL 2128661 (S.D. Cal. May 8, 2018).

made. This was the situation in one case in which an online lender's motion to compel arbitration was initially denied. The court required the online lender to show that the borrower had agreed to the arbitration provision. The online lender produced a declaration detailing its process for obtaining consent to electronic contracting and provided screenshots showing how borrowers agree online to loan agreements and how the platform tracks such agreements and any exercise by a borrower of its right (which the lender's documents allowed) to opt out of the arbitration clause.[497] The court then allowed arbitration. Lenders must take care in determining how they will provide for the electronic execution of contracts since some courts have ruled against contract formation where a touch screen does not enable the customer to review contract terms (and therefore there is no agreement to those terms)[498] or where terms are hidden, are not called to the customer's attention or are located beneath unrelated prompts.[499]

In another action based on a defaulted loan made by a marketplace lender online, the holder of the note filed a motion to compel arbitration to enforce a promissory note executed online. The note utilized a provision often used in online lending transactions allowing the platform to sign the final form of the note as the borrower's attorney-in-fact. The plaintiffs claimed that they neither signed the promissory note nor authorized the marketplace lender to sign the note on their behalf. They also claimed that the defendants had not demonstrated a proper chain of title so as to be able to enforce the loan. The court concluded that the evidence was not sufficient to rule on the motion and requested additional evidence.[500] Hence, any efforts to compel arbitration will require proof of a valid electronic consent process.[501] In that action, after providing additional information, the court granted the motion to compel arbitration.[502]

H. Beware of Electronic Communications

Providing Adequate Disclosures. A recent Seventh Circuit decision should cause lenders and online companies to re-evaluate how they use electronic communications in their day-to-day operations.[503] In a debt collection situation, the plaintiff incurred medical debts and was sent an email by a collector indicating that it had sent the debtor a secure message containing a hyperlink for the debtor to view.

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497 *Moses v. LendingClub*, 217CV03071JADPAL, 2019 WL 489092 (D. Nev. Feb. 6, 2019), distinguishing *Carlos v. Patenaude & Felix A. P.C.*, 736 Fed. Appx. 656 (9th Cir. June 6, 2018) (failure to produce evidence of electronic agreement as presented to borrower); ECF No. ___, Case No. 2:17-cv-03071 (D. Nev.) (underlying allegations deal with improper access of consumer reports in violation of the Fair Credit Reporting Act).

498 *The Nat'l Fed'n of the Blind v. The Container Store*, 904 F.3d 70 (1st Cir. 2018).

499 *See, e.g., Starke v. SquareTrade, Inc.*, 2019 WL 149628 (2d Cir. Jan. 10, 2019). *Starke v. SquareTrade, Inc.*, 913 F.3d 279, 281 (2d Cir. 2019).

500 *Vandehey v. Asset Recovery Sols.*, LLC, 18-C-144, 2018 WL 6804806 (E.D. Wis. Dec. 27, 2018) (Prosper marketplace loan).

501 A loan agreement containing an arbitration clause was upheld in *Ngo v. PMGI Fin., LLC*, 18-CV-05401-JCS, 2018 WL 6618316 (N.D. Cal. Dec. 18, 2018) (recognizing that a checkmark can be an electronic signature and assent is shown where checking a box is required in order to proceed with the transaction).

502 *Vandehey, supra.* Order dated Mar. 24, 2019 also denying motion for class certification.

503 *Lavallee v. Med-1 Solutions, LLC,* 932 F.3d 1049 (7th Cir. 2019).

The secure message contained the validation notice required by the Fair Debt Collection Practices Act to be given in connection with the first communication to a debtor. The technology systems of the collector showed that the debtor never opened the secure message and hyperlink and therefore never accessed the validation disclosure. Later, the debtor received a phone call about the debt, the first time the debtor had known about the debt collector. The collector admitted that it had not provided the validation notice after the phone call. The plaintiff filed an action alleging failure to deliver the required disclosure. The collector claimed that the emails satisfied its disclosure obligation as they allowed the debtor to obtain the disclosures. The lower court disagreed, finding that the required notice was never given since the debtor never downloaded it, adding that "embedding a hyperlink from an unknown sender made receipt of the notices unlikely."

The Court of Appeals found that "the emails don't measure up" as they did not themselves contain the enumerated disclosures. The court noted that in order to access the required notice, the plaintiff would have to go through six steps including clicking on the hyperlink in the email, checking a box to sign for the secured message, clicking a link to open the secured message, clicking on the attachments tab, clicking on the attached file and then viewing the file or saving it and then opening it. The court stated that, "at best, the emails provided a digital pathway to access the required information." The court rejected that this was an adequate communication containing the mandated disclosures, concluding instead that it only provided a means to access them. Therefore, the disclosures were not adequate.[504]

Lenders and online companies should take note of this decision. Generally, in order to receive disclosures electronically the consumer must agree to do so under the provisions of the federal E-Sign Act and the federal banking agencies.[505] Care must then be taken to ensure that consumers know or understand that a legal disclosure is being provided to them. As this case demonstrates, it is not enough to send an email with a hyperlink or a request to access a secure message. A pathway to the disclosure is not the same as making the disclosure. In this particular case, technology showed that the intended recipient had not accessed the required disclosure. As the spread of electronic communications in lending increases, so will challenges to the validity of required disclosures in that electronic context. Care must be taken to ensure that electronic disclosures being provided to consumers are adequate.

Proving Electronic Signatures. Another instructive case deals with the validity of electronic signatures.[506] The court found that a company failed to prove the electronic signature of a contract. The plaintiff received an unsolicited phone call concerning the financing of a solar energy project. The plaintiff claimed she did not receive or sign any documents to finance the project. The company claimed that she had electronically signed the financing agreement that was verified by DocuSign and

504 Interestingly, the CFPB filed an amicus brief in the action in favor of the debtor. It submitted that the emails could not be written notice because they failed to satisfy the requirements of the federal E-Sign Act requiring an agreement of the consumer to receive disclosures electronically. The court, having made its own finding, did not need to consider this issue.

505 15 U.S.C. 7001 *et seq.*

506 *Fabian v. Renovate America, Inc.*, 42 Cal. App. 1062 (Cal. App. 4th App. Dist. 2019).

contained a signature block with a printed signature. To prove the signature, the company provided the agreement containing the signature block. The court found this to be inadequate and stated that there was no explanation of the process used to sign and verify the signature. The court indicated that evidence was needed to show who sent the agreement, how it was sent, how the signature was placed on the document and who received it and how it was sent back to the company and how the identification was verified. Unless these conditions were satisfied, the court ruled that the electronic signature was not authenticated. Lenders and others who conduct business electronically should take note of this case. Even if one has an electronically signed agreement with DocuSign verification markers, this may not prove an authentic signature. In order to rely on an electronic signature, one must be able to show the process of verification and be able to verify that process.

Recording Telephone Conversations. A nationwide online lender was sued in a putative class action for recording telephone conversations with consumers without the knowledge or consent of the consumers in violation of California and Massachusetts laws (where the marketplace lender had call centers).[507] The facts are somewhat interesting as stated in the complaint. The plaintiff got into a "contentious" discussion with a representative of the platform and "regrettably said a number of rude things." The representative filed for a protective order against the plaintiff and at a hearing the representative's counsel played the telephone recording, which plaintiff claimed was the first time he knew that his conversation (which including providing sensitive personal and financial information) was being recorded. On July 28, 2020, the court issued an order addressing several motions. A cause of action based on Massachusetts law was dismissed while claims under California law were stayed pending the determination of a case by the California Supreme Court. However, the court denied a motion to strike class action allegations. Recording telephone conversations merits looking at compliance with applicable law.

Adequate Notice of Terms and Conditions. Another case worth noting deals with whether one has adequate notice that when clicking an online button it constitutes agreement to terms and conditions, in this instance whether allegations of violation of the Telephone Consumer Protection Act were subject to arbitration or not.[508] The plaintiff sued a national sandwich chain after receiving unsolicited text messages after entering his phone number on the company's website in order to receive a free sandwich. The consumer clicked a button stating "I'm in." After being sued, the sandwich chain claimed that the consumer had agreed to its terms and conditions, which were accessible via a hyperlink in connection with the promotion which contained an arbitration provision. The Second Circuit affirmed the district court's denial of arbitration. The court found that the website did not provide sufficient notice that the consumer was agreeing to any legal terms and conditions, but that they were only agreeing to get a free sandwich. The court found that the terms and conditions were not reasonably clear and conspicuous on the promotional page. This decision serves as notice that in

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507 *Erceg v. LendingClub Corp.*, Case No. 3:20-cv-01153 (N.D. Cal. filed Feb. 13, 2020).

508 *Arnaud et al. v. Doctor's Assocs. Inc. d/b/a Subway*, Case No. 19-3057-cv (2d Cir. Sept. 10, 2019).

order to bind consumers to legal terms and conditions on a website, it must be clear that the consumer is agreeing to legal terms and has had the opportunity to access those terms and conditions prior to agreeing.

I. Online Agreements—The Importance of Doing It Right

Not only is obtaining customer consent to conducting business and receiving disclosures necessary to online lending programs, but other legal challenges have been made to electronic communications, including the placement of assent in conjunction with disclosures.

A recent Ninth Circuit case is instructive on the use of an online website and contract formation.[509] The court denied a motion to compel arbitration of a putative class action brought for violations of the Telephone Consumer Protection Act. The decision found that plaintiff borrowers did not assent to binding arbitration when presented with a hyperlinked set of terms that contained an arbitration provision. The defendants claimed that by using the website, the plaintiffs had agreed to arbitration. The court stated that to bind a consumer requires a manifest intent to agree to the contract terms.

The court indicated that "clickwrap" agreements—where a website presents users with specific terms and conditions and requires them to indicate their assent by clicking an "I accept" box—create an enforceable agreement. However, a "browsewrap" agreement that contains a hyperlink to the terms to which assent is ostensibly given by continued use of the site is subject to further inquiry. A website that provides a conspicuous notice of the contract terms and which requires the consumer to take some action to demonstrate assent to those terms can create a contract.

> To be effective contracts there must be online notice and disclosure that continuing on the website will result in agreement to contract terms.

In this situation the court found that the webpages did not provide the degree of notice required, as they did not point the consumer to the fact that the terms contained an arbitration provision. The text disclosing the terms was in tiny gray font rather than the blue font typically associated with hyperlinks and was smaller in size than other parts of the website in close proximity to the hyperlink—according to the court, the text was "barely legible to the naked eye." The court concluded that the user's attention was actually drawn *away* from the disclosure and the terms. The court noted that the failures could have been remedied and a contract created with better formatting, better coloring, and more conspicuous lettering that would call attention to the disclosure and hyperlink to the terms and conditions. Further, the consumer was asked to use a "continue" button rather than an "I agree" button and as a result it could not be shown definitively that the consumer had agreed to be bound by the terms because there was no actual notice that by clicking the continue button they were agreeing to any terms and conditions. The court provided suggested language that would be sufficient: "By

509 *Berman v. Freedom Fin. Network, LLC.*, Case No. 20-16900 (9th Cir. Apr. 5, 2022), *aff'g.* 400 F. Supp. 3d 964 (N.D. Cal. 2019).

clicking the ‘Continue’ button, you agree to the Terms and Conditions which includes mandatory arbitration.”

This case decision is both a warning and a guide to participants in the marketplace lending industry to diligently design their websites in a manner that assures that adequate notice of contract terms are provided and appropriate consumer consent is obtained so that a binding contract is formed.

J. Other Relevant Laws

Bank Secrecy Act Regulations. The federal Bank Secrecy Act[510] and related laws require any bank making a loan, and therefore the Funding Bank in the case of Internet loans and, in some cases, the marketplace lender, to adopt policies and procedures to monitor and enforce the following:

- Establish a customer identification program to verify the true identities of borrowers before an account is opened and provide a notice regarding its use of personal information to confirm a customer’s identity;
- 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;[511]
- Report suspicious account activity that meets the thresholds for submitting a Suspicious Activity Report (*“SAR”*); and
- Implement an anti-money laundering and information sharing program.

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

Telephone Consumer Protection Act.[512] 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.

510 12 U.S.C. §§ 1829, 1951—1959; 31 U.S.C. §§ 5311—5314, 5316—5332; 12 U.S.C. § 1786(9); 31 C.F.R. pt. 103; and 12 C.F.R. § 326.8 (FDIC Regulation).

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

512 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 are found at 15 U.S.C. § 6101-6108 and 16 C.F.R. pt. 310.

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

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

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

Calls to cell phones have prompted large amounts of litigation—much of it in the form of class actions—against marketers, lenders, and servicers. These claims are being made under the Telephone Consumer Protection Act (*"TCPA"*).[513] Plaintiffs' lawyers find TCPA litigation advantageous since violations result in automatic damages of $500 per call, which is tripled to $1,500 if the conduct is willful. Huge damage awards warrant a further discussion of the law and its implications.

Case in Point—Shifting Interpretations of TCPA and the 2015 Order. The TCPA was enacted in 1991 to stem the costs and nuisance of unwanted telemarketing by prohibiting calls using an Automated Telephone Dialing System, commonly referred to as an "autodialer," to call certain types of phones without prior consent. As part of the TCPA, prior consent (and in the case of telemarketers, prior *written* consent) is required when a company makes a call using an autodialer or uses a prerecorded message in a call to a cell phone.[514] Prior consent is also required for some landline telemarketing calls when the call uses a prerecorded message.[515]

Much has changed in technology, in business, and in the way that cell phones are billed since the TCPA was enacted that undermines or creates gray areas with respect to the law's definitions and scope. Over the years the Federal Communications Commission (*"FCC"*), the regulator that has rulemaking and enforcement authority for the TCPA, has issued several Rules and Orders that attempt to interpret the law's requirements, particularly with respect to non-telemarketing companies that use autodialers for

513 47 U.S.C. § 227.

514 47 U.S.C. § 227(b)(1)(A)(iii).

515 47 U.S.C. § 227(b)(1)(B); 47 C.F.R. § 64.1200.

debt collection purposes.[516] A Declaratory Ruling and Order issued in July 2015 (the *"2015 Order"*)[517] is the most recent of these interpretive efforts. The 2015 Order set forth an expansive interpretation of various TCPA concepts in a manner that is detrimental to those subject to its requirements, including financial companies.

Several entities petitioned courts for review of the 2015 Order. These cases were ultimately consolidated and the U.S. Panel on Multidistrict Litigation randomly selected the U.S. Court of Appeals for the D.C. Circuit to hear the matters.[518] The petitions all argue that the FCC in its 2015 Order exceeded its authority and made it very difficult for companies to comply with the TCPA.[519] In October 2016, the U.S. Court of Appeals for the D.C. Circuit heard oral argument in the consolidated case.[520]

Under the 2015 Order, any system that has the present *or future* capacity to be an autodialer counts as one for the purposes of the TCPA.[521] This is contrary to the definition of "capacity" in the TCPA, which refers only to an instrument's present capacity. In oral argument, counsel for the petitioners argued that devices like smartphones, with the ability to install and use certain applications, could therefore be included under the definition of autodialer. Indeed, it is hard to imagine a device that would not fall under this broad definition besides a rotary phone. The parties disputed what types of devices should qualify as an autodialer in oral argument, with the petitioners arguing for a narrower scope than that provided in the 2015 Order.

In addition, under the 2015 Order, consent to be called, one of the main defenses to TCPA litigation, has become easier to revoke. Some courts had previously held that because the TCPA was silent regarding revocation, it was impossible to revoke consent to be called.[522] Others disagreed and pointed to the Fair Debt Collection Practices Act requirement that requests to cease and desist calling be in

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516 *See, e.g., In re Rules & Regs. Implementing the TCPA of 1991*, 7 FCC Rcd. 8752, 8769 (Oct. 16, 1992); *In re Rules & Regs. Implementing the TCPA of 1991*, 27 FCC Rcd. 1830, 1838 (Feb. 15, 2012).

517 *See Rules and Regulations Implementing the Telephone Consumer Protection Act of 1991, Declaratory Ruling and Order*, CG Docket No. 02-278, FCC 15-72, at ¶ 49, 52 (July 10, 2015).

518 The first was *ACA Int'l v. FCC*, No. 15-1211 (D.C. Cir. filed July 10, 2015). Next was *Sirius XM Radio, Inc. v. FCC*, No. 15-1218 (D.C. Cir. filed July 14, 2015), and then *Prof'l Ass'n for Customer Engagement, Inc. v. FCC*, No. 15-2489 (7th Cir. filed July 14, 2015). These cases, along with others, were consolidated since filing and the U.S. Panel on Multidistrict Litigation randomly selected the U.S. Court of Appeals for the D.C. Circuit to hear the matters.

519 *ACA Int'l et al. v. Fed. Commc'ns Comm'n*, Case No. 15-1211, at ECF No. 1599016 (D.C. Cir. Feb. 16, 2015). The petition focuses on four issues: (1) the FCC's interpretations of the TCPA are inconsistent, unclear, and ambiguous; (2) the FCC's interpretation of what constitutes an autodialer is overly broad and inconsistent with other language in the statute; (3) the definition of "called party" under the TCPA is ambiguous due to the frequency of "ported" numbers; and (4) the revocation of consent rules is impractical and unjustified.

520 The "one-call safe harbor" introduced by the FCC in its 2015 Order was another issue raised in oral argument. Many phone lines that used to be associated with a residential landline have now been "ported" to ring on a cell phone, and the safe harbor would give a company that is calling what it thinks is a landline one chance to ascertain if the number has changed to a cell phone, since the compliance requirements for cellular phones are much more stringent than those for landlines. The petitioners argued that the safe harbor is not effective and does not help companies comply with the TCPA.

521 *See Rules and Regs. Implementing the Telephone Consumer Protection Act of 1991, Declaratory Ruling and Order*, CG Docket No. 02-278, FCC 15-72, at ¶ 16 (July 10, 2015).

522 *See Gager v. Dell Fin. Servs., LLC*, 727 F.3d 265, 270 (3d Cir. 2013) for discussion of previous court interpretations of consent.

writing.[523] The 2015 Order, however, allows consent to be revoked by "any reasonable means."[524] Thus, a very difficult burden is placed on companies who now have to make a decision and create new policies on whether an attempted revocation is "reasonable," and can no longer require that revocation be in writing. Petitioners made this point in oral argument and argued that standardized methods of revocation should be codified.

The D.C. Circuit issued its long-awaited decision in March 2018, setting aside the FCC's expansive definition of an autodialer and rescinding the rules related to calling reassigned mobile numbers but retaining consumers' ability to revoke consent in any reasonable manner.

Consumer Ability to Revoke TCPA Consent. The issue of how a consumer can revoke consent to receive autodialed calls continues to be a hotbed of litigation, with potentially conflicting decisions. In the Second Circuit, dealing with an auto loan, the court held that the consumer borrowers cannot revoke their TCPA consent if that consent was part of the bargained for consideration for the loan, *i.e.,* a part of the loan contract.[525] But in the Eleventh Circuit, the court found that a consumer can revoke TCPA consent on a limited basis such as revoking the consent from 8 a.m. to 5 p.m. on business days.[526] More recently, the Eleventh Circuit held that TCPA consent that is contained in a contract cannot be unilaterally revoked.[527]

Online Warning—Location of the TCPA Consent Matters. At least two recent decisions highlight the importance of the placement of the TCPA consent on a website.[528] One of these cases was brought against a lender by a consumer who had completed an online quote request form on the lender's website. The request form required the consumer to provide personal information including a phone number, followed by a "Get your free quote" click button. Below the click button and outside the box containing the request form, there was additional language stating that the consumer consented to receive telephone calls and text messages from the lender. The consumer started receiving phone calls and filed a class action suit alleging a TCPA violation. The lender moved to dismiss the case, claiming that written consent had been provided by the consumer. The court thought otherwise. The court held that the small font used for the TCPA disclosure and its placement below the click button made it unlikely that the consumer knew that by clicking the button, they were agreeing to receive autodialed calls from the lender. The second case also involved a TCPA consent disclosure that appeared below a submit button and in smaller print.

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523 *Id*.

524 *See Rules and Regs. Implementing the Telephone Consumer Protection Act of 1991, Declaratory Ruling and Order*, CG Docket No. 02-278, FCC 15-72, at ¶ 54\5 (July 10, 2015).

525 *Reyes v. Lincoln Auto/ Fin. Serv.*, 2017 WL 2675363 (June 22, 2017).

526 *Schweitzer v. Comenity Bank,* 866 F.3d 1273 (11th Cir. Aug. 10, 2017).

527 *Medley v. Dish Network LLC,* Case No. 18-13841 (11th Cir. 2020).

528 *Barrera v. Guaranteed Rate, Inc.*, 2017 WL 4837597 (Oct. 23, 2017); *Sullivan v. All WebLead, Inc.* 2017 WL 2378079 (June 1, 2017).

Compliance Tip: For marketplace lending participants using websites or giving online disclosures, the clear message from these cases is that TCPA consent language must be placed in a logical location with conspicuous print and call attention to the significance of the language so as to put consumers on notice that they are giving their consent by clicking an "I agree" or similar button. This advice should equally apply to any form of disclosure and online agreement.

TCPA Violations Alleged Against Business Lender. A business filed a class action lawsuit in federal court in Illinois against an online business lender and its funding bank for violations of the TCPA and the Illinois Consumer Fraud Act.[529] The complaint alleges that the plaintiff class members received unsolicited faxes marketing loan products and services from the defendants resulting in a "loss of paper, toner, ink, use of facsimile machines and employee time." Most recently, the court granted a motion to strike the class claims, but gave the plaintiff the chance to amend the complaint to correct deficiencies.[530] Even business lenders are not immune from suit based on consumer types of claims and must defend such actions.

ADA and Website Accessibility for the Disabled. In 2010, the Department of Justice indicated that it would propose rules under the Americans with Disabilities Act (*"ADA"*) with respect to making websites accessible to individuals with disabilities. However, in 2017 the agency indicated that rulemaking on this subject was on its "inactive" regulatory agenda. It is not known if or when any regulations will be promulgated. However, in the interim, a wave of litigation has ensued, primarily against online retailers alleging that their websites fail to accommodate the visually impaired and seek to have software technology imposed that would allow access by the disabled. In June 2017, in the first case to go to trial on the issue, a federal judge ruled that the lack of accessibility of a supermarket chain's website violated a blind man's rights under the ADA.[531] Although we are not aware of any cases pending on this issue against marketplace lenders, without a clear regulatory standard, there is a risk of federal litigation if a website cannot accommodate consumers with disabilities.[532]

CAN-SPAM.[533] The CAN-SPAM Act establishes requirements for anyone who sends commercial or transactional messages by email and gives recipients of commercial emails the right to ask to be placed on an opt-out list. A commercial email is one whose primary purpose is promoting or advertising a commercial product or service, while a transactional email is one that facilitates an agreed-upon

529 *A Custom Heating & Air Conditioning, Inc. v. Kabbage, Inc., Celtic Bank et al.*, No. 16-CV-2513 (N.D. Ill. filed Feb. 3, 2016).

530 2018 U.S. Dist. LEXIS 8975 (N.D. Ill. Jan. 1, 2018).

531 *Gil v. Winn-Dixie Stores Inc.,* 242 F. Supp. 3d 1315 (S.D. Fla. June 13, 2017). The case is on appeal to the 11th Circuit Court of Appeals (Case No. 17-13467).

532 Financial institutions, particularly credit unions have been the focus of ADA claims in litigation. Those cases have largely been thwarted because the disabled person could not become a member of the credit union in any event. Three circuits have dismissed such suits. *See, e.g., Carello v. Aurora Policeman's Credit Union,* 930 F.3d 830 (7th Cir. 2019).

533 The Controlling Assault of Non-Solicited Pornography and Marketing Act of 2003, 15 U.S.C. § 7701 *et seq.*

transaction or updates a customer in an existing business relationship. A commercial email is subject to more restrictions than a transactional one, for example, restrictions on sender information and subject line, identification as an advertisement, and provision of an opt-out method. However, a transactional email cannot contain false or misleading routing information. The CAN-SPAM Act applies to emails sent to both consumers and business entities.

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

Federal Arbitration Act. Many loan agreements in the online lending space contain an arbitration provision. Arbitration is subject to the Federal Arbitration Act.[534] This law facilitates the resolution of private disputes through the use of an arbitrator. The U.S. Supreme Court has shown a preference for arbitration in its decision for example upholding class action waivers in arbitration clauses.[535] The law generally preempts state law except in instances of unconscionability or violation of public policy.[536]

Recent cases have shown that lenders can use these provisions to redirect court proceedings into an arbitration forum where the case is ultimately settled or dismissed. Such was the situation with a recent class action filed in March 2018 in state court by a retailer against a small business lender and its Funding Bank.[537] The defendants removed the case to federal court. The complaint challenged the platform's program with a Utah bank and alleged that it purposefully evades criminal usury laws. The suit asserted violations of California usury laws and consumer protection laws against false advertising and unfair competition and also alleged violations of federal racketeering (*"RICO"*) laws. The defendants' motion to stay the action pending the outcome of arbitration was granted. The case was dismissed in December 2018. The presence of the arbitration agreement not only sent the case to arbitration rather than court, and avoided a class action proceeding, but also resulted in a stipulation of dismissal being filed, thereby ending the case.

Arbitration clauses remain helpful in settling lawsuits and avoiding class actions.

534 9 U.S.C. 1 *et seq*.

535 *Am. Express Co. v. Italian Colors Rest*., 570 U.S. 228 (2013).

536 California cases have ruled that federal law is not preempted where the arbitration clause prohibits the bringing of a public injunction. *McGill v. Citibank, N.A.*, 393 P.3d 85 (Cal. 2017). This came after the U.S. Supreme Court found that a California law making class action waivers unconscionable should not be followed and consumers were bound by contractual provisions containing class action waiver clauses. *AT&T Mobility v. Concepcion*, 563 U.S. 333 (2011). As a result, arbitration remains uncertain in California actions.

537 *Barnabas Clothing, Inc. et al. v. Kabbage, Inc. and Celtic Bank Corp.*, No. 2:18-cv-03414-PSG-SS (C.D. Cal.).

K. State Developments

NYDFS Cybersecurity Rule. On February 16, 2017, the New York Department of Financial Services (*"NYDFS"*) announced that its final cybersecurity rule for financial institutions would take effect beginning on March 1, 2017. The NYDFS had issued a revised version of the proposed rule on December 28, 2016 after receiving more than 150 comments in response to its initial proposed rule.[538] The NYDFS cybersecurity rule imposes broad requirements that are more stringent than the federal requirements under the Gramm-Leach-Bliley Act Safeguards Rule. It requires banks, insurance companies, and other financial services institutions regulated by the NYDFS to establish and maintain a cybersecurity program designed to protect consumers and ensure the safety and soundness of the New York financial services industry.

Specifically, the NYDFS cybersecurity rule requires covered entities to encrypt certain nonpublic data both in transit and at rest; limit the retention and ensure the timely destruction of nonpublic information, essentially mandating a record retention policy; conduct vulnerability assessments at least quarterly; and conduct penetration testing and written risk assessments of their information system at least annually, among other requirements. Although the 2016 revisions to the rule included longer timeframes for compliance and more flexibility for covered entities in satisfying its requirements than the original proposed rule, the NYDFS cybersecurity rule remains substantially different from the federal regulatory approach, and may pose challenges and require significant time and resources for covered entities to comply.

After a two-year transitional period and separate compliance dates for different portions of the NYDFS cybersecurity rule, full compliance was required for all covered entities by March 1, 2019.

California Enforcement Action. A 2016 California Department of Business Oversight (the *"DBO"*) action decision appears to expand entities that need to be licensed under the California Financing Law.[539] The decision upheld a cease and desist order against an entity that did not fund loans to borrowers but solicited borrowers, evaluated the credit, proposed loan terms, and made or participated in credit advances. The DBO rejected the argument that a license was needed only if the entity actually made loans, instead concluding that lending-related activities may also require licensing. It remains to be seen if this could be the DBO's way of reaching marketplace lenders to require licensing. As referenced elsewhere in this book, California has also targeted data aggregators and "buy now pay later" companies for licensing under California law.

State Legislation. Some states are contemplating additional licensing for marketplace lenders. For example, in New York, Governor Cuomo's proposed budget for fiscal year 2018 contained a change to

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538 NYDFS Press Release, Feb. 16, 2017, *available at:* https://www.governor.ny.gov/news/governor-cuomo-announces-first-nation-cybersecurity-regulation-protecting-consumers-and; Proposed 23 NYCRR 500.

539 *In the Matter of the Desist and Refrain Order Against Fin. Servs. Enter. dba Pioneer Capital*, OAH No. 2016040551 (Nov. 29, 2016). The DBO is now the Department of Financial Protection and Innovation.

existing law regarding financial services licenses.[540] While current law requires a license to make loans above 16% to consumers (up to $25,000) and to businesses (up to $50,000), the proposal, if enacted, would require licensing for anyone making loans at any rate and would ensnare many marketplace lending participants, as it would include entities soliciting and purchasing or acquiring consumer and business loans and those who arrange or facilitate the funding of loans.[541] Legislation is also pending in New York that would create a licensing requirement for commercial lenders.[542]

In mid-2016, a bill was introduced in the Illinois legislature that would impose licensing for online commercial lenders and for loan purchasers, regulate commercial lending practices, and require significant loan disclosures and ability to repay assessments. While the legislation was never considered in 2016, it could be re-introduced in the future and shows an interest in regulating small business lending in addition to consumer loans.

State Regulators Promote Innovation. In January 2018, the Conference of State Bank Supervisors (*"CSBS"*) promulgated Vision 2020, an effort to modernize state regulation of non-bank companies, including fintech companies. The goal of this project is to provide an integrated 50-state licensing and supervisory structure by leveraging technology and cooperation among the states, which indicates the CSBS's support for innovation on a national scale.[543] In one of its first actions toward this end, the CSBS appointed an advisory panel consisting of industry participants to advise the state regulators on how to better supervise non-bank fintech companies. Further to these efforts, on February 6, 2018, seven states entered into a compact to coordinate the licensing of money services businesses.[544] This pilot program is the first step toward the integrated multistate approach to licensing and supervision.

Meanwhile, on March 22, 2018, Arizona became the first state to pass legislation allowing financial companies to experiment with innovative products and services directly with consumers in a true regulatory sandbox, which will be administered by the Arizona Attorney General's office. This will allow financial companies to bypass state licensing requirements and offer their products and services to up to 10,000 consumers for a period of two years. The expressed goal of the program is to attract innovators to the state, although the legislation was met with opposition from consumer groups. Modeled after similar experiences in the United Kingdom, Arizona now holds the distinction for being the first state in the United States to legitimize the regulatory sandbox concept. Since then, nine other states have enacted legislation promoting regulatory sandboxes, including Florida, Hawaii, Kentucky, Nevada, Utah, Vermont, West Virginia, and Wyoming.

540 N.Y. BANKING L. § 340.

541 The legislation potentially covers merchant cash advances and factoring. Other states are considering such legislation. See the "Recent Developments" section.

542 S. 1061B.

543 However, as described above, the CSBS has brought litigation against the OCC to prevent it from moving forward with issuing a national bank charter for fintech companies.

544 The states are Georgia, Illinois, Kansas, Massachusetts, Tennessee, Texas, and Washington.

IV. State Developments

A. Enforcement Actions

1. *Massachusetts—$1.25 Million Penalty from Online Lender*

In January 2020, the Massachusetts Attorney General settled allegations against an online lender for $1.25 million.[545] The claim related to the amount of interest charged on small loans. The Commonwealth claimed that the online lender charged excessive interest greater than that allowed by the usury limit on small loans. The fact situation is somewhat unique in that a small loan as defined by Massachusetts law is a loan of $6,000 or less. However, the way the statute is written, the $6,000 is the amount disbursed to the customer, not the face amount of the loan. As a result, it was alleged that while the platform made loans for more than $6,000, the amount disbursed to the borrower was $6,000 or less (due to upfront origination fees) and therefore fell within the ambit of the Small Loan Law which has a maximum interest rate. The platform also agreed to stop making small loans in Massachusetts with interest rates above the allowable rate cap.

2. *Pennsylvania Licensing of Master Servicer Even When Subservicer Is Licensed/Debt Collector*

An online lender was licensed in Pennsylvania as a mortgage lender and as a lender under the Commonwealth's small loan law but was not licensed as a mortgage servicer. The platform believed it was allowed to service loans it originated using a licensed subservicer, although it held the master servicing rights for the loans. However, the applicable Pennsylvania law requires licensing for anyone "directly or indirectly" servicing a mortgage loan.[546] Thus, even a master servicer though not engaging in direct servicing activities was required to be licensed, and failure to have a license was a violation of the statute. In this case, the platform paid a fine of $110,000 to the Commonwealth.[547] Platforms that have servicing rights but contract servicing to others need to be cognizant of applicable licensing requirements. As this action illustrates, while those engaging in direct collection may be required to be licensed, even those not engaged in direct servicing activities but are master servicers or hold servicing rights may need to have a license in some jurisdictions.

Another interesting licensing case was filed in Pennsylvania. In a putative class action, the plaintiff sued a debt collector collecting loans originally made by WebBank but subsequently charged off, alleging that the collector could not collect more than 6% interest, the Pennsylvania usury rate, unless it held a Consumer Discount Company license.[548] The complaint also alleged that collecting interest at

545 *In re LendingClub Corp.*, Civ. Act. No. 20-0155C (Sup. Ct. Suffolk Cty.). Assurance of Discontinuance filed Jan. 17, 2020.

546 7 Pa. C.S. 6102.

547 *Commonwealth of Pennsylvania Dep't of Banking and Sec. Compliance Office v. SoFi Lending Corp.*, Docket No. 19-0079 (BKG-CAO). Commonwealth of Pennsylvania Dep't of Banking and Securities. Consent Agreement and Order of Sept. 12, 2019.

548 *Meola et al. v. Velocity Invs., LLC*, Case No: 2:19-cv-00997-DSC (W.D. Pa. filed Aug. 13, 2019).

greater than the state limit also violated the federal Fair Debt Collection Practices Act. The complaint cited the statute that required a license to "charge, collect, contract for or receive interest" in excess of 6% a year as the basis of its claim. The case was settled and dismissed on undisclosed terms on January 15, 2020. But the complaint reinforces the precept that all aspects of online lending can be subject to state licensing and platforms should ensure that they have any applicable licenses to engage in marketing, lending, servicing, collection or purchasing activities.

3. California—Investigation of Auto Lending Relationship

On January 1, 2020 California law changed. Under legislation known as Assembly Bill 539, interest rates were capped on installment loans between $2,500 and $10,000 were capped at 36% plus the Federal Funds rate. Prior to that time, those loans would not be subject to any rate ceiling if the lender held a California loan license, subject only to the potential theory of unconscionability of the loan.[549] Some lenders indicated that they would attempt to skirt the law by entering into arrangements with federally insured depository institutions. That approach was criticized by lenders and consumer advocates. One licensee that previously made loans under its California Financing Law license entered into a program with a bank in Utah, which under principles of federal preemption could make loans in excess of the California usury limits. In September 2020, the California Department of Business Oversight, which regulates loan licensees, announced that it was investigating an auto loan licensee that had entered into a relationship with the bank to make loans to California residents by the bank rather than under the California loan license.[550] The state indicated it wanted to determine if the licensee's role in the bank program was so extensive as to require compliance with California laws. This would suggest implication of true lender claims. The California regulator entered into a consent order with the Company in December 2021.

V. SECURITIES LAWS

A. Securities and Exchange Commission (SEC)

As of late, the SEC has not had a significant impact on marketplace lending although it oversees the P2P note programs of some industry players. However, in April 2019, the SEC fined an online lender $3 million for allegedly overstating returns for more than 30,000 investors.[551] The overstatement was alleged to have resulted from omission of debts that were unlikely to be repaid. The disclosed returns

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549 *De La Torre v. CashCall, Inc.*, S 241434 (Cal. Sup. Ct. Aug. 13, 2018), question from the Ninth Circuit Court of Appeals Case No. 14-17571 (a loan could be found to be unconscionable even if the statute had no interest rate ceiling). A.B. 539 also provided that a California Financing Law loan cannot be found to be unconscionable based on the interest rate alone. This may not be necessary since the court decision indicated that all of the facts and circumstances surrounding the loan must be considered before declaring the rate as unconscionable. Properly read, the decision itself would not allow the interest rate charged on the loan in and of itself to determine unconscionability.

550 The licensee involved was Wheels Financial Group dba LoanMart. It is somewhat unusual for a regulator to announce that it was issuing a subpoena and starting an investigation as opposed to announcing a formal lawsuit or proceeding.

551 *In re Prosper Funding LLC*, Adm. Proc. No. 3-19148 (Sec. Exch. Comm'n Apr. 2019).

excluded the impact of the worst performing loans.[552] The SEC claimed some returns were double their true value. The SEC stated that it is committed to holding fintech companies to the same standards applicable to other participants in the securities markets.

In March 2021, the SEC adopted its final rule "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets", which implements several amendments to the crowdfunding regulations.[553] The amendments included raising the offering limit from $1.07 million to $5 million, as well as amending the investment limits to remove them entirely for accredited investors and to permit non-accredited investors to invest the greater of their annual income or net worth. These changes suggest a desire by the SEC to make crowdfunding offerings more available and on simpler terms than had been the case under the preexisting regulatory scheme.

B. Background

Two of the largest consumer marketplace lenders—LendingClub Corporation ("*LendingClub*")[554] and Prosper Marketplace, Inc. ("*Prosper*")—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 most marketplace lenders now fund themselves principally from other sources, P2P note programs continue to fund a significant amount of loan originations. Certainly, these programs have attracted and continue to attract a great deal of media attention and public interest. The remainder of this subsection therefore describes the structure of consumer-oriented P2P platforms, as a prelude to the discussion that follows of related securities law issues, 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.[555]

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

552 The company engaged in debt sales where third-party debt buyers purchased defaulted loans and the company's system then stopped including those loans in calculating investors' returns. Investors continued to buy securities based on the inaccurate return figures, allowing the company to profit from additional transaction fees related to the loans, according to the SEC. The company did not admit or deny the SEC's findings but has implemented increased supervision, periodic reviews and testing.

553 86 Fed. Reg. 3496 (Jan. 14, 2021).

554 LendingClub is now a bank holding company and loans are made by LendingClub Bank, N.A.

555 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. Much of the discussion that follows in this "Securities Laws" section will therefore not be relevant to most marketplace lenders. At the same time, even marketplace lenders who do not issue pass-through notes may finance themselves through other types of transactions—such as securitizations—that will be subject to certain of the securities laws discussed below.

consumers seeking credit.[556] 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.[557] 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. The Operator will use the information reported by each borrower to assign a proprietary credit rating to the requested loan and to fix the interest rate for the loan. The Operator will include in the website posting for each loan request the relevant borrower-reported information, the Operator's proprietary credit rating of the borrower, 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.[558] 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

556 The remainder of this section summarizes the structures employed by LendingClub and Prosper. The discussion is not, however, intended to provide a complete description of the LendingClub and Prosper structures or to identify all of the differences that may exist between them. It also does not describe all of the lending businesses in which LendingClub and/or Prosper is currently engaged.

557 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.

558 Marketplace lenders have increasingly come to rely upon institutional rather than retail investors to finance their lending operations and most lenders (excluding LendingClub and Prosper) do not solicit retail funding. These institutional investors may include investment funds organized to acquire P2P loans. It is not efficient for institutional investors to purchase fractional interests in individual consumer loans, and in response most lenders have established "whole-loan" programs through which institutional investors may acquire the entire beneficial interest in individual loans. In certain programs the institutional investor will be able to select the specific loans it purchases; in others the marketplace lender will allocate whole loans to participating institutional investors with reference to category-wide loan eligibility approved by the investor. These programs have greatly facilitated the growth of the industry by accommodating institutional demand, but they also may reduce the opportunities for small investors to purchase interests in certain loans. Increased reliance on whole-loan programs and the securitization market is, to some extent, inconsistent with the argument that has often been made that P2P lending can level the playing field between institutional and individual investors and provide the latter with attractive investment opportunities previously denied to them.

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 nonrecourse obligations of the Operator (except to the extent that the Operator actually receives payments from the borrower on the applicable Borrower Loan). Accordingly, lenders assume all of the credit risk on the applicable Borrower Loan and will not be entitled to recover any deficiency of principal or interest from the Operator if the borrower defaults. The Operator will service the Borrower Loans on behalf of the lenders and may refer any delinquent loan to a collection agency. The relatively low principal amounts of the Borrower Loans, however, generally will make it impracticable for the Operator to commence legal proceedings against defaulting borrowers. The Operator will maintain a segregated deposit account (the *"Collections Account"*) at the Deposit Bank into which it will deposit all payments it receives on the Borrower Loans. The Operator will deduct its servicing fee from each Borrower Loan payment it receives before forwarding the net amount to the applicable lenders as payments on their Platform Notes.[559]

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

559 The servicing fee deducted from each Borrower Loan payment is typically in the area of 1% of the payment amount.

exchange but may be transferable 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 may find P2P lending attractive, as the available performance data indicate that a well-diversified portfolio of Platform Notes can produce attractive risk-adjusted rates of return. At the same time, Operators who fund themselves through Platform Notes will face the challenge of securities law compliance.[560] The P2P platforms are subject on a continuing basis to a number of separate federal and state securities laws. As discussed below, these laws are complex and compliance entails substantial costs.

C. Securities Act

The Securities Act of 1933 (the "*Securities Act*") requires any issuer engaged in a public offering of its securities to register the securities with the SEC unless an exemption from registration applies. The registration exemptions in the Securities Act are rather narrow in scope and none of them will be available for a public offering of Platform Notes.[561] An Operator therefore must register its Platform Notes with the SEC before commencing public sales of its securities.[562]

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

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560 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.

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

562 Operators that do not issue Platform Notes but rather simply sell whole loans (or participations in such loans) are advised to consider whether such loans (or participations therein) are in fact "securities" under the Securities Act. Among the factors relevant to this determination are whether the loan purchaser is a regulated lender or an investor not principally engaged in lending as a business, the plan of distribution of the loans (*i.e.*, whether the loans will be marketed to many unrelated investors in small denominations in a manner more typical for securities distributions than for lending arrangements), the reasonable expectations of the investors, and whether the program will be subject to an alternative regulatory scheme (such as banking and consumer lending laws) that could make the application of the securities laws unnecessary for the protection of investors. The analysis of whether a marketplace loan (or certain commitments by the Operator to investors) is a "security" can also be affected by the composition of the investor base for the loans. *See* footnote 577 below.

the securities. The SEC developed its disclosure guidelines long before Internet-based lending became a possibility and accordingly certain of them are not an exact fit for P2P companies. Although each of LendingClub and Prosper has successfully registered its Platform Notes with the SEC, and although LendingClub's and Prosper's prospectuses may provide some guidance regarding the disclosure formats and level of disclosure that the SEC will approve, prospective Operators should allow at least several months (and probably more) to complete the SEC registration process and should expect to incur substantial related expenses. The timeline for obtaining approval will largely be driven by the number and significance of the comments submitted by the SEC staff on the applicant's filings—a variable that the applicant can affect but not control through careful preparation of its documents.

At the same time, newly formed Operators are likely to qualify for certain advantages that the Jumpstart Our Business Startups Act (the *"JOBS Act"*) provides to "emerging growth companies." Among other matters, an emerging growth company is permitted to (i) reduce the scale of certain financial disclosures that would otherwise be required in its prospectus, (ii) not provide an auditor attestation of its internal controls over financial reporting procedures (as would otherwise be required by the Sarbanes-Oxley Act), and (iii) choose to implement new or revised accounting procedures (when promulgated by FASB) under the extended transition period available to nonpublic companies. An emerging growth company (unlike other issuers) also is permitted to submit its initial registration statement to the SEC on a confidential basis so that the issuer can consider and address initial SEC staff comments before any filings become public. An issuer's status as an emerging growth company does not continue indefinitely but will terminate on specified dates. As initially constructed, issuers that had total annual gross revenues of less than $1 billion during their most recently completed fiscal year and that, as of December 8, 2011, had not sold any of their equity securities under a Securities Act registration statement qualified as an "emerging growth company" under the JOBS Act. Pursuant to the statutory definition, the SEC is required every five years to index to inflation the annual gross revenue amount used to determine emerging growth company status to reflect the change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics. In September 2022, the SEC adopted amendments to Securities Act Rule 405 and Exchange Act Rule 12b-2 to reflect the most recent updates to the emerging growth company definition with an inflation-adjusted annual gross revenue threshold from $1,070,000,000 to $1,235,000,000.

An Operator that registers its securities will need to rely on Securities Act Rule 415. This rule permits issuers to file "shelf" registration statements under which they register a specified amount of a generic category of securities (*e.g.,* "notes" or "debt securities") but don't specify the maturity dates, interest rates, or other negotiated financial terms that will apply to individual securities. When the issuer (or its underwriter) reaches agreement with an investor for an issuance of specific securities, the issuer will take the requisite amount of securities off the "shelf" by delivering to the investor and filing with the SEC a prospectus supplement that specifies the amount of securities sold and the applicable negotiated terms. The alternative approach—under which the issuer files a separate registration statement for each security that it sells—would not work for Operators because of the sheer volume of securities they will sell. Stated differently, if Rule 415 were not available, each Platform Note—because its underlying borrower, maturity date, and interest rate won't in combination match those of any other Platform Note—would constitute a distinct series of securities and would have to be separately registered. The cost of filing multiple registration statements would be prohibitive. Rule 415 therefore makes registered offerings of Platform Notes possible but, at the same time, the Rule was not specifically designed to accommodate P2P lending. In particular, Operators remain subject to the requirement to file with the SEC separate preliminary or final prospectus supplements for each security offered or sold under the shelf registration. Unlike corporate issuers that utilize Rule 415, and that ordinarily will sell debt securities off their shelf registrations only on an occasional basis, Operators will expect to offer and sell multiple series of Platform Notes to multiple investors every day. An Operator therefore will be required to prepare and file with the SEC each year numerous prospectus supplements or "listing reports," which briefly summarize the terms of each Borrower Loan underlying a Platform Note. An Operator can significantly reduce the burden of this filing requirement by automating the preparation and filing of the supplements. The filing nonetheless seems to impose an unnecessary expense on Operators (except, of course, to the extent that it enables them to remain in technical compliance with the Securities Act) since P2P investors almost universally will rely upon the platform website and not on SEC filings to access the terms of their Platform Notes.[563]

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

Regulation AB under the Securities Act sets forth the disclosure requirements that apply to registered offerings of asset-backed securities and to certain periodic reports that the issuers of registered asset-backed securities must file. Operators have not structured their disclosures to Platform Note investors to satisfy Regulation AB requirements and in view of the effort and expense involved may prefer not to do so. Although Platform Notes could, in one sense, be characterized as "asset-backed" obligations since each Platform Note is backed by the cash flow from a specific Borrower Loan, the SEC has not treated Platform Notes as "asset-backed securities" for purposes of Regulation AB, nor should it have done so. Regulation AB defines an "asset-backed security" as a security that is "primarily serviced by the cash flows of a discrete *pool* of receivables or other financial assets" (emphasis supplied). As each Platform Note is backed by only a single Borrower Loan and not by a "pool" of financial assets, Platform Notes are not covered by the Regulation AB definition.[564] In addition, Regulation AB limits

563 The SEC is not unaware of the need for securities regulation to evolve in tandem with changes in financial technology. In October 2018 the SEC announced the launch of its "Strategic Hub for Innovation and Financial Technology" ("*FinHub*"). Among other goals, the SEC intends FinHub to provide a forum through which industry and the public can directly engage with the SEC on innovative ideas and technological developments. See https://www.sec.gov/finhub.

564 It is 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:

the concept of "asset-backed security" to securities of an issuer that limits its activities to "passively owning or holding the pool of assets, issuing the asset-backed securities … and other activities reasonably incidental thereto." An Operator, however, will not limit its activities to "passively owning or holding" the Borrower Loans and issuing the related Platform Notes but will instead be actively engaged in structuring, promoting, and operating its proprietary Internet-based lending system. The Operator, in other words, should be considered an operating company that is fundamentally different from the securitization trusts and other special purpose issuers that historically have been subject to Regulation AB. However, the fact that Platform Notes are not "asset-backed securities" under Regulation AB does not necessarily mean that they are not "asset-backed securities" under certain other federal securities laws. See "Risk Retention Requirements" below.

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

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(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.

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). Under the original version of Rule 506, it would have been difficult for an Operator to conduct a valid private placement 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 provides details on Rule 506 offering procedures.

D. 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 startup companies much easier. Most marketplace lenders who issue Platform Notes, including various companies engaged in consumer, small business, and real estate lending, in fact accept investments only from accredited investors. A prospective Operator must nonetheless consider whether restricting the sale of its Platform Notes to accredited investors will unduly limit its investor base. In relevant part, the term "accredited investor" includes most institutional investors and individuals who (i) individually, or with their spouse, have a net worth exceeding $1 million exclusive of the value of the person's primary residence (and subject to certain adjustments for "underwater" mortgages), or (ii) individually had an income in excess of $200,000 in each of the two preceding years, or had a joint income with spouse in excess of $300,000 in each of those years, and have a reasonable expectation of reaching the same income level in the current year.[565] An Operator that intends to sell Platform Notes

565 On August 26, 2020, the SEC adopted amendments to the definition of accredited investor (SEC Release Nos. 33-10824; 34-89669; File No. S7-25-19). The amendments to the accredited investor definition added new categories of natural persons based on professional knowledge, experience, or certifications and added new categories of entities, including a "catch-all" category for any entity owning in excess of $5 million in investments. In particular, the amendments to the accredited

to individuals may not use Rule 506 unless it excludes nonaccredited investors.[566] Operators whose business plans require a broader investor base should continue to register their Platform Notes with the SEC or, possibly, consider using Regulation A+ (discussed below). The strong interest of institutional investors in marketplace loans as an asset class, however, may well reduce the pressure for prospective Operators to register their notes for public sale.

The Rule 506 amendments that made general solicitation possible also added two important conditions to the Rule 506 exemption. First, the Operator is required to take "reasonable steps to verify" that each purchaser of the Platform Notes is, in fact, an accredited investor. Congress and the SEC have imposed the verification requirement to reduce the risk that general solicitation by Rule 506 issuers will result in sales of securities to nonaccredited investors. This concern applies with particular force when sales are made to natural persons. The SEC has not required that issuers employ any specific procedures to confirm that their investors are accredited but, to facilitate compliance, it has listed in the Rule certain nonexclusive procedures that it will deem sufficient to verify a natural person's status. If, for example, the Operator proposes to sell Notes to a natural person who represents that he or she satisfies the income test, the Operator could verify the prospective purchaser's status by (i) reviewing copies of any Internal Revenue Service form that documents such person's income for the two most recent years (*e.g.*, Form W-2 or 1040), and (ii) obtaining a written representation from such person that he or she has a reasonable expectation of having an income during the current year that is sufficient to satisfy the test. Alternatively, if the prospective purchaser represents that he or she satisfies the net worth test, the Operator could (among other possible approaches) verify the purchaser's status as an accredited investor by reviewing copies of personal brokerage or bank account statements (to confirm assets) and a consumer report from at least one nationwide consumer reporting agency (to confirm liabilities). It will be important for the Operator (or any third party that it engages for the purpose) to perform the verification review diligently as the Operator must have a "reasonable belief" that each of its investors is accredited to qualify for the exemption.[567] It's also important to remember that each investor must

investor definition: (1) added to the definition new categories that permit natural persons to qualify as accredited investors based on certain professional certifications and designations, such as a Series 7, 65 or 82 license, or other credentials issued by an accredited educational institution; (2) with respect to investments in a private fund, added a new category based on the person's status as a "knowledgeable employee" of the fund; (3) added limited liability companies that meet certain conditions, registered investment advisers, exempt reporting advisers and rural business investment companies to the current list of entities that may qualify as accredited investors; (4) added a new category for any entity, including Indian tribes, that owns "investments," as defined in Rule 2a51-1(b) under the Investment Company Act, in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered; (5) added "family offices" with at least $5 million in assets under management and their "family clients," as each term is defined under the Investment Advisers Act; and (6) added the term "spousal equivalent" to the accredited investor definition, so that spousal equivalents may pool their finances for the purpose of qualifying as accredited investors.

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

567 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

be accredited whenever he or she purchases a Note (and not only on the date of the investor's first purchase). The Operator therefore must take care to obtain and review updated financial information for each of the investors on a periodic basis. Finally, the Operator will need to consider whether any verification procedures that require natural persons to deliver personal financial information to the Operator will impair the marketability of the Platform Notes.

Second, Rule 506 contains disqualification provisions 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.

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

A final point to consider in relation to Rule 506 offerings is the potential application of broker-dealer registration requirements. Any company that makes direct offers of securities through an Internet platform (rather than through a broker-dealer registered with the SEC and in the applicable states) potentially is subject to registration as a broker-dealer at both the federal and state levels. To address this issue Congress included in the JOBS Act (codified as Section 4(b) of the Securities Act) an exemption from broker-dealer registration for persons who maintain a platform or mechanism (which may include a website) to offer securities if (i) the securities are offered only under Rule 506, and (ii) certain other conditions are satisfied. Among such other conditions, neither that person nor any person associated with it may receive any compensation in connection with the sale of the securities.

not have a preexisting relationship would likely be deemed to be engaged in "general solicitation" and therefore subject to the verification requirement.

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.

E. Regulation A+

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

Regulation A+ is divided into two tiers: Tier 1, for securities offerings of up to $20 million, and Tier 2, for offerings of up to $50 million.[568] Both Tier 1 and Tier 2 issuers will be required to make certain specified disclosures to investors, file an offering statement with the SEC, and obtain SEC clearance before commencing sales. Each issuer must also provide investors with certain financial statements including, in the case of Tier 2 issuers, audited statements. The disclosure requirements are broader for Tier 2 issuers than for Tier 1 issuers and in many respects, resemble those that would apply in a registered public offering by the same company. In addition, Tier 2 issuers will be subject to ongoing reporting requirements pursuant to which they must file annual, semiannual, and current event reports with the SEC similar to (though less comprehensive than) the periodic reports that registered issuers

568 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.

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.[569] 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 10% 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 (other than issuer affiliates) therefore may resell them free from any Securities Act restrictions as to the amount or timing of sales. In contrast, securities sold under Rule 506 do constitute "restricted securities" and are subject to resale restrictions. See "Secondary Trading" below.

The principal difficulty posed by Regulation A+ for offerings of Platform Notes remains the cap on the permitted offering amount. The respective Tier 1 and Tier 2 caps refer to the amount of securities sold by the issuer in reliance upon the exemption in any 12-month period. The increase in the offering cap relative to prior Regulation A will permit many privately held operating companies to raise substantial amounts of capital, but an Operator engaged in a continuous offering of Platform Notes is unlikely to achieve long-term success if it cannot sell more than $20 million principal amount of Platform Notes (in the case of a Tier 1 offering) or $50 million (in the case of Tier 2) in any 12 months.[570] An Operator could consider selling Platform Notes under Regulation A+ as it ramps up operations and then

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569 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 that defines "qualified purchaser" to include all purchasers of Tier 2 securities. The states of Massachusetts and Montana sued the SEC in federal court to invalidate this rule. These states contended 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. In June 2016, the U.S. Court of Appeals for the District of Columbia ruled in favor of the SEC and upheld the rule. *Linden v. SEC*, 825 F.3d 646 (D.C. Cir. 2016).

570 A study of the Regulation A+ offerings that have been undertaken through December 2016 found that over 85% of Regulation A+ issuers have used the Regulation to sell equity rather than debt securities. A. Knyazeva, "Regulation A+: What Do We Know So Far," *available at* https://www.sec.gov/dera/staff-papers/white-papers/Knyazeva_RegulationA-.pdf. This finding is consistent with our expectation that Regulation A+ will likely be more useful to marketplace lenders seeking to raise limited amounts of equity capital than to those hoping to issue Platform Notes to retail investors. In March 2021, the SEC adopted amendments to the exemptive framework under the Securities Act of 1933 that increases the offering limits for Regulation A and revises certain individual investment limits based on the Commission's experience with the rules, marketplace practices, capital raising trends, and comments received (86 Fed. Reg. 3496 (1/14/2021)) (the *"Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets"*). The amendments also provide for expanded rules governing offering communications between investors and issuers, including permitting certain "demo day" activity without running afoul of the prohibition on general solicitation.

registering its Platform Notes under the Securities Act (at which point the Operator could sell Platform Notes to the public in amounts not exceeding the amount registered with the SEC). However, since we expect that most new Operators will choose not to register their Platform Notes with the SEC because of the costs involved, and since an Operator can sell unlimited amounts of its Platform Notes to accredited investors under Rule 506 without becoming subject to the filing, disclosure, and reporting requirements that apply under Regulation A+ (which are particularly burdensome in Tier 2 offerings), it seems that Operators will have an incentive to use Regulation A+ rather than Rule 506 only if they can accept the offering cap and want to (i) sell a limited amount of Platform Notes to nonaccredited investors, and/or (ii) exempt their Platform Notes from Securities Act resale restrictions.[571]

Takeaway: Regulation A+ may sometimes be helpful to Operators seeking to raise limited amounts of capital (particularly equity capital), but is unlikely to provide an attractive framework on which to base a Platform Notes program.

F. Blue Sky Laws

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

In many states, the state securities commission has authority to apply "merit" regulation and to deny registration to any securities it deems unsuitable for sale. A limited number of states—often citing the novel nature of Platform Notes and/or the Operator's failure to provide lenders with fully verified borrower information—have in fact refused to permit the sale of Platform Notes to retail investors. Alternatively, a state may agree to register the Platform Notes but only subject to suitability criteria that will limit the scope of the offering therein. A state could, for example, limit sales of Platform Notes to investors whose annual income and/or net worth exceeds specified amounts or limit the dollar

571 An Operator might be able to undertake simultaneous Rule 506(c) and Regulation A+ offerings pursuant to which it could sell unlimited amounts of Platform Notes to accredited investors and not more than $50 million of Platform Notes in any 12 months to nonaccredited investors. The Operator would remain subject to the Regulation's ongoing filing and reporting requirements. An important question is whether the SEC would "integrate" the Regulation A+ and Rule 506(c) offerings (*i.e.*, treat the two offerings as a single combined offering for Securities Act purposes). Although Regulation A+ contains a safe harbor from integration of Regulation A+ offerings with other offerings of securities that are registered or fall within certain exemptions from registration if certain safeguards are observed, the Operator and its counsel would need to consider carefully if they can avail themselves of the safe harbor because integration, if applied, could result in the loss of both the Regulation A+ and the Rule 506(c) exemptions.

amount of Platform Notes that any single retail investor may purchase. The Operator must observe these restrictions in the applicable state even though the SEC has not imposed any equivalent restrictions at the federal level. In addition, prospective Operators should note that the Blue Sky laws contain provisions that may impose civil liability on the Operator for (i) disclosure violations (in much the same manner as previously discussed in relation to the Securities Act), or (ii) any failure to maintain required registrations in effect. In particular, the Blue Sky laws generally permit investors to rescind their investments and recover the full purchase price from the issuer (plus interest) if the issuer sold them unregistered, nonexempt securities. In view of the fact that most Blue Sky registrations must be renewed annually, it will be very important for Operators to monitor their Blue Sky filings and timely renew each registration before it expires.

> **Take Care:** When structuring a securities offering, issuers sometimes focus on the Securities Act and the SEC and pay insufficient attention to the Blue Sky laws. This can be a very costly mistake given the civil, administrative and criminal penalties that can result from Blue Sky violations.

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

The Securities Act also prohibits the states from requiring the registration of any securities listed on the New York Stock Exchange or the Nasdaq National Market System (*"Listed Securities"*) or of any securities of a listed issuer that are senior or equal in rank to the Listed Securities. Some commentators have stated that an Operator that lists its common stock will thereby be exempted from Blue Sky restrictions because its Platform Notes will be "senior" securities. However, that statement might not be correct. The Blue Sky laws historically have included exemptions for the securities of listed companies because such companies (i) must satisfy stock exchange listing standards (which can, to some degree, be used as a proxy to identify "quality" companies), and (ii) are subject to ongoing regulation under both stock exchange and SEC rules.[572] 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

572 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.

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.[573]

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

G. Secondary Trading

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

If the Operator sold the Platform Notes in a registered public offering, holders of the notes will be permitted to resell them without restriction under the Securities Act. The registration statement filed by the Operator with the SEC, as a practical matter, covers both the initial placement of the notes and subsequent resales, and no further filings with the SEC by either the Operator or the selling holders will be required. The Blue Sky laws, however, may nonetheless impose significant restrictions on resales. An important point—and one that is sometimes overlooked—is that the Blue Sky laws apply not only to an issuer's sale of its securities but also to all secondary market sales. A holder of Platform Notes that have been registered under the Securities Act therefore will be entitled to resell the notes in

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573 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.

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 such sale.[574]

If the Operator sold the Platform Notes under Regulation A+, holders of the securities (other than the issuer affiliates) may freely resell them without restriction under the Securities Act. In this respect, Regulation A+ securities have the same Securities Act status as registered securities. In addition, the Securities Act and Regulation A+ preempt the application of Blue Sky registration requirements to all securities sales made under Tier 2 of Regulation A+ (but not Tier 1). The preemption of Blue Sky requirements extends, however, only to the initial placement of the Tier 2 securities and not to any resales; any such resales therefore must comply with applicable Blue Sky laws.

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

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

574 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 appears 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 notes' original issuance dates. Federal preemption therefore will sometimes be helpful in creating Blue Sky exemptions for resales of SEC-registered Platform Notes but does not provide a basis for unrestricted trading in all such Platform Notes without regard to the circumstances of the resale.

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 Section 4(a)(7) of the Securities Act.

Rule 144. Rule 144 permits a holder of unregistered securities (other than an affiliate of the issuer) to resell the securities without registration under the Securities Act if the holder has held the securities for at least (i) six months, if the issuer is a reporting company under the Exchange Act, or (ii) one year, if the issuer is not a reporting company. There is no limit on the amount of securities that may be sold in reliance upon the exemption or the types of persons to whom the sales may be made.[575] 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.

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

Section 4(a)(7). Section 4(a)(7) of the Securities Act permits the holders of privately placed securities, including securities originally sold under Rule 506, 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. As discussed below, Section 4(a)(7) could enable accredited investors to trade unregistered Platform Notes that have been outstanding for the requisite period.

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575 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.

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

It's quite clear that Platform Notes will be more attractive as an investment if they are freely tradable. As discussed above, the Securities Act will not restrict trading in Platform Notes originally issued in a registered public offering or under Regulation A+. In addition, Securities Act registration will not be required for any resales of privately placed Platform Notes made to accredited investors under Section 4(a)(7). An Operator might therefore choose to facilitate secondary trading by establishing an electronic marketplace on which outstanding Platform Notes may be resold. The marketplace could be made available to all investors if the Platform Notes were originally sold in a registered offering or pursuant to Regulation A+ (subject to compliance with applicable Blue Sky laws in connection with each such resale) and to any accredited investor if the Platform Notes were sold in a Rule 506 private placement (subject to a determination that the seller's action in listing its securities for sale on an electronic marketplace does not constitute "general solicitation" or "general advertising"). Any such marketplace must be operated by a registered broker-dealer and will likely have to be registered with the SEC under the Exchange Act as an "alternative trading system." In this regard, LendingClub has arranged for a registered broker-dealer, FOLIO*fn*, to operate an alternative trading system on which its outstanding Platform Notes may be traded.[576]

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

576 Prosper previously sponsored a similar FOLIO*fn* trading system for its Platform Notes but terminated it in October 2016 due to low trading volumes.

evidencing consumer loans ordinarily will not constitute "securities" under the Securities Act. In addition, banks and other institutional investors routinely trade very substantial volumes of commercial loans (or participations therein) between themselves without deeming the loans or participations to be "securities." These facts could provide some basis for arguing that the securities laws should not restrict trading in consumer loans originated by Internet-based lenders. Unfortunately, both the SEC and state securities regulators are very unlikely to accept that argument, at least in relation to any trading platform that permits participation by nonaccredited investors. Case law has made it quite clear that instruments that are not "securities" when originated—such as notes evidencing consumer loans—can become "securities" (or can be deemed to entail the offering of an associated "investment contract") because of the manner in which they are marketed or the types of investors to which they are sold. Both the factors the courts have deemed relevant in those cases and the SEC's analysis in the enforcement proceeding in which it held that Platform Notes are "securities" would strongly support a decision by the regulators to treat consumer loans as "securities" to the extent they are made available for trading by the general public on an electronic platform.[577]

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577 The SEC's readiness to treat certain marketplace loan sales as securities offerings is evident in comments made by the SEC staff in 2016 when it approved the registration of two closed-end investment companies organized to invest in marketplace loans. *See* "Closed-End Investment Companies" below. In the course of the registration process, each Fund was advised by the SEC staff that "it is the view of the SEC that the purchase of whole loans through alternative lending platforms involves the purchase of 'securities' under the Securities Act of 1933 … issued by the originating platforms." These statements by the SEC staff are not necessarily inconsistent with the general view that unsecured consumer loans, taken by themselves, are not "securities" because (i) the definition of "security" in the Securities Act also includes any "investment contract," and (ii) it is possible for an investment that is not a "security" to be coupled with an "investment contract" and sold as a single financial product. In other words, the SEC could deem marketplace lenders who sell loans to retail investors also to be offering an associated "investment contract" consisting of the investment-related services that the lender provides to loan purchasers. In this connection, it is significant that the SEC staff stated that it viewed the issuer of the marketplace loan "security" as the originating lender (and not as the borrower under the loan). The relevant lender-provided services may consist of (i) loan servicing, (ii) the platform's assignment of credit ratings to the loans, (iii) representations by the platform that each borrower satisfies specified criteria, (iv) the platform's undertaking to handle all related cash flows (including the application of purchase prices paid by the investors), (v) undertakings to maintain a secondary market or trading platform for the loans, (vi) any general solicitation of borrowers and/or investors by the platform to assemble the mass of participants needed to make the investment scheme possible, and/or (vii) other similar activities. The manner in which the program is marketed to investors (*e.g.*, if it is presented as an alternative to lower-yielding debt investments such as CDs) also can be relevant. It follows that a marketplace lender that sells whole loans to retail investors could reduce the risk that it will be deemed to be offering "securities" by limiting the number of investment-related services it provides to investors. For example, the platform could require each investor to engage its own servicer. However, certain of the foregoing services are integral to any marketplace lending program and could not easily be withdrawn. It further could be difficult in connection with a retail offering to reduce the services provided to a level at which the SEC (and state regulators) would concur that no investment contract exists. It would be reasonable for the SEC to be concerned that individual marketplace loans can be risky and should not be marketed to unsophisticated individual investors without securities law compliance. The SEC therefore is likely to take an expansive view of its jurisdiction in connection with any such offerings. All this being said, an important factor in determining whether "securities" have been offered in connection with a loan sale remains the relative degree of sophistication, bargaining power and financial capacity of the investor, and, unless the SEC clearly states to the contrary, market participants will probably continue to take the position that institutional whole-loan sale programs do not entail a securities offering (although loan sellers may, as a precautionary measure, nonetheless require each purchaser to represent that it is an accredited investor and/or a QIB for Securities Act purposes).

H. Securities Exchange Act

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

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

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

Finally, each Operator should also consider the potential application of state broker-dealer registration requirements. In contrast to Blue Sky securities registration requirements, state laws requiring the registration of broker-dealers and/or sales personnel are not preempted by federal law in offerings by listed companies or in any Regulation A+ or Rule 506 offerings.[578] 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.

I. 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.[579] 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.[580]

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

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

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

579 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.

580 An Operator that offers or sells Notes in violation of the Investment Company Act will face very serious consequences. In addition to the risks of SEC enforcement proceedings and/or civil claims by investors, Section 47 of the Investment Company Act provides that any contract executed by an unregistered, non-exempt investment company "is unenforceable by either party … unless a court finds that under the circumstances enforcement would produce a more equitable result than non-enforcement." In other words, all of the Operator's contracts and Notes would potentially be void.

Internet-based financing platform intended to match borrowers needing credit with third-party lenders. In this regard, it is significant that the Operator, unlike a traditional investment company, does not purchase assets with a view to earning investment returns in the form of interest payments or capital gains but instead is compensated for its services through the onetime origination fees paid by borrowers and the servicing fees paid by lenders. Certain Operators might also claim exemption under Section 3(c)(4) of the Investment Company Act, which exempts from registration any person "substantially all of whose business is confined to making small loans." The SEC deems the term "small loans" to include only consumer loans made to individuals for consumption (and not business) purposes. The availability of Section 3(c)(4) to consumer-oriented platforms that utilize Funding Banks is, however, not entirely clear because such platforms technically do not "make" loans to consumers but instead purchase bank loans that indirectly are funded by the third-party lenders.

A separate exemption may be available for commercial lenders under Section 3(c)(5) of the Investment Company Act. Specifically, Section 3(c)(5) exempts companies primarily engaged in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, loans, accounts receivables, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Although Section 3(c)(5) is broad in scope, it is important to note that it does not extend to all commercial loans and that, in particular, unrestricted working capital loans will not qualify under Section 3(c)(5)(B) because such loans are not made to fund the purchase of "specified" merchandise, insurance, or service. Any small business lender that relies upon Section 3(c)(5)(B) 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. In addition, any such lender should require each of its borrowers to provide specific information on the merchandise, service or insurance which the borrower will purchase with the loan proceeds as general representations from the borrower that it will apply the proceeds to an eligible use may not be sufficient under SEC staff interpretations of Section 3(c)(5)(B).[581]

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.

581 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.

The SEC has stated that it similarly will not deem Rule 506(c) offerings to constitute "public offerings" under Section 3(c)(7). Accordingly, Operators who sell Platform Notes only to investors who are both "accredited investors" and "qualified purchasers" should be able to claim the Section 3(c)(7) exemption. As a practical matter, however, Section 3(c)(7) will be useful only to Operators who intend to solicit only large institutional investors and high net worth individuals. In particular, individuals generally will qualify as "qualified purchasers" only if they beneficially own at least $5 million in "investments" (as defined by the SEC).

Another private placement exemption under the Investment Company Act, Section 3(c)(1), may be useful to Operators who organize investment funds to invest in Borrower Loans (as discussed below). Specifically, Section 3(c)(1) provides an exemption for issuers not engaged in a public offering of securities and that have fewer than 100 security holders (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.[582]

J. 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.[583] Registered investment advisers are subject to a detailed regulatory regime that governs, among other matters, fiduciary duties owed to clients, required disclosures to clients, procedures for handling client assets, recordkeeping and reporting requirements, and the content of investment adviser advertisements. Although the related initial and ongoing compliance expenses would not be insignificant, and material changes to its business practices could be required, an Operator required to register as an investment adviser likely could comply with most of the applicable regulations. At the same time, investment advisers, as fiduciaries to their clients, are required at all times to act in the client's best interests, subject to any

582 The fact that Operators engaged in issuing Platform Notes may be exempt from investment company registration has no bearing on the Investment Company Act status of funds that are organized expressly to enable retail investors to invest in pools of marketplace loans. Any such fund almost certainly will be an investment company and, if its shares are publicly offered, it will need to register with the SEC. *See* "Closed-End Investment Companies" below.

583 15 U.S.C. § 80b-2(a)(11).

advisory contract that the client agrees to after full and fair disclosure. 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 manage and adequately disclose the conflicts that may exist between its fiduciary duty to the fund and its duties to other purchasers of Platform Notes.

As previously mentioned, a number of consumer and small business marketplace lenders assign proprietary credit ratings to borrowers of loans they originate. These ratings may reflect the lender's internal assessment of a borrower's relative creditworthiness and the probability that the borrower may default on a loan. As an example, a lender might assign each borrower a credit rating of "A," "B," "C" or "D," with A-rated borrowers deemed to have the lowest relative probability of default and D-rated borrowers the highest. The ratings do not constitute a statement by the lender of the actual probability that any borrower will default or of the expected loss on any loan given default. The lenders disclose these ratings to investors who may consider them in choosing which loans to purchase. The lenders also may use the ratings in connection with automated investment programs pursuant to which participating investors may direct the lender to allocate their available investment funds (or specified percentages of their available funds) to purchase loans to borrowers having specific credit ratings or loans to borrowers that fall within a specified range of credit ratings.

It could be argued that in posting these ratings the Operator is acting as an investment adviser under the Advisers Act and therefore required to register with the SEC. Registration is generally required if an Operator is considered to be (i) in the business (ii) of providing advice, or issuing reports or analyses, regarding securities (iii) for compensation. In the past, the SEC staff has raised whether an Operator should register as an investment adviser due to its construction of model portfolios that correspond to certain risk levels and estimated returns of loans,[584] and the SEC could raise similar concerns with respect to an Operator's proprietary ratings.

While the analysis inevitably depends on the facts and circumstances of each Operator, ratings that reflect the Operator's view of a borrower's creditworthiness may resemble ratings issued by traditional credit rating agencies, which the SEC staff suggests should not be interpreted as investment advice or viewed as a recommendation to buy or sell any securities.[585] Moreover, ratings are generally impersonal in nature, meaning they do not purport to meet the objectives or needs of specific lenders. Therefore, assuming lenders are already given adequate disclosure of an Operator's business and any applicable conflicts of interest, requiring an Operator to register as an investment adviser with the SEC would seem to offer limited benefits to lenders who use ratings as a tool to invest in loans. Since there is no existing authority from the SEC on the issue, an Operator should take care when using ratings in

584 *See* Letter from Prosper Marketplace, Inc. to the Division of Corporation Finance, at *6 (Nov. 24, 2009), https://www.sec.gov/ Archives/edgar/data/1416265/000141626509000266/filename1.htm.

585 *See* SEC Updated Investor Bulletin: The ABCs of Credit Ratings (Oct. 12, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_creditratings.

its business, including making clear disclosures to lenders that the ratings do not constitute investment advice and should not be viewed by lenders as a recommendation to purchase any Borrower Loans.

The investment adviser analysis is different, however, 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 use investor capital to invest in Borrower Loans generated by the platform. As investment manager, the Operator (or, if applicable, an affiliate thereof formed to be the general partner/manager of the fund) will determine the specific Borrower Loans the fund will purchase and will receive related management and/or performance fees. The status of consumer loans as "securities" under the Advisers Act is not entirely clear, but an Operator should assume that the Advisers Act applies given that the investors' interests in the fund are likely securities. It follows that, in receiving any compensation, including reimbursement of expenses, for managing the fund's investments, the Operator will be acting as an "investment adviser."

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

It is important to note that not all Operators who act as investment advisers will be required, or are indeed eligible, to register with the SEC. The Advisers Act establishes a bifurcated regulatory scheme under which larger investment advisers register with the SEC and smaller advisers (unless an exemption applies) register with the states in which they provide advice. In general, an investment adviser may not register with the SEC unless it has at least $100 million of assets under management. An Operator that manages investment fund(s) and/or managed accounts that invest in Borrower Loans but does not satisfy the $100 million threshold should consider the possible application of state registration requirements. If the Operator is not required to register with its state securities regulator, for example, if a state law exemption applies, then the Operator may be required to register with the SEC as an exempt reporting adviser. An Operator generally will be permitted to treat each of its managed funds as a single client and will not be deemed, for purposes of most 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 it only manages funds that rely upon Section 3(c)(1) or 3(c)(7) of the Investment Company Act (*i.e.*, the Operator does not accept any separately managed accounts). Investment advisers who only advise such private funds are exempt from registering with the SEC if they have less than $150 million in assets under management (including any uncalled commitments and leverage).

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 to employ a random loan allocation procedure and/or require the investment fund to purchase loans only under a predefined investment strategy that restricts both the amount of fund capital that may be employed at any one time and the total amount that may be invested in specific ratings categories of loans. The goal will be to develop parameters that will permit the fund to attract investors but will also provide direct investors with continued access to the most attractive loans. The investment fund must of course fully disclose these parameters in its offering materials along with any conflicts of interest.

K. Risk Retention Requirements

Much of the blame for the "Great Recession" has been placed on the "originate-to-distribute" model of asset securitization. Certainly, it's reasonable to believe that asset originators who transfer all of the credit risk on the securitized assets may have incentives that won't necessarily advance investor protection. Accordingly, the Dodd-Frank Act required the SEC, the Board of Governors of the Federal Reserve System (the *"Federal Reserve Board"*), the Federal Deposit Insurance Corporation (the *"FDIC"*), the Federal Housing Finance Agency (*"FHFA"*), and the Office of the Comptroller of the Currency (the *"OCC"* and, together with the SEC, the FDIC, the Federal Reserve Board, and FHFA, the *"Agencies"*) jointly to prescribe regulations that (i) require a securitizer to retain not less than 5% 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.[586] 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.

Final regulations implementing the risk retention requirement became effective in December 2016 (the *"Retention Rules"*).[587] The requirements apply to both public and private offerings of asset-backed

586 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.

587 The Retention Rules became effective in December 2015 for residential mortgage securitizations that are not otherwise exempted.

securities and securitizers therefore cannot avoid the requirements by selling their securities only in private placements exempt from Securities Act registration. Marketplace lenders need to consider two questions under the Retention Rules. First, does the risk retention requirement apply to Platform Notes? And second, in securitizations of marketplace loans (to which the Retention Rules unquestionably apply), who will be deemed the "sponsor" required to retain the credit risk?[588]

As to the first of these questions, technical arguments can be made that Platform Notes constitute "asset-backed securities" to which the retention requirement applies.[589] If that were the case, the Funding Bank would likely be deemed the party required to retain the risk.[590] At the same time, technical arguments also can be made that the Retention Rules do not extend to Platform Notes.[591] It

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588 Although numerous securitizations of marketplace loans have been completed, 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.

589 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 Retention Rules 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.

590 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 transfer 100% of the credit risk on any Borrower Loan to the Operator. Regulators might also be inclined to 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. However, a court decision strongly suggests that the regulators do not have authority under the Retention Rules to treat the Operator as a "sponsor" in this situation because the Operator, assuming that it does not acquire the Borrower Loans from the Funding Bank and then transfer them to a special-purpose company that issues the Platform Notes, has not transferred any Borrower Loans to the issuing entity (*i.e.,* to itself). *See* footnote 603 below.

591 Under the Retention Rules 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 Retention Rules 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 Retention Rules, 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 564 above.

is unnecessary for us to debate the relative merits of these opposing arguments as the Agencies (although they have made no formal pronouncement) have not applied risk retention to Platform Notes nor have they indicated any intention to do so. In this regard, the industry may consider itself fortunate since, if risk retention did apply, the economic and regulatory capital costs that Funding Banks incur in funding Borrower Loans would increase significantly.

The second question noted above—identifying the party subject to the retention requirement in actual marketplace loan securitizations—sometimes has an easy answer. The Retention Rules apply the risk retention requirement to "sponsors" and define "sponsor," in relevant part, as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, … to the issuing entity." If a balance sheet lender securitizes loans that it originated and holds on its balance sheet, the lender unquestionably will be the "sponsor" since it is both "organizing" and "initiating" the securitization and selling assets to the securitization issuer. At the same time, in many marketplace loan securitizations the loan seller is not the originator but rather a commercial bank, investment fund, or other loan aggregator (each, an *"Aggregator"*) which has acquired a pool of loans that it intends to refinance. In this latter situation, should the sponsor be deemed the Funding Bank, the marketplace lender, or the Aggregator? Each of these entities has been the loan seller in one of the series of transactions through which the securitized loans are transferred to the securitization issuer. 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.[592] It therefore could be argued that each of the Funding Bank, the marketplace lender, and the Aggregator is a "sponsor" for purposes of the Retention Rules.[593] 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.[594]

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592 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 and/or to pay indemnities in respect of such loans. See "Securitization" below.

593 It is possible under the Retention Rules 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.

594 The Agencies have indicated that an entity will not be a "sponsor" for purposes of the Retention Rules unless it has "actively participated" in the "underwriting and selection of the securitized assets." *See* Credit Risk Retention, 79 Fed. Reg. 77609 (Dec. 24, 2014). The marketplace lender and the Funding Bank should not be deemed "sponsors" under this test so long as they are not actively involved in selecting the assets the Aggregator chooses to securitize.

Don't Forget: In every securitization of marketplace loans (including private placements) there must be at least one "sponsor" who retains not less than 5% of the credit risk on the securitized loans.

A sponsor may satisfy its retention obligation by holding an "eligible horizontal residual interest," an "eligible vertical interest," or a combination of eligible horizontal and vertical interests, or by posting cash collateral in an "eligible horizontal cash reserve account."[595] In all cases, however, the interest retained by the sponsor must represent not less than 5% of the credit risk on the securitized assets. The sponsor may hold the retained interest directly or through a "majority-owned affiliate." The latter term includes any entity that owns a majority of the sponsor's equity, in which the sponsor holds a majority of the equity, or which is under common majority control with the sponsor. The option to hold the risk position through a majority-owned affiliate enables sponsors to reduce the economic cost of risk retention by arranging for third parties to provide part of funding for the risk position. Although the third-party investor will require appropriate compensation for the risk it assumes, marketplace lenders who choose to securitize their loans but face capital constraints in funding their risk positions may be able to increase their securitization volumes by holding the positions through majority-owned affiliates organized with outside investors. Alternatively, or in addition, the Retention Rules also permit a securitization sponsor to finance its retained interest and to pledge it as collateral under a loan, repurchase, or other financing agreement so long as the lender has full recourse against the sponsor.[596]

L. Securitization

The volume of marketplace loan securitizations continues to grow rapidly. Securitization entails the creation of asset-backed securities ("*ABS*") that represent the right to receive the cash flow from a pool of segregated financial assets. The goal in the securitization is to create ABS whose credit risk derives solely from the credit quality and payment characteristics of the asset pool and is not tied to the credit standing of the asset originator. Asset classes that have long been securitized include trade receivables, commercial and residential mortgages, credit card receivables, student loans, and auto loans and leases. Although the first marketplace loan securitizations were completed little more than five years ago, marketplace loans have already become an important part of the securitization market and will likely someday represent a significant portion of overall consumer ABS. 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.

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595 An "eligible horizontal residual interest" refers to a subordinate class of securities in the securitization structure to which losses will be allocated before any losses are allocated to other ABS interests. An "eligible horizontal cash reserve account" refers to a cash account funded by the sponsor in the required amount to provide credit support for the ABS interests issued in the securitization. An "eligible vertical interest" refers to the purchase by the sponsor of an equal proportionate interest (but not less than 5%) of all classes of ABS interests issued in the securitization.

596 The European Union ("*EU*") also imposes certain risk retention requirements in securitizations. Sponsors who wish to market their ABS to European investors will need to comply with the applicable EU regulations. A discussion of the EU risk retention regulations is outside the scope of this book.

Look to the Future: Marketplace loan securitizations are getting high credit ratings and gaining broader investor acceptance. Continued rapid growth is likely.

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

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

Another key concept in securitizations is credit enhancement, which can be achieved through a number of means. Most typically, the SPE will issue multiple classes of ABS with different levels of seniority. The more senior classes will be entitled to receive payment before the subordinate classes if the cash flow generated by the underlying assets is not sufficient to allow the SPE to make payments on all of the classes of ABS. Naturally, the senior classes of ABS will carry higher credit ratings whereas the subordinated classes will carry higher interest rates. The SPE also typically will purchase the financial assets from the sponsor at a discount to their face amounts. As a result, the aggregate principal amount of financial assets owned by the SPE will exceed the aggregate principal amount of the debt securities issued by it and such excess (*"overcollateralization"*) helps to protect the security holders against the consequences of defaults on the collateral.[597] 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 overcollateralization and/or the sale of subordinated or equity tranches. A sponsor may also provide credit enhancement by funding a reserve account upon which the SPE will draw to make payments due on the senior securities if the transaction cash flow would otherwise result in a shortfall.[598] 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 performance data for marketplace loan securitizations is still not available for a complete credit cycle, investors in marketplace loan ABS may require the structures to include higher credit enhancement levels than might be expected for similar asset classes; however, these differentials recently have been decreasing as investors gain more confidence in the product.[599]

Rating agencies were originally somewhat reluctant to rate marketplace loan securitizations because of the limited performance history available for marketplace loans (including default, prepayment, and recovery characteristics). The agencies were particularly concerned (and to some extent remain concerned) that Operators cannot supply performance information covering a complete credit cycle. The decision by Moody's in early 2015 to grant the first investment-grade rating to marketplace loan ABS therefore represented something of a milestone, and investment-grade ratings have subsequently become common.[600] 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 availability of investment grade ratings has played an important role in broadening the investor base for marketplace loan securitizations.

Of course, the rating agencies consider many factors beyond performance history when rating marketplace loan securitizations. Among other factors, the agencies will consider (i) default correlation

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597 Any losses resulting from defaults on the collateral will be allocated in the first instance to the holders of the equity (or "residual") in the SPE and thereafter to the several classes of notes issued in the securitization in reverse order of seniority.

598 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.

599 The risks inherent in securitizing a relatively new asset class were demonstrated in 2016 and 2017 when certain marketplace loan securitizations hit early amortization triggers because of poor loan performance.

600 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 marketplace loan securitizations, and a number of rating agencies have published related research reports or policy statements.

among borrowers, (ii) the 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 backup servicing arrangements, (vi) the number and depth of the credit tranches contemplated by the proposed structure, (vii) whether the lender has the financial capacity to repurchase ineligible loans from the SPE if so required (and whether repurchase obligations are triggered by a breach of any of numerous eligibility criteria or only in limited circumstances such as verifiable identity theft), (viii) the possibility that some borrowers may place a lower priority on repaying marketplace loans than other personal obligations (*e.g.*, residential mortgages or auto loans), and (ix) regulatory issues affecting the industry. At least in the short term, certain of these considerations could lower the ratings of marketplace loan ABS below the ratings that might otherwise be assigned to securitizations of traditional consumer loans of an equivalent credit quality (as measured by borrower credit scores).

Most securitizations of traditional asset classes are sponsored by the loan originator or one of its affiliates. In this regard, a number of marketplace lenders regularly securitize loans which they hold on balance sheet and, and as discussed below, certain lenders are now sponsoring securitizations that permit multiple institutional investors to pool and securitize loans which they have purchased from the lender. At the same time, many marketplace loan securitizations have been sponsored by banks, investment funds, or other institutional investors (each, an "*Aggregator*") who have acquired a substantial amount of loans from a particular marketplace lender with whom they are not affiliated. In these transactions, the lack of affiliation between the Aggregator and the lender can complicate the documentation. To take one example, much of the disclosure in the ABS offering materials will focus on risk factors specific to the originating marketplace lender as well as the lender's underwriting policies, servicing practices, regulatory status, and loan performance information. Unless otherwise agreed in the loan purchase agreement pursuant to which the Aggregator has purchased loans from the marketplace lender (the *"Loan Purchase Agreement"*), the Aggregator, because it is not a lender affiliate, cannot require the lender either to provide information needed to prepare the offering materials or to certify that the relevant portions of the offering materials (once prepared by the Aggregator) are accurate. The underwriters or placement agents for the ABS will nonetheless want the Aggregator's counsel and their own counsel to provide unqualified "negative assurance" letters as to the accuracy of the offering materials. Similarly, the Aggregator will want the SPE to have the benefit of any undertakings made by the marketplace lender to the Aggregator to repurchase ineligible loans (*i.e.*, loans the lender sold to the Aggregator in breach of the eligibility criteria stated in the Loan Purchase Agreement) or to pay related indemnities. Again, however, because the Aggregator is not an affiliate of the marketplace lender it cannot—except by contract—compel the lender to consent to any such assignment of the Aggregator's rights. Aggregators therefore will want the marketplace lender to provide certain undertakings intended to facilitate future securitizations. Among other matters, the marketplace lender may agree in the Loan Purchase Agreement (or in a related "multi-party" agreement) to provide certain lender-related information for use in the securitization offering memorandum (including loan performance information); to indemnify the SPE and the underwriters against material inaccuracies in that disclosure; to arrange for its counsel to provide a "negative assurance" letter in relation to such disclosures (other than any financial disclosures); to authorize the SPE to rely upon its representations in the Loan Purchase Agreement; to repurchase ineligible loans from the SPE as if the SPE were the Aggregator; and, if the securities will be rated, to assist the Aggregator in responding to pertinent questions raised by the rating agencies. Marketplace lenders generally have been willing to provide some or all of these types of undertakings as they recognize that Aggregators can (and very often will) reinvest the securitization proceeds in new marketplace loans. The exact terms negotiated between marketplace lenders and Aggregators can nonetheless vary substantially from one transaction to the next. Of particular importance, the scope of the marketplace lender's obligation to repurchase ineligible loans (or to pay related indemnities) has not been uniform across transactions. The lack of uniform terms can reduce secondary market demand for marketplace loan ABS and thereby impair the industry's overall access to the securitization markets.[601]

Looking forward, Aggregator-sponsored securitizations are becoming relatively less common because of an important innovation in marketplace loan securitizations that made its debut in 2017. Specifically, several of the largest consumer marketplace lenders now operate securitization platforms that enable institutional investors to sell loans purchased by them from the lender to an SPE organized and managed by the lender. The ABS issued by the SPE typically will be collateralized by loans that the SPE has purchased both from the lender and from a number of institutional investors not affiliated with the lender. These multiseller structures provide significant benefits to both the participating loan investors and the sponsoring lenders. The investors, for their part, save the expense and administrative burden of sponsoring a securitization that is limited to loans they themselves own[602] and, since they are not the securitization sponsor, they are not subject to credit risk retention obligations under the Retention Rules.[603] The lenders also can use the structures as a convenient means to securitize loans

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

602 Each participating investor will, however, likely be required to reimburse the sponsoring lender for the investor's pro rata share of the transaction expenses and may be required to pay program fees to the lender as a condition to being allowed to participate in the securitizations.

603 Although it could be argued that the participating investors (because they are selling assets into the securitization) are acting as "sponsors" of the securitization under the Retention Rules and are therefore subject to the risk retention requirement, in most cases the sponsoring lender will agree to be treated as the "sponsor" under the Retention Rules and to retain credit risk accordingly. The retention of credit risk by the lender will satisfy any obligation that the investors may have to retain credit risk. A recent decision of the U.S. Court of Appeals for the District of Columbia Circuit does, however, strongly suggest that the lender must itself sell loans into the securitization to constitute a "sponsor" under the Retention Rules and that the Retention Rules will not be satisfied if the lender has organized and manages the ABS issuer and accepts credit risk at the level required by the rules but does not itself transfer any assets into the securitization. *See The Loan Syndications and Trading Ass'n v. Sec. and Exch. Comm'n and Bd. of Governors of Fed. Reserve Ass'n*, 882 F.3d 220 (D.C. Cir. 2018) (holding that open market CLO managers who do not themselves transfer assets into the CLO issuers they manage are not "sponsors" subject to the Retention Rules). There have also been recent securitizations involving multiple sellers in which one of the sellers (other than the marketplace lender) agreed to act as the securitization sponsor and to retain credit risk.

they hold on-balance sheet. Of perhaps equal or greater importance, platform-sponsored securitizations—by providing institutional investors with a convenient means to resell purchased loans—can increase both investor interest in marketplace loan investing and the total volume of marketplace loan securitizations. Lenders further can use the structures to influence (if not control) the timing and amounts of the securitizations of their loans and to help ensure that key terms of the securitizations (*e.g.*, transaction structure, collateral composition, credit enhancement levels and ratings) are consistent from one transaction to the next. Greater consistency between transactions makes it easier for ABS investors to analyze individual ABS tranches and may result in greater investor demand. In view of these advantages, it is not surprising that lender-sponsored multiseller securitizations have accounted for a substantial portion of all marketplace loan ABS issued in the past three years and additional lenders will likely sponsor such platforms as their loan volumes increase.

Certain marketplace lenders have also established ongoing programs to issue asset-backed series certificates ("*ABS Certificates*") collateralized by specific pools of consumer loans. These programs also can provide marketplace lenders and institutional loan investors with enhanced liquidity. At the same time, there are several important distinctions between these programs and other marketplace loan securitizations. The most important of these is perhaps frequency of issuance—whereas an SPE organized to issue marketplace loan ABS typically issues securities only on a single closing date, in an ABS Certificates program the issuer will purchase loans from its sponsor, and will issue a separate series of securities collateralized by the loans then being purchased (the *"Relevant Loans"*), on each of multiple closing dates. Each series of ABS Certificates entitles the holder to receive (through the issuer) the cash flow on the Relevant Loans (net of servicing fees and other expenses) but the holder will have no rights in the loans allocated by the issuer to any of its other ABS Certificates series.[604] Second, in contrast to traditional securitizations, the ABS Certificates programs have no credit tranching or embedded credit support (such as overcollateralization, reserve funds or excess spread) and are not rated. Each ABS Certificate simply passes through to the certificate holder the economic performance of the Relevant Loans.[605] And finally, an ABS Certificates issuer typically will purchase loans only from a single marketplace lender or Aggregator (rather than from multiple potential sellers as in the multiseller securitizations discussed immediately above). An ABS Certificates program can provide a

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These include certain transactions in which the sponsor also acted as the lead ABS underwriter and did not sell any loans to the SPE other than loans it acquired on the securitization closing date from other investors for the express purpose of securitizing them.

604 The ABS Certificates issuer typically will be organized as a Delaware series trust. The Delaware Statutory Trust Act permits these trusts to issue beneficial interests in separate series, to allocate specific trust assets to specific series, and to provide that the debts and obligations of any series shall be enforceable only against the assets of that series and not against the assets of the trust generally or of any other series.

605 As pass-through securities the ABS Certificates bear a strong resemblance to Platform Notes. They differ from Platform Notes, however, insofar as they (i) represent the economic interest in a pool of whole loans, rather than a fractional interest in a single loan, (ii) are sold only to institutional investors in private placements rather than to the general public in registered public offerings, (iii) require the sponsors to comply with the Retention Rules, and (iv) would generally be characterized as equity interests in the underlying debt comprising the loan pool, rather than as directly constituting debt themselves, for U.S. federal income tax purposes. See "Tax Considerations—Tax Treatment of Platform Notes" below.

convenient means for a marketplace lender or Aggregator to effect periodic sales of loans that it has funded or acquired and reduces execution costs because all such sales will be made under a common template. Of course, since the programs have no credit enhancement, a structural solution may not be readily available if poor loan performance depresses investor demand for the ABS Certificates of any particular program.

Any marketplace lender or Aggregator who sponsors a securitization will be subject to the federal risk retention rules previously discussed. The sponsor therefore will be required to retain at least 5% of the credit risk on each of the securitized loans. See "Risk Retention Requirements" above. The sponsor also must comply with a number of other SEC rules governing ABS offerings. Among other matters, the sponsor will be required to file periodic reports with the SEC disclosing the amounts of any demands that it receives from investors (or from an indenture trustee on behalf of investors) to repurchase ineligible loans and of any such repurchases that it makes. Any marketplace lender or Aggregator who sponsors a securitization should take care to review and understand the applicable requirements.

M. Closed-End Investment Companies

In 2016 the SEC approved the registration of the first marketplace lending funds to be registered with the SEC as investment companies under the Investment Company Act. These two investment companies—the RiverNorth Specialty Finance Corporation (formerly, the RiverNorth Marketplace Lending Corporation)[606] and the Stone Ridge Alternative Lending Risk Premium Fund,[607] together with subsequent launches of investment companies investing in marketplace loans[608] (each, a *"Fund,"* and together, the *"Funds"*)—operate as closed-end investment companies, or "closed-end funds," one of three basic types of investment companies.[609]

Interval Closed-End Fund Structure. The Funds currently operate as an "interval closed-end fund." Interval funds are classified as closed-end funds but they are very different from "traditional" closed-end funds in that their shares typically do not trade on an exchange in the secondary market. Instead, their shares are subject to periodic repurchase offers by the Fund.[610] As an interval fund, the

606 *See* RiverNorth Specialty Finance Corporation (SEC File Nos. 333-204866; 811-23067).

607 *See* Stone Ridge Trust V (SEC File Nos. 333-208513; 811-23120).

608 *See, e.g.,* AlphaCentric Prime Meridian Income Fund (SEC File Nos. 333-21603; 811-01397).

609 The SEC prohibits the two other basic types of investment companies, open-end mutual funds and unit investment trusts, from investing more than 15% of their portfolio in "illiquid assets" in order to ensure that they can generate enough cash to meet redemption requests. An illiquid asset is one that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund. Revisions of Guideline to Form N-1A, 57 Fed. Reg. 9828, 9829 (Mar. 20, 1992). As there is currently no developed secondary market for marketplace loans or Platform Notes, these assets would be considered illiquid assets under the Investment Company Act and thus a fund investing substantially in such instruments could not be a mutual fund or UIT. However, because closed-end funds are not required to make redemptions, they are not subject to the Investment Company Act liquidity requirements.

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

Funds will make periodic repurchase offers to their shareholders, generally every three, six, or twelve months, as disclosed in the Fund's prospectus. When the Funds make a repurchase offer to their shareholders, they will specify a date by which shareholders must accept the repurchase offer. The price that shareholders will receive on a repurchase will be based on the per-share net asset value determined as of a specified (and disclosed) date. In addition, the Funds continuously offer their shares at a price based on the Fund's net asset value.

Platform Concentration Issues. Registered investment companies are required to meet a diversification test in order to qualify as a regulated investment company (*"RIC"*) under the Internal Revenue Code of 1986, as amended (the *"Code"*). An investment company is required to be treated as a RIC under the Code in order to avoid entity-level income taxes. If an investment company is not eligible to be treated as a RIC due to its failure to meet the RIC diversification test, it would be obligated to pay applicable federal and state corporate income taxes on its taxable income. At the close of each quarter of the taxable year, (a) at least 50% of the value of a RIC's total assets must be represented by (i) cash, cash equivalents, U.S. government securities, or securities of other RICs and (ii) other securities whose value with respect to any one issuer is not greater than 5% of the value of the total assets and does not represent more than 10% of the outstanding voting securities of any one issuer and (b) not more than 25% of the value of the RIC's total assets may consist of (i) the securities of any one issuer (other than U.S. government securities or RICs) or of any two or more issuers controlled by the RIC and that are engaged in the same or similar trades or businesses or a related business, or (ii) the securities of one or more qualified publicly traded partnerships.[611] As a result of the above requirements, there is a concern that an investment company's investment in marketplace loans concentrated in a particular platform would violate the RIC test.[612] For general U.S. federal income tax purposes, the person who is obligated under a debt is viewed as the issuer of the debt. As such, for purposes of the RIC diversification test, the individual borrowers of the marketplace loans purchased by the Fund should be considered to be the "issuer," not the platform through which such whole loans were originated. In regard to the marketplace loans purchases, the Funds become the owner of the marketplace loans for U.S. tax purposes, bearing the risk of loss and the potential for profit on the purchase. A Fund's risk exposure on the marketplace loans is dependent upon the willingness and ability of the individual borrowers to pay—if one of the individual borrowers were not to pay, the platform seller would not be obligated to make the Fund whole. The platform seller, although retained as servicer, no longer bears the risk of loss on marketplace loans sold. This contrasts with Platform Notes, in which the applicable platform

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RiverNorth Specialty Finance Corporation, which remains an interval closed-end fund, began trading on the New York Stock Exchange (NYSE) effective June 12, 2019 under the ticker symbol "RSF."

611 I.R.C. § 851(b)(3).

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

should be considered the issuer, as the Fund's risk exposure is also dependent upon the platform's ability to make the pass-through payments.

Separately, an investment company will need to limit the portion of its investments which it allocates to the marketplace loans from any single platform in order to avoid the potential for the SEC to require a platform to co-register as an issuer on the investment company's registration statement during the continuous offering of the securities. As set forth in the registration statements for the Funds and as further discussed herein, the SEC currently takes the position that marketplace loans facilitated by a platform involve an associated investment contract, or "security" under the Securities Act, issued by the platform in connection with the prepurchase activity by the platform, as well as the servicing and other arrangements.[613] Pursuant to Rule 140 under the Securities Act, a co-issuer is generally considered to exist with respect to "[a] person, the *chief* part of whose business consists of the purchase of the *securities* of one issuer …" The SEC has interpreted the term "chief" as used in Rule 140 to mean an investment of greater than 45% of a person's assets in an issuer.[614] Because the marketplace loans are treated as securities issued by a platform with respect to determining the co-issuer status of such platform, the Funds may be required to agree in its registration statement that it will not invest greater than 45% of its managed assets in the securities of, or marketplace loans originated by, any single platform.

Investment Company Act Custody Requirements. Section 17(f) of the Investment Company Act requires that an investment company's "securities and similar investments" be placed and maintained in the custody of a bank, a member firm of a national securities exchange, or the investment company itself, subject to certain conditions or in accordance with the rules and regulations or orders as the SEC may prescribe. With respect to an investment company's custody of traditional loans, the SEC has conditioned compliance with Section 17(f) on whether (i) the fund's custodian would hold relevant documentation evidencing the fund's ownership in the loan; (ii) the documentation would permit the custodian to enforce all the fund's ownership rights in a court of law; and (iii) the administrative agents, in transmitting interest and principal payments to the fund, do not hold assets of the fund, but act as paying agents.[615]

As described in the Funds' registration statements, each borrower under a marketplace loan electronically signs the loan documents, binding the borrower to the terms of the loan, including provisions authorizing the lender to transfer the loan to another party. In general, each Fund will direct its custodian to open an account with each platform selected by the Fund. The account will be opened in the name of the custodian as custodian for the Fund. When a Fund directs the purchase of a loan,

613 *See* footnote 577 above for a more detailed discussion of the "investment contract" issue in the context of marketplace loan sales.

614 *See*, *e.g.*, FBC Conduit Trust I, SEC No-Action Letter (Oct. 6, 1987).

615 The SEC issued a no-action letter to a Merrill Lynch fund that invested in loans. Merrill Lynch Prime Fund, SEC No Action Letter (Nov. 4, 1992).

the Fund custodian receives electronically from the platform the loan documents and evidence of the Fund's purchase and ownership of the loan, thereby obtaining custody of the documentation that creates and represents the Fund's rights in the loan. In addition to the promissory note, such documentation generally includes (depending on the platform) the borrower agreement, authorization to obtain a credit report for loan listing, truth in lending disclosure, terms of use and consent to electronic transactions and disclosures, credit profile authorization, bank account verification, and debit authorization (or equivalents thereof). The Fund's custodian then wires funds to the platform in payment for the loans. The custodian maintains on its books a custodial account for the Fund through which the custodian holds in custody the platform account, the loan/loan documents, and, if applicable, any cash in the platform account including the interest and principal payments received on the loan. As transferee of the platform's contractual rights in the loan, the Fund obtains all of the platform's rights in the loan and is able to enforce those contractual rights against the platform and the borrower, as applicable.

Valuation Considerations. Investment companies are required to adopt and implement policies and procedures designed to prevent violation of the federal securities laws, including investment portfolio valuation requirements under the Investment Company Act.[616] An investment company's board must approve procedures pursuant to which the investment company will value its investments. If market quotations are not readily available (including in cases where available market quotations are deemed to be unreliable or infrequent), the Fund's investments will be valued as determined in good faith pursuant to policies and procedures approved by its board of directors (*"fair value pricing"*). As there is no developed secondary market for marketplace loans and Platform Notes, these instruments will necessarily be required to be fair valued.

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

616 Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) (adopting rule 38a-1). Investment companies are required to adopt policies and procedures that require monitoring for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments. Funds may be required to fair value portfolio securities if an event affecting the value of the security occurs after the market closes but before the fund prices its shares.

basis throughout the life of each individual loan that is updated periodically as often as the Fund's net asset value is calculated to reflect new information regarding the borrower or loan.

VI. Bankruptcy Considerations

A. Addressing Insolvency Risk

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

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

The risks to the Platform Note holders will be particularly acute if, as may be the case, the Operator does not pledge the Borrower Loans to secure the Platform Notes and is permitted by its governing documents to incur other indebtedness that is not subordinated to the Platform Notes and/or is permitted to pledge the Borrower Loans to secure indebtedness other than the Platform Notes. In this situation, the holders may see some or all of the collections on the Borrower Loans paid to other creditors of the Operator if the Operator becomes bankrupt. The risk to investors also is heightened if the Operator is thinly capitalized and/or has exposure to significant potential liabilities (*e.g.*, pending litigation claims). It seems likely that many retail investors in Platform Notes—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 preexisting litigation claims. The Affiliated Issuer's governing documents will prohibit it from engaging in any business other than the issuance of Platform Notes and related activities and otherwise will impose limitations on its activities intended to reduce the likelihood that it will become subject to voluntary or involuntary bankruptcy proceedings. The structure therefore (i) makes the Operator solely responsible for the platform's operating expenses (other than the servicing fees payable to the Operator itself), (ii) isolates the Affiliated Issuer from the Operator's preexisting or future liabilities, and (iii) provides for the issuance of the Platform Notes through a special purpose, bankruptcy-remote entity (*i.e.*, the Affiliated Issuer) that will have no significant liabilities other than the Platform Notes.

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

An Operator that forms an Affiliated Issuer therefore must structure its program carefully to reduce the risk of substantive consolidation. The fact that the Affiliated Issuer will engage the Operator to manage the website and oversee the performance of the Affiliated Issuer's contractual duties does not by itself mean that substantive consolidation would (or should) be ordered if the Operator were to become bankrupt. It is instead common in securitization transactions for the transaction sponsor and the special purpose issuer that it forms and services to address substantive consolidation risk by making certain "separateness covenants" intended to ensure that the parties will maintain separate legal identities and to make clear to investors that neither party is liable for the other's debts. Although P2P lending does not involve traditional asset securitization, Operators and any Affiliated Issuers should follow the same approach. To that end, among other covenants the Affiliated Issuer should undertake to (i) conduct its business only in its own name, (ii) strictly comply with all organizational formalities required to maintain its separate existence, (iii) maintain its own separate books, records, and bank accounts, (iv) prepare its own financial statements and tax returns, (v) pay its liabilities only out of its own funds, (vi) maintain adequate capital in light of its contemplated business purpose, transactions, and liabilities, (vii) not hold out its credit or assets as being available to satisfy the obligations of others, and (viii) maintain an arm's-length relationship with the Operator and its other affiliates. Without limitation to the foregoing, the Affiliated Issuer should operate the P2P website in its own name (rather than that of its parent) and should execute in its own name all contracts with borrowers and lenders. If these and similar steps are taken (and the parties in fact observe their respective undertakings), there should be little risk that a Bankruptcy Court overseeing Operator bankruptcy proceedings would substantively consolidate the Operator and the Affiliated Issuer.[617]

The second approach that Operators have utilized to address Operator credit risk also entails the formation of a special purpose entity to issue pass-through securities but differs from the first approach insofar as the Operator itself continues to issue Platform Notes. Specifically, under the second approach the Operator forms (i) an investment fund that offers partnership interests or similar securities to institutional and/or high net worth investors on a private placement basis (the *"Fund"*), (ii) a subsidiary that acts as the Fund's general partner and investment manager (the *"Manager"*), and (iii) a statutory trust or similar special purpose company that purchases Borrower Loans (or portions thereof) from the Operator (the *"Trust"*). The Fund will use its members' capital contributions to purchase certificates (*"Certificates"*) from the Trust and the Trust in turn will use the Certificates' purchase price to purchase the Borrower Loans from the Operator. Each Certificate will represent the right to receive all principal and interest payments (net of servicing fees) made on the related Borrower Loan. The Trust will appoint the Operator to service all Borrower Loans that it purchases. Although all Borrower Loans will continue to be funded through the website and initially will be purchased by the Operator from the Funding Bank, this structure largely eliminates Operator credit risk for the Fund investors by enabling them indirectly to invest in pass-through securities issued by an SPE (*i.e.*, the Trust) rather than in Platform Notes issued by the Operator.

The establishment of Funds rather than an Affiliated Issuer may offer the Operator greater flexibility in tailoring investment opportunities to specific investor interests. Stated differently, the Operator may be able to broaden its appeal to different institutional investors by forming multiple Funds that differ from one another in investment periods, management fees, minimum commitments, and/or investment strategies. An Operator that uses an Affiliated Issuer will not have such opportunities. At the same time, the use of Funds can have some disadvantages. As an initial matter, unless the Fund registers its interests under the Securities Act (and incurs the substantial related expenses) or is willing to observe the Regulation A+ offering cap, it will be permitted to offer its interests only to institutional and/or high net worth investors. The Operator accordingly will want to continue to sell Platform Notes through its website. The purchasers of the Platform Notes, however, will continue to have exposure to

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617 It should be noted, however, that if the Affiliated Issuer structure is used, because of the nature and extent of the Operator's continuing involvement in managing the website, evaluating proposed loan postings, assigning proprietary credit ratings, participating in the loan origination process with the Funding Bank, and servicing the Borrower Loans, the SEC may deem the Operator to be offering "management rights" or an "investment contract" that constitutes a security that must be separately registered under the Securities Act. *See* footnote 577 above. Because such an approach results in prospective lenders being offered two separate securities by distinct but affiliated issuers in order to make an investment in Platform Notes, and therefore may arguably be confusing to investors as to whether they are looking to the Operator or the Affiliated Issuer, or both, as the party responsible to them for specific aspects of their investment, the substantive consolidation analysis becomes more complex. Under these circumstances, in addition to strict adherence to the "separateness covenants," the manner in which the respective roles and obligations of the Operator and the Affiliated Issuer are presented in the disclosure in the offering materials, as well as the 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.

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 backup servicer. Any such rejection or delay would not by itself expose investors to claims by the Operator's creditors but could result in collections on the Borrower Loans being delayed or reduced. The funds available for distribution to investors similarly would be reduced if the backup servicer charges higher servicing fees than the Operator had charged.

B. 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 and any bank account (other than the Collections Account) that it maintains to receive payments made on the related Borrower Loans (a *"Receipts Account"*).[618] If the Operator subsequently

618 As previously discussed, the Operator (if acting as loan servicer) typically will maintain a Collections Account into which all Borrowers are directed to make payments on their Borrower Loans. If the Operator is itself the issuer of secured Platform Notes, it will also maintain a Receipts Account with the indenture trustee and promptly transfer from the Collections Account to the Receipts Account any payments it receives on the underlying Borrower Loans (net of servicing fees and expenses). If the Operator is issuing the Platform Notes through an Affiliated Issuer, it similarly will be required, in its capacity as servicer, promptly to transfer from the Collections Account to the Receipts Account maintained by the Affiliated Issuer any payments it receives on the Borrower Loans owned by the Affiliated Issuer. If the Operator is servicing Borrower Loans that have been sold to an SPE in connection with a securitization or collateralized loan facility, it will be required promptly to transfer from the Collections Account to a Receipts Account maintained by the SPE any payments which the Operator receives on Borrower Loans owned by the SPE. The Operator typically will not grant a security interest over the Collections Account for the benefit of Platform Noteholders, ABS investors or warehouse lenders because the Collections Account will hold payments received on all of the Borrower Loans and not only on those owned by the Affiliated Issuer or SPE. Investors and lenders must instead accept the risk associated with the temporary commingling in the Collections Account of payments due to them with other Operator funds. This risk is addressed by requiring the Operator to transfer any relevant collections from the Collections Account to the applicable Receipts Account promptly after its receipt thereof (typically within several business days) and by structuring the transaction to minimize substantive consolidation risk. See "Addressing Insolvency Risk" above.

does become insolvent, the security interest should provide the indenture trustee with a first priority claim on the Borrower Loans, any funds held in the Receipts Account, and any proceeds thereof. The security interest thus helps to ensure that any collections received on the Borrower Loans (including the proceeds of any dispositions) will be applied in the insolvency proceeding to the payment of the Platform Notes in priority over any claims that other Operator creditors might assert. An SPE that issues ABS in a securitization similarly will pledge its pool of Borrower Loans and the related Receipts Account 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 and any related Receipts Account.

The UCC has been enacted in every state (subject to certain variations between the states), and therefore consistent legal principles apply to transactions covered by the UCC regardless of jurisdiction. Article 9 of the UCC governs security interests granted on most types of personal property collateral, including assets like the Borrower Loans and deposit or securities accounts such as Receipts Accounts.[619] Article 9 also treats the interest of a buyer of most types of accounts, chattel paper, payment intangibles and promissory notes as a security interest.[620] Therefore, to the extent Borrower Loans fall within one of those four categories of collateral, Article 9 will apply to sales of those loans. Borrower Loans are not "promissory notes" because they are originated and documented in electronic form and are not evidenced by tangible written "instruments."[621] Similarly, Borrower Loans are likely not "accounts" because they do not evidence a payment obligation for property sold or services rendered and therefore may not meet the requirements of that definition.[622] 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." Consumer Borrower Loans 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.[623] The term "payment intangible" is defined as a payment obligation where the "account debtor's principal obligation is a monetary obligation" and such obligation is not one of the other collateral types defined in Article 9. Because

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619 The Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (Concluded 5 July 2006) became effective in the United States on April 1, 2017 (the *"Hague Securities Convention"*), and supplants the ordinary UCC choice of law rules as applied to collateral held in securities accounts. A detailed analysis of the Hague Securities Convention is beyond the scope of this book. Lenders should consult legal counsel to determine the effect of the Hague Securities Convention on any transaction involving collateral held in a securities account.

620 *See* UCC §§ 1-201(b)(35) and 9-109(a)(3).

621 *See* UCC § 9-102(a)(65) ("a promissory note means an instrument") and UCC § 9-102(47) (defining an "instrument" as "a 'negotiable instrument' or any other writing that evidences a right to payment of a monetary obligation"). *See also*, UCC § 1-201 ("writing" and "written" requires a "tangible form"), and UCC §§ 3-104(e), and 3-103(a)(12) (note that is a negotiable instrument is required to be in writing).

622 *See* UCC § 9-102(a)(2) (defining accounts primarily as "payment obligations" for "property that has been sold" or for "services rendered").

623 Electronic chattel paper is defined as "chattel paper evidenced by a record or records consisting of information stored in an electronic medium."

Borrower Loans are either payment intangibles or, in certain instances, electronic chattel paper, Article 9 applies to sales of Borrower Loans.

The requirements for an enforceable security interest under Article 9 are: value, collateral rights, and an "authenticated" security agreement that includes a collateral description.[624] A loan to a Borrower or a payment of the purchase price to the seller of Borrower Loans constitutes value under the UCC. Depending on the structure of a transaction, satisfaction of the other two requirements may not be quite as straightforward. Often, the securitization of marketplace loans involves an SPE that is a statutory trust under Delaware law. Because the Delaware Statutory Trust Act[625] permits a trustee to hold "legal title to the property of the statutory trust"[626] a secured party must determine if the trust or the trustee (or a combination of the two) has rights in the collateral. If the trustee holds legal title to any portion of the trust estate, then both the trust and the trustee should be grantors under the security agreement. Although the Borrower Loans and related loan documents will be signed electronically in accordance with the E-Sign Act and UETA,[627] Platform Note indentures and ABS securitization documents are not typically prepared and executed with the E-Sign Act or UETA in mind. Therefore, a security agreement must be manually signed or electronically authenticated in accordance with the UCC.[628] The requirement that a security agreement adequately describe the collateral is easy to satisfy when the secured party takes a blanket lien on all of the debtor's assets.[629] Collateral descriptions are more challenging when the security interest arises out of a sale of Borrower Loans, however, because the sold loans must be specifically identified each time a sale occurs.

Creation of a valid security interest is only half of the story. A security interest must be perfected under Article 9 before it will be enforceable against third parties.[630] Filing a financing statement disclosing the security interest with the Secretary of State (or other appropriate authority) of the state in which

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624 UCC § 9-203(b). Article 9 permits parties to document security agreements either electronically or in tangible form. *See*, *e.g.*, UCC § 9-203(b)(3) (permitting security agreements to be "stored in an electronic or other medium and that is retrievable in perceivable form"). In addition, a signature that meets the requirements of an "electronic signature" under the E-Sign Act or UETA will satisfy the requirements of "authentication" under Article 9. *Compare*, UCC § 9-102(a)(7)(B) (defining authenticate to include "with present intent to adopt or accept a record, to attach to or logically associate with the record an electronic sound, symbol or process") to 15 U.S.C. § 7006(5) of the E-Sign Act (defining an electronic signature to mean "an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record") and UETA § 2(8) (defining an electronic signature to mean "an electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record."). The term "authenticate" also includes manual "wet-ink" signatures under Article 9. *See*, UCC § 9-102(a)(7)(A).

625 Delaware Statutory Trust Act, DEL. CODE ANN. tit. 12, § 3801 *et seq.*

626 Delaware Statutory Trust Act, DEL. CODE ANN. tit. 12 § 3805(f).

627 *See* footnote 483 above.

628 UCC § 9-102(a)(7).

629 *See*, UCC § 9-108(b)(3) (permitting the use of Article 9 defined terms to describe the collateral).

630 UCC §§ 9-308 and 9-317. A security interest created upon the sale of payment intangibles and promissory notes is automatically perfected when the sale occurs. UCC § 9-309(3) and (4). Nevertheless, purchasers should file financing statements to ensure that third parties are aware of the purchaser's rights in the assets that have been sold.

the debtor is located[631] is necessary to perfect a security interest in most types of collateral.[632] If more than one financing statement is filed in relation to the same collateral, the financing statement with the earliest filing date will have priority.[633] A security interest in collateral consisting of electronic chattel paper or a securities account may be perfected by filing or by "control,"[634] but a security interest in a deposit account may only be perfected by "control."[635] A security interest perfected by "control" will generally have priority over a security interest perfected by filing—even if the perfection by filing occurred first.[636] A security interest in tangible collateral may also be perfected by possession.[637] However, that method of perfection is not available with respect to Borrower Loans and related loan records that are documented entirely in electronic, or intangible, form.

> **Worth Remembering:** A security interest in electronic notes evidencing Borrower Loans *cannot* be perfected by possession because electronic notes are not in tangible form. Similarly, a security interest in electronic notes *cannot* be perfected by "control" unless such electronic notes constitute "electronic chattel paper." A financing statement should be filed to perfect a security interest in electronic notes evidencing Borrower Loans and related electronic loan records.

The definition of "control" depends on the type of collateral. A secured party has "control" of electronic chattel paper if, among other requirements, there exists "a single authoritative copy" of the paper which is "unique, identifiable and [with limited exceptions] unalterable" and such authoritative copy is "communicated to and maintained by the secured party or its designated custodian." Although the UCC does not indicate how the parties are to create a "single authoritative copy," creditors who are secured by electronic chattel paper often arrange for an e-service provider to act as custodian of the electronic records. The custodian will hold each electronic record in a dedicated electronic "vault" (with the copies so held being deemed to constitute the authoritative copies), will "tag" each authoritative copy with an electronic identifier that permits it to be distinguished from all other electronic copies of the same record, and will

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631 This is usually the jurisdiction in which the debtor is organized, but different rules apply for certain foreign entities and for entities organized under federal law. *See*, UCC § 9-307.

632 *See*, UCC §§ 9-310 and 9-312.

633 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.

634 UCC § 9-314.

635 UCC § 9-312(b)(1).

636 *See*, UCC § 9-322(f)(1). *See also*, UCC §§ 9-327, 9-328, 9-329, 9-330, and 9-331.

637 UCC § 9-313.

otherwise employ procedures intended to provide the creditor with requisite degree of "control."[638] To obtain "control" over a securities account or deposit account, the secured party must enter into a control agreement with the debtor and securities intermediary or depositary bank, as applicable, whereby the securities intermediary or depositary bank, as applicable, agrees to comply with instructions from the secured party without the need for consent or approval from the debtor.[639]

> **Takeaway:** Warehouse lenders and whole loan purchasers should carefully review the security arrangements in their transaction documents to ensure that their interests are fully protected.

C. Transferable Records

Article 3 of the UCC[640] governs promissory notes that qualify as "negotiable instruments" by meeting the following requirements: (1) the note contains an unconditional written promise to pay a fixed amount of money (with or without interest); (2) the note is payable "to bearer" or "to order" on demand or at a definite time; and (3) the note does not (subject to certain limited exceptions) include any other undertaking or covenant in addition to the payment of money.[641] The purpose of Article 3 is to facilitate the transfer of negotiable instruments by granting special rights to good faith purchasers of such instruments.[642] More specifically, a holder in due course[643] obtains a negotiable instrument free from

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638 The creditor also should file a financing statement so that it will retain a perfected security interest even if the custodial arrangements are later determined not to have established "control." A creditor secured by electronic notes other than electronic chattel paper also could decide to implement custodial arrangements of this type but, as discussed, doing so will likely not be sufficient under Article 9 to perfect the creditor's security interest.

639 *See*, § 9-104 (Control of Deposit Account) and §§ 8-106 (Control) and 9-106 (Control of Investment Property). As is the case with electronic chattel paper, the secured party should also file a financing statement with respect to its security interest in any securities account. It is not necessary to file a financing statement with respect to a deposit account, because a financing statement is ineffective to perfect a security interest in a deposit account.

640 UCC § 3-102(a). Every state other than New York has adopted the 1990 version of Article 3 of the UCC. *See*, Legislative Fact Sheet—UCC Article 3, Negotiable Instruments (1990):

http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=UCC%20Article%203,%20Negotiable%20Instruments%20(1990) (viewed 3.19.2018).

New York follows the version of Article 3 of the UCC that was adopted in 1962. Eleven states have adopted the 2002 amendments to the 1990 version of Article 3 of the UCC. *See*, Legislative Fact Sheet—UCC Article 3, Negotiable Instruments and Article 4, Bank Deposits (2002):

http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=UCC%20Article%203,%20Negotiable%20Instruments%20and%20Article%204,%20Bank%20Deposits%20(2002).

References in this book to Article 3 of the UCC are to the 1990 version of Article 3.

641 UCC § 3-104(a) and (e).

642 Hart, Frederick M.; Gerding, Erik F.; and Willier, William F., *Negotiable Instruments under the Uniform Commercial Code* (Matthew Bender, 2d ed.) (hereinafter *"Negotiable Instruments under the UCC"*) at § 1B.02.

643 Article 3 of the UCC refers to a good faith purchaser as a "holder in due course." *See*, § 3-302 for the requirements of a holder in due course.

the claims of others, including prior perfected security interests.[644] Furthermore, Article 3 limits the payment defenses that an obligor may raise against a holder in due course.[645] Unlike Article 9, Article 3 does not contemplate or permit the use of electronic documents or electronic signatures. Therefore, electronic notes are not negotiable instruments under Article 3 even if all of the other requirements of negotiability are satisfied.

To facilitate electronic commerce and create legal parity for electronic transactions, both the E-Sign Act and UETA include the concept of "transferable records" which are intended to be electronic equivalents of tangible negotiable instruments.[646] Neither statute attempts to insert the concept of a transferable record into the UCC or otherwise override Article 3. Instead, the E-Sign Act and UETA import from the UCC those concepts that are necessary to create a legal framework for transferable records that is the equivalent to the existing legal framework for tangible negotiable documents.[647] UETA defines a "transferable record" as "an electronic record that: (1) would be a note under [Article 3 of the UCC] … if the electronic record were in writing; and (2) the issuer of the electronic record expressly has agreed is a transferable record."[648] The E-Sign Act adds a further requirement that a transferable record must relate "to a loan secured by real property."[649] A transferable record can only be created at the time of issuance because the issuer of an electronic record must expressly agree that such record be treated as a transferable record in order to qualify as such.[650] In other words, a document that is issued as a tangible negotiable instrument *cannot* later be converted to an intangible transferable record (for example, by storing an electronic copy of the tangible negotiable instrument and destroying the paper original.)[651]

644 UCC § 3-306. *See also*, UCC § 9-331(a) (Article 9 does "not limit the rights of a holder in due course … [t]hese holders or purchasers take priority over an earlier security interest, even if perfected").

645 UCC § 3-305.

646 Documents governed by Article 7 of the UCC are also included in the definition of "transferable record" under UETA, but are not included under the E-Sign Act. Because documents governed by Article 7 are not relevant to this book, they are not discussed here. New York's ESRA does not specifically include the concept of a "transferable record." Rather, § 307 of New York's ESRA states: "This article shall not apply … To any negotiable instruments and other instruments of title wherein possession of the instrument is deemed to confer title, unless an electronic version of such record is created, stored or transferred pursuant to this article in a manner that allows for the existence of only one unique, identifiable and unalterable version which cannot be copied except in a form that is readily identifiable as a copy."

647 The "provisions of UETA are broader in scope [than the E-Sign Act], applying to all documents which would, if on paper, be … a promissory note under UCC Article 3." *Why Enact UETA? The Role of UETA After THE E-SIGN ACT*, Patricia Brumfield Fry, Uniform Law Commission. The practical effect of these differences is that all transferable records under the E-Sign Act are transferable records under UETA. The converse, however, is not true.

648 UETA § 16(a). Transferable records are a specific subset of "electronic records" under UETA. If a record does not meet the requirements of an "electronic record," it cannot be a "transferable record." *See*, Subsection 6 *"Electronic Commerce Laws"* of Section C, *"Consumer Protection Laws"* above, for a further discussion of the requirements of electronic records.

649 *See*, 15 U.S.C. § 7021(a).

650 *See, e.g.*, UETA § 16 Official Comment 2. Because New York's ESRA does not include a requirement that the issuer of an electronic record expressly agree that such record is a transferable record, it may be possible for a tangible negotiable instrument to be converted to an electronic negotiable instrument under New York's ESRA.

651 In fact, the intentional destruction of a negotiable instrument by the holder thereof may discharge the underlying obligation. UCC § 3-604.

Another element of creating an electronic equivalent to tangible negotiable instruments is to establish an equivalent method of transferring such records. UETA does this by "borrowing" the concept of "control" of electronic chattel paper from the UCC[652] which is discussed in the prior section of this book. Under UETA, a person has control of a transferable record if a system employed for evidencing the transfer of interests in the transferable record reliably establishes that person as the person to which the transferable record was issued or transferred.[653] Because "control" requires an uninterrupted and verifiable "chain of title," the original holder to whom the transferable record is issued must have control of the transferable record from the outset to be able to transfer control to an assignee. A person having "control" of a transferable record has the same rights and defenses as a holder of a tangible negotiable instrument under the UCC, including, if the applicable statutory requirements under the UCC are satisfied, the rights and defenses of a holder in due course.[654] It is important to remember that "control" of a transferable record under UETA and the E-Sign Act does *not* perfect a security interest in such transferable record under Article 9.

Worth Remembering: Neither UETA nor the E-Sign Act amend or modify the UCC. Control of a transferable record under UETA and the E-Sign Act does *not* perfect an Article 9 security interest in such transferable record. A secured party must still comply with Article 9 to perfect its security interest.

Whether or not a marketplace lender should use transferable records is a business decision based on weighing the benefits and costs of creating transferable records. The benefit of using transferable records is that a holder of a transferable record with "control" may qualify as a holder in due course under the UCC.[655] The primary costs of using transferable records is the need to retain a third-party custodian to provide an electronic "vault" for establishing and maintaining control of the transferable records. If a marketplace lender is already using a third-party custodian to hold other electronic records, then the use of transferable records will cause significant additional expense. Another downside to using a transferable record is the requirements that the electronic note be payable "to bearer" or "to order." Restrictions on assignment in the electronic note will adversely affect negotiability. Finally, the prohibition on including undertakings or covenants of the borrower in addition to the obligation to repay the loan, may not be acceptable to certain marketplace lenders. If a

652 *See, e.g.*, UETA § 16 Official Comment 3. Notably, the definition of "control" in the E-Sign Act is essentially identical to the corresponding definition in UETA. *See*, 15 U.S.C. § 7021(b) and (c). Although New York has not adopted UETA's definition of "transferable record," it recognizes the existence of an electronic equivalent of negotiable documents and uses similar language for the concept of "control" without defining it as such. *See*, ESRA § 307.

653 UETA § 16(b). *See,* "Bankruptcy Considerations— Security Interests in Electronic Collateral" for a further discussion of the requirements of "control."

654 UETA § 16(d) through (f) and the 15 U.S.C. § 7021(d) through (f). New York's ESRA does not lay out the rules governing the manner and effect of enforcing electronic negotiable records in the detail specified in UETA § 16(d) through (f).

655 At the same time, potential lenders against marketplace loans as collateral may prefer that the loans not be transferable records to eliminate the risk that a third party not associated with the financing will assert that it has acquired "control" of the loans from the borrower (or its assignee) and therefore has rights in the loans senior to those of the lenders.

marketplace lender wishes to use transferable records, then the form of electronic note should be drafted to conform with the express requirements of UETA and, if applicable, the E-Sign Act. Conversely, if a marketplace lender does not want to use transferable records, then the form electronic note should not include the issuer's agreement to treat the electronic note as a transferable record.[656] The classification of an electronic note must be made at the time it is issued, and once made that classification cannot be changed.

VII. TAX CONSIDERATIONS

A. 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."[657] 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

656 For added certainty, the electronic note should include an express statement that it is neither a negotiable note under Article 3 of the UCC nor a transferable record under UETA or the E-Sign Act (if applicable). *See*, UCC § 3-104(d) (a note that bears a conspicuous statement when it first comes into possession of a holder that such note not negotiable or is not an instrument governed by Article 3 of the UCC is not a negotiable instrument).

657 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"—an eminently reasonable assumption given that interest is payable only to the extent received on an underlying Borrower Loan. It is possible, however, that interest on Platform Notes technically may be regarded as "unconditionally payable" based on the interest on the underlying Borrower Loans so qualifying and the economic linkage between Platform Notes and Borrower Loans—in which case, Platform Notes would not be subject to the OID rules. Most Operators do, nonetheless, apply OID reporting in their Platform Note programs, and do so notwithstanding the additional complexity, perhaps because—for the reasons expressed in the text immediately following this footnote—the Internal Revenue Service seems unlikely to question that treatment.

clearly reflect the investor's economic income—but it also requires the investor to forego the otherwise potentially tax-advantageous income deferral that cash method accounting might allow.[658]

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

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

Operators will be required under the Debt Approach to provide each investor with an annual tax information statement, generally 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

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

Platform Notes—*i.e.*, treatment as Operator stock—in particular could be adverse as the Operator could no longer claim interest or OID deductions for payments or accruals made on the Platform Notes, and non-U.S. holders of the Platform Notes could become subject to 30% withholding tax (*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.[659]

B. 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 book. 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 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 startup 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.[660] 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).[661] Securitization and funding structures also are often designed indirectly to achieve the same result with respect to loans that are not in registered form, by first repackaging the loans in pass-through trusts that issue certificates of

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659 Prosper, for example, generally does not permit non-U.S. residents to register as investors on its platform, while LendingClub restricts non-U.S. based persons from registering as investors and does not facilitate investment in Platform Notes outside the U.S. Further, neither Operator provides assurances or comfort in its tax disclosure regarding the tax consequences of an investment in Platform Notes to non-U.S. investors, perhaps shifting (or, at least, allowing for shifting by allowing for withholding) the withholding risk introduced by any such investors.

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

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

beneficial interest which are themselves in registered form.[662] 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 as widely as from 5 to 90 days) before they are sold to the investor. The extended retention period bolsters the argument that the investor is purchasing the loans in a secondary market investment transaction (rather than as part of a business of originating loans) and therefore is exempt from U.S. net income tax under a safe harbor provided for "securities trading."[663] Importantly, satisfactory resolution of both issues—*i.e.*, the adequacy of registered form provisions and the avoidance of material trade or business risk—will matter not only to foreign investors but also (and perhaps even more so) to marketplace lenders who, in serving as paying agents to pay through to investors amounts received by them (as servicers) on the purchased loans, may be liable for any tax owing by the investors but not properly withheld and remitted to the U.S. Treasury by such lenders.

VIII. BLOCKCHAIN

"Revolutionary!" "A Game-Changer!" "The Hottest Topic in Financial Services!" Such were the calls of proponents, media commentators and public company 10-Ks in 2017. The frenzy around blockchain technology has subsided in the subsequent year; however, the move toward actually building projects on blockchain has inched forward. In the lending world, the focus has been on finding ways to use this new technology to reduce processing costs and improve information security in documenting, executing and settling commercial and financial transactions. In addition, 2020 has seen the emergence of decentralized finance (or *"DeFi"*) protocols that create online markets for collateralized borrowing in digital assets, creating yield for liquidity providers.

In evaluating the claims made for blockchain, however, it is important to remember in the first instance that blockchain is not itself a financial product but refers instead to a new form of the computer science technology used to develop and maintain databases. Instead of traditional structures that used a single, trusted server to maintain a database, blockchain technology allows for a shared record, or "distributed ledger," that is accessible to all transaction participants and capable of near-instantaneous updating but which is (at least in certain cases) designed to prevent unauthorized transactions or after-the-fact changes to the record.

662 This technique was originally authorized by U.S. Treasury Regulations in order to facilitate non-U.S. investment in pools of mortgage loans, since such loans were also traditionally not documented in registered form.

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

Advocates and analysts of blockchain-based solutions are still trying to identify where these data structures improve on existing, centralized systems, and are assessing where value accrues in so-called DeFi ecosystems. Blockchains can be applied in a variety of methods, and the applications (and blockchain networks, themselves) can be designed to fit the needs of the network participants. This means that market participants can select a network or platform with features involving decentralization, or with semi-centralization that relies on blockchains only in part.

Blockchain networks can be open and transparent, or can be made accessible only to a controlled set of users who have limited data access. Any changes in the ledger can be made only through the consensus of the participants.[664] Any information that is added to the ledger is recorded in a distinct electronic "block" and each block is irrevocably tied (or "chained") to all blocks previously created for the transaction. The electronic records thus created are accessible to all transaction participants and, since each record has been created through consensus, the blockchain ledger at any point in time will constitute an authoritative statement of the transaction terms and status. In this regard, since each ledger is, in effect, created by the parties themselves according to the rules established for the network, blockchain can eliminate the need for the parties to affect their transactions through "trusted intermediaries" of the types that have traditionally been employed in similar transactions (*e.g.*, registrars or escrow agents) and can thereby reduce both transaction costs and processing times.

Although Bitcoin is the first and most well-known blockchain network, newer blockchains are battling for open-source supremacy, particularly in the world of smart contract computing on which enterprise use cases are theorized. Like the networks and platforms that utilize them, these smart contracts are designed to be somewhat decentralized, in that they operate automatically. But they are also architected or encoded by individuals, an important reminder that design choices and platform control impact the application and adoption of blockchain technologies.[665]

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664 Consensus for each data point proposed for the ledger is achieved through computations automatically performed by the computers having access to the database and does not require any hands-on intervention by the transaction participants' employees (which would rather defeat the purpose of blockchain).

665 Smart contracts are, generally speaking, computer programs that are designed to be posted to a blockchain network, such as Ethereum, with a designed set of rules that operate strictly in accordance with the code. These programs can be complex, with participant voting rights, algorithmic decision-making, and references to on-chain events, or they can be simple "if this than that" scenarios that rely on a specific data point or particular actions that trigger a defined result. In many ways, smart contracts can reflect the commercial agreement, only documented electronically to provide for self-execution when applicable conditions precedent have been satisfied. As an example, a smart contract could provide for the automatic transfer of funds or delivery of goods to a contract participant when the conditions to such transfer or delivery have been satisfied as recorded in the related blockchain ledger. Smart contracts can interpret data from the resident blockchain, in messages or voting from contract participants, or from designated data streams known as "oracles."

While most blockchain networks permit some forms of smart contract, development of standards on the Ethereum network has permitted large scale experimentation. At the same time, smart contracts are both living systems and static code; once published to Ethereum, a smart contract may not be easily amended, if at all, presenting significant issues relating to risk assessment and potential developer and administrator liability for both public and private systems. On private or administered networks, smart contract errors may be remedies based on agreed-upon rules, but errors relating to Ethereum contracts have resulted in catastrophic losses and controversy.

Blockchain technology has application in many contexts and the financial services industry and cryptocurrency and token issuers have not been and will not be the only users.[666] The potential for blockchain to improve the efficiency of payment, clearance and settlement procedures is nonetheless of particular interest to financial institutions and commercial and investment banks have been among the leaders in blockchain implementation. Marketplace lenders also are well positioned to utilize blockchain, in part because their business models focus on technological innovation, but also, in part, because they have relatively little capital committed to legacy recordkeeping or transaction processing systems that blockchain could supplant.

A marketplace lender interested in its blockchain options must first decide whether it will use the technology to create a settlement system or a communications channel. In a settlement system, the underlying assets (*i.e.*, the marketplace loans) are "tokenized" using smart contracts and the rights that attach to the tokens can be transferred and settled on the blockchain with near instant settlement. If the related regulatory issues could be solved, the tokenization process could greatly facilitate the development of an active secondary trading market for marketplace loans.[667]

In a communications channel, the blockchain is used as an interactive system that automates reconciliation, but does not consolidate all records and settlement within the blockchain. Under these circumstances, the assets are recorded and settlement takes place on traditional database stacks and the blockchain merely serves as a means of facilitating instructions and record transmission.

As one would expect, blockchain raises many novel legal questions, depending upon the specific uses to which the technology is put. The most fundamental question a marketplace lender will confront when approaching a potential blockchain-focused project or proposal is who "owns" the blockchain and what are the network characteristics. In this, a participant must consider who is selecting the type of blockchain (open or private[668]), who is providing administrative controls and maintenance, and who is granting permission for access.

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666 As examples of the use of blockchain outside of the financial industry, manufacturers can use blockchain to track the movement of assets through their supply chains and shipping companies can use it to track the status and location of shipping containers. A discussion of such uses of blockchain is beyond the scope of this book.

667 It would be necessary to consider whether any tokens representing financial interests in marketplace loans constitute "securities" subject to regulation under federal and state securities laws. Any such tokens offered to retail investors would likely be treated as securities (which in turn would likely make the offering impractical because of securities law registration requirements).

668 An open blockchain network, such as Bitcoin or Ethereum, features relative transparency of the data and transactions that appear on the network. This means that smart contract code, transaction volume, and transaction memo field contents are posted to the distributed ledger storing all network data. This data may be encrypted, at least in part, or may be shielded by technology such as zero knowledge proofs that has been pioneered in the digital asset world; however, one of the fundamental questions regarding enterprise use of blockchain technology is the largely immutable publication of data to a public ledger.

Private blockchains, often built on top of Ethereum or Hyperledger code, can be designed to restrict both read and write access, meaning that some of the transparency and data retention issues can be mitigated; however, as parties move to private blockchains, they sometimes determine that the potential benefits of blockchain technology are removed, and that traditional data-structures with distributed systems can satisfy these results. In these cases, the specific uses and the

Parties joining onto blockchain-based projects must also negotiate the terms of such access, particularly when the platform or network will be shared among multiple business participants. Although blockchain based projects are at least partially decentralized, the smart contract does not typically replace the legal constructs among counterparties. While many of the issues that relate to these platforms will be similar to other fintech ventures, marketplace lenders and banks will be concerned with issues including whether or not a blockchain will be considered the definitive record of transactions recorded upon it, what administrative rights are held with respect to the blockchain, and how data is shared, monitored and owned on the blockchain. Recent developments in consumer data privacy also raise issues of the storage of financial and personally identifiable information on a relatively immutable and somewhat transparent data set. Blockchain technology may also raise unique questions of interpretation in regard to on-network governance and dispute resolution. To the extent that the programs are also built on open, distributed networks, allocation of liability for errors in code or in execution, as well as counterparty identification and anti-money laundering requirements will be heavily negotiated.

Lenders joining settlement-based platforms and networks will also need to address the legal status of "tokens" used to transmit and settle information. In particular, the tokenization of information, rights and value can create issues under both securities laws and money service business laws. The facts and circumstances around a platform or networks architecture will largely determine this analysis, both for the tokens themselves and the rights or value tokenized therein. A growing body of guidance and, in some instances, case law is developing with respect to federal and state securities and money service laws.

In addition to these issues, there are jurisdictional questions. Several states have promoted pro-blockchain and pro-digital asset legislation over the past two years. As the extreme example, Wyoming has aggressively pushed blockchain-friendly legislation to address issues relating to state money transmission licensing, securities law, the enforceability of electronic signatures and smart contracts, and the application of the UCC to various forms of digital assets. However, these states are the outlier, and issues exist on both the federal and state level in the United States' fragmented system of regulation. In addition, many platforms and most blockchain networks have global audiences and participants, opening up additional questions in this ever expanding landscape.

Finally, blockchain-based platforms have increasingly incorporated the use of digital assets, including stablecoins intended to represent fiat currencies.[669] Digital Assets are often used as collateral for loans

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potential benefits of smart contract implementations and immediate settlement and reconciliations systems drive considerations.

669 A stablecoin is intended to be a digital asset that retains a relatively consistent value based on (i) the right of users to create and redeem the digital asset for an underlying asset (which may be a single asset or basket of assets) or (ii) an algorithmic or smart contract based system that incentivizes the stabilization of assets through supply control and collateralization. Although the first widely used dollar-based stablecoin Tether continues to dominate market share, the proposal of the Libra stablecoin associated with Facebook brought intense regulatory scrutiny to this type of token. Regulatory issues relating to

in such platforms, and information regarding real world collateral may be tokenized for easy movement. This activity is occurring on centralized lending platforms and through smart contract-based DeFi systems. In centralized lending platforms, the activity is more plainly similar to traditional lending services to which the principles discussed in this book may be applied; however, in DeFi protocols the issues become more complex—although participants are cautioned against assuming the notion that technology choices would obviate existing lending, consumer protection, Bank Secrecy Act, securities laws or commodities laws.

In a DeFi protocol, a developer establishes a series of smart contracts and decentralized applications (*"DApps")* that create an ecosystem for defined activities that exist wholly or largely on the blockchain network. These systems are generally intended to be accessible to any party with access to the blockchain network, although some require the acquisition of a particular token or, more rarely, the white-listing of access. These DeFi systems include projects that seek to remove intermediaries from digital asset trading platforms (decentralized exchanges or *"DEXs"*), to provide investment exposure to baskets of digital assets (basket or set tokens) and to generate yield based on over-collateralized loans (DeFi lending or *"yield farming"*). A general premise often advanced for DeFi projects is that, following publication of the smart contracts and DApps, the developers of the project cede control to the network users, meaning that no administrator, issuer or sponsor controls the system and has operational or regulatory responsibility for its activity. The accuracy and practicality of this premise is largely untested, both on a factual and legal basis. This presents a significant issue for both retail users and potential market entrants seeking to assess DeFi opportunities.

Keep in Mind: The open access of most popular blockchain networks presents an issue for any party seeking to access a public blockchain for even the most simple of purposes. In most blockchain activity, standard transactions are bilateral in nature, simplifying the "know your counterparty" equation and risks. With DeFi, a prospective participant cannot easily ascertain the identity of the counterparties that also access the DeFi application. As government agencies—including the Office of Foreign Asset Control—have begun to focus more on digital asset networks, financial institutions and all other users exploring DeFi must consider anti-money laundering, countering the financing of terrorism and sanctions compliance risks.

It may be years before firm guidance exists regarding the use of digital assets in lending or confirmation that blockchain and smart contract technology can be used to adequately describe assets intended as collateral for purposes of the UCC. Even more complex issues are raised by the emergence of DeFi protocols that seek to entirely remove intermediaries and sponsors that fill regulated roles in

stablecoins are complex and legislators and regulators have brought significant focus on how stablecoin issuers may be impacted by Bank Secrecy Act, securities laws, and consumer protection rules, among other areas.

commercial activity. It follows that for the foreseeable future, certain aspects of blockchain systems will likely remain subject to some (or a great) degree of legal uncertainty.

IX. 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.[670] There is yet another category of crowdfunding, however, that after a long incubation period finally became a reality in 2016: small business equity or debt securities offerings. Specifically, Congress in 2012 concluded that the federal securities laws unduly impeded small business capital formation and, accordingly, in the JOBS Act directed the SEC to provide an exemption from securities registration to small businesses that engage in crowdfunding in compliance with specified criteria. After considerable delay—resulting partly from the need to consider the views of multiple constituencies but also from significant concerns within the SEC that the exemption could be abused—the SEC in November 2015 adopted final rules (the *"Rules"*) to implement the crowdfunding exemption. The Rules became effective in May 2016. The remainder of this section summarizes the key provisions of the Rules.

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

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

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670 These latter sites include such well-known venues as Kickstarter. The companies or projects that obtain funding through these sites may provide their backers with nonfinancial "perks" (*e.g.,* samples of the company's products), but they don't transfer ownership interests to the backers and don't undertake to repay the backers' contribution with interest. As the sites don't entitle the backers to any financial return on the contributed funds, they are not deemed to offer "securities" and therefore are not subject to securities or broker-dealer registration requirements under the federal securities laws.

- The aggregate amount of securities sold by the issuer in reliance upon the Section 4(a)(6) crowdfunding exemption may not exceed $1.07 million in any 12-month period. Securities sold by the issuer in offerings registered with the SEC or pursuant to other exemptions will not count against the $1.07 million limit. An issuer therefore could undertake simultaneous Regulation D and Section 4(a)(6) offerings and could, in theory, sell unlimited amounts of the securities to accredited investors under Regulation D and not more than $1.07 million of securities to other investors under Section 4(a)(6). Since, however, issuers may not advertise crowdfunding securities (except to the limited extent discussed below), issuers and crowdfunding platforms must take certain precautions if the issuer will undertake concurrent Rule 506(c) and Section 4(a)(6) offerings, as any general solicitation the issuer uses in the Regulation D offering could otherwise be deemed an unlawful advertisement for the crowdfunded securities.

- Investors are strictly limited in the amount of securities they may purchase under Section 4(a)(6) in any 12-month period. Investors having an annual income and/or a net worth of less than $107,000 may purchase not more than the greater of $2,200 or 5% of the lesser of the investor's annual income or net worth, and investors having both an annual income and a net worth of $107,000 or more may purchase not more than the lesser of $107,000 or 10% of the lesser of the investor's annual income or net worth. Note that these caps are applied against the aggregate amount of securities the investor purchases from any issuer through any crowdfunding platform and therefore any purchase of crowdfunding securities by an investor will reduce the amount of other crowdfunding securities that the investor may purchase during the following 12 months.

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

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

- The issuer must make specified disclosures. Among other items, the issuer must provide the intermediary and investors with descriptions of its business, ownership, capital structure, and financial condition; the names and backgrounds of its officers and directors; statements of its anticipated business plan and of any material risk factors; the target offering amount and the intended use of proceeds; and the offering price or method for determining the price. Any issuer offering more than $535,000 of securities must provide audited financial statements (subject to an exception for certain first-time issuers).[671] If the offering amount exceeds $107,000 but not $535,000, 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 $107,000 or less, the issuer must provide audited or reviewed financial statements or, if such statements are not available, must disclose its total income, taxable income, and total tax for its most recently completed fiscal year and must provide its financial statements, in each case certified by its principal executive officer. The issuer must file the disclosure information with the SEC before commencing the offering and must make certain other filings during the course of the offering.

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

- If the issuer succeeds in selling its securities it must thereafter file annual reports with the SEC containing information specified in the Rules until such time as (i) the issuer becomes a reporting company required to submit periodic reports under the Exchange Act, (ii) the issuer or another party repurchases all of the crowdfunded securities (including the full payment of any debt securities and the complete redemption of any redeemable securities), (iii) the issuer has filed at least one annual report and has fewer than 300 holders of record, (iv) the issuer has filed at least three annual reports and its total assets do not exceed $10 million, or (v) the issuer liquidates or dissolves its business.

Any securities sold by an issuer pursuant to Section 4(a)(6) will also be exempt from registration under state securities (Blue Sky) laws.

Many commentators have praised the crowdfunding exemption as an important step toward the "democratization" of finance since it can, in theory, permit small investors to make early-stage investments in promising companies that previously would have been funded only by venture

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671 First-time issuers may provide financial statements reviewed (rather than audited) by an independent public accountant if the offering amount exceeds $535,000 but not $1.07 million. In determining the financial disclosure requirements, the offering amount will be deemed to include the current offering and any other offering made by the issuer under Section 4(a)(6) of the Securities Act in the preceding 12-month period.

capitalists and other accredited investors.[672] At the same time, there is certainly reason to question whether crowdfunding will meet the expectations of its strongest proponents. The percentage of startup 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).[673] 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.

In March 2021, the SEC adopted its final rule "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets", which implements several amendments to the crowdfunding regulations.[674] The amendments included raising the offering limit from $1.07 million to $5 million, as well as amending the investment limits to remove them entirely for accredited investors and to permit non-accredited investors to invest the greater of their annual income or net worth. These changes suggest a desire by the SEC to make crowdfunding offerings more available and on simpler terms than had been the case under the preexisting regulatory scheme. It will be interesting to see whether Section 4(a)(6) crowdfunding, over the longer term, provides a net benefit to small investors.

672 The number of offerings conducted and the amount of funds raised under the Rules both increased significantly in 2018 (680 offerings in 2018 versus 474 in 2017 and total proceeds of $109.2 million versus $71.2 million). "*Regulation Crowdfunding performed solidly in 2018. Here's the data,*" Sherwood Neiss, Crowdfund Capital Advisors (Jan. 30, 2019). A number of aspects of the Rules—including the disclosure and reporting requirements, the caps on the offering and investment amounts and the exclusion of investment funds under the issuer eligibility criteria—nonetheless create obstacles or expense for potential issuers that may constrain future market growth.

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

674 86 Fed. Reg. 3496 (1/14/2021).

More Information

We are available at any time to answer questions, discuss scenarios, and provide guidance. Please do not hesitate to reach out to book author Marc Franson, a member of our marketplace lending team, or any other Chapman attorney with whom you regularly work.

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Annex A

About Chapman

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

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

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

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

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

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

Marketplace Lending Services

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

Startup Advice. We advise startup 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.

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