

Client Update

Regulators Probe Marketplace Lending Business Model

WASHINGTON, D.C.

David A. Luigs
daluigs@debevoise.com

Naeha Prakash
nprakash@debevoise.com

Ebunoluwa A. Taiwo
eataiwo@debevoise.com

NEW YORK

Liz Alspector
lalspector@debevoise.com

Gabriel W. Lezra
gwlezra@debevoise.com

On Tuesday, June 21, the Financial Stability Oversight Council (“FSOC”) published its 2016 Annual Report, as required under the Dodd-Frank Act, to address, among other issues, any “potential emerging threats to the financial stability of the United States.” In the Annual Report, the FSOC declared “financial innovation,” including marketplace lending, as one potential emerging threat to the stability of the U.S. financial system.¹ In particular, the FSOC directed financial regulators to be alert to how existing regulations apply to entities engaged in financial innovation to mitigate any potential for unanticipated risks to markets or institutions, such as a decline in lending standards. FSOC’s comments on marketplace lending, while brief, are yet another example of the growing concern by regulators of the risks of this industry.

In our last update on marketplace lending, we explored the initial warning signs of increased scrutiny by federal and state regulators of online marketplace lending activity.² In this update, we examine recent inquiries by regulators into the marketplace lending business model and consider the implications for the future of the industry. Specifically, following its 2015 request for information (“RFI”) concerning the online marketplace lending industry, on May 10, the Department of the Treasury (“Treasury”) released its long-awaited white paper,

¹ FINANCIAL STABILITY OVERSIGHT COUNCIL, 2016 ANNUAL REPORT (June 21, 2016) at 132 available at <https://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/FSOC%202016%20Annual%20Report.pdf>.

² David A. Luigs, Christopher Rosenkrans, Lee A. Schneider, Liz Alspector, Harriet M. Antczak, Naeha Prakash, Ebunoluwa A. Taiwo and Gabriel W. Lezra, “Regulators Set Sights on Online Marketplace Lenders,” DEBEVOISE & PLIMPTON LLP (May 5, 2016) available at http://www.debevoise.com/~media/files/insights/publications/2016/05/20160505_regulators_set_sights_on_online_marketplace_lenders.pdf.

Opportunities and Challenges in Online Marketplace Lending (the “Whitepaper”).³ Additionally, both the California Department of Business Oversight (“DBO”) and the New York Department of Financial Services (“DFS”) recently sent inquiries to marketplace lending platforms regarding, among other things, these platforms’ compliance with fair lending laws and seeking further clarity on their underwriting standards. These developments, and FSOC’s inclusion of marketplace lending in the “potential emerging threats” section of its annual report, suggest that regulatory reform, or at least increased regulatory scrutiny of the industry, is imminent.

TREASURY WHITEPAPER

In the Whitepaper, Treasury outlines three broad themes in the responses to Treasury’s RFI: the risks in the business model, the potential opportunities that could be supported and the need for regulatory clarity. The Whitepaper explores the need to balance consumer concerns about the mechanisms for underwriting loans with industry concern about any regulation potentially impeding access to credit. Although the Whitepaper appears to err on the side of encouraging the expansion of access to credit for individuals and small businesses, the Whitepaper’s policy prescriptions are focused almost exclusively on protecting consumers and small businesses from the purported risks of online marketplace lending. For example, Treasury focuses on risk associated with inaccurate or unfair data and underwriting models and suggests that promoting a transparent marketplace would allow borrowers to consider lenders’ underwriting processes while providing a mechanism by which borrowers and regulators could spot fair lending or credit reporting violations.

In addition, Treasury argues that building “robust small business” protections would be a key component to expanding credit. Because these small business protections would help to expand the market for marketplace loans (which, the Whitepaper notes, is dominated by student debt and other consumer refinancing), the burden that lenders might experience due to rising compliance costs would be far outweighed by the expansion of the market.

Although Treasury states that it plans, along with other regulators, to continue monitoring certain areas of concern, the Whitepaper suggests that regulatory clarity may benefit the market. For example, the Whitepaper highlights the continued instability of funding in the market, which has recently plagued several market participants. The recent increase in delinquency rates among

³ U.S. DEPARTMENT OF THE TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING (May 2016).

some lenders, in conjunction with a heightened regulatory environment, may lead to reluctance on the part of investors. Regulatory clarity may mitigate this risk somewhat by eliminating uncertainties in the industry.

DBO INQUIRY

At a more granular level, the California DBO's recent actions speak to similar concerns with the online marketplace lending business model. On May 9, the DBO sent letters to 14 marketplace lending firms with detailed questions following on the responses the DBO received from its initial request in December 2015.⁴ The letters represent the second phase in the DBO's inquiry into the industry's practices.

The letters focus on five main areas of concern: (i) fair lending (particularly with respect to so-called "digital redlining" by zip code); (ii) referral fees paid to brokers or other entities; (iii) loan underwriting (particularly those loans underwritten using alternative credit scoring models); (iv) partnerships with originating banks; and (v) investor protections for purchased and securitized loans.

The DBO inquiry could, among other things, explore whether these entities are appropriately licensed under current state regulations, or whether a separate charter or body of regulations may be warranted for these companies. In addition, it is possible that the inquiry could lead to enforcement actions by the DBO itself or in conjunction with the Consumer Financial Protection Bureau ("CFPB").

MADDEN

The DBO's request for additional information on loan-bank partnerships may presage a rise in class-action activity. For example, a recent class action against an online marketplace lender has challenged the lender's business model, based on the recent Second Circuit opinion in *Madden v. Midland Funding LLC*.⁵

In *Madden*, the plaintiff filed a putative class-action complaint against Midland, the debt collection firm that purchased her charged-off account from a bank, claiming that, since New York usury law caps annual interest at 25%, Midland's attempt to collect the debt (which included interest at 27%) violated the Fair

⁴ See, e.g., Kevin Wack, "Online Lenders Queried by Regulators on Referral Fees, Bank Deals," *AMERICAN BANKER* (May 9, 2016).

⁵ *Bethune v. LendingClub Corp.*, Case 1:16-cv-02578-NRB, Compl. at 17 (S.D.N.Y. Apr. 4, 2016) (citing *Madden v. Midland Funding LLC*, 786 F.3d 246 (2d Cir. 2015)).

Debt Collection Practices Act. The Second Circuit held that Midland, which is neither a bank nor acting on behalf of a bank, was not entitled to the benefit of the preemption provisions of the National Bank Act. Midland petitioned for certiorari, urging the Supreme Court to address the question of whether the National Bank Act, which preempts state usury laws regulating the interest a national bank may charge on a loan, continues to have preemptive effect after a national bank has sold or otherwise assigned the loan to another entity.⁶

At the Supreme Court's invitation, the Solicitor General's Office, in conjunction with the Office of the Comptroller of the Currency ("OCC"), filed an amicus brief in *Madden*, taking the position that the case was wrongly decided and that instead "a loan that was valid when made will not be rendered usurious by transfer."⁷ The government's brief made clear that the OCC's position is that the National Bank Act sets a single federal usury ceiling which continues to apply to loans transferred in interstate commerce, and preempts individual state laws that set lower state-specific ceilings. Nonetheless, the Solicitor General urged the Supreme Court to deny the petition, noting that resolution of the question presented may not affect the outcome of the case, as Midland may win on remand.

On June 27, the Supreme Court denied Midland's petition for certiorari, allowing the Second Circuit's decision to stand.⁸ Thus, in the Second Circuit (New York, Connecticut and Vermont), an acquirer of a loan originated by a national bank may not be able to rely on the usury preemption that was originally available to the originating national bank in circumstances like those in the *Madden* case.

DFS INQUIRY

New York's inquiry reportedly focused specifically on the activities of a single market participant, LendingClub.⁹ While it is unclear whether the DFS inquiry is the beginning of broader industry-wide investigation in New York, it may be the prelude to a more comprehensive review of the industry. Some recent reports suggest that the DFS is planning similar inquiries into other industry participants, focusing in part on whether marketplace lenders should be licensed

⁶ Petition for Writ of Certiorari, *Midland Funding, LLC, et al. v. Madden*, No. 15-610 (2016).

⁷ Brief for the United States as Amicus Curiae at 10, *Midland LLC, et al. v. Madden*, No. 15-610 (2016).

⁸ *Midland Funding, et al. v. Madden*, No. 15-610 (June 27, 2016).

⁹ See, e.g., Peter Rudegeair, "New York's Financial Cop Subpoenas LendingClub," THE WALL ST. JOURNAL (May 19, 2016).

in New York.¹⁰ According to a recent news article, the DFS inquiry focuses specifically on the interest rates, fees, duration and volume of loans made to New Yorkers, as well as LendingClub's policies for complying with fair lending and consumer protection laws.¹¹ Similar to the DBO inquiry, the DFS inquiry seeks to understand the contours of this business and the effects, if any, it might have on New Yorkers.

TAKEAWAY

Recent developments suggest that a variety of possible regulatory reforms of the online marketplace lending industry may be forthcoming. As federal and state regulators express concern about the potential risks of the business model, it remains to be seen whether any forthcoming reforms will help or hinder the industry. The uncertainty in this space provides the opportunity for industry participants to take a proactive approach to compliance and influencing regulatory policy.

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Please do not hesitate to contact us with any questions.

¹⁰ See, e.g., Suzanne Barlyn, "Exclusive: New York financial regulator gearing up to probe online lenders – source" REUTERS (May 26, 2016).

¹¹ See *id.*