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“Examining the Opportunities and Challenges with Financial Technology (“FinTech”): The Development of Online Marketplace Lending”

Testimony of Bimal Patel

Chairman Neugebauer, Ranking Member Clay, and Members of the Subcommittee, it is an honor to testify before you today about the development of online marketplace lending. My name is Bimal Patel. I am currently a Partner and Head of the Financial Advisory and Regulation Practice at O’Melveny & Myers LLP. Immediately prior to re-joining O’Melveny, I served from 2012-2015 as Senior Advisor to Jeremiah O. Norton, then a member of the Board of Directors of the Federal Deposit Insurance Corporation. Since returning to the private practice of law, I have advised banks, online lending platforms, and investors on regulatory and commercial issues related to the operation of marketplace and alternative lending platforms.

My written testimony will proceed in several parts. First, I will provide a brief overview of online marketplace lending business models. Second, I will describe the market penetration and opportunity of marketplace lending based on publicly-available statistics. Third, I will then discuss some of the factors that have been identified as fueling the growth of online lending. Fourth, I will identify some of the statutes and regulations that currently apply to various online lending models. Finally, I will explain some regulatory considerations and recent developments that will shape the continuing development of this industry.

Introduction to Online Marketplace Lending

According to the U.S. Department of the Treasury in its recent white paper on online marketplace lending, “[o]nline marketplace lending refers to the segment of the financial services industry that uses investment capital and data-driven online platforms to lend to small businesses and consumers.”¹ Within this broad framework, marketplace lending business models vary considerably, focusing on different customer segments with

¹ U.S. DEP’T OF TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING, May 10, 2016, at 5,
<https://www.treasury.gov/connect/blog/Documents/Opportunities%20and%20Challenges%20in%20Online%20Marketplace%20Lending%20vRevised.pdf>

different operational and underwriting models. One key point of distinction within marketplace lending models centers on whether a particular marketplace lender partners with a bank in its origination process. As described more fully below, federal law permits banks to “export” their home state rate of interest to all borrowers regardless of the state in which a borrower resides.

Consequently, loans originated by banks whose home state have no effective usury limitation—a limitation on maximum interest rates—can carry higher interest rates than loans originated by other banks and non-bank lenders. Thus, some marketplace lending business models depend on such a partnership to enable them to underwrite loans at rates that would otherwise violate state usury laws. Such a partnership is generally most advantageous in the context of consumer lending because state usury laws tend to be most restrictive with respect to these loans. Consumer marketplace lenders such as LendingClub and Prosper utilize bank partnerships in origination. As an alternative to partnering with a funding bank, marketplace lenders can engage in lending by procuring state lending licenses in the states in which they make loans, but these loans are subject to state law interest rate restrictions that vary by state and pose administrative and financial burdens that can be prohibitive to certain business models.

The cornerstone on which marketplace lending businesses are built is the marketplace lender’s online platform, which should be designed to facilitate efficient matching of borrowers and investors. The typical lifecycle of a marketplace loan is as follows: First, a borrower applies for a loan on the lender’s online platform, a secure website where prospective borrowers can provide information about: (1) the size of the loan requested; (2) how the borrower intends to use the funds; and (3) the borrower’s current finances. Using an automated algorithm, the lender then determines whether the loan request satisfies the criteria of the platform and, if so, the payable interest rate and fees of each loan, based on information such as (but not necessarily) the borrower’s FICO score, the size of the loan, the borrower’s debt-to-income ratio, the borrower’s self-reported income, and the borrower’s employment history and trajectory. The marketplace lender then posts the loan request onto the platform for consideration by the platform’s registered prospective investors. Once a borrower and investor have accepted the loan terms, the marketplace lender originates the loan or collects an origination fee and arranges for the loans to be originated at a partner bank or originates the loan itself. If the loan is originated by a partner bank, the marketplace lender then purchases the loan from the partner bank. Then, the marketplace lender will transfer the loan to the investors, often via a securitization process in the form of notes registered with the Securities and Exchange Commission.

While marketplace lenders operate differing business models for differing customer segments, many share some or all of the following characteristics:

- **User-friendly online experience:** Most marketplace lenders use online platforms to reach their customers and investors, and can provide a prospective borrower with a loan offer at the near-instant speeds which online customers have come to expect, rather than the weeks it takes to apply through a bank lender.

- ***Non-traditional funding:*** While many marketplace lenders still rely on a peer-to-peer model in which a significant portion of their fund derives from selling pass-through notes to retail investors as described above, marketplace lenders possess a diverse set of non-traditional funding mechanisms including equity investments, private placements, whole loan sales to institutional investors, and lines of credit from institutional investors.
- ***“Balance sheet light”:*** Many marketplace lenders do not keep loans on their balance sheets. Instead, these marketplace lenders collect origination and service fees from arranging loans, which are sold shortly after origination, either to individual investors or in the form of securities. In doing so, marketplace lenders are able to provide loans to prospective borrowers without exposure to credit risk or keeping capital tied up in loans.
- ***Alternative credit decisioning models:*** Many marketplace lenders base their formation on leveraging alternative credit models to identify underserved or undervalued segments of borrowers or mispriced credit. In many cases, marketplace lenders still use FICO scores as the primary driver of underwriting decisions, but in many cases the very purported advantage of a marketplace lending business lies in its alternative underwriting methodology. SoFi is a prominent example and has funded over \$7 billion in student, home, and personal loans² using a proprietary credit decisioning algorithm, which as of early 2016 completely abandons the use of FICO scores in underwriting.³ As described below, these credit decisioning models might bring additional regulatory and compliance considerations into play, particularly with respect to fair lending.

Market Penetration and Size

Estimates of the size of loan originations by marketplace lenders in the U.S. vary, but recent data released by the California Department of Business Oversight (“DBO”) provide a good starting point for determining the current state of the online lending industry. The DBO collected data from 13 of the largest online marketplace and alternative lenders,⁴ which it published in an April 2016 report.⁵ According to the DBO report, the aggregate volume of loan originations made by the 13 respondents in 2014 was \$15.91 billion, up from \$1.99 billion in 2010, marking an increase of 699.5%.⁶ Data

² Leena Rao, *This Bank Wants to Be Your Best Friend*, FORTUNE, Mar. 19, 2016, at 68.

³ Peter Rudgeair, *Silicon Valley: We Don’t Trust FICO Scores*, WALL STREET J., Jan. 11, 2016, <http://www.wsj.com/articles/silicon-valley-gives-fico-low-score-1452556468?tesla=y>.

⁴ The 13 respondents to the California DBO’s Survey of Online Consumer and Small Business Financing Companies were Affirm, Avant, Bond Street, CAN Capital, Fundbox, Funding Circle, Kabbage, LendingClub, OnDeck, PayPal, Prosper, SoFi and Square.

⁵ CAL. DEP’T OF BUSINESS OVERSIGHT, SURVEY OF ONLINE CONSUMER AND SMALL BUSINESS FINANCING COMPANIES —01/01/2010 THROUGH 06/30/2015: SUMMARY REPORT OF AGGREGATE TRANSACTION DATA, http://dbo.ca.gov/Press/press_releases/2016/Survey%20Response%20Summary%20Report%2004-08-16.pdf

⁶ *Id.* at 2.

for the first half of 2015 reflect originations of \$12.47 billion.⁷ These figures include term loans, but also lines of credit, merchant cash advances, factoring transactions and other products. Other estimates of the volume of loan originations by online marketplace lenders for 2015 range from \$15 billion to nearly \$40 billion.⁸

To date, the substantial majority of this activity has taken place in the consumer lending arena, with small business lending also seeing significant activity. Increasingly, online marketplace lenders are serving broader market segments including education lending, auto lending, and mortgage lending. Indeed, growth rates for online marketplace loan volume origination are impressive. Yet, these loans continue to represent a small percentage of the total addressable market for consumer and business loans in the U.S. Data cited by the Department of the Treasury suggest that the total addressable market for U.S. credit (excluding mortgage credit) exceeds \$1 trillion dollars.⁹ The total volume of online marketplace lending appears even smaller relative to the \$3.5 trillion U.S. consumer lending market.¹⁰ Recent data with respect to small business lending underscore the opportunity for online marketplace lending to address unmet demand in this market as well. According to a recent Harvard Business School Working Paper citing data from the Federal Reserve Bank of New York:

[A]bout 37 percent of all small businesses applied for credit in the fall of 2013. About 45 percent did not apply, presumably because they did not need credit, but about 20 percent did not apply because they were discouraged from doing so, either because they felt that they would not qualify or because they thought the process would be too arduous to justify the time commitment. Of businesses that did apply, over 40 percent either received no capital at all or received less than the amount that they requested. This underscores the manner in which seeking bank credit can be difficult, though not necessarily impossible, for many small businesses to secure.¹¹

⁷ *Id.*

⁸ See Rudegair, *supra* n. 3 (\$37 billion); see also CAMBRIDGE CENTRE FOR ALTERNATIVE FINANCING, UNIVERSITY OF CAMBRIDGE JUDGE BUSINESS SCHOOL, BREAKING NEW GROUND: THE AMERICAS ALTERNATIVE FINANCE BENCHMARKING REPORT (2016) at 24 (https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2016-americas-alternative-finance-benchmarking-report.pdf) (above \$30 billion); DELOITTE, MARKETPLACE LENDING - A TEMPORARY PHENOMENON? (2016) at 4, (<https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fs-marketplace-lending.pdf>) (\$23 billion); Marketplace Lending, in 2015 - A Year of Performance and Growth, Dec. 28, 2015, (<http://www.pmfunds.com/marketplace-lending-in-2015-a-year-of-performance-and-growth/>) (\$18 billion)

⁹ DEPT OF TREASURY, *supra* n.1, at 9; see also HEATH P. TERRY ET AL., GOLDMAN SACHS, THE FUTURE OF FINANCE: THE SOCIALIZATION OF FINANCE, at 4 exhibit 2 (2015).

¹⁰ Board of Governors, Federal Reserve System, *Consumer Credit Outstanding* (Jan. 2016), <https://www.federalreserve.gov/releases/g19/20160307/>.

¹¹ Karen G. Mills and Brayden McCarthy, *The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game* (Harvard Business School Working Paper, No. 15-004, July 2014) at 23.

Currently, there are dozens of online lenders across consumer, business, and student lending in the U.S. The online marketplace lending market, however, remains concentrated, with a small number of firms generating a substantial share of loan originations within each respective market segment.

What Has Caused the Growth in Marketplace Lending Volume?

Several factors have contributed to a perfect storm that has borne rapid growth among marketplace and alternative lenders.

Low Interest Rate Environment

In the wake of the financial crisis, investors were challenged to find returns in an unprecedented low-interest environment.¹² Between December 16, 2008 and December 17, 2015 the Federal Open Market Committee kept its target federal funds rates at near zero for a period of 84 months.¹³ At the same time, many consumers burdened with high-interest debt sought to refinance their loans at more manageable interest rates.¹⁴ This presented an opportunity to link borrowers seeking lower rates with investors seeking higher yields.

Against this backdrop, many investors turned to marketplace lending as a means to obtain higher returns by funding loans to online borrowers. According to one index, marketplace lending in the aggregate provided a net annual return of 6.84 percent in 2015.¹⁵ For the year ending December 2015, marketplace lenders LendingClub and Prosper boasted average returns of 5.25 percent to 8.57 percent¹⁶ and 4.34 percent to 11.44 percent,¹⁷ respectively. In addition to receiving higher average annual returns, investors at marketplace lenders like LendingClub and Prosper also enjoyed the ability to select their preferred level of risk and diversify their portfolios by funding many different loans to borrowers of varying creditworthiness. Today, even though interest rates are no

¹² Currently, five-year Treasury bonds offer yields of less than one percent, and seasoned AAA corporate bonds offer less than four percent. U.S. DEP'T OF TREASURY, *Daily Treasury Yield Curve Rates*, <https://www.treasury.gov/resource-center/data-chart-center/interestrates/Pages/TextView.aspx?data=yield> (last updated Jul. 8, 2016); see also MOODY'S, *Moody's Seasoned Aaa Corporate Bond Yield*, https://ycharts.com/indicators/moodys_seasoned_aaa_corporate_bond_yield (last updated Jul. 7, 2016).

¹³ BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, *Open Market Operations: FOMC's Target Federal Funds Rate or Range, Change (basis points) and Level (2008-2015)* (Dec. 16, 2015), <https://www.federalreserve.gov/monetarypolicy/openmarket.htm>.

¹⁴ Bloomberg, Mortgage Bankers Association Refinancing Index (SA), <http://www.bloomberg.com/chart/icJsdXbuXYxM> (last visited June 10, 2016).

¹⁵ The Orchard US Consumer Marketplace Lending Index tracks the performance of the aggregate amount of loans to consumers originated and funded on eligible US-based online lending platforms. Orchard, Orchard US Consumer Marketplace Lending Index (2011-2015), <https://www.orchardindexes.com/> (last visited June 10, 2016); see also Tom Anderson, *More Investors Turn to P2P Lenders for High Yield*, CNBC, Aug. 28, 2015, <http://www.cnbc.com/2015/08/28/more-investors-turn-to-p2p-lenders-for-high-yield.html>.

¹⁶ *Investing: Earn Solid Returns*, LENDINGCLUB, <https://www.lendingclub.com/public/steady-returns.action> (last visited June 10, 2016).

¹⁷ *Why Invest with Prosper?: Competitive Returns*, PROSPER, <https://www.prosper.com/invest> (last visited Mar. 29, 2016).

longer at their lowest point, the promise of greater returns continues to draw investors to fund loans originated via marketplace lending platforms.

Interest Rate Exportation

In 1978, the Supreme Court clarified that the National Bank Act, as codified in 12 U.S.C. § 85, and the constitutional supremacy of federal law over state law allow banks to “export” interest rates across state lines. Under the current regime, the maximum interest rate that a bank can charge on loans is determined by the laws of the state in which the bank is located, as opposed to the state in which a borrower resides. In *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, the Supreme Court held that state usury laws could not be the basis of claims against nationally-chartered banks located in other states as long as those banks complied with federal law.¹⁸ The Court held that the National Bank Act¹⁹ preempted state law in this area. Later, in 1980, Congress amended the Federal Deposit Insurance Act by adding a new section granting State-chartered insured banks the same right to charge out-of-state customers any interest rate that would be allowed under the laws of the bank’s home state.²⁰

Internet-based marketplace lenders benefit from this regime as well. To the extent marketplace lenders elect to originate loans through partner banks located in states with unrestrictive interest rate caps, marketplace lenders are able to offer loans that might be uneconomical under the laws of a borrower’s home state. In fact, some marketplace lenders have specialized in offering loans to a segment of higher-risk borrowers that might be underserved if bound by restrictive usury laws.²¹

The ability to underwrite and offer loans without being subject to state interest rate restrictions remains central to many marketplace lending models. It is important to note, however, that a recent decision by the U.S. Court of Appeals for the Second Circuit has raised fresh questions about the legal viability of such a model. Specifically, in *Madden v. Midland Funding, LLC*, the court held that the interest rate exportation provision of the National Bank Act, 12 U.S.C. § 85, could not be invoked by a non-national bank assignee.²² The U.S. Supreme Court recently declined to review the

¹⁸ 439 U.S. 299 (1978).

¹⁹ Under the National Bank Act, “Any association may take, receive, reserve, and charge on any loan . . . interest at the rate allowed by the laws of the State, Territory, or District where the bank is located, or at a rate of 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may be the greater, and no more” 12 U.S.C. § 85.

²⁰ “In order to prevent discrimination against State-chartered insured depository institutions. . . such State bank or such insured branch of a foreign bank may . . . charge on any loan or discount made . . . interest at a rate of not more than 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where such State bank or such insured branch of a foreign bank is located or at the rate allowed by the laws of the State, territory, or district where the bank is located, whichever may be greater.” *Id.* § 1831d(a).

²¹ Alan Zibel and AnnaMaria Andriotis, *Lenders Step Up Financing to Subprime Borrowers*, WALL STREET J., Feb. 18, 2015, <http://www.wsj.com/articles/lenders-step-up-financing-to-subprime-borrowers-1424296649>.

²² 786 F.3d 246 (2d Cir. 2015).

Second Circuit's decision,²³ and if this line of reasoning is applied to loans originated through online marketplace lending channels, this precedent might put a partner bank origination model at risk if marketplace lenders lose rate exportation benefits upon purchase or assignment of loans.²⁴ In fact, marketplace lenders have recently begun to modify agreements with partner banks to try to ensure that partner banks retain an ongoing economic interest in loans and remain the true lender for loans.²⁵

Institutional Support

In the face of the low interest rate environment, institutional investors too face a dilemma in realizing appropriate yields. Many have turned to marketplace lending as a means to tap into several profitable lending markets, including those for personal loans, small business loans, real estate loans, and student loans.

Institutional investors have played a major role in marketplace lending by purchasing the loans originated by marketplace lenders. This demand for loans is what fueled the marketplace lending model, freeing up capital for the lenders to continue to generate additional loans. According to a 2015 PriceWaterhouseCoopers report, institutional investors provided about 80 percent of the funding on the peer-to-peer subset of marketplace lending.²⁶ Without the support of institutional investors willing to purchase loans as quickly as marketplace lenders could generate them, the lenders would likely not have been able to generate the large value of marketplace loans that have been originated to date.

In addition, institutional investors have supported marketplace lenders at the point before a single loan is originated. Institutional investors have become a key source of start-up funding for the newest generation of marketplace lenders, providing borrowers with an ever-growing list of borrowing alternatives.²⁷ In 2015, SoFi raised over \$1.25 billion from Softbank Group Corp., based in Japan, and Third Point Ventures, based in New York.²⁸ In just one week, five different marketplace lenders received over \$500 million in venture capital to provide loans targeting small businesses, consumers, and

²³ The U.S. Supreme Court denied a pending petition for certiorari declining review of the case on June 27, 2016. No. 15-610, 2016 WL 3461580 (U.S. June 27, 2016).

²⁴ Some sources report that investors have begun to avoid loans originated within the Second Circuit, which decided *Madden*, which could have significant implications for marketplace lending platforms as well as borrower access to credit in the subject states. See Kadhim Shubber, *The Online Lending Lie*, FIN. TIMES: ALPHAVILLE (Feb. 4, 2016), <http://ftalphaville.ft.com/2016/02/04/2152142/the-online-lending-lie/>.

²⁵ See, e.g., LendingClub Corp., Current Report (Form 8-K), at § 2, sched. 2(i) (Feb. 25, 2016), available at <http://ir.lendingclub.com/Cache/33197558.pdf?IID=4213397&FID=33197558&O=3&OSID=9> (Ex. 10.1, Loan and Receivable Sale Agreement between WebBank and LendingClub Corp.).

²⁶ PWC, PEER PRESSURE: HOW PEER-TO-PEER LENDING PLATFORMS ARE TRANSFORMING THE CUSTOMER LENDING INDUSTRY 3 (Feb. 2015), <http://www.pwc.com/us/en/consumer-finance/publications/peer-to-peer-lending.html>.

²⁷ For example, since 2010, Victory Park Capital has invested more than \$2.2 billion across a number of marketplace lending firms. Press Release, Victory Park Capital, Victory Park Capital and KKR Lead an Inaugural \$175 Million Asset-Backed Securitization of Avant Consumer Loans (Nov. 19, 2015), <http://victoryparkcapital.com/2015/ November-19.html>.

²⁸ Dan Primack, *SoFi Raises Whopping \$1 Billion to Refinance Student Loans*, FORTUNE, Sept. 30, 2015, <http://fortune.com/2015/09/30/sofi-raises-whopping-1-billion-to-refinance-studentloans/>.

clean energy.²⁹ For the moment, it seems that there are strong tailwinds aiding those looking to secure the funding to design and operate an online lending platform.

Statutes and Regulations Potentially Applicable to Online Marketplace Lending

Federal and state regulation and compliance considerations affect the marketplace lending business at all points during the lifecycle of a marketplace lending transaction. The following is a summary of the federal and state statutes and implementing regulations for which compliance obligations might attach.

- **The Equal Credit Opportunity Act** (“ECOA”)³⁰ prohibits creditors from discriminating against prospective borrowers on the basis of any of the following: race, color, sex, age, religion, national origin, marital status, percentage of income derived from public assistance programs, or prior history of exercising in good faith any right under the Consumer Credit Protection Act or any applicable state law. Marketplace lenders and partner banks as applicable engaging in some form of underwriting must take care to comply with ECOA’s prohibitions on discrimination.
- **The Bank Secrecy Act** (“BSA”),³¹ as implemented through various regulations, is the primary federal anti-money laundering statute and requires any financial institution making loans to implement policies and procedures to: (1) engage in customer identification procedures; (2) identify and reject any customers who are known or suspected terrorists or are engaged in money laundering activities or prohibited transactions; (3) report suspicious activity; and (4) share anti-money laundering information with relevant government authorities.³² BSA requirements apply to partner banks when applicable and might apply to marketplace lenders themselves if those marketplace lenders fall within the definition of a “financial institution” under applicable law.
- **The Fair Credit Reporting Act** (“FCRA”)³³ governs the use of “consumer reports,” and imposes numerous restrictions and requirements on any companies that access them in the course of business. Many marketplace lenders use consumer reports to determine the credit risk of prospective borrowers, and must take care to comply with the numerous use, notice, disclosure, and privacy requirements imposed by the FCRA.

²⁹ Aliza Hornbass, *Top 5 FinTech Rounds: Marketplace Lenders Keep Piling Up Capital*, BANK INNOVATION, July 27, 2015, <http://bankinnovation.net/2015/07/top-5-fintech-rounds-marketplace-lenders-keep-piling-up-capital/>.

³⁰ 15 U.S.C. § 1691 *et seq.*; 12 C.F.R. § 1002.2(z) (“Prohibited basis means race, color, religion, national origin, sex, marital status, or age (provided that the applicant has the capacity to enter into a binding contract); 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 Consumer Credit Protection Act or any state law upon which an exemption has been granted by the Bureau.”).

³¹ 31 U.S.C. § 5311 *et seq.*

³² *Id.* § 5318 (g), (k), (l).

³³ 15 U.S.C. § 1681 *et seq.*

- ***The Truth in Lending Act*** (“TILA”),³⁴ as implemented by Regulation Z,³⁵ requires all lenders to provide consumers with a uniform set of disclosures containing information about the terms and conditions of their loan, including interest rates and finance charges. TILA requirements apply to partner banks or to marketplace lenders themselves if they lend via state lending licenses.
- ***The Electronic Funds Transfer Act*** (“EFTA”),³⁶ as implemented by Regulation E,³⁷ establishes the rights, liabilities, and responsibilities of persons engaged in electronic funds transfers. The EFTA requires companies to obtain written authorization from a consumer before automatically debiting the consumer’s account in connection with a payment. The EFTA also prohibits lenders from requiring borrowers to make payments electronically. EFTA requirements can apply to partner banks and marketplace lenders themselves depending on their respective roles in lending transaction flows.
- ***The Electronic Signatures in Global and National Commerce Act*** (“E-Sign Act”),³⁸ sets forth the requirements that must be followed in order for an electronic signature to be considered valid, such as reserving the rights of individuals to use a paper signature and requiring certain disclosures. Because marketplace lenders conduct the vast majority of their activities online, they must carefully follow the requirements of the E-Sign Act in order to ensure that any loan documentation completed online will be considered valid.
- ***The Securities Act of 1933*** (“Securities Act”)³⁹ requires any issuer offering its securities to the public to register its securities with the SEC unless a specific exemption applies. Many marketplace lenders, including LendingClub and Prosper, have gone through the process of registering their securities with the SEC. The Securities Act also gives investors a cause of action against companies that provide inaccurate or misleading information to investors. Marketplace lenders face potential liability under this provision for any false or misleading information they provide, as well as any false or misleading information which borrowers provide that the marketplace lender passes on to investors through its platform.
- ***State Laws*** Many states have laws imposing various licensing requirements on brokers, lenders, and debt collectors, as well as other laws governing usury limits, and advertising. Levels of regulation and enforcement vary from state-to-state, potentially imposing a heavy compliance burden on marketplace lenders which

³⁴ *Id.* § 1601 *et seq.*

³⁵ 12 C.F.R. § 1026.

³⁶ 15 U.S.C. § 1693 *et seq.*

³⁷ 12 C.F.R. § 1005.

³⁸ 15 U.S.C. § 7001 *et seq.*

³⁹ 15 U.S.C. § 77a *et seq.*

offer loans to borrowers in all 50 states. For example, each state has its own “blue sky law” requiring the registration of all securities offerings and sales, which could apply to the sale of participation notes by marketplace lenders that are not “covered securities” under the National Securities Market Improvement Act of 1996 (“NMSIA”).⁴⁰ Furthermore, marketplace lenders must be cognizant of recent case law that might be construed to require marketplace lenders to fulfill licensing requirements under state law.⁴¹

Regulatory Considerations and Developments

The statutes and regulations discussed above can apply to online marketplace lenders either directly or indirectly through partner originating banks for those that utilize a bank partner.

There are many legal paths through which marketplace lenders might be subject to direct supervision by regulators at various points in the transaction lifecycle. One point at which marketplace lenders have already encountered compliance difficulties involved registration requirements of notes offered to investors in connection with loans originated via LendingClub and Prosper.⁴² With respect to many of the consumer protection statutes and regulations identified above, marketplace lenders might also be subject to supervision and examination as a “Larger participant” in a consumer financial market or as a “service provider” to a bank or other person who engages in the offering or providing of a consumer financial product or service.⁴³ Indeed, the *Wall Street Journal* has reported that the CFPB plans to begin directly supervising Marketplace Lenders as soon as late 2017.⁴⁴ Additionally, on March 7, 2016, the CFPB established an online complaint portal for marketplace lending⁴⁵ and issued guidance to consumers regarding

⁴⁰ The NMSIA preempts the registration and qualification requirements of state blue sky laws with regards to “covered securities.” *Id.* § 77r.

⁴¹ See, e.g., Memorandum Opinion, *Pa. Dep’t of Banking and Sec. v. Autoloans, LLC*, No. 566 M.D. 2015 (Pa. Commw. Ct. Jan. 22, 2016) (upholding a cease and desist order against an out-of-state internet lender for charging rates of interest in excess of those allowed for an unlicensed lender); Opinion, *Maryland Comm’r of Fin. Regulation v. CashCall, Inc.*, 225 Md. App. 313 (2015) (upholding civil money penalty imposed by Maryland Commissioner of Financial Regulation because CashCall was engaged in the business of arranging consumer loans without being licensed).

⁴² For example, in 2008, both LendingClub and Prosper went through a “quiet period,” and ceased all new lending until completing the security registration process with the SEC. *Lending Club Completes \$600 Million SEC Registration and Offers New Alternative for Consumer Credit*, LENDINGCLUB, <http://blog.lendingclub.com/lending-club-sec-registration/> (last visited June 10, 2016); *Prosper.com Reopens for Lending*, N.Y. TIMES ON THE WEB: DEALBOOK, <http://dealbook.nytimes.com/2009/04/28/prospercom-reopens-for-lending/> (last visited June 10, 2016).

⁴³ 12 U.S.C. § 5481(26).

⁴⁴ Rachel Witkowski, *Consumer Finance Watchdog Plans to Supervise Marketplace Lenders*, WALL STREET J., Apr. 27, 2016, <http://www.wsj.com/articles/consumer-finance-watchdog-plans-to-supervise-marketplace-lenders-1461794493>.

⁴⁵ Press Release, Consumer Fin. Protection Bureau., CFPB Now Accepting Complaints on Consumer Loans From Online Marketplace Lender, Mar. 7, 2016, <http://www.consumerfinance.gov/newsroom/cfpb-now-accepting-complaints-on-consumer-loans-from-online-marketplace-lender/>.

marketplace lending.⁴⁶ Furthermore, specific statutes might provide for direct liability for marketplace lenders depending on the context of the transactions in which claims arise, such as assignee liability under TILA.⁴⁷ And, if a marketplace lender is deemed a “financial institution” under applicable BSA/AML regulations, it would be responsible for compliance with these regulations. Finally, marketplace lenders might be subject to direct regulation or supervision under state law and have already begun garnering significant interest from state regulators in that regard.⁴⁸

Regulators have recently underscored their expectation that banks monitor their third-party relationships in a similar manner to which they would monitor activities in which they would engage themselves. Recently, Comptroller Thomas J. Curry has even suggested that FinTech companies who partner with national banks or federal savings associations should be subject to the same safety and soundness and consumer compliance obligations as partner banks: “[C]ompanies operating with a federal charter or in partnership with a federally chartered bank [should be] sound and comply with basic consumer safeguards that apply to all creditors. I would be very concerned, for example, if we were to authorize a federal license that offers the benefits of the national bank charter, including preemption, without any of the safeguards or responsibilities that apply to banks and thrifts.”⁴⁹ These remarks accompanied new guidelines on responsible innovation in the federal banking system that the OCC issued for comment in March 2016.⁵⁰ Previously, in discussing third-party relationships more generally, the OCC advised banks of that “[t]he Office of the Comptroller of the Currency (OCC) expects a bank to practice effective risk management *regardless of whether the bank performs the activity internally or through a third party*. A bank’s use of third parties does not diminish the responsibility of its board of directors and senior management to ensure that the activity is performed in a safe and sound manner and in compliance with applicable laws.” (emphasis added).⁵¹ The FDIC has issued similar comments specifically aimed at banks partnering with marketplace lenders:

Bank management is encouraged to develop a strong understanding of the marketplace lending company’s business model, establish contractual agreements that protect the bank from risk, regularly monitor the

⁴⁶ CONSUMER FIN. PROTECTION BUREAU, UNDERSTANDING ONLINE MARKETPLACE LENDING 1-2 (2016), http://files.consumerfinance.gov/f/201603_cfpb_understanding-online-marketplace-lending.pdf

⁴⁷ 15 U.S.C. § 1641.

⁴⁸ Ruth Simon, *California Regulator Launches Inquiry Into Marketplace Lenders*, WALL STREET J., Dec. 11, 2015, <http://www.wsj.com/articles/california-regulator-launches-inquiry-into-marketplace-lenders-1449810242>.

⁴⁹ Thomas J. Curry, Comptroller, Office of Comptroller of Currency, Remarks Before the Harvard Kennedy School’s New Directions in Regulation Seminar at 7 (Mar. 31, 2016), <http://www.occ.gov/news-issuances/speeches/2016/pub-speech-2016-39.pdf>.

⁵⁰ OFFICE OF THE COMPTROLLER OF THE CURRENCY, SUPPORTING RESPONSIBLE INNOVATION IN THE FEDERAL BANKING SYSTEM: AN OCC PERSPECTIVE (Mar. 31, 2016), <http://www.occ.gov/publications-publications-by-type/other-publications-reports/pub-responsible-innovation-banking-systemocc-perspective.pdf>.

⁵¹ OCC Bulletin 2013-29: Third Party Relationships (Oct. 30, 2013), [\(emphasis added\).](http://www.occ.gov/news-issuances/bulletins/2013/bulletin-201329.html)

marketplace service provider, and require the marketplace lending company to take corrective action when gaps or deficiencies occur. This due diligence may result in banks requiring policies and procedures from the marketplace lending company with respect to legal and regulatory compliance prior to the bank's investment or before any services are offered. Some considerations include, but are not limited to, compliance with applicable federal laws such as lending laws, consumer protection requirements, anti-money laundering rules, and fair credit responsibilities along with adherence to any applicable state laws, licensing, or required registrations.⁵²

Thus, marketplace lending models that use partner banks are not relieved from regulatory compliance obligations; rather, these obligations remain the responsibility of partner banks. This enhanced emphasis should lead partner banks to engage in the monitoring called for by the regulators as well as impose contractual obligations on their marketplace lender partners to facilitate data collection and compliance with the operative regulations.

Recently, the OCC has publicly discussed that it is considering whether to offer a national bank charter for online marketplace lenders or even some form of a more limited purpose charter for these entities.⁵³ These considerations are in their nascent stages but, if calibrated appropriately, could accelerate innovation and economic growth.

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Again, I thank the Committee for the opportunity to discuss these matters, and I welcome your questions.

⁵² Angela M. Herrbolt, Division of Risk Management, Federal Deposit Insurance Corp., *Marketplace Lending*, SUPERVISORY INSIGHTS at 15–16 (Winter 2015), https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin15/SI_Winter2015.pdf.

⁵³ Lalita Clozel, *OCC Weighs New Charter for Fintech Firms*, AM. BANKER, May 9, 2016, <http://www.americanbanker.com/news/law-regulation/occ-weighs-new-charter-for-fintech-firms-1080908-1.html>.