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EXPERT ANALYSIS

Understanding the Evolving Legal And Regulatory Landscape for Consumer Marketplace Lending

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As online consumer marketplace and peer-to-peer lending continue to move into the mainstream, marketplace lending platform operators (the companies that provide a website or other technology platform), lenders (the individual or institutional investors who fund loans made through the platform), and their service providers will come under greater scrutiny from federal and state regulators and policymakers. This pressure will likely increase as small-dollar lenders, banks, credit unions and institutional investors shift from traditional lending to marketplace lending in search of new markets and the potential for higher (or safer) returns. As is usually the case, additional scrutiny will lead to questions as to whether there are adequate consumer protections in place for marketplace lending.

This article summarizes the complex and evolving regulatory framework for marketplace lending and provides suggested best practices for mitigating potential risk. In particular, three broad trends will drive operational and regulatory risk for the industry moving forward:

- Increased operational costs driven by regulatory pressure.
- Heightened regulatory and examination risks, most likely pushed by the Consumer Financial Protection Bureau and the Securities and Exchange Commission.
- More emphasis on compliance with consumer protection laws and regulations, and in particular the need to implement an effective, efficient compliance management system.

We address these challenges below, along with suggestions for how operators, lenders and others in the industry can minimize potential regulatory risk and set up their businesses for long-term success.

WHAT IS MARKETPLACE LENDING?

Marketplace lending involves the use of online and other financial technology, known as FinTech, to allow direct lending between individuals (e.g., peers) in the consumer lending marketplaces. A traditional marketplace lending operator manages an online platform that connects consumers seeking to obtain loans with consumers interested in lending their own money to borrowers. The operator does not lend its own funds; it makes money by charging fees and interest for each loan originated through the platform.

In recent years operators have begun to expand operations by partnering with banks and institutional investors to fund lending platforms. A hedge or private equity fund, for example, might fund loans through a platform or purchase loans that have been bundled and securitized.

Although marketplace lending has received considerable attention in recent years as a disruptive force in the industry, at a basic level the business model involves many of the same steps as traditional lending. It includes the marketing, underwriting, closing, servicing, securitization (in some cases) and collection of loans that have defaulted.

All these activities have traditionally been subject to significant state and federal regulation and oversight. The fact that they take place through a different mechanism may not always protect operators, lenders and their service providers from federal and state regulatory scrutiny.

LAWS AND REGULATIONS

Marketplace lending — like other forms of lending — involves activities that trigger a host of federal and state consumer protection laws and regulations. In fact, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 directed the U.S. Government Accountability Office to issue a report exploring potential future approaches for regulating marketplace lending.

The GAO report, issued in 2011, identified two approaches: The first, an SEC-centered approach, would focus on protecting investors in connection with the purchase of federally regulated securities. The second, a CFPB-centered approach, would place that agency in charge of regulating marketplace lending loans as "consumer financial products."

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Although the GAO did not recommend a particular approach, the CFPB is well-positioned to take the lead in supervising and regulating marketplace lending. The CFPB, after all, has broad supervisory and examination, rulemaking and enforcement authority over traditional lenders and a broad consumer protection mandate. Until a lead regulator emerges, however, the marketplace lending industry must be cognizant of the overlapping roles of the various federal and state regulators. These regulators include:

- Consumer Financial Protection Bureau: The CFPB is an independent federal agency responsible for enforcing "federal consumer financial law," including Dodd-Frank's prohibition on unfair, deceptive or abusive acts or practices in the provision of consumer financial products and services. The CFPB's supervisory and enforcement authority extends to certain banks and nonbank entities that offer or provide financial products or services. The authority also extends to any "larger participants" in the markets for consumer financial products and services. The CFPB defines these entities by rule.

- Federal Trade Commission: The FTC is responsible for enforcing many federal consumer protection laws. In addition, the agency investigates nonbank financial services providers that may be engaged in unfair or deceptive acts or practices. For example, it recently brought an enforcement action against an individual who engaged in deceptive acts and practices in raising funds for a crowdfunding campaign.

- Banking regulators: Depository institutions are subject to comprehensive federal regulation and examination to ensure their safety and soundness. Regulators include the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corp. and the National Credit Union Administration.

- Securities and Exchange Commission: The SEC enforces federal securities regulations to protect investors. The agency enforces disclosure requirements and anti-fraud provisions that can be used to hold companies liable for providing false or misleading information to investors. Several marketplace lending platforms have registered with the SEC in connection with selling securities in the form of loan promissory notes to the public.

- State regulators: State regulators often supervise nonbank financial services providers. The scope of this supervision varies by state. Most states have usury, debt collection and advertising laws that are enforced by state attorneys general. In addition, many states have licensing requirements that extend to lenders, brokers and debt collectors. These requirements may apply to marketplace lending.

Each of these exercises a degree of jurisdiction over the marketplace lending industry.

The business of consumer lending has long been subject to a host of federal and state laws and regulations, including the:

- Bank Secrecy Act: Requires financial institutions to adopt anti-money-laundering policies and procedures.
- Electronic Fund Transfer Act: Protects consumers by establishing the rights, liabilities and responsibilities of parties to electronic funds transfers.
- Equal Credit Opportunity Act: Prohibits discrimination against credit applicants, establishes guidelines for evaluating credit information and requires written notification to consumers when credit is denied.
- Fair Credit Reporting Act: Requires that entities have a permissible purpose to obtain a credit report, obligates "furnishers" of information to credit reporting agencies (i.e., credit bureaus) to ensure accuracy, requires creditors who take adverse action based on credit reports to notify consumers, and compels creditors to develop and maintain an identity theft prevention program.
- Fair Debt Collection Practices Act: Prohibits certain abusive and unfair acts and practices in connection with the third-party collection of consumer debts.
- Gramm-Leach-Bliley Act: Restricts disclosure of nonpublic personal information to nonaffiliated third parties, and requires financial institutions to notify consumers about their information-sharing practices and the consumers' right to "opt out" in certain circumstances if they do not want their information shared with certain nonaffiliated third parties.
- Securities Act of 1933: Requires an issuer engaged in the public offering of securities to register the securities with the SEC.
- Truth in Lending Act: Establishes uniform methods for calculating the cost of credit, disclosing credit terms and resolving errors on certain types of credit accounts.

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PRACTICAL CONSIDERATIONS

Fortunately, even within this increasingly aggressive regulatory environment there are steps that operators, lenders and their service providers can take to limit potential scrutiny. The starting point is the implementation of a comprehensive compliance management system that covers the entity's business operations and ensures compliance with applicable laws.

Compliance management system

A CMS should be integrated into a company's operations at every level. The focus on compliance must be top-down and bottom-up, with the board and senior management exercising appropriate oversight to ensure that employees have the right direction, training, resources and support to carry out the compliance function. A company should:

- Provide appropriate training for board members, management and staff that covers compliance with federal financial and consumer protection laws.
- Implement underwriting policies with an eye toward preventing potential consumer harm.

- Set up a process for regular internal and external audits to review operations for compliance with applicable legal requirements.
- Create systems to monitor for, respond to and resolve consumer complaints and inquiries.
- Develop third-party oversight, management and training to ensure that service providers comply with applicable federal financial and consumer protection laws.

Prepare for and cooperate with examinations

While a regulator may lead with an investigation rather than an examination, preparing in advance for a potential exam can help a company focus its compliance efforts and mitigate regulatory risk. In the event of a CFPB or other regulatory examination (or the need for state licensure), the examinee should take steps to present its operations and compliance policies in the best possible light:

- Designate an employee (preferably within the legal or compliance department) to serve as the point of contact for the regulator examination team and the document collection and production process.
- Prepare and train staff who will likely interface with regulatory examiners.
- Set up an initial meeting with examiners to explain the company's business model and set appropriate expectations.
- Work with counsel to review all submissions to the regulator for responsiveness, privilege and consistency.
- Respond in a timely manner to examiner requests, and work with examiners to identify their key areas of interest and how the company can provide the requested information.
- Manage examiner expectations and maintain clear lines of communication.
- Review the draft examination report closely to identify any factual inaccuracies or areas of potential misunderstanding. If the regulator identifies any areas of potential concern, work with counsel to identify steps to "self-correct" or resolve the issues prior to the regulator's issuance of a final examination report, as appropriate.

Legal developments and heightened scrutiny

The marketplace lending industry should keep a close eye on federal and state legal developments. As the legal framework continues to evolve, the industry risks drawing the attention of regulators if it does not keep pace.

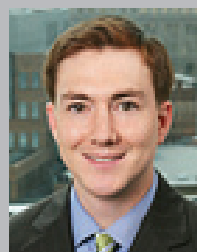
On March 26, 2015, for example, the CFPB announced several proposals to regulate short-term and longer-term consumer lending, focusing primarily on payday and related lending. As explained by Director Richard Cordray in announcing the proposals, the bureau is concerned that some lending products may extend "credit to people in a way that sets them up to fail."

In this regard, the bureau's proposals are an example of its focus on holding financial institutions responsible under certain circumstances for confirming that individual consumers can afford the institution's products or services. Although the proposals do not apply to marketplace lending, they nevertheless provide insight into the types of lending practices that have drawn scrutiny.

CONCLUSION

As small-dollar lenders, banks, credit unions and institutional investors shift into this new market, so too will the regulators that enforce the relevant laws and regulations. With the creation of the CFPB, there is now a single regulator of consumer financial products and services that has rulemaking, enforcement and examination authority, including — potentially — authority over marketplace lenders and their service providers.

Although the CFPB has been on the scene for only a few years, it has shown a willingness to use its tools aggressively to address perceived weaknesses in the markets for consumer products and services.

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