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## Financing Marketplace Loans: Ten Key Things to Know Before Catching the Securitization Wave

By Anthony R. G. Nolan and Edward T. Dartley

Marketplace loans are the most exciting securitization asset class to emerge since credit cards and student loans. Securitization provides marketplace loan investors with liquidity, diversified funding and interest rate arbitrage opportunities. Securitization also involves complex legal requirements and specialized expertise that investors need to be familiar with if they want to grow with this new market.

This article provides a basic overview of important issues that must be considered in a securitization, including structural issues, ratings, securities law reporting, and liability and credit risk retention requirements. It also addresses how the JOBS Act, the Volcker rule, Regulation AB and other regulations might affect marketplace loan securitizations.<sup>1</sup>

### 1. This is how securitization differs from other techniques for financing portfolios of marketplace loans.

Sometimes we see confusion about the meaning of the term “securitization” and how it differs from other types of secured finance, such as asset-based financing and warehouse lines. Securitization differs from those other types of financing because it represents disintermediated financing that is delinked from the creditworthiness of the sponsor.

Securitization classically involves the issuance to capital markets investors of securities that are backed by and paid from a distinct pool of financial assets. The asset-backed securities are issued by a special purpose vehicle (an “SPV”) that has purchased the financial assets from the sponsor or originator and that pledges them as security for its obligations under the asset-backed securities. The asset-backed securities consist of two or more tranches, each of which assumes a distinct credit or other risk of the securitized assets. If the SPV is established in a bankruptcy-remote manner, and if the transfer satisfies the requirements for a “true sale”, then the securitized assets can be presumptively removed from the bankruptcy estate of the originator of the assets.<sup>2</sup>

A key objective in tranching of asset-backed securities is to create as large a senior class as possible that has a better credit profile than the securitized assets generally, thus permitting the sponsor to issue asset-backed securities with a lower net funding cost than the interest and fees received on the securitized assets. Tranching is accomplished through the use of credit enhancements, such as prioritization of payments to the more senior tranches. Initial losses are absorbed by the first-loss tranche, followed by a mezzanine tranche, which absorbs additional losses until reduced to zero, with further losses being absorbed by senior tranches in reverse order of seniority until each is reduced to zero. Tranching insulates the most senior investors from the default risk of the underlying asset pool to the extent that the more junior tranches absorb credit losses.

<sup>1</sup> For a discussion of certain securities law, investment advisory and investment company regulatory issues applicable to this industry, please see our alert entitled *Securities Law Considerations in Marketplace Lending*.

<sup>2</sup> See section 3 below for a discussion of bankruptcy remote structuring considerations.

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Marketplace loan securitizations involve the issuance of “asset-backed securities” (“Exchange Act ABS”), as defined in section 3(a)(77) of the Securities Exchange Act (“the Exchange Act”). An Exchange Act ABS is “a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset.” The definition of Exchange Act ABS is generally understood to apply to tranching exposures. Exchange Act ABS may be issued as notes or as pass-through certificates and may be publicly registered, privately placed or sold in Rule 144A offerings. A servicer (and possibly one or more back-up servicers) is appointed to manage the securitized assets and payments made thereunder.

Representations and warranties and repurchase obligations are standard features of securitizations. In the underlying transaction agreements for an asset securitization, the sponsor and the originators typically make representations and warranties relating to the pool assets and their origination, including about the quality of the pool assets. Upon discovery that a pool asset does not comply with the representation or warranty, under transaction covenants, an obligated party, typically the sponsor, must repurchase the asset or substitute a different asset that complies with the representations and warranties for the non-compliant asset. The practical impact of repurchase obligations in a marketplace loan securitization may be different than it is in securitizations of many other asset classes because the online lending platform often retains recourse only in very limited circumstances. This means that the sponsor may not be able to look to the marketplace lending platform or the originator to satisfy repurchase demands.<sup>3</sup>

The appeal of securitized marketplace loans is that they have the attributes of a fixed-income security with a relatively low default risk. Marketplace loans are both suitable and desirable for securitization 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. A marketplace loan securitization does not raise particularly complex tax issues (unless it is backed by mortgage loans).

However, the asset class is not without challenges. These include consumer protection laws, potential applicability of state usury laws, and potential assignee liability. They also include particular risks associated with the originators of the loans and the lending platforms that sell and service the loans, including risks that may arise from their bankruptcy, violations of lending laws and the potential unavailability of federal preemption of state usury and consumer protection laws.

In addition, a securitization is vulnerable to performance and bankruptcy risks of the online lending marketplace that acts as the servicer, because any disruption to the ability of the platform to service the loans can impact the SPV’s ability to timely receive payments on the securitized loans and meet payment deadlines on the asset-backed securities. Another risk is that in the case of fractional marketplace loans (as opposed to whole loans), the SPV does not own actual loans, but instead holds borrower payment-dependent notes issued by a separate trust vehicle, giving the SPV a participation right that is subject to additional risks created by having an intermediate trust vehicle in the chain of ownership. These risks may

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<sup>3</sup> For a discussion of these issues and of differences in the approaches that some marketplace lending platforms take with respect to recourse on assets sold to securitizers, see *Why Lending Club has shunned securitisations*, Financial Times (Jan. 11, 2016).

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be mitigated by back-up servicing arrangements, perfection of ownership interests in the assets under the applicable uniform commercial code and other devices.

### **2. To be or not to be rated —these are the questions.**

A key threshold question for the sponsor of a marketplace loan securitization is whether or not to seek a rating on the asset-backed securities from a nationally recognized statistical rating organization (“NRSRO”). The answer will depend on the nature of the investors being targeted, the costs of obtaining and maintaining a rating, and the size of the deal and whether NRSRO ratings become a standard feature of marketplace securitization as the asset class involves.

Ratings are useful for several reasons. A rating may enhance liquidity by providing a seal of approval that certain investors would find attractive. Some investors may rely on the ratings as a complement to their own review of the disclosure and other due diligence. Some investors may be subject to investment guidelines or regulatory restrictions that permit them to invest only in asset-backed securities that are rated at specified levels. However, a rating also imposes costs. These include the fees of any NRSRO that is engaged to rate a deal, the costs of complying with the NRSRO’s criteria, which may impact the structure and documentation of a securitization, and the costs of ongoing surveillance.

If a marketplace loan securitization is rated by a NRSRO it will also be subject to disclosure requirements imposed by the U.S. Securities and Exchange Commission (“SEC”). Exchange Act Rules 15Ga-2 and 17g-10 require disclosure of third party due diligence reports to investors, and pursuant to Rule 17g-5, each NRSRO hired to rate a securitization is entitled to receive certain information from the sponsor or arranger. Those rules became effective in 2015 and apply to registered offerings, Rule 144A exempt offerings and private placements. The disclosure is made by “furnishing” the report to the SEC by filing Form ABS-15G on the SEC’s EDGAR website.<sup>4</sup>

Rule 17g-5 requires the issuer of a rated securitization to maintain a password-protected website to which the issuer, sponsor or arranger must post all information that is provided to each NRSRO that has been hired to rate the asset-backed securities for the purpose of determining an initial rating or undertaking rating surveillance. Information to be provided is not subject to a materiality limitation and can include emails, telephone calls, and the like. Complying with the formalities imposed by Rule 17g-5 can be a hassle for a securitizer in its communications with NRSROs. The foregoing disclosures are required only in connection with the initial rating of the securitization.

### **3. “Bankruptcy remoteness” in marketplace loan securitizations – what it gets you and what it doesn’t.**

A key objective in any securitization is to de-link the risks inherent in the securitized assets from the operating and credit risk of the sponsor. This de-linkage is known as “bankruptcy remoteness” because it alleviates the risk that the sponsor’s bankruptcy will cause an interruption of payments to the securitization investors. Bankruptcy remoteness is not synonymous with being bankruptcy proof, but a securitization that is properly structured to be bankruptcy remote will tend to be relatively attractive to investors and will also qualify for a

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<sup>4</sup> Reports and other information that are “furnished” to the SEC generally are not subject to Section 18 of the Exchange Act, which imposes liability for material misstatements or omissions contained in reports and other information filed with SEC. However, they may attract disclosure liability under other provisions of securities law, such as Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

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rating. Bankruptcy remoteness does not address the risk of credit risk of any obligors on the marketplace loans or the risk that a servicer or originator will become bankrupt or insolvent.

Bankruptcy remoteness is normally achieved by structuring the transfer of the securitized assets as a “true sale” to bankruptcy remote entity. A “true sale” is a transfer that qualifies as a sale under state law and that will not be recharacterized as a security arrangement by a bankruptcy court. The tax and accounting treatment of the transfer are relevant to the legal analysis, but depending on the circumstances may not be dispositive.

Generally speaking, a bankruptcy remote SPV is an entity that is unlikely to be a debtor in a bankruptcy case or have its assets and liabilities be substantively consolidated with a bankrupt entity or to be dissolved as a result of the sponsor's bankruptcy. In considering the SPV's remoteness from being a debtor in its own bankruptcy it is necessary to protect it from filing a voluntary bankruptcy petition on its own behalf and also to protect it from being the subject of an involuntary bankruptcy petition. Protection against voluntary bankruptcy is afforded by provisions in the SPV's charter documents that authorize it to file a bankruptcy petition only with the consent of its independent directors or managers who do not owe fiduciary duties to the sponsor. Protection against an involuntary bankruptcy filing against the SPV is provided by charter provisions that prohibit the SPV from engaging in any business other than that required to consummate the securitization transaction. It is also provided by agreements among the parties to the securitization transaction not to file a bankruptcy petition against the SPV until the end of the voidable preference period.

Substantive consolidation is another important consideration in bankruptcy remote structuring. This term refers to features that protect the SPV from having its assets and liabilities substantively consolidated with those of the sponsor in a bankruptcy of the sponsor. An important factor in this analysis is whether SPV is a mere alter ego or instrumentality of the sponsor. Another is whether the SPV is so hopelessly intertwined with the sponsor that its creditors should effectively be considered to be creditors of the sponsor. The application of these factors to a particular case may depend on circumstances, including the district in which a sponsor's bankruptcy would be likely to be filed.

Law firms typically render reasoned opinions addressing bankruptcy remoteness by focusing on whether a bankruptcy court would likely recharacterize the transfer of assets by the sponsor to the SPV as security for a loan and substantively consolidate the SPV with the sponsor. A key consideration in the legal analysis of whether a transaction is bankruptcy remote is the extent to which the securitization investors have recourse to the sponsor or originator for credit losses on the securitized assets. This is distinct from remedies for breach of standard representations and warranties about the existence, characteristics and quality of the securitized assets.

#### **4. Who's afraid of the SEC?**

Because a securitization involves an offering of securities, the sponsor and the arranger are subject to antifraud liability under U.S. securities laws. The scope of liability depends on whether the securitization was publicly offered pursuant to a registration statement or was offered in a transaction exempt from registration such as a Rule 144A offering or a private placement.

A registered offering gives rise to liability for material misstatements and omissions under Section 11 of the Securities Act. Section 11 imposes strict liability on the issuer, its directors, and any person who signs the registration statement for any material misstatements or omissions in the registration statement. It also imposes strict liability on any “expert” who



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has, prepared or certified any portion of the disclosure, but only with respect to that disclosure prepared or comforted by the expert. Section 11 also imposes liability on the underwriter, but if the underwriter took reasonable steps to conduct due diligence on the disclosure it would be able to escape strict liability and assert its “due diligence” as a defense. (The provisions described below would also apply to a registered offering.)

Section 11 does not apply to Rule 144A offerings or private placements.<sup>5</sup> This eliminates strict liability concerns, but any offering document provided to prospective investors would be subject to liability for material misstatements and omissions under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. To state a claim for a violation of Section 10(b) and Rule 10b-5, a plaintiff must show that the defendant made misstatements or omissions of material fact that it knew or should have known about, that the plaintiff relied on the misstatement in connection with the purchase or sale of securities, and the plaintiff’s reliance was the proximate cause of its injury.

There are other statutory bases of anti-fraud liability that can apply to both registered and unregistered offerings of asset-backed securities. Section 17(a) of the Securities Act provides a similar basis for enforcement actions by the SEC, although it does not focus on the “making” of a misstatement or omission, but rather on obtaining money or property by means of a material misstatement. Similar language in Section 12(b) of the Securities Act also provides a basis for enforcement action by the SEC. Regulation AB does not affect disclosure liability except indirectly to the extent described below in part 8.

In addition to disclosure liability, there are limitations on the timing of communications and the manner of the offering that may give rise to liability if they are contravened, and that may cause an unregistered offering to lose its exemption from registration under the Securities Act.

### **5. Looking ahead: Prepare to hold skin in the game when the SEC’s credit risk retention requirements become applicable to marketplace loan securitizations.**

If you securitize marketplace loans after December 24, 2016 you will have to comply with the credit risk retention requirements of Section 15G of the Securities Act and Rule 15G thereunder.<sup>6</sup> Those requirements are designed to force a securitizer to maintain “skin in the game” in order to counter the perceived evils of the “originate to distribute” securitization model that was widely blamed for sparking the global financial crisis of 2008.

Rule 15G generally requires the person who organizes a securitization and sells assets to the issuing SPV (the “sponsor”) to retain 5 percent of the credit risk associated with a securitization, either directly or through a “majority-owned affiliate.” The person holding the credit risk may not transfer, sell or hedge an economic interest in it and cannot finance it on a non-recourse basis.

Holding credit risk retention through a majority-owned affiliate may give the sponsor greater flexibility than direct retention to structure or finance the mandated credit risk retention. Majority ownership can be satisfied by majority voting control or through ownership of a “controlling financial interest” under GAAP. There is a lot of ambiguity about these requirements, including how far below 51% a sponsor’s interest in a “majority-owned affiliate” can go without violating Rule 15G.

<sup>5</sup> *Gustafson v. Alloyd Company Incorporated*, 513 U.S. 561 (1995).

<sup>6</sup> Securitizations backed by residential mortgages have been subject to Rule 15G since December 24, 2015.

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There are some exemptions from the credit risk retention obligation for securitizations consisting solely of commercial loans, commercial real estate loans, and automobile loans that meet specific proposed underwriting standards for the specific asset class. Except in the case of commercial loans, this exemption applies only to securitizations of loans that are secured by real or personal property.

The sponsor can reduce its required risk retention obligation to the extent that an originator of at least 20% of the securitized assets in the underlying asset pool retains the credit risk on those assets. Although an investor acquires marketplace loans from the online lending platform that originated and services those assets, marketplace lending platforms typically do not seek to retain credit risk on the assets it has sold to investors. Lending platforms may have different policies in this area depending on how well established they are, how much they rely on institutional investors, and the depth of their capitalization. The 5% required credit risk can take one of the following three forms: (i) a first loss interest equal to 5% of the fair value of all tranches issued by the securitization (“eligible horizontal residual interest”); (ii) 5% of the par amount of each tranche issued in the transaction, or a single security representing the cash flows paid on each such class (“eligible vertical interest”); and (iii) any combination of an eligible vertical interest and a horizontal residual interest as long as the eligible vertical interest claimed as retention under the rule, when added to the percentage of the fair value of the eligible horizontal residual interest claimed as retention for purposes of the rule, is at least 5%.

There are a few important considerations for sponsors that want to use an eligible horizontal residual interest to satisfy the credit risk retention requirement. First, overcollateralization is not an eligible horizontal residual interest. However, excess collateral can be structured fairly easily into an interest that would satisfy the risk retention rules. Second, a 5% eligible horizontal residual interest is not the same as 5% of the equity tranche, but rather involves holding an equity tranche equal to 5% of the fair value of entire deal. Third, certain types of retention that would satisfy U.S. requirements may not be appropriate for a transaction that is marketed at EU financial institutions because of the differences between Section 15G and the credit risk requirements of the European Union’s Capital Requirements Rule.

### **6. Disclosure, disclosure, disclosure: what you have to report to the SEC during the life of a marketplace loan securitization.**

Rule 15Ga-1 requires securitizers to disclose fulfilled and unfulfilled repurchase requests with respect to any Exchange Act ABS for which the underlying transaction agreements contain a covenant to repurchase or replace an underlying asset for breach of a representation or warranty. The disclosure must be made by “furnishing” Form ABS-15G to the SEC through a filing on the EDGAR website. (See footnote 4 for the distinction between furnishing and filing).

Rule 15Ga-1 also requires NRSROs to include information regarding the representations, warranties and enforcement mechanisms available to investors in an asset-backed securities offering in any report accompanying a credit rating issued in connection with such offering, including a preliminary credit rating.

The Form ABS-15G furnishment filing for this purpose must be made at least annually, but a securitizer must also furnish Form ABS-15G within 45 days of the end of any calendar quarter in which it issued Exchange Act ABS or otherwise securitized an asset, or in which non-affiliates held any of its outstanding Exchange Act ABS. This requirement was instituted to address the SEC’s concern that contractual provisions related to representations and

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warranties were not effective during the global financial crisis and that sponsors and trustees were not vigilant in enforcing remedies for breaches of representations and warranties.

### 7. How do the JOBS Act and the FAST Act affect marketplace loan securitization?

#### a. JOBS Act

Despite the hype that accompanied its passage into law, the Jumpstart Our Business Startups Act (“JOBS Act”) will not have a significant impact on marketplace loan securitization. It might, however, make it marginally easier for sponsors with robust compliance infrastructure to expand their investor base. The JOBS Act is more likely to have an impact on online lending platforms that seek to obtain peer-to-peer investors, but it should have a marginal effect on institutional markets.

The JOBS Act was enacted by Congress in order to expand employment and unleash entrepreneurial energy. The SEC implemented the JOBS Act by amending several regulations to facilitate broader access to securities investors. One of these was an amendment to Rule 506 to permit an issuer to engage in general solicitation or general advertising in offering and selling securities pursuant to Rule 506, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that such purchasers are accredited investors. The SEC also amended Rule 144A to provide that securities may be offered pursuant to Rule 144A to persons other than qualified institutional buyers, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are qualified institutional buyers. While marketplace loan securitizations can be offered more broadly than was previously the case, they cannot be sold more broadly and there are significant penalties for so-called “bad actors” that sell securities to persons whose eligibility to purchase has not been adequately verified.

#### b. FAST Act

The Fixing America’s Surface Transportation Act (the “FAST Act”) amends the Securities Act by adding new Section 4(a)(7), which provides a nonexclusive safe harbor for private resales of securities. Section 4(a)(7) is intended to codify the common-law exemption from registration commonly known as “4(a)(1½).” As it turns out, the Section 4(a)(7) safe harbor will probably not have a big impact on marketplace loan securitizations for two reasons. In the first place, the securities to be resold will have to have been outstanding for at least 90 days, meaning that the initial purchaser would not be able to resell the securities immediately upon acquisition. That imposes a drag on liquidity that will make the safe harbor unattractive in most cases. In addition, the seller would be required to provide its buyer with the issuer’s most recent balance sheet, statement of profit and loss, and similar financial statements for the two preceding fiscal years in which the issuer has been in operation; these statements must have been prepared in accordance with applicable accounting principles and standards. The financial statement requirement is similar to that under Rule 144A(d)(4). However, issuers of asset-backed securities that are privately placed under the 4(a)(1½) exemption typically do not prepare financial statements. Indeed, this is a common reason that securities are resold under the 4(a)(1½) exemption.

### 8. Here’s what a marketplace loan securitizer needs to know about Regulation AB, from A to B.

Regulation AB is a comprehensive body of regulations that address the registration, disclosure and reporting requirements for asset-backed securities under the Securities Act

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and the Securities Exchange Act. It was adopted in 2004 and amended in 2014. It currently applies only to securitizations that involve a public offering of asset-backed securities pursuant to a registration statement filed with the SEC. Most marketplace loan securitizations are offered in the Rule 144A market and not through public offerings. Therefore, such a securitization will not be subject to Regulation AB unless it is offered pursuant to a registration statement or the SEC extends Regulation AB to Rule 144A offerings.

The SEC has been considering for quite some time whether to extend the Regulation AB disclosure requirements to Rule 144A offerings. If the SEC ever decides to make the Rule 144A disclosure standards applicable to Rule 144A offerings of ABS, sponsors will have to decide whether to continue issuing in the Rule 144A market and comply with the heightened disclosure obligations, to issue registered securities that are fully subject to Regulation AB (and to other provisions such as Exchange Act reporting requirements), or to avoid the compliance cost altogether and simply issue in private placements. In that event, securitization sponsors will likely move in divergent directions based on individual circumstances and the dynamics of particular asset classes, with some issuers opting to register their deals with the SEC in order to obtain greater liquidity and others moving to private placement execution in order to avoid the hassle of greater regulation. It is not certain whether the SEC will ever take this step, or, if it does, how quickly it might act.

Even though Regulation AB does not apply to Rule 144A offerings, its disclosure requirements have been adopted to a greater or lesser extent for many Rule 144A transactions because they are considered to be a guide of what the SEC considers to be material disclosure for a securitization. Thus, your lawyers and bankers may use Regulation AB as a template for disclosure on the basis that it provides a standard of the SEC's view of what constitutes material disclosure.

### **9. How the Volcker Rule might impact securitizations that target bank investors.**

Launching a marketplace loan securitization requires careful consideration of the Volcker Rule. If a securitization SPV is a "covered fund" as defined in the Volcker Rule, banking entities will generally be prohibited from having ownership interests in it and will be restricted from being able to engage in financial transactions with it, such as providing leverage, liquidity or hedges.

The Volcker Rule essentially defines a covered fund as an entity that would be an investment company but for the exclusions contained in sections 3(c)(1) or 3(c)(7) of the Investment Company Act. Many marketplace loan securitization SPVs should be able to avoid being a covered fund because of their ability to rely on alternative exclusions from the definition of investment company, such as section 3(c)(4) for small loan companies, section 3(c)(5) for mortgage and receivables finance companies. Rule 3a-7 for securitizations generally. It is critical to carefully consider the potential applicability of any Investment Company Act exclusion in light of all relevant circumstances, including the nature of the assets being securitized and the structure of the securitization and other aspects of the securitization sponsor's business.

If a securitization SPV cannot rely on an Investment Company Act exclusion other than Section 3(c)(1) or section 3(c)(7), the securitization may qualify for the "loan securitization" exclusion from the definition of "covered fund." However, depending on the nature of the transaction reliance on this exclusion may raise some regulatory risks that should be considered carefully with counsel.



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Banking entities can invest in securities issued by a covered fund as long as those securities do not constitute an “ownership interest” in the fund as defined in the Volcker Rule. Essentially, the definition of ownership interest identifies debt-like features, including the absence of contingent element in payment entitlements and the lack of equity-like rights to terminate the servicer. However, banking entities would still be subject to restrictions on the ability to engage in transactions with the securitization SPV. This could be a practical issue in structuring liquidity facilities or hedges for the securitization.

### 10. Here’s how to get far from the *Madden* crowd.

Some marketplace lending platforms originate from federally insured banks that act as lenders of record for the marketplace loans. Sometimes referred to derisively as “rent-a-charter,” using a federally insured depository institution to serve as lender of record affords the benefits of federal preemption to the lending platform and subsequent assignees. Under federal preemption, a loan can be originated nationwide without the lender having to be licensed under any state’s laws, and the loan can bear the interest rate and lending 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 nonbank 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, and 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 West Virginia’s usury ceiling.<sup>7</sup> More recently, the United States Court of Appeals for the Second Circuit held that non-bank debt collectors that purchase written-off credit card accounts from a bank cannot benefit from the bank’s federal preemption of state usury laws, a decision that could eventually apply to bank-originated consumer marketplace loans. The ruling applies in New York, Connecticut and Vermont.<sup>8</sup> Consequently, the assignee of that loan may charge interest only at a rate that does not exceed the usury limitation of Connecticut, New York or Vermont (the states that comprise the Second Circuit), depending on which of the three is the borrower’s state of residence.

The *Madden* decision creates a risk that the effective rate of interest on marketplace loans that have not been originated by a bank or licensed lender affiliate of the marketplace lending platform may be capped at the applicable usury rate for the borrower’s state of residence. This could affect the relative attractiveness of loans purchased from marketplace lending platforms 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. In order to protect investors, the risk of loans being voided or unenforceable under non-preempted state usury laws may also be addressed through representations and warranties and repurchase obligations with respect to usury. It may also be mitigated through structural features such as initial over-collateralization and over-collateralization built up via excess spread.

<sup>7</sup> *Cash Call, Inc. v. Morrissey*, No. 12-1274, 2014 WL 2404300 (W. Va. May 30, 2014).

<sup>8</sup> *Madden v. Midland Funding*, No. 14-2131-cv. (2d Cir. Decided: May 22, 2015). The Second Circuit Court of Appeals has been asked to rehear this case *en banc*, and it may ultimately find its way to the United States Supreme Court, but in the meantime there is some uncertainty about the enforceability of bank loans that are assigned to non-bank entities, including in connection with a securitization.

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### Last but not least: the secret of managing it all.

Securitization is ripe with opportunities for investment advisors and managers of collective investment vehicles that invest in marketplace loans. By selecting and purchasing marketplace loans and then sponsoring a securitization of those loans an investment advisor can significantly increase its assets under management and obtain efficient funding. However, the investment manager must be ready to address the legal and compliance challenges posed by securitization. For established asset managers, this means taking a close look at the manager's existing compliance program and determining what adjustments need to be made to it. Marketplace loans are a distinct and growing asset class, with special considerations in areas such as valuation, allocation, online platform counterparty risk, and other areas that are specific to the marketplace lending industry. Accordingly, the manager's compliance program needs to be tailored to the specific investment activities involving this asset class.

These considerations take on heightened importance for first-time or emerging managers. Entering the asset management industry for the first time in this age of increased regulation and SEC-scrutiny is challenging in and of itself. Launching a new business to engage in a relatively new asset class adds to the challenges of building a successful investment firm with low regulatory risk. Before embarking on a securitization, first-time managers need to be particularly cognizant of the "rules of the road" for a successful securitization.

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### Authors:

#### Anthony R. G. Nolan

anthony.nolan@klgates.com  
+1.212.536.4843

#### Edward T. Dartley

ed.dartley@klgates.com  
+1.212.536.4874

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