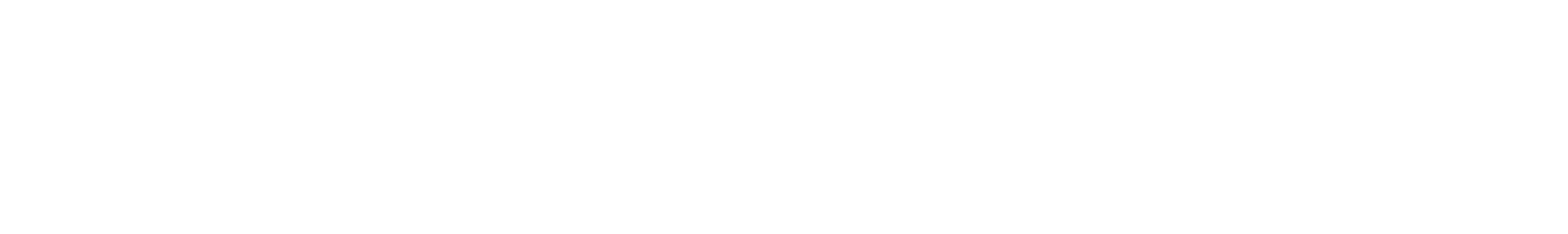
Practice Pointers on



P2P Lending: How It Works,

Current Regulations and Considerations

**What Is P2P Lending?**

Peer-to-peer, or person-to-person, lending (“P2P lending”) replace parentheses and brackets by comma and remove quotations and Hyphens is a type of crowdfunding that involves the facilitation of loan originations outside of the traditional consumer banking system by connecting borrowers directly with lenders, or investors, through an Internet platform. P2P lending’s use of Internet platforms reduces costs by eliminating many operational expenses associated with traditional consumer bank loans, such as the cost of maintaining and staffing physical branches. Some cost savings are passed along to borrowers through lower interest rates than those offered by traditional banks.

Although the majority of P2P lending is for mortgages and credit card refinancing, some P2P lending platforms focus on particular segments of the consumer lending market, including small-business lending (OnDeck, Funding Circle, Quicken Loans, Kabbage), student loans (SoFi, Kiva), low income entrepreneurs (Kiva), and younger borrowers (Upstart). P2P lending is also being used to raise capital through real estate crowdfunding platforms (Fundrise, CrowdStreet).

P2P lending platforms typically issue loans in amounts ranging from $1,000 to $35,000 replace money units by characters and , in money values with fixed interest rates and maturities of three to five years. P2P lending platforms also set minimum FICO credit scores (e.g., replace abbreviations by real word 660 and 640). The P2P lending platform that makes the loan then receives origination fees (usually 1% to 2% of the loan balance) and servicing fees (typically 1% replace % by percent of the outstanding loan balance).

**How Does P2P Lending Work?**

The P2P lending process can vary by platform, but it generally involves the following steps: Remove bullet points (this can be done by regix)

and connect the lines or add first, second, ….

* Before a loan is posted on a platform’s website, a prospective borrower submits an application to the platform for

consideration;

* The platform obtains a credit report on the applicant and uses this information, along with other data (e.g., loan characteristics), in proprietary models to assign a risk grade to the proposed loan and set an interest rate corresponding to the assigned risk grade;
* If accepted, a loan request is posted on the platform’s website, where investors can review all loans or search for

specific loans that meet their desired risk/ replace with or return characteristics;

* If there are enough investors to fund the loan (a single loan is typically divided into many pieces to allow investors to diversify their portfolio and distribute the default risk among multiple investors), the loan is then originated by a bank (the “originating bank”), the deposits of which are insured by the Federal Deposit Insurance Corporation (FDIC);
* The originating bank then sells the notes associated with the specific loan to the platform, which at the same time, sells the notes to each lender that has agreed to fund the loan in the principal amount of that commitment. The notes issued by the platform are specific to each borrower, and some notes may be registered with the Securities and Exchange Commission (SEC);
* The notes issued by the platform (sometimes referred to as “borrower payment dependent notes”) are guaranteed by the underlying loan, which means that investors are only due payment by the platform if the underlying borrower repays the loan; and
* The platform receives a fee on the loan, as well as origination and servicing fees, before lending the remaining proceeds to the underlying borrower.

**Advantages of P2P Lending**

P2P lending platforms have grown in popularity, due to advantages offered to both borrowers and investors. The advantages to borrowers include the following:

* Lower interest rates on average than those charged by traditional banks for credit cards or installment loans;
*  Ease of use of online platforms;
* Transparency of platforms through uniform and clearly disclosed loan terms; and
* Efficient decision-making through the use of technology to quickly assess and assign risk grades and interest rates to loan applicants.
* The advantages to investors include the following:
* High risk-adjusted returns;
* Access to a high yield investment class (traditionally reserved for institutional investors) in investment increments as low as $25;
* Transparency and autonomy in selecting which loans to invest in (through the ability to examine each loan at a granular level before investing, and monitor loan performance in real time); and
* Ready access to credit profile data for each approved loan.

P2P lending platforms themselves enjoy cost savings through more efficient use of technology. P2P lending can in fact be viewed as a form of securitization where efficiencies of automation permit P2P lending platforms to divide individual loans (with individual borrowers) into numerous notes issued to numerous investors. Although there are significant cost savings from the resulting elimination of a physical branch network, the more enduring cost savings stem from the fact that P2P loans are not carried on the books of the originating banks or the P2P lending platforms and are not subject to bank

capital requirements. For more information regarding regulatory considerations, see “Consumer Credit Regulatory

Considerations” below.

**Risks Associated with P2P Lending**

Although P2P lending provides significant advantages to both investors and borrowers, there are certain considerations that should be taken into account. As a general matter, investors are exposed to more risk than borrowers in P2P lending, as typical borrower protections — including usury laws and regulations against unfair collection practices, misleading advertising, and discriminatory practices — generally still apply to P2P lending platforms. Investors in P2P lending, like investors in other types of lending, are exposed to borrower credit risk, interest rate risk, liquidity risk, and regulatory risk.

**Consumer Credit Regulatory Considerations**

P2P lending platforms may be subject to certain consumer banking and related regulations. Consumer credit, whether bank- originated or otherwise, is subject to an extensive web of federal and state laws, and participants in consumer credit markets are subject to the authority of numerous federal and state regulators. This web of federal and state law regulates all aspects of the credit life-cycle, including advertisements and solicitations, underwriting, agreements and disclosures, payment terms, and debt collection practices. Federal and state laws also prohibit credit discrimination and unfair or deceptive acts or practices. Other bodies of law that regulate relationships between financial institutions and consumers — e.g., privacy and data security and anti-money laundering laws — would also apply. Because of this complex web of regulation, and to take advantage of banks’ powers with respect to interest rates, non-bank creditors often partner with banks that have existing compliance infrastructure. However, bank partnerships with non-bank consumer lenders in other contexts (e.g., payday lending) have drawn scrutiny from courts, banking regulators and state Attorneys General with respect to their lending practices and compliance with state usury laws.

Where a non-bank platform has partnered with a bank to originate consumer loans, the platform may still be subject to regulatory oversight and examination. For example, in the context of P2P lending platforms, the platform provider may be viewed as a service provider with respect to its origination or servicing activities. The Consumer Financial Protection Bureau (CFPB) would have unfair, deceptive, or abusive acts or practices (UDAAP) enforcement authority over bank originators of P2P loans if the bank has assets of greater than $10 billion, and the same authority with respect to a service provider to such a bank. The CFPB could also adopt UDAAP rules applicable to all banks and platforms involved in P2P lending. In addition, the Federal Trade Commission can investigate and enforce consumer protection statutes as applied to non-bank platforms under its authority under Section 5 of the Federal Trade Commission Act and state Attorneys General have similar authority.

Notwithstanding that a non-bank platform has partnered with a bank to originate consumer loans, a court may nonetheless determine that, based on the nature of the loans and the structure of the partnership, the non-bank platform is the “true

lender.” In some cases, courts will examine whether the non-bank platform has the “predominant economic interest” in the loan and, if so, that partner is deemed to be the “true lender.” If the non-bank platform is determined to be the true lender, the loan would be subject to state usury restrictions as well as other state licensing or consumer protection laws. However, even if the bank is determined to be the “true lender,” the Second Circuit’s decision in *Madden v. Midland Funding, LLC*

held that Section 85 of the National Bank Act, which allows national banks to charge the rate of interest permissible in the state where the national bank is located, did not allow a purchaser of the loan for collection purposes to charge the same rate of interest. This decision has cast a cloud over higher interest rate loans purchased from a bank where the borrower is located in the Second Circuit (New York, Connecticut and Vermont); however, legislative fixes for this uncertainty are under consideration.

Regulators have also taken an active interest in marketplace lending developments. On May 10, 2016, the U.S. replace country abvs. With the word Treasury Department issued a report entitled “Opportunities and Challenges in Online Marketplace Lending,” which outlined its findings from its 2015 request for information and provided recommendations to federal government and privacy sector marketplace lending participants to encourage safe growth and access to credit. The Office of the Comptroller of the Currency (OCC) has also expressed interest in marketplace lending and other financial technology developments. On May 13,

2016, the OCC released a white paper on financial technology innovation (the “White Paper”), which lays out a preliminary framework for “responsible innovation.” The White Paper articulates eight principles that the OCC will follow when evaluating innovative products, services, and processes that require regulatory approval and identifying associated potential risks. The White Paper also sought feedback on the challenges banks face with respect to marketplace lending and how the OCC can facilitate innovation, including by issuing guidance to banks and non-banks and by establishing formal channels for communication with stakeholders. On September 12, 2016, Comptroller of the Currency Thomas J. Curry discussed marketplace lending’s risks and associated policy questions at the inaugural Marketplace Lending Policy Summit, raising five policy and regulatory questions regarding marketplace lending and reiterating the eight principles enumerated in the White Paper guiding the OCC’s regulatory efforts.

On October 26, 2016, the OCC announced the creation of the Office of Innovation, which is dedicated to responsible innovation and implement a formal framework to improve the OCC’s ability to identify, understand, and respond to financial innovation affecting the federal banking system. On December 2, 2016, Mr. Curry announced that the OCC would move

forward with considering applications from fintech companies to become special purpose national banks. In response, the New York Department of Financial Services (NYDFS) and the Conference of State Bank Supervisors filed complaints challenging the OCC’s authority to grant special purpose charters to fintech companies. On December 12, 2017, the court granted the OCC’s motion to dismiss the NYDFS complaint, in part because the OCC had not yet decided whether it will offer special purpose charters, and therefore the complaint failed to establish any injury in fact or standing.

On March 15, 2017, OCC released a Draft Supplement to its existing licensing manual laying out its framework for evaluating fintech companies that apply for a special purpose national bank charter. On September 25, 2017, Acting Comptroller of

the Currency Keith A. Noreika discussed online lending and responsible innovation at the 2017 Online Lending Policy

Summit and reaffirmed the OCC’s authority to issue special purpose national bank charters to non depository fintech companies. There has also been increasing interest in marketplace lending at the state level.

**Regulation of Funding Side of P2P Lending**

In addition to consumer credit regulations, the funding side of P2P lending platforms is subject to SEC regulation. In November 2008, the SEC issued a “cease and desist” order to P2P lending platform Prosper Marketplace, Inc. (“Prosper”), indicating that notes issued by Prosper were unregistered securities. In finding that the notes were unregistered securities, the SEC applied the analysis used in *Reves v. Ernst & Young*. To determine whether a note is a security, the *Reves* analysis begins with the rebuttable presumption that every note is considered a security. When there is a question, a determination needs to be made whether the notes offered bear a “family resemblance” to cases where notes have been deemed not to be securities. The following four-part balancing test must be applied to determine whether this resemblance exists:

* The motivation of the buyer and seller;
* The plan of distribution of the notes;
* The expectations of the investing public; and
* Whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the Securities Act unnecessary.

Although the exact application of these factors is somewhat ambiguous and fact-dependent, when applying the test, the *Reves* court emphasized that the presumption is that notes should be treated as securities. Applying the *Reves* analysis to the notes in question, the SEC indicated that the notes are securities because:

* Lenders are motivated by an expected return on their funds;
* Prosper loans are offered to the general public;
* A reasonable investor would likely expect that the loans are an investment; and
* There is no alternate regulatory scheme that reduces the risks to investors presented by the P2P lending platform.

As a result of the SEC action, Prosper registered its notes with the SEC. Lending Club Corporation, another P2P lending platform, also has registered its notes with the SEC. The costs and administrative burdens associated with registering notes with the SEC have potentially reduced the number of platforms in the P2P lending space. Furthermore, P2P lending platforms are still subject to blue sky registration requirements because the notes may not be “covered securities” under the National Securities Markets Improvement Act of 1996.

A report issued in 2011 by the U.S. Government Accountability Office (GAO) pursuant to requirements under the Dodd- Frank Act acknowledged the confusing overlapping jurisdiction of multiple regulatory agencies, including the SEC, state securities regulators, state banking regulators, the FDIC, and the CFPB, with respect to P2P lending. The GAO report outlined two approaches to the future regulation of P2P lending on the federal level:

* An **SEC-centered approach**, whereby potential risks to investors are regulated at the federal level by the SEC.

Under this approach, there would be broad exemptions to individual state-level securities regulations for P2P

lending platforms that are in compliance with federal regulations. However, borrower protections would remain

under the jurisdiction of state regulators.

* A **CFPB-centered approach** that would bring together the monitoring of investors and borrowers under the CFPB. Instead of being federally regulated securities, P2P loans and investments in P2P loans would be “consumer financial products” and the CFPB would regulate the relationship between investors and P2P lending platforms.

Despite the GAO’s thorough analysis, due to the infancy of the industry and expected evolution of P2P lending over time, the GAO did not make any firm recommendations as to which of these regulatory models was best. Subsequently, the SEC remains the primary regulatory agency for the funding side of P2P lending.

**Title III of the JOBS Act**

When President Obama signed Title III of the Jumpstart Our Business Startups Act (the “JOBS Act”) in April 2012, it was thought that the long-awaited federal crowdfunding exemption of the JOBS Act would offer relief to P2P lending platforms. Title III of the JOBS Act addresses crowdfunding — of which P2P lending may be considered a type — by providing an exemption from registration, provided that:

* The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, is not more than $1 million;
* The aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, does not exceed;
* The transaction is conducted through a registered broker or funding portal that complies with the requirements of the exemption; and
* The issuer complies with a number of specific informational and other requirements specified under the exemption.

**Final Rules**

On October 30, 2015, the SEC adopted final rules to implement the crowdfunding exemption (referred to as “Regulation Crowdfunding”), which went into effect on May 16, 2016. Below we briefly summarize some of the principal requirements of Regulation Crowdfunding. Rule references below are to those under Regulation Crowdfunding.

**Limit on Capital Raised**

Consistent with the statutory limitations, Rule 100(a) provides that an issuer may sell up to $1.07 million in any 12- month period to investors in an offering made pursuant to the exemption. Of course, an issuer may consider conducting other exempt offerings in close proximity with its crowdfunded offering. In calculating the amounts sold for purposes of the threshold, amounts sold by a predecessor or by an entity under common control with the issuer will be aggregated with the amounts sold by the issuer.

**Individual Investment Limits**

The SEC modified the investor limits from those included in its proposed rules. The final rules make clear that the individual investor limit is an aggregate limit, which applies to all investments made by the individual over a 12-month period in crowdfunded offerings and not to a specific offering. An investor will be limited to investing:

(1) The greater of: $2,200 or 5% of the lesser of the investor’s annual income or net worth if either annual income or net

worth is less than $107,000; or

(2) 10% of the lesser of the investor’s annual income or net worth, not to exceed an amount sold of $107,000, if both annual income and net worth are $107,000 or more.

The issuer can rely on the intermediary’s calculation of the investment limit; provided that the issuer does not have knowledge that the investor has exceeded, or would exceed, the investment limits as a result of participating in the issuer’s offering.

|  |  |
| --- | --- |
| **Contacts** |  |
| Ze’-ev Eiger  New York  (212) 468-8222  [zeiger@mofo.com](mailto:zeiger@mofo.com) | Jeremy Mandell Washington, D.C. (202) 887-1505 [jmandell@mofo.com](mailto:jmandell@mofo.com) |

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life sciences companies. We’ve been included on *The American Lawyer*’s A-List for 13 years, and *Fortune* named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients while preserving the differences that make us stronger. This is MoFo. Visit us at [www.mofo.com.](http://www.mofo.com/)

© 2018 Morrison & Foerster LLP. All rights reserved. For more updates, follow Thinkingcapmarkets, our Twitter feed:

[www.twitter.com/Thinkingcapmkts.](http://www.twitter.com/Thinkingcapmkts)

*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular*  *situations.*