20 July 2016

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Bridging the Great Divide: Collaboration Considerations for Banks and Marketplace Lenders

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Marketplace lending has grown dramatically over the last several years, but it still remains a nascent industry. As it continues to expand its reach, players in the industry and the traditional banking/investment sector are discovering the mutual benefits of cooperation. While marketplace lending often has been heralded as a disruptor of traditional banking, industry participants are being presented with opportunities to collaborate with banking institutions as the industry matures.

Partnering with banking institutions provides access to valuable sources of capital, but it also raises regulatory considerations that marketplace lenders must navigate. In addition, banking and consumer-protection regulators are assessing the marketplace-lending industry—and the effect of its partnerships with and sales to traditional banks and investment funds. The Treasury Department, the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), and the Consumer Financial Protection Bureau ("CFPB") each have indicated that they intend to step up scrutiny of the marketplace lending industry. Even the Department of Justice ("DOJ") has waded into the fray, issuing a federal grand jury subpoena to one of the largest marketplace-lending platforms in the world. This alert discusses some of the compliance challenges foremost on the minds of agencies overseeing marketplace lending, and the response of the industry through the launch of the Marketplace Lending Association.

Overview of Regulatory Considerations

Marketplace lending presents both challenges and opportunities, as does any emerging industry. Due to the industry's success in providing a new model for getting loans into the hands of financially underserved populations of consumers and small businesses, it has grown to the point where significant regulatory oversight is inevitable. However, to date, industry oversight remains a relative patchwork of efforts by different agencies—federal and state—acting either directly or indirectly. This oversight has the potential to be a significant benefit to the industry, providing the kind of certainty and legitimacy necessary to access new sources of capital. However, it also requires planning on the part of individual platforms to ensure the embrace of the responsibilities this oversight entails.

Marketplace lending impacts regulatory policy in several areas, including consumer-protection laws applicable to all consumer loans, the regulation of securities backed by these loans, and—indirectly—the supervision of major financial institutions partnering with or purchasing from marketplace lending platforms. Agencies enjoying at least some degree of direct regulatory authority over marketplace lenders include the CFPB, the Federal Trade Commission, the Securities and Exchange Commission, and various state regulators, such as the California Department of Business Oversight. In addition, prudential banking regulators (like the FDIC, the OCC, and the Federal Reserve Board) indirectly oversee marketplace lenders via their oversight of financial institutions that partner with marketplace lenders. This at times indirect and relatively patchwork financial regulatory framework is an imperfect fit for an industry based on a new tech-based business model.

Current Issues in Marketplace Lending Regulation

To date, various issues regarding the regulation of marketplace lending remain unresolved. For instance, differing levels of regulation between loan originators and loan purchasers could create a situation in which nonbank lenders could originate loans free of certain regulatory constraints, such as anti-discrimination regulations and usury limits, and sell them to purchasers (including banks) that would be free of constraints with which they might otherwise have had to comply. The following is a nonexhaustive list of outstanding legal and regulatory concerns for the industry.

Anti-Discrimination Provisions

Secondary market purchasers are not subject to anti-redlining laws, which prohibit banks from refusing to lend in certain localities based on residents' race or ethnicity. Marketplace lending raises a concern that a bank effectively could do an end-run around anti-redlining laws by avoiding purchasing loans from certain areas. The Community Reinvestment Act (12 U.S.C. § 2901) ("CRA") may raise analogous issues because marketplace lenders, which have no physical presence or deposits, are not subject to any CRA requirements or incentives to lend locally to lower-income or diverse populations. Strategic use of data by marketplace-lending platforms, such as targeting loans to certain ZIP codes, may exacerbate these concerns.

On the other hand, the marketplace-lending model and the ability of marketplace lenders to make credit available to customers that banks cannot acquire by themselves in a cost-effective way can also make FinTech a solution that helps expand lending under the CRA, as demonstrated by one megabank's arrangement with a large marketplace lender in 2015 to purchase loans to help it satisfy its obligations under the CRA.[1] Additionally, some marketplace lenders are filling the gaps to serve low-income, unbanked, migrant, foreign-student, or upstart-entrepreneurial populations by creating platforms specifically designed to reach and evaluate people without typical creditworthiness indicators or scores.

Prudential Regulators

Banking regulations can apply to loans originated by marketplace lenders in several ways. The FDIC requires insured depository institutions that acquire loans from marketplace lenders to perform the same level of due diligence on marketplace loans they acquire as if they had originated the loans themselves.[2] Marketplace lenders that provide white-label services to banks are subject to the same diligence to which bank vendors are subject, possibly enhanced to the extent borrowers access the marketplace-lending platform through the bank's own website. Understanding these obligations, banks are likely to monitor their marketplace-lending partners and insist upon a high level of diligence in their business practices. Given that marketplace lenders are obligated to perform the diligence functions

[1] http://www.thepaypers.com/default/citigroup-enters-marketplace-lending-with-lending-club-usd-150-mln-deal/759553-0/abstract

[2] FIL-49-2015 November 6, 2015 (FDIC).

associated with banks (if not already independently obligated to do so), their ability to internalize and effectively carry out these functions will be a key test for the industry moving forward.

State Usury Limits

Another area of concern is that some online lenders have borrowed the "rent-a-charter" model from the payday-lending industry to sidestep state usury laws under federal pre-emption doctrines. Marketplace lenders and others have to a significant degree relied upon the bank-partnership model in loan originations and acquisitions to obtain federal preemption and apply rates above state usury limits. This business model was called into doubt by the Second Circuit Court of Appeals' decision last year in *Madden v. Midland Funding*, where the court held that a debt collector, which had bought a national bank's charged-off accounts, could not rely on federal National Bank Act preemption to avoid liability under state usury laws because the debt collector was not a national bank, a subsidiary or agent of a national bank, or "otherwise acting on behalf of a national bank."[3] This June, the U.S. Supreme Court decided not to hear the case, ensuring that the uncertainty surrounding this practice will persist.[4]

The increase in relationships between chartered banks and third parties offering loan-origination services raises the question of whether and how much prudential regulation should apply to nonbank marketplace lenders. There are many ways that relationships may manifest. At least two large marketplace lenders have signed partnership agreements with consortiums of community banks to originate loans to those banks' customers. Another marketplace lender currently has a relationship with a megabank to service the megabank's small-business customers. These relationships raise the question as to whether a marketplace lender should obtain a charter—either under federal or state law—as the marketplace lender will directly be under the authority of additional prudential regulators, which already indirectly reach their activities through the partner banks.

Online Platforms as Chartered Banks

The increasingly close relationship between banks and marketplace-lending platforms, as well as the uncertainty surrounding the "rent-a-charter" model to avoid state usury limits described above, have led to speculation that marketplace lenders may ultimately obtain bank charters. A fundamental issue is whether the equity and institutional investment markets will provide a stable long-term source of funding for the industry. This issue has garnered attention in recent months as leading marketplace-lending platforms have experienced steep declines in their stock prices and as questions have been raised about how lending platforms interact with fund investors and about weak secondary-market trading of asset-backed securities. The question may acquire renewed urgency in light of the governance issues at a leading marketplace lender that recently made headlines, along with its disclosure that the DOJ is now investigating.[5]

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[3] http://www.klgates.com/second-circuit-holds-that-national-bank-act-preemption-does-not-apply-to-an-independent-third-party-debt-collector-that-purchased-debt-from-a-national-bank-06-01-2015/

[4] This outcome was favored by the Obama Administration, which—after being asked for its thoughts by the Court—asked the Court to deny certiorari, though indicating that the Second Circuit decision indeed was erroneous.

[5] http://www.wsj.com/articles/lendingclub-discloses-receipt-of-grand-jury-subpoena-from-justice-department-1463440153

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An important prudential regulatory concern with acquisitions of bank charters by marketplace lenders is a desire to avoid making the marketplace-lending industry an attractive supplier of brokered deposits, which are an unstable source of capital and may be particularly risky where a bank has inadequate anti-money-laundering controls or is undercapitalized. Regulators also anticipate grappling with the activities of many lending platforms that may be incompatible with partner banks that have charters limiting their activities to those activities that are considered "incidental to the business of banking"—typically insurance and securities work. The edgy innovations of marketplace-lending platforms that use technology in creative ways to marry finance with social media offerings are a particular challenge in this regard.

Grappling with Regulatory Challenges

On May 9, 2016, a leading marketplace-lending platform and industry advocate made the surprise announcement that $22 million in subprime loans sold in March and April of this year to a single investor, which went against the investor's expressed terms.[6] Still more damaging, certain staff members, including the former CEO, allegedly were less than forthcoming during the review process. This news naturally hurt investor confidence in both the specific business entity at issue and in the marketplace lending industry as a whole. Indeed, two major institutional investors reportedly elected to back out of the market.[7]

Lenders, investors, and regulators have recognized marketplace lending's risks and are engaged in finding solutions. The Treasury Department's recent white paper highlights innovative data analysis as a business efficiency that nonetheless must be monitored for disparate impacts.[8] Similarly, the ability of marketplace lending to reach new, unbanked consumers is weighed against the caution to be exercised by a nascent industry that has not yet endured a complete credit cycle where economic conditions have deteriorated akin to the global financial crisis in 2007. Both a new industry group (the Marketplace Lending Association) and the Treasury Department agree on the need for transparency, robust compliance controls, and ongoing risk management. It is perhaps in these areas where we will see coordination between both industry and regulators (all of them) in an effort to standardize goals and best practices.

LendIt USA 2016

The regulatory environment for online lending was an area of focus at LendIt USA 2016, a leading industry conference that took place in San Francisco on April 11 and 12 of this year. In personal remarks delivered at the conference, the president and CEO of the San Francisco Federal Reserve, John C. Williams, struck a cautiously optimistic tone about marketplace lending.[9] First, while he noted that the role of regulators is not to stifle innovation that expands the availability of credit, he expressed a concern about regulatory arbitrage opportunities hidden in the relationship between FinTech and fair-lending protections and the need to prevent unintended consequences. Second, he discussed concerns that certain aspects of FinTech, such as anonymity and access to digital

[6] http://ir.lendingclub.com/file.aspx?IID=4213397&FID=34233669

[7] http://www.americanbanker.com/news/bank-technology/dead-people-dont-pay-tech-takes-on-marketplace-lending-fraud-1090084-1.html

[8] https://www.treasury.gov/connect/blog/Pages/Opportunities-and-Challenges-in-Online-Marketplace-Lending.aspx

[9] http://www.frbsf.org/our-district/files/Williams-Speech-Fintech-The-Power-of-the-Possible-and-Potential-Pitfalls.pdf

currencies, could make terrorist and criminal activity even easier. Third, he noted that the safety and soundness of the industry is an increasing concern, proportional to marketplace lending's increasing market share. Finally, he noted that "it's important that we have a level playing field, regardless of how institutions prefer to describe themselves or what kind of charter they hold."

Other discussions of regulation at the LendIt USA 2016 conference included thought-provoking comments by the general counsels of Lending Club and SoFi on the extent of the convergence between marketplace-lending regulation and prudential regulation. Additionally, the conference had many well-attended panels on a variety of regulatory topics that addressed consumer protection, prudential regulation, and systemic considerations, such as anti-money-laundering trends, terrorism prevention, and sanctions compliance. Despite the troubles the industry has faced recently, the conference served as a testament to the creativity and determination of market participants to build a framework that works for lenders, investors, and the public.

Industry Response: The Marketplace Lending Association

A significant industry announcement was the formation of the Marketplace Lending Association ("MLA"). This U.S. nonprofit membership organization was created to promote responsible business practices and sound public policy to benefit borrowers and investors. The MLA was launched by three of the leading online marketplace lenders on April 6, 2016.[10] The MLA has notable membership restrictions, including:

- a bar on payday lenders;
- significant revenue requirements; and
- a requirement that 75 percent of loans be funded by third-party investors.

The MLA's decision to adopt these membership restrictions is significant. These rules may consolidate the influence of the major players—or overly restrict MLA access by start-ups and ultimately reduce the association's influence when it may be needed most.

Perhaps the most significant immediate consequence of the formation of the MLA is its six-page list of "Marketplace Lending Operating Standards" (the "MLA Standards"), which all members must commit to follow. The goal is for the MLA Standards to set the basis for best practices across the entire industry, though potential MLA review and enforcement mechanisms (if any) against any nonconforming members remain unclear. The MLA Standards therefore provide useful insight into the practices and risks that industry leaders consider most crucial to promote the integrity, growth, and stability of the industry.

The new MLA Standards have five main components, each discussed here in order:

1. **Investor Transparency and Fairness** – providing investors with highly transparent data and fair access to loans within the marketplace investment programs they participate in, with policies to avoid conflicts of interest and ensure all categories of investors are treated fairly.

[10] The founding members of the MLA are Funding Circle, LendingClub, and Prosper.

2. **Responsible Lending** – providing access to responsible, borrower-friendly loan products on a nondiscriminatory basis and with policies and procedures that are designed to protect the rights of borrowers in the collections process.
3. **Safety and Soundness** – maintaining strong internal policies that ensure their reliability for the benefit of borrowers and investors alike, including requirements for operating liquidity and contingency plans, as well as designating a backup loan servicer should the lender's platform cease functioning, similar to the "living will" requirements the Dodd-Frank Act imposes on systemically important banks.
4. **Governance and Controls** – developing and maintaining strong internal controls that ensure compliance with laws, as well as the integrity of investment programs and financial transactions, including participating in regulator-sponsored complaint portals and—addressing an issue that is considered important by the CFPB—maintaining a compliance framework for responding to complaints by investors or borrowers.
5. **Risk Management** – maintaining sophisticated risk-management techniques roughly equivalent to those employed by traditional banks in areas such as anti-money-laundering compliance, monitoring for terrorism financing, complying with government sanctions programs by monitoring watch lists (e.g., the Office of Foreign Assets Control's Specially Designated Nationals List), and implementing data-protection and privacy standards. Many of these topics are principally responsive to prudential regulation, but the CFPB has also recently focused on data protection and privacy under its authority to regulate unfair, deceptive, or abusive acts or practices.

It will be interesting to see how the MLA Standards inform the development of marketplace lending in the European Union, where the European Commission through its Capital Markets Union proposal seeks to expand the availability of nonbank financing, particularly for small- and medium-sized enterprises.[11] K&L Gates is closely following these developments and working to influence policy and regulatory developments in this area for our clients on both sides of the Atlantic.

Moving Forward

The MLA Standards appear to recognize the reality that, as marketplace lending takes up an ever-increasing share of the U.S. loan market, the industry will be increasingly scrutinized by regulators for potential systemic risk. Taken together, the MLA Standards and the launch of the MLA suggest that the industry is embracing the transition to the mainstream of the financial marketplace, including the regulatory and legal responsibilities that come with it. If the MLA Standards prove influential among major industry players, they could serve as a useful tool towards the MLA's stated goal of "supporting the responsible growth of marketplace lending, fostering innovation in financial technology, and encouraging sound public policy."[12]

Nonetheless, regardless of the MLA's launch, regulators will be increasingly looking to apply the existing regulatory framework to marketplace lenders and developing new regulations that target the unique aspects of marketplace lending. The lending platforms that thrive in

[11] For an overview of the European Commission's proposed plans, *see* http://www.klgates.com/european-commission-publishes-plans-for-a-capital-markets-union-10-06-2015/

[12] http://www.marketplacelendingassociation.org/faq

this environment are likely to be those that embrace the capital and access this transition to the mainstream brings, as well as the accompanying responsibilities.

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