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Considerations for Investment Managers Considering Acquiring Portfolios of Online or Marketplace Loans

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Marketplace and online lending has a small but growing share of the US and global lending market. Online loans to consumers and small businesses represent a growing asset class for investment managers seeking non-correlated high returns in a low-yield environment.

This article will provide an overview of important considerations for investment advisers and investment fund managers seeking to understand how marketplace loans as an asset class can fit into an investment strategy and which issues must be considered when investing in marketplace loans, including regulatory compliance and disclosure risks.

Overview of the Online and Marketplace Lending Industry

What is Marketplace Lending?

The US Treasury Department defines “marketplace lending” as “the segment of the financial services industry that uses investment capital and data-driven online platforms to lend to small businesses and consumers[.]”¹ Online lending marketplaces use technology to drive a simple and speedy matching of borrowers and lenders. These internet-based platforms reduce costs by eliminating many

operational expenses associated with traditional bank loans to consumers, such as the cost of maintaining and staffing physical branches. Cost reduction, in turn, makes relatively minor loans to small businesses and individuals economically feasible for all parties involved. Online lending marketplace platforms use proprietary algorithms and models to assign a risk grade to the proposed borrowers and set an interest rate corresponding to the assigned risk grade and the tenor of the loan.

Marketplace lending (or online lending) is classically regarded as the process of connecting borrowers and lenders without using banks. The classic concept is being stretched as the online lending industry continues to evolve and mature. One example of this development can be seen in the evolution of funding sources. Having started with a business model derived from crowdfunding, many online lending platforms have increasingly come to rely on balance sheet funding in addition to marketplace funding techniques. Additionally, the classic peer-to-peer model of marketplace funding has been supplanted by flow purchases of assets in bulk as institutional investors have become more prominent—so much so that the industry has shifted away from calling itself “peer-to-peer” to “marketplace lending,” “online lending,” or “direct lending.”

The impact of regulation is another area where the classic definition is subject to change. Emerging as a largely-unregulated lending source that would compete with banks by relying on big data analysis more than classic credit underwriting, the online lending industry has seen growing convergence with more traditional lending. One such area of convergence is seen in the growing sensitivity to classic consumer financial services regulation and other types of regulation, such as anti-money laundering considerations.

Another area of convergence between online lending and traditional finance is seen in the growth of partnerships between online lending platforms and deposit-taking institutions. These have taken many forms, including acquisitions of platforms by banks, white label arrangements, and targeted investments by banks through funding vehicles, either for regulatory compliance purposes or with strategic goals in mind. This convergence may be accelerated as online lending platforms seek to enhance the role of originating banks in underwriting and servicing loans in order to obtain the benefits of federal preemption of certain state laws such as those governing usury.

Why Invest in Marketplace Loans?

Online lending marketplaces provide individual and institutional investors an opportunity to earn attractive risk-adjusted returns through equal access to standard program loans offered through the online lending marketplace. The platform typically permits investors to tailor or modify their own portfolios by utilizing specific investment criteria, such as credit attributes, financial data and loan characteristics. The platforms use proprietary credit algorithms to approve loans and help investors construct loan portfolios and model targeted returns. The business model began as a peer-to-peer marketplace that permitted borrowers to use a web-based platform to borrow money from other platform users. More recently marketplace lending has become a more institutional market, with a wide variety of financial

institutions and credit funds accessing financial assets through flow purchase agreements with online lending marketplaces.

Securitization of marketplace loans provides investors with liquidity, diversified funding and interest rate arbitrage opportunities. Securitized marketplace loans have the attributes of a fixed-income security with a relatively low default risk. Marketplace loans are both suitable and desirable for securitizations for a number of reasons. They are a highly homogenous asset class with low borrower concentration and a steady flow of new originations. They have relatively high risk-adjusted interest rates and have thus far enjoyed relatively low default rates. They pay a predictable stream of principal and interest payments over a relatively short three- or five-year time horizon. Also, a marketplace loan securitization does not raise particularly complex tax issues (unless it is backed by mortgage loans).

Online Loan Origination and Monetization Processes

While there are variations, online loan generation typically follows a similar process. An online lending marketplace will host its own website on which prospective borrowers can apply for loans. In some cases the website might be maintained in conjunction with a bank that partners with the lending platform. When a prospective borrower requests a loan he or she will complete a loan application, the information from which is used by the marketplace platform to obtain a credit report and evaluate whether the prospective borrower meets the underwriting criteria established in conjunction with the entity originating and funding the loan.

The marketplace sponsor will use its own credit algorithms to assign a risk grade to the prospective borrower and proposed loan to determine whether such prospective borrower and proposed loan meet the lending standards of the online lending marketplace or platform. If a borrower qualifies, the online lending marketplace will approve the loan on a preliminary basis and will disseminate information

about the loan to potential investors, each of whom may determine to fund all or part of the loan.

If there is sufficient investor interest in funding a marketplace loan, the marketplace platform sponsor either originates the loan directly or through an affiliated licensed lending company or bank, or alternatively sends the loan application to a third-party bank with which it has a relationship. That bank then acts as the lender of record, originating the loan and selling and assigning the promissory notes evidencing the loans to the online lending marketplace sponsor.

The relationship between the lending platform and the originating bank is typically governed by a loan account program agreement. This document sets forth the framework under which the marketplace sponsor manages the operations of the lending marketplace that relate to the submission of loan applications, as well as the originating and funding of loans by the bank in exchange for a fee equal to the origination fee charged by the bank. Additionally, the marketplace lending platform will enter into a loan sale agreement, under which the bank sells and assigns the promissory notes evidencing the loans to the marketplace sponsor. As consideration for the bank's agreement to sell and assign the promissory notes, the marketplace lending platform typically pays the bank a periodic fee (usually monthly) in addition to the purchase price for the loan assignment.

Marketplace lending platforms may offer either whole loans or fractional interests in loans. In the case of whole loans, an online lending marketplace sponsor has several avenues available to it for funding the underlying loans. It may sell entire portfolios of loans pursuant to whole loan purchase and sale agreements to investors that want to hold loans on their own balance sheets, either a single portfolio or on a flow basis.

Alternatively, the marketplace sponsor may offer fractional interests in loans through the issuance of unsecured payment-dependent notes (Marketplace Platform Notes) to investors that meet the online

lending marketplace's financial suitability requirements and the eligibility requirements under the Securities Act of 1933 (the Securities Act) and that have established an account with the platform. When the marketplace sponsor issues and sells Marketplace Platform Notes to an investor, the notes are registered in the name of the investor on the marketplace sponsor's books and records. The Marketplace Platform Notes are special, limited obligations of the online lending marketplace issuer and pay through obligations that are dependent on payments received by the marketplace platform on the underlying loans.

The issuer's obligation to make payments on a Marketplace Platform Note is limited to an amount equal to the note holder's *pro rata* share of amounts it receives with respect to the corresponding borrower loan, net of servicing fees. Marketplace Platform Notes typically bear interest from the date of issuance, have a fixed rate, are payable monthly, and have an initial maturity of three or five years from issuance. A note holder's recourse is generally very limited in the event that borrower information is inaccurate for any reason, or if the borrower defaults. Investors in Marketplace Platform Notes are also subject to ongoing credit and insolvency risk of the platform, including the risk that the Marketplace Platform Notes could be characterized as unsecured obligations in bankruptcy of the platform.

An online lending marketplace may also afford facilities to eligible investors (such as accredited investors or qualified purchasers) to establish a relationship with a registered investment adviser in order to invest in Marketplace Platform Notes or to purchase pass-through certificates or other interests in trusts or entities established by the marketplace sponsor to purchase Marketplace Platform Notes selected by the investor.

Structural Issues for Private Funds that Invest in Marketplace Loans

Marketplace lending has attracted strong interest from investment managers seeking to deliver attractive fixed income-like returns to their investors at what

has so far been a relatively low risk profile. Investment managers can offer clients exposure to the marketplace lending asset class through either a private fund vehicle or through a separate account structure. For private funds, investment managers have structured these vehicles as both hedge funds and private equity funds.²

Investors in a hedge fund structure obtain the opportunity to invest in the fund on a continuous basis, as would be typical for such funds. Investors in those types of funds are typically charged a management fee and a performance fee, often subject to a high-water mark provision.

One important consideration for an investment manager using a hedge fund model is the relative illiquidity of the asset class. While marketplace loans have enjoyed increasing popularity in recent years, there is no developed, efficient market for either Marketplace Platform Notes or whole consumer or small-to-medium enterprise loans. Accordingly, an investment manager for a marketplace loan fund should carefully consider how the liquidity features of the fund are aligned with the illiquid nature of the fund assets. In particular, an investment manager should consider the redemption features of their fund. This means not only employing traditional hedge fund-style mechanisms such as lock-up periods and gates, but also avoiding granting larger investors the ability to withdraw funds through side letter agreements.

Valuation represents another material consideration for hedge fund investment managers seeking to acquire marketplace loan exposure. Because investors have the ability to acquire fund interests on a continuous basis, there is a need to value the portfolio on a periodic basis. Again, the illiquidity of the asset class requires hedge fund managers to pay particular attention to valuation methodologies and procedures for the portfolio.

Marketplace loan funds that are structured as private equity vehicles have different strategic imperatives and structural considerations than those that are structured as hedge funds. Each investor in such a vehicle makes a capital commitment, which may be drawn over a set period of time or all at once. The

sponsor of the vehicle typically receives a management fee and a share of the profits, after the investors receive a priority return. A private equity fund structure eliminates the concern with respect to investor redemptions since capital is locked up for the life of the investment. Using a private equity fund model also eliminates concerns regarding valuation of assets for purposes of admitting new investors.

A series limited liability company can provide a suitable structure for investment managers that want to bring new investors into a private equity fund structure on a regular basis. With this model, investors commit capital to a specific series, the series is then closed and the next series is opened. New investors may be admitted to this new series and existing investors can be given the option to roll principal and interest payments into the new series or to make new capital commitments to the new series.

Finally, a separate account structure can be used for investors that want a bespoke vehicle for investing in marketplace loans. The investment manager, through a separate account investment management agreement, can provide a highly tailored investment opportunity to individual institutional investors.

Securities Act Considerations Affecting Marketplace Loan Investments

Marketplace Platform Notes (and securities that may be issued by an investment fund investing in marketplace loan exposures) are subject to securities regulation as investment contracts. They may be offered in exempt transactions, typically in private placements under Regulation D under the Securities Act or, less commonly, in unregistered public offerings pursuant to Regulation A under the Securities Act or in public offerings that are registered pursuant to Section 5 of the Securities Act.

Private Placements

If Marketplace Platform Notes are offered in multiple states through a Regulation D private placement, the sponsor has the option to offer them

in compliance with Rule 506(b) or Rule 506(c), which permits the use of general solicitation and advertising. Rule 506(b) prohibits the use of general solicitation and advertising. On the other hand, Rule 506(c) permits offerings to be advertised in an unlimited manner, including in print, digital, and electronic media. Rule 506(c) was added to Regulation D pursuant to the Jumpstart Our Business Startups Act (JOBS Act), to broaden the scope of communications with prospective investors without causing a private placement to lose its exemption from registration. A marketplace lender that offers Marketplace Platform Notes in reliance on Rule 506(b) must have a reasonable belief that each prospective investor who views offering materials for the Marketplace Platform Notes are “accredited investors” as defined in Rule 501(a) under Regulation D.³ To that end, the marketplace lender must screen potential investors for their accredited investor status prior to allowing them to access the platform and view any offerings. It must also limit its marketing communication to avoid being considered to be engaged in a general solicitation of offers to purchase Marketplace Platform Notes.

On the other hand, a marketplace lender may take advantage of the flexibility provided by the JOBS Act by offering Marketplace Platform Notes pursuant to Rule 506(c). An offering under Rule 506(c) is not subject to any limitations on communications with prospective investors or solicitation activity. In a Rule 506(c) offering the prospective investors may also view offering materials before the issuer has verified their status as accredited investors. However, in a Rule 506(c) offering the issuer must take “reasonable steps to verify” that all persons who actually purchase Marketplace Platform Notes are accredited investors as defined in Regulation D. Rule 506(c) sets forth certain non-exclusive methods of verification that can satisfy this requirement.⁴ The staff of the Securities and Exchange Commission (the SEC) has identified a number of factors which may be considered under Rule 506(c) for purposes of verification.⁵

Finally, a Form D must be filed in each state in which securities are sold pursuant to Regulation D, regardless of whether it is made under Rule 506(b) or Rule 506(c).⁶

Public Offerings Pursuant to Regulation A and A+

Regulation A, as amended in 2015 pursuant to the JOBS Act (known as Regulation A+), permits qualifying issuers to engage in public offers and sales of up to an annual limit (\$50 million or \$20 million with sublimits for sales by selling security-holders) depending on whether the issuer is a tier 1 issuer or a tier 2 issuer as defined in Regulation A+. As with a registered offering, Regulation A+ requires that the issuer provide specified disclosures to investors and file an offering statement with the SEC and it provides the SEC with power to issue stop orders. (Both tier 1 and tier 2 issuers are subject to the same basic requirements while tier 2 issuers are also subject to additional disclosure and ongoing reporting requirements.)

Securities issued pursuant to Regulation A+ are not “restricted securities” for purposes of Rule 144 under the Securities Act, which means they can be resold without restriction as if they were issued in a registered offering. Regulation A+ provides greater flexibility than Regulation D for smaller online lending marketplaces that are ramping up volume. However, the annual volume limits make it impracticable for an online lending platform to rely on Regulation A+ for continuous offerings of the sort that are commonly registered on Form S-1.

Registered Offerings on Form S-1

In order for Marketplace Platform Notes to be offered to the public without the volume restrictions of Regulation A+, they must be offered and sold pursuant to a registration statement that is filed with the SEC. The offer and sale may be registered on either Form S-1 or S-3 but, as a practical matter, marketplace lending platforms will generally use Form S-1 to register a continuous offering of securities rather than registering a securities shelf on Form S-3.

A registered offering of Marketplace Platform Notes involves significant regulatory and other issues. These include significant limitations on the sponsor's ability to offer multiple series of Marketplace Platform Notes using a single base prospectus for multiple offerings. In continuous offerings they also include complications arising from the fact that Form S-1 (unlike Form S-3) does not provide for incorporation by reference of subsequent periodic reports.

As a result, the registration process may be lengthy and costly and the issuer will be subject to ongoing requirements to monitor and update the prospectus if it is used for continuous offerings. For example, every time the prospectus is updated to include reports under the Securities Exchange Act of 1934 (the Exchange Act) that were filed after the effective date of the Form S-1, the issuer will have to consider whether it needs to make additional changes as required by Item 512(a)(1) of Regulation S-K. These could include an update of prospectus information as required by Section 10(a)(3) of the Securities Act if the prospectus is more than nine months old, updated disclosure to reflect facts or events that represent a fundamental change in the information set forth in the registration statement, updated disclosure to reflect material changes in the plan of distribution or make certain other changes as permitted under the Securities Act.

Investment Company Act Considerations

The sponsors of online lending marketplaces have traditionally held loans acquired through their marketplace lending programs on their balance sheets. If those loans are deemed to be securities, a sponsor (or any affiliate holding the loans) could fall within the definition of an investment company under the Investment Company Act of 1940 (the Investment Company Act); this could cause the sponsor (or its affiliate) to be required to register as an investment company and be regulated under the Investment Company Act.

Depending on the precise model used for a marketplace lending program and the types of loans a sponsor holds, however, sponsors may be able to rely on one or more bases for the conclusion that they do not fall within the definition of an investment company, including Section 3(a), Section 3(b)(1), Section 3(c)(4) and Section 3(c)(5). The analysis applicable to a particular online lending marketplace would also depend on a wide range of facts and circumstances. These would include such matters as whether loans are made primarily to consumers or to businesses, the purpose of the loans, whether loans are secured and, if so, the nature of the collateral.

The San Bernardino terrorist case in December 2015 highlighted an interesting wrinkle on the Investment Company Act analysis of marketplace loan investments. Shortly before the shooting the terrorist borrowed over \$30,000 from the Prosper marketplace lending platform and identified the use of proceeds of the loan as "other" rather than credit card consolidation. This fact pattern may suggest that the exceptions under Section 3(c)(4) and Section 3(c)(5) may not be available in cases where they would appear to apply and illustrates that the Investment Company Act analysis in this asset class may be tricky. This would be a practical issue only for investment managers seeking to invest in an asset class that may lend itself to a public distribution or seeking to establish an Investment Company Act exception that would permit a fund not to be a "covered fund" under the Volcker Rule.

Other US Regulatory Considerations for Investors in Marketplace Loans

General

While currently there is no comprehensive regulation of online marketplace lending in the United States, lenders are subject to various federal and state laws and regulations. They include federal and state consumer-protection statutes and regulations, lender and broker licensing and usury laws, data-privacy laws, and securities regulation.⁷

Consumer Regulation and Usury Considerations

To the extent that an online lending marketplace is involved with loans to consumers, the rules enforced by the Consumer Financial Protection Bureau are a material consideration for the companies and their investors. These include the Truth in Lending Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act, the Consumer Credit Protection Act and the Telephone Consumer Protection Act, among others. There may also be applicable state laws to the extent that federal law does not have preemptive effect. These affect disclosures, indemnifications, and other material issues. Loans to small businesses may be subject to some of these rules if they are guaranteed by individuals and it is possible that the Federal Trade Commission will become active in regulating such loans. State consumer protection laws may also be applicable. State usury laws have recently emerged as a particular area of concern.

Although some online lending marketplaces originate loans through affiliated banks or licensed lending companies, many have traditionally tended to acquire the loans they originate from banks that act as lenders of record for the marketplace loans. Using a federally insured depository institution to serve as lender of record affords the benefits of federal preemption to subsequent assignees of the loan, including the online lending platform and its investors. Under federal preemption, a loan can be originated nationwide without the lender having to be licensed in any state and the loan can bear an interest rate and fees that are permitted in the home state of the lender of record, regardless of the borrower's location.

There have been some relatively recent challenges to this view of preemption. For example, in 2014, the West Virginia Supreme Court of Appeals held that a non bank consumer finance company that originated loans over the internet through a federally insured bank as lender of record violated West Virginia's usury and debt collection laws. The court found that the finance company, not the lender of

record, was the "true lender" of the loans; as a consequence, the court voided the loans to borrowers in West Virginia because they exceeded the West Virginia usury cap.⁸

More recently, in *Madden v. Midland Funding* the United States Court of Appeals for the Second Circuit held that a non-bank debt collector that purchased written-off credit card accounts from a bank on a servicing-released basis cannot benefit from federal preemption of state usury laws. That decision, which could eventually apply to bank-originated consumer marketplace loans, applies in New York, Connecticut, and Vermont, as the states that comprise the Second Circuit.⁹ Consequently, the assignee of a loan made to a borrower in one of those states may charge interest only at a rate that does not exceed the usury limitation of that state. The *Madden* decision could adversely affect investors in marketplace loans and may affect the ability to securitize those loans. This could create a bifurcation in how investors perceive online lending marketplaces that have their own lending licenses or operate their own banks as compared to those that purchase loans that are originated by a third-party bank that acts as lender of record. In the case of the former category of marketplace loans, it may result in concentration limitations for loans to borrowers who reside in affected states. The *Madden* case is currently before the Supreme Court of the United States. While the Supreme Court has not yet decided to hear the case, on March 21, 2016 it called for the views of the solicitor general on whether it should grant *certiorari* in the case.¹⁰

Anti-Money Laundering and Bank Secrecy Act Considerations

Recent events have focused attention on the intersection of the marketplace lending industry and regulatory concerns that relate specifically to counter-terrorism and national security concerns are of particular relevance. Notably, marketplace lending is subject to anti-money laundering laws and regulations under the Bank Secrecy Act as amended by the

USA PATRIOT Act. Non-bank online lending platforms may not be directly subject to these obligations, but depending on their structure and services offered, a particular platform may be subject to regulation as a money-services business, a money transfer system, an investment company, an investment adviser, or a securities broker-dealer. These regulatory concerns indirectly affect investment managers and their investors.

Conclusion

The digital revolution in consumer and small business finance has helped create a small but growing investment management asset class. As is the case with many asset classes, marketplace loans will require investment managers to understand the performance characteristics and risks associated with marketplace lending. The rapid development of the asset class will make these features increasingly important, particularly if the industry faces a correction as many predict will occur in time.

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NOTES

¹ *Public Input on Expanding Access to Credit Through Online Marketplace Lending*, 80 Fed. Reg. 42866 (July 20, 2015).

² Institutional investment in marketplace lending in the United States has tended to be made through private funds rather than publicly distributed vehicles that can be distributed to retail investors in the United States, notwithstanding the existence of a handful of closed-end marketplace loan mutual funds such as Van Eck Overland Online Funding Trust Rivernorth MPL Corp. (This situation is different than that in Europe, where several closed-end retail marketplace loan funds have been listed on the London Stock Exchange, including VPC, Ranger and Funding Circle, though they are not available to United States retail investors.). One consideration

driving this tendency is that the Investment Company Act of 1940 imposes compliance burdens on registered investment companies and limits their ability to incur leverage or engage in certain transactions or relationships. Some have considered the formation of funding vehicles that are not registered investment companies and that can sell marketplace loan exposures to retail investors and that are not registered investment companies. Some models used in other industries include real estate investment trusts and master limited partnerships, but those would not be available for this asset class without legislative changes. Other models include retail funds that rely on an exemption from the definition of “investment company” in the Investment Company Act of 1940 that is consistent with a public offering. As described below, finding such an exemption can be a challenge. This section will focus on private investment vehicles.

³ Generally, the term “accredited investor” includes companies with total assets of more than \$5 million, companies in which all equity owners are accredited investors, natural persons with a net worth (alone or with a spouse) of more than \$1 million, and natural persons with an individual income in excess of \$200,000 in each of the two most recent years, or joint income with a spouse in excess of \$300,000 in each of those years, and a reasonable expectation of reaching the same income level in the current year.

⁴ The methods for verification generally include reviewing Internal Revenue Service forms reporting income, reviewing certain statements of assets provided by regulated financial entities in conjunction with consumer reports. In addition, the SEC observed that certain categories of outside service providers, including licensed attorneys, certified public accountants, registered investment advisers, and broker-dealers, could perform the verification function.

⁵ See generally SEC, *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, 78 Fed. Reg. 44771 (July 24, 2014) (discussing the factors to consider in determining whether a method constitutes “reasonable

steps to verify,” including the nature of the purchaser and the type of accredited investor that the purchaser claims to be; the amount and type of information that the issuer has about the purchaser; and the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount). *See also* SEC, *Use of Electronic Media*, 65 Fed. Reg. 25843, 25852 n. 85 and accompanying text (Apr. 28, 2000) (stating that websites that allow for self-certification of accredited investor status “call into question” the ability of an issuer to form a reasonable belief regarding investor qualifications).

- ⁶ Rule 147 under the Securities Act provides an exemption for offerings of securities entirely within a single state. That would not be of practical significance to marketplace platforms because the Internet distribution typically targets investors across wider geographic areas.
- ⁷ *See* <http://www.klgates.com/securities-law-considerations-in-online-marketplace-lending-02-03-2016>.
- ⁸ *Cash Call, Inc. v. Morrissey*, No. 12-1274, 2014 WL 2404300 (W. Va. May 30, 2014).
- ⁹ *Madden v. Midland Funding*, No. 14-2131-cv (2d Cir. May 22, 2015), *cert. pending*.
- ¹⁰ 577 U.S 15-610 (March 21, 2016).

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