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The Legal Landscape for Peer-to-Peer Lending

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Peer-to-peer (P2P) lending is a rapidly growing vehicle for consumer and business purpose lending. It can provide fast, efficient access to capital, particularly for small businesses, and relatively attractive financing to consumers who may not otherwise qualify for traditional loans from mainstream lenders. Investors are also attracted by the business model, because of the ease with which they can invest in loans and earn relatively high rates of return. Like all lending activities, however, P2P lending is heavily regulated. While some of the regulatory burdens can be reduced by structuring the business appropriately, regulatory costs – both in dollars and time – need to be factored into strategic planning. This article discusses some of the key regulatory considerations that P2P lending companies must address.

State Licensing

States regulate lending practices principally through licensing requirements. A range of licensing requirements for the originating, brokering, and servicing of loans exists. Prior to engaging in P2P lending, a company should make sure that it is appropriately licensed in the states in which it will be brokering, making, or servicing loans. Licensing requirements vary from state to state, and whether a particular state's licensing requirements are triggered depends on various factors, including the size of the loans being made, interest rates and fees, and whether the loans are secured by real estate or are made for business purposes. Further, most states assert jurisdiction over out-of-state companies that make loans to residents of the state, particularly consumer loans.

In an effort to minimize certain lender licensing requirements, some P2P lending companies have used bank sponsors to make loans, as banks are generally exempt from state licensing requirements. Use of a bank lender, however, does not completely relieve a company from all state licensing requirements. For example, licensure as a loan broker may be required to the extent a company is arranging loans. Additionally, servicing the loans can implicate certain loan servicer or collection agency licensing requirements.

Moreover, there are often substantive state requirements with which licensed entities have to comply. Licensees frequently have recordkeeping, disclosure, surety bond, minimum net worth, and reporting requirements, among others. Licensees are also subject to examination by the appropriate state regulators and may have to notify regulators of significant corporate changes (e.g., address changes and changes in ownership). State licensing regimes may also impose certain restrictions on the practices of licensees, including advertising restrictions.

Federal and State Consumer Protection Laws

Federal and state laws also regulate the conduct of lending business by imposing substantive requirements, such as usury ceilings and anti-discrimination laws, and extensive disclosure requirements, particularly for consumer loans, on lenders and brokers.

P2P lenders generally must comply with state usury laws, but partnering with a bank to act as the lender can be advantageous because a bank can "export" the interest rate and fees permitted to it under the laws of the state where it is located. There have been recent legal challenges to such arrangements, alleging that they are schemes to circumvent state usury laws and that the non-bank company is the "true lender."

The federal Equal Credit Opportunity Act and some state laws prohibit creditors and others that regularly participate in credit decisions from discriminating against credit applicants and borrowers (both consumers and businesses) with respect to any aspect of a credit transaction on prohibited bases, such as race, color, religion, national origin, sex, marital status, or age. Therefore, even if a P2P lending company uses a bank sponsor to make the loans, compliance with anti-discrimination laws is still required.

The federal Truth in Lending Act and numerous state laws contain substantive restrictions and disclosure requirements on consumer purpose loans of all types, including mortgage loans. Substantive rules relating to mortgage loans have mushroomed in the years since the housing crisis began and regulate all aspects of mortgage lending, from detailed tests to determine whether the consumer has the ability to repay the loan to foreclosure and loss mitigation requirements.

Federal and state laws relating to financial privacy, anti-money laundering and terrorist financing, data collection, the validity of electronic transactions, data security, and real estate-related protections (such as lead paint certifications) may also be applicable to P2P lending activities.

Secured Loans

In the event that P2P loans are secured by either real or personal property, there will be filing requirements that must be complied with in order to perfect the lender's security interest in the collateral. Each state has its own version of the Uniform Commercial Code, which governs the types of filings that need to be completed in order for a lender to make its security interest in the collateral property a matter of public record. The filings afford the lender more protection in the event of a borrower default on the underlying loan. With respect to loans secured by an interest in real property, the mortgage or deed of trust must be recorded in the appropriate local recorder's office.

Securities Regulations

As part of their business model, P2P lending companies usually sell payment-dependent notes to investors. Under the federal Securities Act of 1933, these payment-dependent notes are considered securities. In connection with these notes being treated as securities, P2P lending companies should consider whether any other federal or state securities laws apply. These requirements may include registration, disclosure and conduct obligations. Such requirements should be considered prior to the issuance or sale of any payment-dependent notes to investors.

Conclusion

Given the significant regulatory oversight of P2P lending, the structure of the business needs to be influenced by a company's tolerance for supervision and the costs of compliance. Although certain regulatory obstacles can be avoided by structuring lending operations in certain ways (e.g., through the use of a bank sponsor as the lender), any company seeking to engage in the P2P lending business needs to implement and maintain a legal compliance structure that addresses the myriad federal and state requirements applicable to lending and securities. ∎

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