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All the Moving Parts: What Do They Mean for You?

A number of recent developments affecting the marketplace lending industry are raising questions about what the industry will look like in the future and how it will be regulated. Senior members of Pepper Hamilton's Marketplace Lending practice sat down for a podcast to discuss their views leading into LendIt USA 2016. Here we highlight some of marketplace lending's hottest topics and how they may impact you from that podcast. These highlights only scratch the surface of what is happening in marketplace lending.

For more information, listen to the full Pepper podcast.

Scan the QR code using a reader on your smartphone or tablet, or visit our website pepper.law.

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Madden v. Midland Funding

The Second Circuit's *Madden* decision continues to raise questions about whether the longstanding "valid at inception" rule still stands. In *Madden*, the court held that the National Bank Act does not preempt the application of state usury laws to third-party, non-bank assignees. There is currently a pending petition for certiorari before the U.S. Supreme Court in the case.

The latest development came on March 18 when the Supreme Court asked the U.S. Solicitor General to submit a brief detailing the government's position in *Madden*. The brief is due in mid-May and should provide insight into the thoughts of the Consumer Financial Protection Bureau (CFPB) and the Office of the Comptroller of the Currency, which have yet to comment on the case.

Until a *certiorari* decision is made, there continues to be uncertainty as to how *Madden* will impact marketplace lending, and many industry players are taking a "wait and see" approach. Yet, recent changes to the relationship between Lending Club and WebBank, which appear to be a response to *Madden*, are evidence that the case is already impacting marketplace lenders that collaborate with banks.

Secondary Markets and Blockchain Technology

There has long been talk about the creation of a secondary market for marketplace loans, but a few significant roadblocks have stood in the way. Most notably, marketplace lending lacks its own version of the Depository Trust and Clearing Corporation — a repository of ownership information that facilitates electronic transfers of securities. Without this resource, transfers of marketplace loans still require parties to actually "move the paper," but a new technological advancement could solve this problem in the future.

Blockchain technology, once known only for its use when transferring Bitcoins, is emerging as a powerful tool in the financial services industry. The distributive ledger technology allows parties to have all evidence of a transaction in one digital file. Because this information moves through the Internet, there is no need for a custodian to move a piece of paper. A future where marketplace loans are bought and sold completely online is still many years away, but the advent of blockchain could solve some technological difficulties and bring us closer to a viable secondary market. Pepper has recently created a Blockchain Team to help clients with this technology.

Regulation D's Rule 506(c)

When the JOBS Act created Rule 506(c) of Regulation D, it allowed private placement issuers to seek investments from accredited investors through general solicitation. It is a powerful tool that enables issuers to sell securities to investors beyond those investors who are known to them. The market, however, has been generally slow to embrace the new rule.

The reasons for this vary. Some issuers do not wish to gather the information necessary to verify each investor's accredited status; others are concerned with the privacy implications of holding this sensitive information. There is a lot to consider when planning your offering process, and issuers that decide not to use 506(c) should be careful to avoid general solicitation through a website or open delivery of investment materials and those that use make that choice carefully as there is generally no reversion to a 506(b) once the solicitation is out the door. And if they choose to use 506(c), they should meticulously document satisfaction of the verification requirements.

CFPB Regulation

The CFPB has shown an interest in playing a greater role in regulating small-business lending, and the latest development is a newly launched portal where consumers can register complaints about online lenders. This is the CFPB's first foray into regulating marketplace lenders, and it will likely use the complaints received through the portal to focus on certain industry practices or companies that are frequent subjects of complaints. To avoid possible CFPB scrutiny, marketplace lenders

should pay close attention to their customers' issues and work to resolve them before a complaint is submitted through the portal.

Bank- vs. State-Licensing Models

The debate over whether marketplace lenders should pursue a bank-licensing or state-licensing model continues to wage on, with significant benefits to each structure. The bank model allows lenders to export interest rates, and a lot of large players choose this structure to avoid having to account for differing laws among states.

Lenders should not default to a bank-licensing model, however, as state-licensing could be more beneficial under certain circumstances. For example, many states do not require a license at all if interest rates charged are below a certain threshold. Further, the state-licensing model provides greater certainty as to the interest rates you can charge, although this certainty brings with it greater compliance requirements.

Retention Rule

The bank retention rule is a relatively new development in marketplace lending, but it has its origins in the post-financial crisis environment of 2009–2010. Designed to prevent systemic risk, the rule states that 5 percent of loans written by a bank need to stay on its own balance sheet.

The retention rule has many legal implications, including on the true-lender analysis, but the marketplace lending community should pay close attention to its practical effects — including its impact on the cash flow and capital requirements of those subject to the rule.

Acquisition Fees and Investment Advising

As the marketplace lending industry develops and evolves, new questions arise about broker-dealer and investment adviser registration and when it is required. In many cases, the issue is not free from doubt, but there is some available guidance.

First, do you need to be a registered broker-dealer to accept acquisition fees? Although these fees look like commissions, they are not, and the literature says an advisor is free to set any compensation arrangement, provided it is fully disclosed and not otherwise prohibited.

Second, do you need to be a registered investment adviser to advise on the buying and selling of marketplace loans? This depends on whether marketplace loans are considered to be "securities." The issuer of a loan is not issuing a security, but purchasing a financial instrument through an investment contract will likely be treated as a securities transaction by the SEC. Thus, individuals who advise on buying/selling instruments on major marketplace platforms need to carefully evaluate their activities to determine whether they need to register as an investment advisor.