Marketplace Lending Update: Recent Developments Place Pressure on Industry

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Following a spate of heightened regulatory, enforcement and legislative scrutiny, investor concerns around industry practices, and bad press, the marketplace lending industry is at a crossroad.

Some companies will struggle to respond adequately to these developments, and the industry may experience herd thinning. However, in this environment, industry players that embrace change and address the concerns motivating recent events will retain or regain the competitive advantages responsible for the sector's rapid growth, such as speed and an enhanced borrower experience, and find themselves in a stronger, more enduring market position. The following discussion highlights these recent developments and explores possible responses that will enable marketplace lenders to continue to realize the industry's promise.

Intensifying Regulatory and Legislative Scrutiny

Federal agencies and legislators have increased their scrutiny of marketplace lending in recent months, telegraphing a number of important messages to the industry:

- Earlier this month, the U.S. Department of the Treasury ("Treasury") issued a 42-page whitepaper in which, notwithstanding words of encouragement for future growth of the industry, Treasury called for increased regulatory and legislative oversight due to concerns of profitability and liquidity as the industry progresses through the credit cycle. While Treasury acknowledged online lending's potential to expand access to credit and reduce credit costs, the agency expressed concern about risks associated with the industry's use of big data and "machine underwriting."

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- Also earlier this month, the California Department of Business Oversight ("DBO"), in connection with the second phase of its ongoing industry inquiry, contacted 14 of the largest online lenders in the second phase of its inquiry to obtain information on practices relating to fair lending, referral fees, loan underwriting, bank partnership arrangements and investor protections.[1]
- In April, three U.S. Senators asked the Government and Accountability Office ("GAO") to update a 2011 peer-to-peer lending report to cover more broadly the "fintech marketplace" and the adequacy of existing regulatory oversight.
- In March, the Consumer Financial Protection Bureau ("CFPB" or "Bureau") announced it would begin accepting complaints on consumer loans obtained from marketplace lenders, an act widely seen as presaging a "larger participant" rulemaking initiative to bring the industry squarely within the CFPB's supervisory authority, as well as implicating potential enforcement scrutiny by the agency in this area.
- Also in March, the Securities and Exchange Commission ("SEC") announced that it is closely monitoring marketplace lending platforms. The SEC specifically indicated it has an expectation that investors should receive disclosures on characteristics of loans underlying the investment, borrower characteristics (such as ability to repay) and the platform's proprietary risk and lending models.
- The Department of Justice ("DOJ") recently indicted certain internet payday lenders under novel theories applying the Racketeer Influenced and Corrupt Organizations Act ("RICO"). Traditionally, violation of a state's usury law would subject an online lender to action by that state's attorney general. In the past year, however, the DOJ has taken action in federal court under RICO based on violations of usury law.

Although these developments portend further legislative, regulatory and enforcement activity, the silver lining for the industry is the degree of clarity with which government agencies have expressed their chief concerns. Marketplace lenders would be well-served to regard the warning notices the various agencies have provided; effectively, they provide a roadmap for business process enhancements the industry should consider as part of a comprehensive legal risk-mitigation strategy. In particular, recent activity suggests marketplace lenders should pay close attention to their business practices in the following areas:

Mitigating Bad Actor Risk: Treasury expressed particular concern about the ongoing risks with bad actors, including risks related to cybersecurity, terrorism and money laundering. The Treasury whitepaper recommends that businesses develop a detailed response and recovery plan to minimize the threat, fallout, and contagion from a cybersecurity event. It also notes that Treasury's Financial Crimes Enforcement Network ("FinCEN") will continue to monitor the industry to determine if rulemaking is appropriate. These concerns and potential government response suggest that lenders should consider proactive steps, such as obtaining an independent review of their intake systems to identify gaps in their current anti-money laundering programs and specially designated nationals list checks and of their cyber threat response plans, including when, how and what to notify law enforcement and regulatory authorities, customers and the public.

Fair Lending: Treasury noted that credit scoring models, while promoting accuracy and efficiency in credit allocation, may also reflect and exacerbate underlying biases and discrimination. In light of this assessment and the DBO's inquiry into fair lending, marketplace lenders should consider a privilege-protected assessment of fair lending program risk. This should include a review of lenders' marketing, lending and servicing activities and statistical outcomes to identify and remediate potential violations of federal and state fair lending laws, as appropriate.

Capital Markets Transparency: Industry groups would also benefit by taking the time to develop standards for secondary market activity. To this end, participants, as a baseline, should engage in careful recordkeeping with respect to whole loan sales and bundling of loans for resale. In addition, the industry could band together to establish loan-and-pool level disclosures and reporting standards. Marketplace lenders could also develop securitization standards for contract representations and warranties, origination and portfolio performance reporting, loan securitization performance transparency, and pricing methodology. Standardization of contract terms and pricing methods would increase investor confidence and security in a currently hesitant secondary market.

Servicing and Collection: As discussed below, Treasury also expressed concerns that new marketplace lending platforms might have servicing and collection gaps that could prove challenging during a credit cycle. This is a concern not only for the industry, but also for the various banks and other lenders that provide funding at different points within a lending platform and should prompt consideration and review of existing servicing and debt collection practices, including, in particular, whether and how third parties contracted with to perform such functions meet regulator expectations.

Small business lenders in particular should be on alert for potential new rulemaking. The Treasury whitepaper indicated that small business borrowers taking out loans less than $100,000 could benefit from additional safeguards, particularly around the transparency of pricing terms, similar to those that protect consumers. This appears to be the first time a federal government agency has identified a potential threshold that would separate one class of small business borrowers from another in connection with the application of consumer financial protection type safeguards.

Marketplace lenders operating in California should be especially attuned to potential violations of state law with respect to referral fees and securities laws. Because California law restricts referral payments to licensed entities, lenders in California would benefit from reviewing their referral fees for compliance with such laws. In addition, California operators should revisit their sales of whole loans and bundling of loans into bonds to ensure compliance with California securities laws.

The threat of state-level action is also present elsewhere. For example, state (and federal) regulators with authority over finance lenders and brokers may look to DBO's ongoing activities and efforts in this context and, pending the execution of a successful enforcement action, may seek to mirror such results. In addition, certain states are not waiting for federal regulation and have already taken steps to regulate online lenders. The Illinois State Senate, for one, is considering a bill that would prohibit small businesses lenders from making loans that exceed 50% of a business's monthly net revenue, an approach that would effectively prohibit lending to businesses that are breaking even or operating at a loss.[2] Other states already require certain commercial lenders to be licensed.[3]

Potential CFPB Supervision

The CFPB's decision in March to accept marketplace lending complaints was widely viewed by industry as a development that not only increased the likelihood of enforcement scrutiny, but also signaled possible rulemaking to bring marketplace lending fully under the Bureau's supervisory authority inasmuch as the complaint information is the type of data the CFPB's rulemaking team has leveraged in the past for such purposes. Still, a couple of months ago when the CFPB started accepting marketplace lending complaints, a larger participant marketplace lending rule still seemed like a longer-term agenda item. However, recent news reports have suggested the CFPB may try to assert supervisory jurisdiction over the industry as early as late 2016. Those reports further suggest the Bureau would accomplish this by wrapping marketplace lenders into the definition of a consumer installment loan as a means to include the industry as part of the Bureau's on-going efforts to publish a proposed rule to define the consumer installment and vehicle title loan markets.

There are several reasons why the scenario discussed in recent news reports seems unlikely. First, larger participant rulemaking of the sort contemplated would require the Bureau to define a market that includes traditional installment lenders, auto title lenders, and online marketplace lenders. Given the vast differences between these industries and the products they offer, such efforts would be extremely time-consuming and face myriad difficulties. Second, rulemaking will likely not move forward without a robust data source, which the CFPB may have difficulty assembling given the limited marketplace complaint data currently available.

Finally, the CFPB's recently-released spring 2016 regulatory agenda delayed the pre-rule activity deadline for the consumer installment and vehicle title larger participant rule to December 2016, which suggests that a Notice of Proposed Rulemaking is unlikely to be issued until 2017. In light of the time the Bureau must allot for comments and issuance of any final rule, it appears the earliest marketplace lenders could expect to see rules that bring them into the ambit of CFPB supervision is 2018.

Judicial Developments Creating Legal Uncertainty

For some time, online marketplace lenders have been grappling with how to manage the legal risk created by the Second Circuit's May 2015 ruling in *Madden v. Midland Funding, LLC* (*Madden*).[4] We provide a detailed summary of the *Madden* case and its implications in a recent client alert.

While waiting to see whether and, if so, how the U.S. Supreme Court will resolve the issues raised by *Madden*, participants in the primary and secondary loan markets have been managing the *Madden* and true lender risk by amending loan sale and purchase structures. For example, some marketplace lending program managers are now deferring payments over the life of the loans and tying payments to loan performance – a structure that gives sponsor bank partners an ongoing economic interest in loans sold as well as an ongoing contractual relationship with the borrower even post-sale. Similarly, some sponsor banks are holding a piece of each loan originated through their platform and/or retaining the borrower account relationship. Marketplace lenders and their sponsor banks that operate under an originate-to-sell model may want to explore similar partnership terms and arrangements.

Part of the California DBO inquiry discussed above focused on how lenders use bank partnerships to avoid state-level licensing and usury laws, which showed an awareness of industry partnerships and issues similar to those raised in *Madden*. Marketplace lenders and sponsor banks, if they have not already done so, should assess their current business relationships to ensure that the roles and responsibilities of each party are appropriately and clearly set forth in program documentation to mitigate the nature and extent of true lender risk.

Loan Quality and Investor Issues

The recent increase in legal uncertainty and heightened regulatory scrutiny has also coincided with recent revelations that expose weaknesses in the marketplace lending business model and raise questions regarding the adequacy of internal controls.

Regarding potential weaknesses in the business model, the Treasury whitepaper notes concerns that the recent rise in delinquency and charge-off rates may continue if the credit environment becomes less favorable. An upward trend could strain the servicing and collections infrastructure of existing marketplace platforms. To address existing infrastructure gaps before they are exposed by a credit cycle, Treasury urged online lending platforms to develop, if they have not already, back-up servicing plans to ensure proper loan management in the event of company failure. Treasury also recommended that marketplace lenders explore ways to contractually align the interests of borrowers and investors and maintain a focus on strong customer service from origination to payment. Lenders, especially those making mortgage loans, should consider conducting privileged assessments of their existing servicing and collections infrastructure or, if those functions are outsourced, ensuring provider practices are adequate. DBO's recent inquiry to online lenders (discussed above) specifically requested data on loans made without verification of income, revenue, employment status and other information, which suggests a concern with lender assessments of borrower ability to repay. As mentioned, the SEC expects that information about borrowers, including ability to repay, will be disclosed to investors. Marketplace lenders should consolidate information regarding ability to repay and other borrower information and discuss the optimal way to present such information to investors and, as appropriate, to regulators.

Regarding internal controls, recent events at one marketplace loan industry leader, including a management shake-up, receipt of a DOJ subpoena and a shareholder lawsuit, highlight the need to ensure strong internal company controls.[5] As reported by the company, its board of directors accepted the Chairman and CEO's resignation "follow[ing] an internal review of sales of $22 million in near-prime loans to a single investor, in contravention of the investor's express instructions as to a non-credit and non-pricing element," which the board viewed as "a violation of the Company's business practices along with a lack of full disclosure during the review [that] was unacceptable to the board."[6] The shareholder suit was filed after the CEO's departure; it leverages the Company's own disclosures to allege that shareholders were misled as to the strength of the Company's internal controls.[7] At this stage, marketplace lenders may be wise to consider engaging counsel and compliance specialists to perform an audit of their compliance management system and other internal controls to identify and correct any potential deficiencies.

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Recent developments have marketplace lenders under a spotlight. Issues referenced in the Treasury whitepaper, potential CFPB rulemaking activities, ongoing SEC and FinCEN monitoring, U.S. Senate and state-level probes, and revelations regarding the business practices of certain marketplace lenders highlight serious concerns and challenges for the industry. Regulatory involvement was inevitable and, in many respects, its swift arrival is a testament to the industry's remarkable growth. At this point, the key is for the industry to work with regulators and legislators, educating them about the benefits of online marketplace lending, the importance of continued innovation in the financial sector, and their advancements in self-regulation.

The industry must also work to restore and maintain investor confidence and develop a robust secondary market that can provide it with needed liquidity. In order to do so, industry participants and other stakeholders must assess the current legal and regulatory landscape to determine the best path forward. To this end, marketplace lenders and sponsor banks should consider what they can learn from recent developments to ensure that the industry can weather the current storm and emerge as a viable lending platform going forward.

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[1] California Department of Business Oversight Press Release, California DBO Announces Inquiry into 'Marketplace' Lending Industry (Dec. 11, 2015) (DBO phase one inquiry).

[2] Illinois Small Business Lending Act, Amendment to S.B. 2865, *available at* http://www.ilga.gov/legislation/99/SB/PDF/09900SB2865sam001.pdf.

[3] *See, e.g.*, Cal. Fin. Code § 22000 *et seq.* and Vt. Stat. Ann. tit. 8, § 2200 *et seq.*

[4] 786 F.3d 246 (2nd Cir. 2015).

[5] LendingClub Current Report on Form 8-K, dated May 6, 2016.

[6] *Id*.

[7] *Id.*