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Journal

UCLA School of Law Law & Economics

Author

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Publication Date

2011-04-01

The Misregulation of Person-to-Person Lending

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Amid a financial crisis and credit crunch, retail investors are lending a billion dollars over the Internet, on an unsecured basis, to total strangers. Technological and financial innovation allows person-to-person (“P2P”) lending to connect lenders and borrowers in inspiring ways never before imagined. However, all is not well with P2P lending. The SEC threatens the entire industry by asserting jurisdiction with a fundamental misunderstanding of P2P lending. This Article illustrates how the SEC has transformed this industry, making P2P lending less safe and more costly, threatening its very existence. The SEC’s misregulation of P2P lending provides an opportunity to theorize about regulation in a rapidly disintermediating world. The Article then proposes a preferable regulatory scheme designed to preserve and discipline P2P lending’s innovative mix of social finance, microlending, and disintermediation. This proposal consists of regulation by the new Consumer Financial Protection Bureau.

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* Copyright © 2011 Andrew Verstein. Associate Research Scholar in Law and John R. Raben/Sullivan & Cromwell Executive Director, Yale Law School Center for the Study of Corporate Law, Yale Law School. I would like to thank Ian Ayres, Steven Bradford, Eric Chaffee, Steven M. Davidoff, Kevin Davis, Anna Gelpert, Matthew Grieder, Mitzi Huang, Jonathan Macey, John Morley, Adam C. Pritchard, Larry Ribstein, Roberta Romano, Lanny Schwartz, Natalya Shnitser, Norman Silber, Robert C. Strong, II, Geoffrey Rapp, Gabriel Rauterberg, Lynn Wang, Anthony Weaver, and Ralph Winter for extensive comments. I am also grateful to my numerous interview subjects.

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INTRODUCTION

Amid a financial crisis and credit crunch, retail investors have lent over \$1.5 billion through the Internet, on an unsecured basis, to complete strangers.¹ Technological and financial innovation allows person-to-person (“P2P”) lending to connect lenders and borrowers in inspiring ways never before imagined. Industry analysts project that P2P lending could exceed \$5 billion annually by 2013,² with some even suggesting figures of greater than \$30 billion.³ This blossoming of P2P lending brings with it both new risks and new regulatory concerns. For example, lenders may not be repaid in full, borrowers risk their privacy, and Internet platforms extend questionable

¹ Rachel Gotbaum, *Avoiding the Pitfalls of Family Borrowing*, NAT’L PUB. RADIO (Oct. 6, 2006), available at <http://www.npr.org/templates/story/story.php?storyId=6208227> (stating that Circle Lending, later Virgin Money USA, lent over \$100,000,000); *About Us: Statistics*, KIVA, <http://www.kiva.org/about/facts> (last visited Sept. 24, 2011) (\$244,323,625); *Lending Club Statistics*, LENDING CLUB, <https://www.lendingclub.com/info/statistics.action> (last visited Sept. 24, 2011) (\$366,103,025); *Performance Data*, PROSPER, <http://www.prosper.com/invest/performance.aspx> (last visited Sept. 24, 2011) (\$258,229,901); *The Largest P2P Lending Service Is . . .*, P2P-BANKING.COM (Feb. 20, 2011, 6:30 AM), <http://www.wiseclerk.com/group-news/countries/china-the-largest-p2p-lending-service-is/> (CreditEase: about \$300,000,000 annually); *Zopa Sees Surge in Demand as Banks Fail to Meet Consumer Interests*, FINEXTRA (Mar. 9, 2011, 10:09 AM), <http://www.finextra.com/News/Fullstory.aspx?newsitemid=22342> (£125,000,000, or about \$200,000,000).

² Press Release, Gartner Newsroom, Gartner Says 50 Per Cent of Banks Will Still Lack an Innovation Programme and Budget by 2013 (Jan. 5, 2010), available at <http://www.gartner.com/it/page.jsp?id=1272313> (“By 2013, P2P lending will soar at least 66 per cent to \$5 billion of outstanding loans.”).

³ \$30 billion would represent a modest 1% of the U.S. consumer credit market. BD. OF GOVERNORS OF THE FED. RESERVE SYS., *FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS, SECOND QUARTER 2011*, at 100 tbl.L.222 (2011), available at <http://www.federalreserve.gov/releases/z1/current/z1.pdf> (indicating total consumer credit liabilities of households and nonprofit organizations is about \$2.4 trillion); see David G. Blanchflower & David S. Evans, *The Role of Credit Cards in Providing Financing for Small Businesses*, 2 PAYMENT CARD ECON. REV. 77, 79 n.4 (2004) (“Other estimates place the amount of [consumer] credit available at over \$4 trillion.”); see also Alan Farnham, *New Ways to Get a Loan Without Going to a Bank*, ABC NEWS, (Jan. 6, 2011), <http://abcnews.go.com/Business/online-peer-peer-loans-benefit-borrowers-lenders/story?id=12547398> (quoting LendingClub CEO and co-founder Renaud Laplanche’s explanation that “[i]f you compound [Lending Club’s] growth rate, [they]’ll be the size of Citibank in three years”); Press Release, Zopa, *Zopa Lending Passes £100 Million Milestone* (Sept. 30, 2010) (available at <http://uk.zopa.com/ApplicationResources/press/2010/Zopa%20lending%20passes%20100%20million%20milestone.pdf>) (stating that one UK P2P firm currently accounts for more than 1% of all UK consumer credit transactions).

promises to transacting parties.⁴ Who will police this burgeoning market and under what regulatory scheme?

The U.S. Securities and Exchange Commission ("SEC") currently asserts itself as the chief regulator over P2P lending and requires P2P lending firms to register as issuers under the Securities Acts.⁵ This Article argues that the SEC fundamentally misunderstands this innovative industry of P2P lending. As a result of the SEC's inability to grasp the true nature of P2P finance, the SEC overreaches its authority and threatens the very existence of P2P marketplaces. Thus, SEC oversight increases both risk for P2P lenders and cost for P2P borrowers.⁶

This Article begins in Part I by introducing P2P lending and demonstrating that P2P transactions provide a core economic function worth preserving. Consumers, and the financial system, as a whole, benefit from P2P lending. Part I also presents risks associated with P2P lending, such as fraud and identity theft, that require sensible regulation.⁷

Part II traces the SEC's involvement in the P2P lending market. The SEC approached P2P regulation under the ill-fit vocabulary and logic of the traditional investor and issuer.⁸ This misapplication led the SEC to conclude that P2P transactions must register under the Securities Acts.⁹ Operating under the wrong assumptions and the wrong regime, the SEC forced P2P online lending firms to offer even riskier assets. Imposing the securities regime on the P2P lending market also discourages competition by raising costs, and leaves consumer complaints unanswered.¹⁰ Part II also analyzes the SEC's response to P2P lending,¹¹ assesses the SEC's role in the twenty-first century, and questions why the SEC was unable or unwilling to fashion a nuanced response to P2P lending. The analysis suggests that the SEC's failure

⁴ By "platform," I refer to the various internet sites providing access to P2P lending services.

⁵ The securities laws require issuers of securities to disclose certain information to investors through the prospectus, a legal offering document, and through periodic filing with the SEC. Securities Act of 1933 §§ 6, 7, 10, 15 U.S.C. § 77(f)-(g), (j) (2006); Securities Exchange Act of 1934 §§ 12-13, 15 U.S.C. § 78(l)-(m) (2006).

⁶ See *infra* Part II.B.

⁷ See *infra* Part I.

⁸ It is not wrong to refer to P2P lenders as "investors," a term this article, too, uses. Rather, the language of investment led the SEC to apply the wrong regulatory framework to the putative issuer. See *infra* Part II.

⁹ See *infra* Part II.A.

¹⁰ See *infra* Part II.B.

¹¹ See *infra* Part II.C.

may be part of a general trend of regulatory discomfort with a rising trend of disintermediation.¹²

Part III recommends naming the Consumer Financial Protection Bureau as the primary regulator of P2P lending. Efficient and effective regulation must fit the industry and its users.¹³ Thus, a newly formed Consumer Financial Protection Bureau would be well-suited to preserve and discipline the innovative mix of social finance, micro-lending and disintermediation that the P2P marketplace offers to consumers.

This Article is especially timely. Through the Dodd-Frank Act, Congress mandated the Government Accountability Office (“GAO”) to study P2P lending and suggest its optimal regulatory regime.¹⁴ The GAO released its proposal on July 7, 2011,¹⁵ which analyzes the P2P market and evaluates two rival regulatory approaches for Congress to consider: a modified version of the status quo, or a transition to a new regulatory regime parallel to the recommendations in Part III.¹⁶ Given the sometimes lumbering nature of our legislative system, Congress’s response to the GAO report represents its last P2P lending examination for a long time. Accordingly, it is important to evaluate and critique P2P lending while policy change remains eminently possible.¹⁷

¹² For many scholars, disintermediation no doubt calls to mind the capital flights from traditional intermediaries in previous decades due to statutory caps on depository interest rates. *E.g.*, Samuel B. Chase, Jr., *Financial Structure and Regulation: Some Knotty Problems*, 26 J. FIN. 585, 587-88 (1971). Instead, I use the term more generally. *Cf.* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 200 (2008) (“[D]isintermediation – or enabling companies to access the ultimate source of funds, the capital markets, without going through banks or other financial intermediaries . . .”).

¹³ See John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don’t Work in Mutual Funds*, 120 YALE L.J. 84, 90-91, 131-40 (2010) (arguing that mutual funds should be regulated through product regulation rather than disclosure and litigation regime).

¹⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989F(a)(1), 124 Stat. 1376, 1947 (2010) (“The Comptroller General of the United States shall conduct a study of person to person lending to determine the optimal Federal regulatory structure.”).

¹⁵ U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-11-613, PERSON-TO-PERSON LENDING: NEW REGULATORY CHALLENGES COULD EMERGE AS THE INDUSTRY GROWS (2011) [hereinafter GAO-11-613 PERSON-TO-PERSON LENDING], available at <http://www.gao.gov/new.items/d11613.pdf>.

¹⁶ *Id.* at 42-56.

¹⁷ Indeed, a bill has just been introduced to Congress that would seem to respond to inefficiencies in P2P lending. *See, e.g.*, Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (2011). Though a step in the right direction, I argue in a

In addition to the GAO study, the government's treatment of P2P lending will serve as a model around the world as a dozen of other nations examine their P2P lending policy. New Zealand is currently debating how to adapt its P2P lending laws to render the industry viable.¹⁸ England is abolishing its primary financial regulator, and its P2P lending industry is clamoring to have a voice in the next regulatory structure.¹⁹ Even China is home to a wild new P2P lending industry that will eventually require more thorough legal authorization.²⁰ Moreover, a rational regulatory landscape in the United States will substantially impact microfinance institution ("MFI") partner organizations of international P2P firms.²¹

Increasingly, scholars have turned their attention to P2P lending.²² By providing a focused analytic treatment of the economics of P2P

forthcoming article that this bill is inadequate.

¹⁸ See MINISTRY OF ECON. DEV., REVIEW OF SECURITIES LAW 19, 25-26 (2010), available at <http://www.med.govt.nz/upload/73375/discussion-document.pdf>.

¹⁹ See Sean Farrell, *Zopa Calls on Government and FSA to Regulate Social Lending Sector*, THE TELEGRAPH (Sept. 20, 2010, 7:00 AM GMT), <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8012269/Zopa-calls-on-Government-and-FSA-to-regulate-social-lending-sector.html>; Gonzalo Vina, *U.K. Scraps FSA in Biggest Bank Overhaul Since 1997*, BLOOMBERG (June 17, 2010, 4:22 PM), <http://www.bloomberg.com/news/2010-06-16/u-k-scraps-fsa-in-biggest-bank-regulation-overhaul-since-1997.html>.

²⁰ Though fast-growing, Chinese P2P platforms operate with tenuous legality. One P2P CEO in China admitted that Chinese lending law, which restricts lending to financial institutions, probably disallows P2P companies. However, he had received assurances from Chinese officials that his business would be tolerated as long as it served a socially valuable end. Interview with anonymous CEO (Nov. 27, 2009). How long platforms can operate without specific legal authorization is not clear. Until then, the market is hot: among the world's largest P2P by volume is CreditEase, a young company in China. Shen Hu, *China's Brave New World of P2P Credit: Online, Offline Lending Platforms Skirt Rules, Raising New Questions*, CAIXIN ONLINE (Sept. 18, 2011, 8:09 PM EDT), <http://www.marketwatch.com/story/chinas-brave-new-world-of-p2p-credit-2011-09-18>; cf. *Fairplace Faces Investigation by Federal Police*, P2P-BANKING.COM (Dec. 27, 2010, 6:50 AM), <http://www.wiseclerk.com/group-news/countries/latinamerica-fairplace-faces-investigation-by-federal-police/> (describing Brazil's shutdown and investigation of its first P2P platform because law only permits financial institutions to make loans).

²¹ See Raj. M. Desai & Homi Kharas, *Democratizing Foreign Aid: Online Philanthropy and International Development Assistance*, 42 N.Y.U. J. INT'L L. & POL. 1111, 1142 (2010) (discussing problems MFI partners face in interfacing with donor P2P and using money on ground); Anna Gelpern & Kevin E. Davis, *Peer-to-Peer Financing for Development: Regulating the Intermediaries*, 42 N.Y.U. J. INT'L L. & POL. 1209, 1216-17 (2010).

²² See generally Desai & Kharas, *supra* note 21 (addressing concerns with current regulation of peer-to-peer intermediaries engaged in cross-border transactions); Gelpern & Davis, *supra* note 21 (identifying problems MFI partners face in interfacing with donor P2P and using money on ground); Sarah B. Lawsky, *Money for Nothing: Charitable Deductions for Microfinance Lenders*, 61 SMU L. REV. 1525 (2008)

firms and federal regulation of P2P, this Article joins and redirects the conversation toward current policy issues.²³ Building on prior scholarship, and informed by policy considerations in the United States and abroad, this Article suggests concrete strategies for policy makers and provokes further question for dialogue among scholars.

I. PERSON-TO-PERSON LENDING

A. *The Heartland of Person-to-Person Lending*

Financial intermediaries, such as banks, help bridge the gap between suppliers and users of capital.²⁴ All lending faces certain challenges and transaction costs. Borrowers often require money for a longer period of time than that for which ordinary lenders wish to lend.²⁵ Moreover, it is expensive for each lender to vet and monitor each borrower, unless the lender dedicates a particularly large amount of capital to that borrower. Lending such a large amount, however, provides too little diversification — particularly for risk-averse lenders.²⁶ Intermediaries help solve these problems.

(discussing tax treatment of P2P loans from lenders' perspectives).

²³ Chaffee and Rapp have responded to this Article in their own very fine article, which critiques some of my conclusions and provides sustained analysis of state P2P regulation — a matter receiving less attention in this Article. Eric C. Chaffee & Geoffrey C. Rapp, *Regulating On-line Peer-to-Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry*, 69 WASH. & LEE L. REV. (forthcoming 2012) (manuscript at 25-30, 35). For both space and publication timing reasons, is not feasible for me to respond to their argument in this Article. Suffice it to say that, notwithstanding their lucid discussion, from which I have benefited, I have not been persuaded. See also C. Stephen Bradford, *Crowdfunding and the Federal Securities Laws*, COLUM. BUS. L. REV. (forthcoming 2011) (manuscript at 7, 14-15, 22-24, 26, 28, 34, 67, 84), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1916184 (citing this Article to respond to its analysis).

²⁴ See Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 8 (2010) (“In a frictionless world, the financial markets would allocate the kinds and amounts of capital that businesses require, without the assistance (or cost) of an intermediary.”).

²⁵ See Bruce D. Smith, *Taking Intermediation Seriously*, 35 J. MONEY, CREDIT & BANKING, 1319, 1321-22 (2003) (stating that a bank's primary role is providing liquidity); Richard J. Herring & Anthony M. Santomero, *What is Optimal Financial Regulation?*, 13-14 (Wharton Fin. Insts. Ctr., Working Paper No. 00-34, 1999), available at <http://fic.wharton.upenn.edu/fic/papers/00/0034.pdf> (addressing bank's roles and vulnerabilities in relation to asset and maturity transformation).

²⁶ See Bert Scholtens & Dick van Wensveen, *A Critique on the Theory of Financial Intermediation*, 24 J. BANKING & FIN. 1243, 1247-48 (2000) (explaining that managing risk is “the bread and butter of financial intermediaries”).

P2P financial companies assist borrowers and lenders to effect financial transactions without employing a traditional intermediary.²⁷ While users must rely on a P2P platform to facilitate lender-borrower connections, lenders ultimately finance borrowers without banks interposing their own credit risks and guarantees. Thus, P2P lending hints at a world with the benefits of intermediation but none of the costs.

This Article focuses on the dominant form of P2P lending: unsecured consumer loans brokered between strangers by an Internet platform. This “heartland” of P2P lending remains the most developed P2P market and the largest form of P2P lending by transaction volume.²⁸ It is also the form of P2P lending under the most immediate scrutiny as well as the primary subject of the 2011 GAO study.²⁹

This Article specifically considers two P2P lending companies, Prosper Marketplace, Inc. (“Prosper”) and LendingClub Corporation (“Lending Club”), that dominate the heartland of P2P lending in America.³⁰ These platforms currently offer very similar services, so this Article discusses them together, comparing and contrasting their operations.

In P2P lending, individual borrowers may request loan amounts up to \$25,000, while individual lenders may acquire interests in a loan of as little as \$25. The typical P2P borrower will, thus, borrow from many lenders, and the typical P2P lender will hold interests in hundreds of borrowers. In other words, P2P lenders have a wide portfolio of loans. Most P2P loans include three-year terms with no

²⁷ In emphasizing disintermediation, this Article addresses social lending and microfinance only indirectly. Readers who come to this paper with special interest in these issues should examine Appendix A, which treats these issues in detail.

²⁸ Prosper and Lending Club, in the heartland as I have defined it, have loaned substantially more money than Kiva, which is not in the heartland. See sources cited *supra* note 1. Virgin Money, a large platform outside of the heartland, is no longer doing business. Sara Lepro, *Virgin Money Closes Shop in the U.S., Victim of Bad Timing*, U.S. BANKER (Dec. 2010), <http://www.americanbanker.com/bulletins/-1029613-1.html>.

²⁹ Although shining the spotlight on Kiva, too, the study clearly follows the for-profit platforms in greater detail. GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 7-14 (beginning platform discussion with Lending Club and Prosper and discussing them more than all other platforms combined).

³⁰ *Company Overview*, PROSPER, www.prosper.com/about/ (last visited Sept. 25, 2011) (advertising personal loans and online investing through “the world’s largest peer-to-peer lending marketplace”); *Earn Steady Returns*, LENDING CLUB, <http://www.lendingclub.com/public/steady-returns.action> (last visited Oct. 26, 2011) (stating one can “[e]arn [s]teady [r]eturns” through “a consumer loan origination and investment platform” that has “originated nearly \$360,000,000 loans to prime credit borrowers”).

prepayment penalty, but some loans have terms as short as one year or as long as five years.³¹

P2P borrowers are vetted twice before receiving P2P loans: first by the platform, and then by the lenders. The platforms perform traditional underwriting activities, such as evaluating credit history and ability to repay, to determine which borrowers may request loans. Lending Club traditionally accepts fewer than 10% of all loan applicants.³² Prosper, on the contrary, initially allowed most potential borrowers to request funds, trusting lenders to reject most of the risky borrowers.³³ Now, Prosper's culling is essentially as selective as Lending Club. Today the minimum FICO score for new borrowers on Prosper and Lending Club is 640 and 660, respectively, evidencing Prosper's increasingly stringent lending criteria.³⁴

Once a platform accepts a borrower, it uses its own underwriting algorithm to assign a credit classification to borrowers based on available credit and employment information. Then, the platform attempts to estimate for lenders the losses due to default for a given class of borrowers. The borrowers then are permitted to provide

³¹ Since June, 2007, Lending Club has facilitated 28,575 three-year loans and 9,365 five-year loans. *Lending Club Statistics*, LENDING CLUB, <https://www.lendingclub.com/info/download-data.action?file=LoanStats.csv> (last visited Oct. 26, 2011).

³² *Lending Club Statistics*, LENDING CLUB, <https://www.lendingclub.com/info/statistics.action> (last visited Sept. 25, 2011) (showing over \$366 million, or 35,333 loans, accepted and over \$4 billion, or 352,374 loans, rejected).

³³ See Kirk Inglis, *Quality Loan Listings on Prosper.com*, PROSPER BLOG (Aug. 11, 2009), <http://blog.prosper.com/2009/08/11/quality-loan-listings-on-prospercom/> (explaining that Prosper's prior minimum FICO score was 520). Compare JOE RYAN, KATYA REUK & CHARLES WANG, STANFORD GRADUATE SCH. OF BUS., *TO FUND OR NOT TO FUND: DETERMINANTS OF LOAN FUNDABILITY IN THE PROSPER.COM MARKETPLACE 5* (2007), available at http://www.prosper.com/Downloads/Research/Prosper_Regression_Project-Fundability_Study.pdf (finding in an early study of Prosper that only 9% of loans are fully funded, meaning that full 91% of loans accepted by the platform are rejected by its lenders), with *Prosper Listing Summary: September 2011*, LENDINGSTATS.COM, <http://www.lendstats.com/loansum/loansum.php?mo=09&yr=11> (last visited Nov. 11, 2011) (indicating more than half of Prosper loans funded in September of 2011).

³⁴ See Inglis, *supra* note 33; *Peer-to-Peer Lending — How It Works*, LENDING CLUB BLOG, <http://blog.lendingclub.com/how-peer-to-peer-lending-works/> (last visited Sept. 25, 2011). See generally *Credit Basics*, MYFICO, <http://www.myfico.com/CreditEducation/WhatsInYourScore.aspx> (last visited Sept. 25, 2011) (explaining factors considered when determining FICO score). These are, essentially, prime borrowers. Although there is no authoritative definition of subprime, scores below 640 are often taken to indicate "subprime" borrowers. See, e.g., *Fair Isaac Defines Subprime As, Generally, Less Than 640 FICO Score*, THE CREDIT SCORING SITE, available at <http://www.creditscoring.com/influence/industry/fairisaac/subprime-FICO-640.htm> (citing Fair Isaac CEO Mark Greene in a CNBC interview on February 26, 2009, as defining subprime population as "generally, a FICO score of less than 640. . .").

unverified, narrative information to accompany their loan requests. They may even include information intended to make them more sympathetic.³⁵ Loans no longer include a photo of borrowers, but borrowers may still personalize a “member page” if they wish to provide more personal information to lenders.³⁶

Selecting among these potential borrowers, lenders can browse loan requests individually, or they can purchase from a bundle of loans selected by the platform on the basis of the lenders’ expressed selection criteria.³⁷ While lenders decide where to invest, they may keep cash in accounts that the platforms provide through a partner bank. These platform-provided accounts are also where borrower payments to lenders are deposited. Although FDIC insured, these accounts pay no interest on the balance. Thus, lenders who neglect to timely reinvest or who withdraw from their accounts can receive substantially lower real returns.³⁸

Borrowers pay an average of 20.6% interest rates using Prosper and 11.4% using Lending Club.³⁹ Lenders receive that interest as profit, less the platform’s fee. Platforms generate revenue by charging fees to both borrowers and lenders. First, platforms charge the borrower an origination fee for each loan executed. Second, platforms charge the lender an annual servicing fee as a percentage of principal outstanding. Currently, Prosper charges borrowers a 0.5–4.5%

³⁵ Prosper Marketplace Inc., Prospectus (Form 424/b/3) (Dec. 29, 2010), available at http://www.sec.gov/Archives/edgar/data/1416265/000141626510000576/listing_20101229-0921.htm (“I returned to the US in July after finishing 2 years of volunteer service.”).

³⁶ Borrower photos and narrative information led to substantial interest — voyeuristic, or otherwise — in online lender communities. See, e.g., *Photos That Make You Bid (or Cry, or Barf)*, PROSPERS.ORG, http://www.prospers.org/forum/photos_that_make_you_bid_or_cry_or_barf-t1139.1845.html (last visited Oct. 26, 2011) (discussing and sharing photos of Prosper borrowers).

³⁷ *Building a Portfolio*, LENDINGCLUB, <http://www.lendingclub.com/public/build-portfolio.action> (last visited Nov. 6, 2011) (stating that LendingClub has three default investment allocation plans); *Quick Invest*, PROSPER, <http://www.prosper.com/invest/quick-invest.aspx> (last visited Nov. 12, 2011) (explaining Prosper’s “Quick Invest” option, which invests based on features such as credit risk or loan duration).

³⁸ A simplified example may clarify: \$1000 invested for three years at 9% interest and compounded annually with reinvestment of the interest at the same rate will yield a nominal gain of \$295.03. The same investment without reinvestment of interest payments will pay \$270. This is equivalent to investing at only 8.3% with reinvestment. In other words, failure to invest the interest payments has cost this user almost 10% of her nominal gain from investing. The difference would be even greater for a fully amortized loan, as P2P loans are, because principal would also need to be reinvested.

³⁹ GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 9. Different rates may reflect Prosper’s lower FICO score requirement.

origination fee (increasing with credit risk) and lenders an annual fee based on 1% of principal.⁴⁰ Similarly, Lending Club charges 1.11–5.00% at origination and 1% of all amounts borrowers pay.⁴¹ This spread between what borrowers pay and what lenders receive is relatively narrow, underscoring the potential cost savings implicit in P2P lending. Both sites are proud to point out their low fees as they ask customers to compare the implicit spread between what banks pay on certificates of deposit and what banks receive in mortgage and credit card payments.⁴²

Such comparisons can be misleading, however. Bank deposits are far more liquid than P2P assets. P2P notes may only be sold to other lenders through one specific broker-dealer, FOLIOfn. Further, the notes may sell for a discount or premium and the sales incur a fee. If buyers are not available at an appropriate price, P2P lenders have no alternative but to wait out the duration of the loan. P2P loans are also less safe than bank deposits or CDs. Because P2P lenders' interests are unsecured and uninsured, lenders rely on borrowers to repay loan amounts. Borrowers' incentives to repay P2P loans are similar to incentives for other unsecured credit sources. For example, people repay their credit card company to avoid unpleasant debt collection, preserve their credit rating, quell a general sense of obligation, and perhaps for other reasons as well.

If P2P borrowers default, platforms may attempt to collect payments directly from borrowers or may assign unpaid obligations to collection agencies. Platforms are motivated to pursue borrower payments by contractual obligations, desires to preserve reputation, and interests in continuing to collect fees from the borrower. However, successful collections are rare. Lenders often do not to recover their entire investments.⁴³ "Because P2P loans are relatively small sums, most

⁴⁰ *Fees and Charges*, PROSPER, <http://www.prosper.com/loans/rates-and-fees/> (last visited Oct. 30, 2011).

⁴¹ *Rates and Fees*, LENDING CLUB, <http://www.lendingclub.com/public/rates-and-fees.action> (last visited Sept. 25, 2011). Note that a 1% annual fee on principal is different from a 1% servicing fee on all payments made. Which is bigger will depend on loan characteristics.

⁴² Even the GAO Report compares P2P returns to bank products, perpetuating a sense of similarity. GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 9 ("As of March 31, 2011, Prosper reported that lenders received average net annualized returns exceeding 11 percent Around the same time, the annual percentage yields for savings and money market accounts and 3-year certificates of deposit listed on bankrate.com were lower, ranging from 0.1 percent to 1.2 percent and 1.3 percent to 2.2 percent respectively.").

⁴³ See e.g., LendingClub Corp., Annual Report (Form 10-K) F-9 to -10 (June 29, 2011) [hereinafter LendingClub Annual Report (June 29, 2011)], *available at*

collection mechanisms simply are not sufficiently cost-effective to justify enforcement, especially because defunct borrowers rarely have significant assets to collect.” Therefore, lenders hope that a sufficient number of borrowers repay their loans to offset any losses from defaulting borrowers.

The foregoing discussion concerned the operations of Prosper and Lending Club, but the P2P universe extends far beyond the bounds of these large platforms.⁴⁴ It includes a diversity of other platforms, both foreign and domestic. Some platforms choose a specific focus, specializing in transactions as varied as real estate financing,⁴⁵ venture capital,⁴⁶ business-to-business,⁴⁷ or consumer-to-consumer loans for transactions such as eBay purchases.⁴⁸ Some of these other platforms do not pay interest to their lenders,⁴⁹ or pay only small interest amounts.⁵⁰ Kiva is the most famous zero-interest platform, providing

<https://www.lendingclub.com/extdata/secFilings/10-K/10-K-MAR-31-2011.pdf> (stating that for year ending March 31, 2010, Lending Club charged off as uncollectable loans about \$1.7 million); see also *Lending Club Statistics*, LENDING CLUB, <https://www.lendingclub.com/info/statistics-performance.action> (last visited Sept. 25, 2011) (stating that of loans which had missed a payment in August 2010, 17% were completely unrecovered in February 2011, and 83% were fully or partially recovered).

⁴⁴ Lately, scholars and policymakers have turned their attention to crowdfunding. See generally, Thomas Lee Hazen, *Crowdfunding, Social Networks, and the Securities Laws – The Inadvisability of a Specially Tailored Exemption Without Imposing Affirmative Disclosure Requirements*, U.N.C.L. REV. (forthcoming). Common usage suggests that crowdfunding refers to disintermediated financing for the benefit of enterprises, with compensation tending to come as either some share of profits or else some in-kind payment, such as the product the enterprise produces.

⁴⁵ *About Money360*, MONEY360, <http://www.money360.com/about-money360.aspx> (last visited Sept. 25, 2011).

⁴⁶ MICROVENTURES, <http://www.microventures.com/> (last visited Sept. 25, 2011).

⁴⁷ *About Us*, FUNDING CIRCLE, <http://www.fundingcircle.com/home/about-us/> (last visited Oct. 25, 2011) (stating that Funding Circle is “an online marketplace where people can lend directly to small businesses in the UK, eliminating the high cost and complexity of banks”); *Testimonials*, MYASIMIA.ORG, <http://www.myazimia.org/testimonials> (last visited Sept. 25, 2011) (selling P2P functionality software to B-2-B lenders, such as Peervestors).

⁴⁸ See, e.g., *About Us*, DUCK9.COM, <http://www.duck9.com/about-us.htm> (last visited Nov. 6, 2011) (stating that Duck9 platform allows student peer-to-peer lending).

⁴⁹ See e.g., KIVA, <http://www.kiva.org/about> (last visited Sept. 25, 2011) (“Kiva does not charge interest to [its] Field Partners, who administer the loans.”).

⁵⁰ See e.g., MICROPLACE, <https://www.microplace.com/howitworks/faq> (last visited Sept. 25, 2011) (indicating that lenders can earn interest on money invested); MYC4, http://www.myc4.com/Invest/AboutInvesting#DETERMINE_MY_IR (last visited Sept. 25, 2011) (explaining that interest rate is based on Dutch Auction principle).

microloans to entrepreneurs in the developing world.⁵¹ At the other extreme, some platforms reach not across an ocean, but across the living room; these platforms formalize the loans that friends and family would make to one another anyway.⁵² Though P2P lending includes a variety of platforms, this Article focuses on the heartland of P2p: Prosper and Lending Club.

B. *Core Benefits and Efficiencies of P2P Lending*

Many P2P platforms market themselves on their ability to save money by cutting out the middleman. By eliminating the intermediating bank, they can offer low rates for borrowers and high returns for lenders.⁵³ Eliminating a middleman can be prudent or imprudent, however, depending on whether the middleman provides services that are valuable to lenders or borrowers. Saving costs of bank vetting, however, is no bargain if default rates rise precipitously — the costs of which will be borne by lenders and borrowers.

Further, middleman services may be useful to some borrowers, but not to others. P2P platforms decrease the costs of extending credit by unbundling any unnecessary or unwanted services that are associated with traditional intermediaries. For example, P2P platforms operate without a physical location. Not all borrowers have the same need for convenience that in-person physical lenders provide. Brick-and-mortar banks are useful to some customers, but others are happy to conduct most of their business electronically.⁵⁴ Since P2P platforms have no physical location, they cut out the costs of employing a teller and paying overhead expenses to maintain a physical location. Conversely, payday-loan companies offer accessible in-person services at a physical location with actual business hours. Retaining a physical location and operating hours are costly services to provide, and those costs are likely to be borne largely by borrowers who use them. Though some

⁵¹ But see Leena Rao, *Kiva Brings Microlending Home to U.S. Entrepreneurs in Need*, TECHCRUNCH (June 10, 2009), <http://techcrunch.com/2009/06/10/kiva-brings-microlending-home-to-us-entrepreneurs-in-need/> (last visited Sept. 25, 2011) (stating that Kiva recently expanded its scope to include entrepreneurs in United States).

⁵² See, e.g., ZIMPLEMONEY, <http://www.zimplemoney.com/Family-Friend-Loan.aspx> (last visited Sept. 25, 2011) (providing documentation and payment services).

⁵³ ZOPA, <http://uk.zopa.com/ZopaWeb/> (last visited Mar. 18, 2011) (“This is where people get together to lend and borrow money directly with each other, sidestepping the banks for a better deal. Everyone wins except the fat cats.”).

⁵⁴ ABA Survey: *Consumers Prefer Online Banking*, AM. BANKERS ASS’N (Sept. 21, 2009), <http://www.aba.com/Press+Room/092109ConsumerSurveyPBM.htm> (stating that majority of consumers prefer to bank online, but consumers age 55 or older prefer going to their local branch).

borrowers value these features, others may primarily focus on obtaining a loan at the best possible price. Those borrowers who do not need the benefits of in-person services can enjoy substantial savings by choosing a web-based system like P2P lending.

Similarly, credit card companies provide bundled transactions services and lines of credit to their users.⁵⁵ Like maintaining physical bank locations, offering credit card services is costly. Credit card users likely bear these cost such that P2P lending may appeal to users for whom the costs of transactions services and credit lines outweigh the benefits. By contrast, P2P platforms have no physical location, provide no transactional services, extend no lines of credit, and therefore need not pass such costs on to their users. The majority of P2P borrowers are refinancing other, more costly, debts.⁵⁶ They are signaling that they can do without the benefits of brick-and-mortar banks and payday loans, as well as the convenience of a credit card, in exchange for a lower rate with P2P lending.⁵⁷

There is one middleman, in particular, that lenders and borrowers can comfortably eliminate to ensure substantial savings in almost any transaction: the government regulator. Banking regulations mandate a ratio of a bank's deposits that must be held as reserves.⁵⁸ These reserves must be allocated to safe, liquid assets rather than reinvestment. When a bank borrows one dollar subject to reserve

⁵⁵ Todd J. Zywicki, *Bankruptcy Symposium: The Economics of Credit Cards*, 3 CHAP. L. REV. 79, 83 (2000) (arguing that "credit cards perform two functions" a transactional medium, substituting for cash or checks, and credit, substituting for pawn shops and the like).

⁵⁶ LendingClub Corp., Registration Statement (Form S-1) 31 (Jan. 4, 2011), available at https://www.lendingclub.com/extdata/Clean_As_Filed_20110107.pdf (stating that 64% of borrowers intend to refinance other debts); Prosper Marketplace, Inc., Prospectus (Form 424/b/3) 59 (Mar. 4, 2011), available at http://www.prosper.com/downloads/Legal/Prosper_Prospectus_2011_03_04.pdf (stating that 47% of borrowers intend debt consolidation). P2P loans are not cheap. Borrowers pay an average of 20.6% on Prosper and 11.4% on LendingClub, respectively. See GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 9. However, they can be cheaper than cash advances, payday loans, and bounced checks.

⁵⁷ Carolyn Bigda, *Peer-to-Peer Loans Gaining Interest From Regulators*, CHI. TRIB., Feb. 18, 2011, http://articles.chicagotribune.com/2011-02-18/business/sc-cons-0217-started-20110218_1_loans-borrowers-renaud-laplanche (identifying P2P interest rates as about two percentiles lower than credit card rates and quoting Lending Club CEO Renaud Laplanche: "The main reason that consumers use our platform is for debt replacement They're replacing a credit card balance, a revolving debt that amortizes over a very long time, with an installment loan that gets paid off in three or five years").

⁵⁸ 12 C.F.R. § 204.4 (2011) (stating that large banks must set aside \$1,443,000 plus 10% of demand deposits for reserves).

requirements, it pays interest on that full dollar, but can earn appreciable interest on less than that full dollar. As such, banking regulation requirements ultimately function as a regulatory tax.⁵⁹ P2P platforms, however, can avoid these costs.

P2P finance achieves a substantial part of its cost advantage over other forms of lending by way of regulatory savings.⁶⁰ P2P platforms essentially sell securitized assets to lenders, making loans and promptly selling them to lenders who have committed to buying them. The platforms make loans without deposits and are not subject to the capital or reserve requirements mandated for banks. Thus, P2P lenders can lend at a lower relative cost.⁶¹ Operating leanly, platforms can bring a high portion of revenue back to lenders as interest, adding to P2P's appeal as an investment method.

⁵⁹ See, e.g., Eugene F. Fama, *What's Different About Banks?*, 15 J. MONETARY & ECON. 29, 29 (1985) ("The banking literature treats the interests foregone on reserves as a tax on deposits."); Christopher James, *Some Evidence on the Uniqueness of Bank Loans*, 19 J. FIN. ECON. 217, 221 (1987) (arguing that reserve requirement functions as a tax that is born by depositors). See generally Fischer Black, *Bank Funds Management in an Efficient Market*, 2 J. FIN. ECON. 323, 334 (1975) ("The economic function of reserve requirements in the current system, I believe, is simply to tax demand deposits."). Banks seeking relief from regulatory costs may resort to securitizing their assets by trimming loans from their balance sheets. This allows banks to lend large amounts without growing their deposits.

⁶⁰ Many scholars have condemned regulatory arbitrage, where actors achieve substantively similar results but in a way that does not trigger costly regulation. See, e.g., Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1661-67 (2008) (arguing that although bank loans and standby letters of credit expose banks to similar credit risks, the Office of the Comptroller of the Currency ("OCC") treated standby letters of credit to the more favorable regulatory treatment of regular letters of credit. In this way, the OCC created a profitable regulatory arbitrage for banks to issue standby letters of credit rather than make loans). Others have praised regulatory arbitrage. See MERTON H. MILLER, *MERTON MILLER ON DERIVATIVES* 6 (1997); James C. Spindler, *The Going-Private Phenomenon: How Private Is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 311, 312 (2009). There is no need to resolve this debate comprehensively, as P2P regulation avoidance comes with risk reduction. The regulatory costs associated with deposit taking tracks the systemic risks of deposits. Insofar as P2P profits by funding without those risks and costs, it has responded to a Pigouvian tax. See generally William J. Baumol, *On Taxation and the Control of Externalities*, 62 AM. ECON. REV. 307 (1972) (arguing that Pigouvian taxes on the producers of an externality are all that is required to motivate efficient production).

⁶¹ See Telephone Interview with Giles Andrews, CEO, Zopa (Oct. 12, 2010); see also James Alexander, Zopa Co-Founder, *on Peer to Peer Lending*, P2P-BANKING.COM (Aug. 27, 2007, 8:17 AM), <http://intruders.tv/en-tech/james-alexander-zopa-co-founder-on-peer-to-peer-lending/> (citing the capital cost of regulation as important opportunity for exchange and its clients). Of course they are subject to costly securities regulation. But see *infra* Part II.B.

However, investors are not solely concerned with investment returns. Investors also care about risk. P2P lending is a lending option that promises to reduce the risk in lenders' investment portfolios.⁶² Specifically, P2P lending provides access to new credit classes, allowing investors to reduce risk by achieving superior diversification.⁶³ Investors who own a representative share of the total market suffer no idiosyncratic risk and should obtain returns that approximate only their exposure to market risk.⁶⁴ Consumer credit is a new asset class for most investors.⁶⁵ Previously, retail investors' best option for accessing consumer credit involved buying securities from companies engaged in consumer finance transactions.⁶⁶ By providing access to a new asset class, P2P notes bring retail investors closer to risk-reducing diversification.

Lenders are not the only parties who may benefit from a competitive P2P market. P2P lenders often lend to borrowers who would have difficulty obtaining credit through traditional channels. Some borrowers present an attractive but unusual credit profile. As such, traditional lenders who intend to bundle and securitize similar loans may overlook certain borrowers.⁶⁷ P2P lenders, however, have less need for uniformity and may be willing to lend to these overlooked borrowers. Likewise, borrowers who pose a substantial credit risk may be able to find philanthropic lenders through P2P platforms.⁶⁸ Still

⁶² Note that this does not mean that P2P notes are themselves safe investments. See *infra* Part I.C.

⁶³ See generally HARRY MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (1959) (explaining that portfolio diversification reduces risk).

⁶⁴ BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET, IN FOUNDATIONS OF CORPORATE LAW 35-36 (1999); see generally MARKOWITZ, *supra* note 63 (discussing how portfolio diversification reduces risk).

⁶⁵ See GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 18 ("[Lenders can] diversify their portfolios by investing in consumer and commercial (i.e., small business) loans as an alternative asset class to stocks or mutual funds.").

⁶⁶ Alternatively, a consumer could obtain a lending license and enter the business herself. The investment in such regulatory capital would rarely be justified. However, more sophisticated investors, could buy securitized consumer financial assets, such as auto-loan backed securities. But even sophisticated investors often lacked access to many unconventional borrowers. See Ian Galloway, *Peer-to-Peer Lending and Community Finance*, 21 COMMUNITY INV. 18, 19 (2009).

⁶⁷ See Galloway, *supra* note 66, at 19 ("Unlike commonly traded assets such as mortgage-backed securities (MBS), community development loans tend to be unconventional and difficult to pool. The capital markets value standardized, predictable assets and community development loans tend to be neither.").

⁶⁸ Of course, some borrowers may lend to bad candidates and later rationalize their motives.

other borrowers have access to alternative forms of credit, but opt to use P2P to refinance at a better price, thereby sharing in the surplus created by cutting out middlemen.⁶⁹ Currently a plurality of P2P borrowers uses loans to replace existing consumer credit at a lower rate.⁷⁰ Overall, a competitive P2P market provides opportunities for a variety of borrower types.

Robust competition generally benefits consumers by lowering prices and encouraging innovation.⁷¹ Further, evidence suggests that consumer credit is an area where increased competition is particularly desirable.⁷² Many scholars argue that there are systematic failures of competition in mainstream consumer credit, particularly with respect to credit card⁷³ and payday lenders.⁷⁴ Regardless of whether borrowers

⁶⁹ See *infra* Part I.B (discussing core benefits).

⁷⁰ See sources cited *supra* note 56.

⁷¹ See generally JOHN H. SHENEFIELD & IRWIN M. STELZER, *THE ANTITRUST LAWS: A PRIMER* 13 (4th ed. 2001) (explaining objectives of antitrust laws).

⁷² See Felix Salmon, *Chart of the Day, Consumer Credit Edition*, REUTERS BLOG (Sept. 22, 2010, 10:14 AM) <http://blogs.reuters.com/felix-salmon/2010/09/22/chart-of-the-day-consumer-credit-edition/> (stating that consumer credit rates have not dropped nearly as far as other types of debt since 1981). But see Stijn Claessens, *Competition in the Financial Sector: Overview of Competition Policies*, 10 WORLD BANK RES. OBSERVER 83, 83 (2009) ("The view that competition in financial services is unambiguously good, however, is more naive than is the case in other industries: vigorous rivalry here may not be the best approach."); Stijn Claessens & Luc Laeven, *What Drives Bank Competition? Some International Evidence*, 36 J. MONEY, CREDIT & BANKING 563, 577 (2004) (stating that concentrated banking markets are more competitive, contrary to intuition); M. Peterson & R. Rajan, *The Effect of Credit Market Competition on Lending Relationships*, 110 Q.J. ECON. 407, 407 (1995) (arguing that market power in banking may be beneficial for access to financing); Xavier Vives, *Competition in the Changing World of Banking*, 17 OXFORD REV. ECON. POL'Y 535, 538 (2001) (arguing that competition in financial sector is not always efficient); Daniel Indiviglio, *Why is Consumer Credit Still So Expensive?*, ATLANTIC (Sept. 23, 2010, 12:21 PM), <http://www.theatlantic.com/business/archive/2010/09/why-is-consumer-credit-still-so-expensive/63442/> (arguing that federal data can be interpreted in other ways).

⁷³ See Michael Simkovic, *The Effect of BAPCPA on Credit Card Industry Profits and Prices*, 83 AM. BANKR. L.J. 1, 10 (2009) (stating that credit card interest rates have been climbing and become less transparent, notwithstanding BAPCPA); *id.* at 21 (arguing that competition stymied by difficulty of acquiring consumer information). But see DAVID S. EVANS & RICHARD SCHMALENSEE, *PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING* 251-56 (1999) (refuting the "Myth of Exorbitant Profits"); Zywicki, *supra* note 55, at 99-111 (arguing that credit card pricing is rational).

⁷⁴ See Mark J. Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?* 20 (FDIC Ctr. for Fin. Research, Working Paper No. 2005-09, 2005), available at http://www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP_2005-09_Flannery_Samolyk.pdf (stating that geographic competition does not seem to drive down price, implying monopolistic competition).

benefit overall from the presence of those high-interest lenders,⁷⁵ they certainly benefit from greater market competition.⁷⁶ Innovative financial businesses, especially Internet-based businesses, play an important role in improving competition.⁷⁷ Introducing retail investors into the consumer credit market will increase the quality of competition for borrowers by potentially offering them a better rate than comparable sources of credit.

In addition to financial benefits for lenders and borrowers, P2P finance also promises admirable simplicity and transparency that may

⁷⁵ Cf. Gregory Elliehausen, *Consumers' Use of High-Price Credit Products: Do They Know What They Are Doing?* 27, 33-34 (Networks Fin. Inst. at Ind. State Univ., Working Paper No. 2006-WP-02, 2006), available at <http://www.frbsf.org/community/research/assets/DoHighPriceCreditCustomers.pdf> (stating that payday loan users show deliberation but not problem solving). Compare Paige Marta Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* (Vanderbilt Univ. Law Sch., Working Paper No. 11-13, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266215 (stating that, after two years, payday loans double odds of bankruptcy), and Brian T. Melzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market* 30 (Jan. 3, 2009) (unpublished manuscript) (on file with Northwestern University), available at http://www.kellogg.northwestern.edu/~media/Files/Faculty/Research/melzer_realcosts_01_03_09.ashx (arguing that payday loans worsen hardship), with Adair Morse, *Payday Lenders: Heroes or Villains*, 102 J. FIN. ECON. 28, 37-42 (2011) (stating that existence of payday lenders can reduce emergency-related home foreclosures by about 25% and reduce disaster-induced larcenies), and DONALD. P. MORGAN & MICHAEL R. STRAIN, FED. RESERVE BANK OF NEW YORK STAFF REPORT NO. 309, *PAYDAY HOLIDAY: HOW HOUSEHOLDS FAIR AFTER PAYDAY CREDIT BANS* (Nov. 2007, revised in Feb. 2008) (banning payday lending increases chapter seven bankruptcy, bounced checks, and unfair collections process).

⁷⁶ See Flannery & Samolyk, *supra* note 74, at 22 (“[T]o those who would simply outlaw payday loans, we ask, ‘Where will the people who use the product as intended go to fulfill their financial needs?’”); cf. William Adams, Liran Einav & Jonathan Levin, *Liquidity Constraints and Imperfect Information in Subprime Lending*, 99 AM. ECON. REV. 49 (2009) (arguing that loans compete with higher interest alternatives); Thomas F. Cargill & Jeanne Wendel, *Bank Credit Cards: Consumer Irrationality Versus Market Forces*, 30 J. CONSUMER AFF. 373, 381 (1996) (stating that unless search for better rate “can be conducted quickly, easily, and with little resource cost, consumers may find it more cost effective to use search time to catch a good sale at a supermarket or discount store”).

⁷⁷ See, e.g., Jeffrey R. Brown & Austan Goolsbee, *Does the Internet Make Markets More Competitive?: Evidence from the Life Insurance Industry*, 110 J. POL. ECON. 481, 482 (2002) (finding Internet improved competition and prices in life insurance market); Judith Chevalier & Austan Goolsbee, *Measuring Prices and Price Competition Online: Amazon and BarnesandNoble.com*, 1 QUANTITATIVE MARKET & ECON. 203, 203-05 (2003) (finding high price sensitivity among online buyers); Fiona Scott Morton, Florian Zettelmeyer & Jorge Silva-Risso, *How the Internet Lowers Prices: Evidence from Matched Survey and Automobile Transaction Data*, 43 J. MKTG. RES. 168, 168 (2006) (investigating reasons why internet helps consumers pay less for automobiles).

reduce systemic risk. Many scholars express concern that financial intermediation and securitization increase complexity and opacity in the credit market.⁷⁸ Traditional intermediaries often securitize consumer loans, pooling and dividing them and promising individual tranches to investors. Consequently, traditional consumer loans become opaque and complex, which hinders monitoring of assets and distorts incentives for servicers and originators.⁷⁹ These effects are particularly pronounced in borrower insolvency, where complex assets can inhibit orderly bankruptcy proceedings and impose third party costs.⁸⁰ In a time of financial stress, difficulties valuing or monitoring complex assets may spread from the assets' owner, to their counterparties and beyond.

However, P2P lending platforms promise a simpler, more transparent landscape. They offer only a few standardized contracts, varying only in principal balance, interest rate, and repayment period. Further, all P2P borrowers know to which particular lenders they are liable, and all P2P lenders know which particular borrowers make their payments. If P2P returns fall, lenders know immediately which loans defaulted and can adjust accordingly — either by modifying their portfolio strategy, or exercising some means of exit if ultimately displeased.

P2P lending's simplicity comes with a commitment to transparency. For example, all Lending Club data is available for download, including data from rejected applicants.⁸¹ Similarly, while Prosper's

⁷⁸ See Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 443-51, 443 n.20 (2011) (discussing definitions of systemic risk).

⁷⁹ Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed To Prevent The CDO Meltdown, And How To Fix It*, U. ILL. L. REV. 1359, 1361-63 (2009) (stating that CDO market's "failure in transparency is a classic securities law problem"); Whitehead, *supra* note 24, at 4-6, 29 (arguing that agency costs rise in credit default swaps). But see Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 910 (1986) (stating that securitization allows creditors to specialize in their monitoring).

⁸⁰ See Edward Janger, *The Costs of Liquidity Enhancement: Transparency Cost, Risk Alteration, and Coordination Problems*, 4 BROOK. J. CORP. FIN. & COM. L. 39, 50 (2010); see also Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. 373, 382-83, 398 (2002); cf. Michael A. Heller, *The Boundaries of Private Property*, 108 YALE L.J. 1163, 1197 (1999) (discussing fragmentation of private property into commons with too many users).

⁸¹ See *Lending Club Statistics*, LENDING CLUB, <https://www.lendingclub.com/info/download-data.action> (last visited Sept. 27, 2011). However, an essential kind of transparency is necessarily absent: Lending Club lenders cannot see the underlying borrower data except as it has been obscured to protect privacy. See LENDINGCLUBSTATS.COM, <http://www.lendingclubstats.com/> (last visited Oct. 27, 2011).

data is not fully downloadable,⁸² it is still largely available for developers,⁸³ which makes it useful even for academics without intrinsic interest in P2P lending.⁸⁴ A cottage industry of web services has sprouted to provide analytic tools and data analysis,⁸⁵ enabling investors to determine useful statistics such as the median lender return on investment.⁸⁶

Where data is available, lenders show a remarkable propensity to shoulder the burden of monitoring underlying loan debts. Web forums and message boards are replete with the adventures of P2P lender *qua* detective, ferreting out frauds that have been overlooked by the platform.⁸⁷ Consider the matter of Jessica Wolcott, who made national headlines for attempted extortion of \$125,000 from Pepsi Bottling Group Executive Vice President, Gary Wandschneider.⁸⁸ Long before FBI investigators discovered Wolcott's scheme, Prosper lenders uncovered another of Wolcott's plots: to obtain a P2P loan under false pretenses. After reviewing Wolcott's six separate loan applications, lenders discovered inconsistencies that spurred further examination. Though Wolcott eventually obtained a fraudulent loan in her mother's name, lenders quickly identified fraud in her loan application by

(using LendingClub data for a variety of applications).

⁸² Among other things, data regarding secondary sales is difficult to obtain.

⁸³ See e.g., ERIC'S CREDIT COMMUNITY, <http://www.ericccc.com/> (last visited Oct. 25, 2011) (using Prosper data for a variety of applications).

⁸⁴ Christopher Crowe & Rodney Ramcharan, *House Prices and Household Credit Access: Evidence from Prosper.Com* 1-4 (Fed. Reserve Bd., Int'l Monetary Fund (IMF), Working Paper No. 1336579, 2009), available at <http://ssrn.com/abstract=1336579>.

⁸⁵ E.g., ERIC'S CREDIT COMMUNITY, *supra* note 83 (providing loan data, statistics, and blogging community for Prosper); LENDSTATS.COM, <http://www.lendstats.com/> (last visited Oct. 25, 2011) (giving lenders tools and information, including returns on investment data, for Prosper and Lending Club.); *Stats*, LENDINGCLUBSTATS.COM, <http://www.lendingclubstats.com/stats> (last visited Oct. 25, 2011) (providing loan data, statistics, and blogging community for LendingClub).

⁸⁶ See *Lender Return Distribution*, ERIC'S CREDIT COMMUNITY, <http://www.ericccc.com/stats/lender-return-distribution> (last visited Oct. 25, 2011).

⁸⁷ Of course, not all is well in the world of user-generated oversight. Prosper has closed down its once-robust forums, and it used an increasingly heavy hand in moderating comments prior to that point. At the same time, its explanation for the end of such transparency has not always been forthright. See *Prosper "Poofs" User Forums, Explains*, PROSPERS.ORG, http://www.prospers.org/forum/prosper_poofs_user_forums_explains-t10196.30.html (last visited Oct. 25, 2011).

⁸⁸ "Con Artist" Sentenced to Prison Term, PITTSBURGH TRIB.-REV., Dec. 15, 2007, http://www.pittsburghlive.com/x/pittsburghtrib/news/westmoreland/s_542875.html; Gigi Stone, *Philandering Rich Targeted for Extortion*, ABC NEWS (Dec. 1, 2006), <http://abcnews.go.com/US/story?id=2694280&page=1>.

comparing them to materials from her criminal prosecution.⁸⁹ The Wolcott story illustrates P2p lenders going to extraordinary lengths to vet borrowers, either in search of community prestige or out of a sense of satisfaction.⁹⁰ Though extensive investigation of borrowers is rarely rational for lenders in a narrow economic sense, spontaneous monitoring is common for the P2P market.

While traditional securitization creates difficulties upon a party's default, P2P borrower insolvency remains relatively orderly.⁹¹ When a borrower defaults on a P2P loan, all lenders hold equal priority, so a single trustee can represent the lenders collectively. More importantly, platform insolvency does not affect the lenders' interests in the borrowers' loans.⁹² The signature feature of disintermediated lending is that the intermediary does not create a credit risk.⁹³ The platform's insolvency has no legal effect on lender claims against borrowers, whereas creditors of a traditional lending intermediary may not have any direct claim against that intermediary's borrowers. By removing the intermediary, P2P lending considerably reduces the complexity of default and insolvency.

Finally, structural differences between P2P and intermediated lending lessen risk factors for P2P loans relative to those associated with traditional finance. First, FDIC-insured lenders may take excessive risks. These lenders know that they enjoy all of the gains of risky lending, but that the government pays much of the cost if the bank loses its investments. Thus, deposit insurance encourages moral hazard.⁹⁴ P2P lenders are not insured against losses, so they do not

⁸⁹ *A Proper Scam: The Story of Jessica Wolcott*, PROSPER LENDING REVIEW (June 25, 2007, 12:08 PM), <http://prosperlending.blogspot.com/2007/06/prosper-scam-story-of-jessica-wolcott.html> ("According to Jess' mom, at one point she was in Australia to do a photo shoot yet, according to the US attorney, she never had a passport.").

⁹⁰ Cf. Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1288-89 (1999) (discussing investing for social benefit).

⁹¹ Or, rather, it should be easier. The SEC has forced platforms to adopt formats that are every bit as messy in bankruptcy. See *infra* Part II.B.1.

⁹² To be sure, platform insolvency is inconvenient unless platforms have prepared a "living will." See *infra* Part III.

⁹³ That is the "financial alchemy" of securitization. See Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 134 (1994).

⁹⁴ Douglas W. Diamond et al., *Bank Runs, Deposit Insurance, and Liquidity*, 24 FED. RES. BANK OF MINN. Q. REV. 14, 20 (2000). See generally John H. Kareken & Neil Wallace, *Deposit Insurance and Bank Regulation: A Partial-Equilibrium Exposition*, 51 J. BUS. 413 (1978) (pricing deposit insurance); Robert C. Merton, *An Analytic Derivation of the Cost of Deposit Insurance and Loan Guarantees: An Application of Modern Option Pricing Theory*, 1 J. BANK. & FIN. 3 (1977) (considering costs of deposit insurance).

suffer from those perverse incentives. Second, traditional banks offer demand deposits, but lend for a period of years or decades, which creates a risk of maturity mismatch and interest rate risk.⁹⁵ Depositors may demand higher interest rates for their loans or to withdraw their money after the bank has committed funds to long-term projects. Under P2P lending, however, all borrower loans mature at the same time, and at the same interest rate, as their paired lender entitlements, so there is no maturity mismatch maturity considerations do not create the same risk of failure experienced in traditional lending.

Moreover, there is no risk of a traditional bank run on a P2P platform, because lender claims are illiquid with respect to the platform. Specifically, P2P lenders cannot demand their money back from platforms, which eliminates the risk that the platform will fail due to sudden inability to meet liabilities. All of these differences show a model for lending without many of the risks commonly associated with traditional lending. Importantly, traditional banking risks are often thought to create externalities, so containing them likely will have a salutary effect on system stability. Thus, simplicity and transparency are two additional benefits of P2P lending, enjoyed by lenders and borrowers, as well as third parties in the form of stability.

C. *Risks: Lender's Money, Borrower's Privacy*

For all of P2P lending's merits, it also raises serious concerns. P2P lenders often fail to appreciate the risks associated with investment. P2P loans tend to be small and divided amongst many lenders. For example, 96% of Prosper's active lenders invested less than \$5,000, and 67% invested less than \$500.⁹⁶ While large, institutional investors may be able to fend for themselves, the small stakes for individual P2P investors makes it less likely that they have adequately researched or fully understand the risks inherent in P2P investments. Small investors are also particularly susceptible to intentionally misleading. As Professor Langevoort stated, "When you're talking about loans of

⁹⁵ Even solvent banks worry that their depositors might ask for deposits back before their borrowers repay. See John Bryant, *A Model of Reserves, Bank Runs, and Deposit Insurance*, 4 J. BANK. & FIN. 335, 339-43 (1980). See generally IRVING FISHER, *THE PURCHASING POWER OF MONEY: ITS DETERMINATION AND RELATION TO CREDIT, INTEREST AND CRISES* (1911) (describing effect of inflation on, among other things, banks, depositors, and bank runs); MILTON FRIEDMAN & ANNA J. SCHWARTZ, *A MONETARY HISTORY OF THE UNITED STATES 1867-1960* (1963) (describing how bank failure followed withdrawal of deposits from banking system).

⁹⁶ *Lenders Brackets by Amount Invested*, ERIC'S CREDIT COMMUNITY, <http://www.ericcc.com/stats/lender-brackets> (last visited Jan. 30, 2011).

hundreds of dollars, that's when the antenna goes up because it means you are targeting very unsophisticated people . . . [and others can] make money off these people, and usually it's by not quite telling the truth."⁹⁷

P2P platforms present the risk that lenders may fall victim to fraud by dishonest strangers. By design, P2P lending platforms allow lenders to connect with borrowers over matters of shared identity, which creates opportunity for fraud.⁹⁸ Further, P2P lenders may consider inappropriate factors in selecting borrowers. For example, lenders might consider race⁹⁹ or beauty¹⁰⁰ after seeing a photo of the borrower.

⁹⁷ Robert Schmidt & Jesse Westbrook, *Prosper Back to Making Loans, Still Battles SEC*, SFGATE.COM (June 11, 2010), http://articles.sfgate.com/2010-06-11/business/21905016_1_prosper-peer-to-peer-lending-chris-larsen.

⁹⁸ See Lisa M. Fairfax, *The Thin Line Between Love and Hate: Why Affinity-Based Securities and Investment Fraud Constitutes a Hate Crime*, 36 UC DAVIS L. REV. 1073, 1073-75 (2003); David E. Austin, Comment, "In God We Trust": *The Cultural And Social Impact Of Affinity Fraud in the African American Church*, 4 MD. L.J. RACE RELIGION GENDER & CLASS 365, 367-71 (2004); Laura S. Unger, SEC Commissioner, *Investing in the Internet Age: What You Should Know and What Your Computer May Not Tell You*, Remarks at the Association of Retired Persons National Legislative Council Annual Meeting (Feb. 3, 2000) (transcript available at www.sec.gov/news/speech/spch342.htm) ("It seems likely that online communities will be an inviting venue for [affinity fraud] cases to migrate to the Internet."); *Affinity Fraud: How To Avoid Investment Scams That Target Groups*, SEC., <http://www.sec.gov/investor/pubs/affinity.htm> (last visited Oct. 25, 2011) (defining affinity fraud); Jay Perlman, *Securities Fraud: Affinity Fraud*, THE MOTLEY FOOL (Feb. 23, 2000), <http://www.fool.com/specials/2000/sp000223fraud4.htm> (stating that "the Internet has made [affinity fraud] more efficient, more effective, and cheaper"). See generally Lisa M. Fairfax, "With Friends Like These...": *Toward a More Efficacious Response to Affinity-Based Securities and Investment Fraud*, 36 GA. L. REV. 63 (2001) (discussing securing investment schemes involving affinity fraud).

⁹⁹ See, e.g., Devin G. Pope & Justin R. Sydnor, *What's in a Picture? Evidence of Discrimination from Prosper.com*, 46 J. HUM. RESOURCES 53 (2011) (noting a tendency for borrowers to avoid similarly situated black borrowers, but also noting that black borrowers still tend to have an increased default rate, implying lenders are not discriminatory enough). But see Michal Herzenstein, Rick L. Andrews, Utpal M. Dholakia, & Evgeny Lyandres, *The Democratization of Personal Consumer Loans? Determinants of Success in Online Peer-to-Peer Communities* 30-34 (June 2008) (unpublished manuscript), available at <http://www.prosper.com/downloads/research/democratization-consumer-loans.pdf> (finding almost no discrimination except for African American borrowers). Note, however, that this study focused on whether loans received funding, not at what interest rate. See sources in prior cite at 5-6. This study is consistent with minorities being charged more (or less) for the same loan. See *id.* Racism also exists in the broader lending market. See, e.g., David G. Blanchflower, Phillip B. Levine & David J. Zimmerman, *Discrimination in the Small-Business Credit Market*, 85 REV. ECON. & STAT. 930 (2003) (noting that black-owned small businesses are twice as likely to be denied credit, even after controlling for other factors); James H. Carr & Isaac F. Megbolugbe, *The Federal Reserve Bank of Boston Study on Mortgage*

Nevertheless, platforms currently vet borrowers and set interest rates such that lenders have only limited ability to make unwise lending decisions. But, in approving borrowers, lending platforms may not always have lenders' best interests in mind and may take advantage of lenders' lack of sophistication. This conflict of interest arises because platforms have an incentive to encourage lending, through origination fees, while lenders bear the brunt of the loss if the lending is imprudent.

Today, scholars commonly acknowledge that securitization can lead to lax lending standards.¹⁰¹ For example, many scholars believe that widespread securitization in the housing market allowed proliferation of subprime loans, fraudulent applications, and general decline in loan quality.¹⁰² Lenders and brokers recklessly extended credit, knowing that someone else would ultimately bear the risk. Worse yet, servicing fees for defaulted assets provide an affirmative benefit for reckless lending by paying an attractive fee to the originator to manage a loan if it becomes seriously delinquent.¹⁰³

Lending Revisited, 4 J. HOUS. RES. 277 (1993) (noting that lenders' subjective assessment of creditworthiness correlated with borrower's race, to benefit of Caucasians relative to African Americans and Hispanics, even after controlling for credit history); Michael LaCour-Little, *Discrimination in Mortgage Lending: A Critical Review of the Literature*, 7 J. REAL EST. LIT. 15 (1999) (examining 35 articles on racism in the mortgage industry, finding strong evidence of racism in 16). And for gender, see Helen F. Ladd, *Equal Credit Opportunity: Women and Mortgage Credit*, 72 AM. ECON. REV. 166, 168 (1982) (arguing that banks in some jurisdictions are more likely to deny mortgage requests from single men and married or single women, relative to married men).

¹⁰⁰ See Enrichetta Ravina, LOVE & LOANS: THE EFFECT OF BEAUTY AND PERSONAL CHARACTERISTICS IN CREDIT MARKETS 31-33 (July 2008) (draft), available at <http://www0.gsb.columbia.edu/faculty/eravina/research.html>.

¹⁰¹ Benjamin J. Keys, Tanmoy Mukherjee, Amit Seru & Vikrant Vig, *Did Securitization Lead to Lax Screening? Evidence from Subprime Loans*, 125 Q.J. ECON. 307, 310-13 (2010); Frank Partnoy & David A. Skeel, Jr., *Nineteenth Annual Corporate Law Symposium: Debt as A Lever Of Control: The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1024-25 (2007).

¹⁰² See, e.g., Gerard V. Comizio, *Viewpoints: Eight Financial Priorities for Next Administration*, 173 AM. BANKER 11 (2008) ("It is widely acknowledged that prudential standards went out the window once mortgage lenders were able to originate and sell loans promptly, getting the loans off their books and on to those of investors. The loan securitization market cannot ever again be turned into the financial version of the game 'pass the trash.'").

¹⁰³ See Janger, *supra* note 80, at 49 ("For instance, in the case of mortgage backed securities, the originator/servicer may not have a real economic interest in the mortgage pool but may stand to make more money charging fees for foreclosing on the asset than by restructuring."); see also Peter S. Goodman, *Lucrative Fees May Deter Efforts to Alter Loans*, N.Y. TIMES, July 29, 2009, at A1.

Similarly, platforms charge fees on the basis of loans originated and serviced. While platforms have long-term incentives to gain clientele through impressive returns, they profit from origination fees in the short term so long as lenders lend to anyone, with good credit or bad.¹⁰⁴ Lending Club currently verifies only about 60% of its borrowers' employment or income information.¹⁰⁵ These verification efforts include little more than an investigation of paystubs, IRS Forms such as W-2s, or other tax records.¹⁰⁶ Prosper verifies even fewer documents.¹⁰⁷ The result of these minimal efforts has been truly disappointing investment returns for some P2P lenders.¹⁰⁸

In the early days of P2P lending, default rates were startlingly high. For example, about 36% of all Prosper loans originating between November 2005 and July 12, 2009 defaulted.¹⁰⁹ Many high risk loans were funded at low interest rates by lenders who presumably did not appreciate the risks they undertook.¹¹⁰ Lenders likely overestimated the

¹⁰⁴ See *supra* notes 40-41 and accompanying text (describing Prosper and Lending Club origination fees).

¹⁰⁵ Ron Lieber, *The Gamble of Lending Peer to Peer*, N.Y. TIMES, Feb. 5, 2011, at B1 ("From April through the end of November 2010, the [Lending Club] verified income or employment data on about 60 percent of borrower applications."). To be sure, platforms' low-vetting policies are partially justified by the underwriting realities of adverse selection. Lending Club CEO Renaud Laplanche argues that the best borrowers have the lowest "tolerance for a cumbersome income verification process." See Felix Salmon, *Lending Club's Loss-Rate Number*, REUTERS BLOG (Feb. 7, 2011, 11:30 EST), <http://blogs.reuters.com/felix-salmon/2011/02/07/lending-clubs-loss-rate-numbers/>. As a result, the loss rate is *lower* for unverified loans than for verified loans. *Id.* ("The loss rate for loans where Lending Club has verified the borrower's income is 2.8%; the loss rate for loans where Lending Club *hasn't* verified the borrower's income is lower, at 2.7%.").

¹⁰⁶ LendingClub Annual Report (June 29, 2011), *supra* note 43, at 6.

¹⁰⁷ Prosper Marketplace, Inc., Prospectus (Form 424/b/3) 59 (Oct. 7, 2011) available at http://www.prosper.com/Downloads/Legal/Prosper_Prospectus_2011-10-07.pdf.

¹⁰⁸ See Mark Gimein, *You Are Unlikely to Prosper*, THE BIG MONEY (Jan. 18, 2010), <http://www.thebigmoney.com/articles/money-trail/2010/01/18/you-are-unlikely-prosper?page=full> ("[H]ow many of the loans with interest rates of 18 percent and up have gone into default before the three-year payment period is up[?] The answer: 54 percent. So *more than half* of these high-rate borrowers failed to fully repay their debt.").

¹⁰⁹ *Performance Data*, PROSPER, <http://www.prosper.com/invest/performance.aspx> (Oct. 30, 2011) (observing 10,569 charge-offs of 28,949 loans originated between Nov. 1, 2005 and July 12, 2009).

¹¹⁰ Of course, some philanthropic lenders may have wanted to take abnormal credit risks. Prosper prided itself on allowing questionable borrowers to make an appeal to lenders whose interests were not only pecuniary. Some lenders seemed to want to take a philanthropic leap of faith, and average returns were no doubt pulled down as a result. Still, some lenders may have accidentally found themselves lending

quality of the platform's underwriting or overestimated their own ability to judge character and financial information. Ultimately, Prosper's sunny estimates of credit quality and losses, however, did not deter lenders' improvident choices.¹¹¹

Parallel to platform underwriting standards, P2P platforms have imperfect collections incentives. For example, a lender reviewing the status of her loans noticed that Prosper had not updated the effect of bankruptcy on a defaulted note. She requested that Prosper explain the delay, which prompted Prosper to reveal that it failed to timely file a claim with the bankruptcy court. The bankruptcy judge rejected Prosper's late claim to the borrower's funds, while other unsecured creditors were paid in full.¹¹² Because P2P lenders are creditors on the debt, Prosper's late filing cost lenders the entire \$15,506.20 debt loaned to the borrower. Almost three years after the bankruptcy, and after the tenacious lender's inquiry, Prosper agreed to reimburse lenders for their losses. We would not expect Prosper to pursue every deadbeat borrower, if only because it is expensive to file bankruptcy claims, often incurring costs that may exceed benefits to lenders. However, given that Prosper decides to file a claim, there is no justification to filing late. This example raises the question whether Prosper would have missed the deadline if it knew that Prosper, rather than the lenders, would bear the resulting loss.¹¹³

Similar concerns arise for identity theft and fraud in P2P lending. On one hand, the risk of fraudulent borrowing seems greater online, requiring attentive detection.¹¹⁴ As such, platforms promise to

"philanthropically" or adopting that justification in hindsight.

¹¹¹ Platforms learn from their mistakes, since lender losses make for difficult marketing. Prosper has recently modified its underwriting standard, raised interest rates, and eliminated competitive auctions. Loans originated in recent months have performed much better than the historical average: they now show about 3.5% charge-offs for loans originated from April 13, 2010 to April 13, 2011, which is only 2.5% by value. See *Performance Data*, *supra* note 112 (observing charge-offs and net-charge-offs for loans originated between April 13, 2010 and April 13, 2011). Of course, many of these loans may still default in the coming days.

¹¹² See *Bankruptcy Update*, PROSPERS.ORG, http://www.prospers.org/forum/bankruptcy_update-t22912.0.html (last visited Oct. 30, 2011).

¹¹³ Similar questions can be asked of bad debt sale. Although the terms of service promised many lenders several annual debt sales, Prosper's last debt sale was in 2007. See *Loan Debt Sale History*, PROSPER, http://www.prosper.com/help/topics/lender-debt_sale_history.aspx (last visited Oct. 30, 2011) (recovering about 10¢ on the dollar).

¹¹⁴ See, e.g., Dan Tynan, *Top Five Online Scams*, PCWORLD (Mar. 8, 2005, 10:00 PM), http://www.pcworld.com/article/119941/top_five_online_scams.html (highlighting online fraud risk).

reimburse lenders if a debt is uncollectable due to identity theft. On the other hand, platforms reserve the sole right to investigate claims and deem loans fraudulent.¹¹⁵ Prosper's prospectus correctly identifies that "The fact that Prosper has the exclusive right and ability to investigate claims of identity theft in the origination of loans creates a significant conflict of interest between Prosper and the lender members."¹¹⁶ Platforms both determine whether lenders should be reimbursed and stand as the reimbursor. Platforms' conflicted role may decrease their vigilance in detecting fraud after the fact.

Given that platforms' incentives may not always align with prudent lending practices, it is important for lenders to understand the risks they face. Yet P2P platforms have potential to mislead lenders regarding the nature of P2P lending. Platforms may understate risk and overstate liquidity by implying that their products are substitutes for banking products like CDs or savings accounts.¹¹⁷

Moreover, P2P platforms overstate returns by presenting returns only under advantageous conditions.¹¹⁸ For example, Lending Club's

¹¹⁵ Prosper Marketplace Inc., Prospectus (Form 424/b/3) 16 (July 14, 2011) [hereinafter Prosper Prospectus], available at http://www.prosper.com/Downloads/Legal/Prosper_Prospectus_2011-07-14.pdf ("The determination of whether verifiable identity theft has occurred is in our sole discretion.").

¹¹⁶ *Id.* at 25.

¹¹⁷ See, e.g., *An Alternative to CDs*, PROSPER, <http://www.prosper.com/invest/about-investing/cds/> (last visited Oct. 30, 2011) ("You could compare a 3-year CD with one of Prosper's direct peer-to-peer loans (since we offer loans that amortize over 1, 3, or 5 years)"); *How Do Money Market Accounts Measure Up Against Prosper's Peer-to-Peer Lending?*, PROSPER, <http://www.prosper.com/invest/about-investing/money-market-accounts/> (last visited Oct. 30, 2011) (describing money markets); Mike Smith, *Person-to-Person Loans, Laddering and Short-Term Savings*, LENDING CLUB BLOG (Nov. 29, 2007, 6:47 AM), <http://blog.lendingclub.com/2007/11/29/person-to-person-loans-laddering-for-short-term-savings/> ("When you consider the fact that Lending Club person-to-person loans offer lenders better rates than CDs, while still preserving the laddering feature of returning a portion of your investment to you each month, you may find that a portfolio of loans is a better fit for your financial goals than a laddered CD."); see also *Securities and Exchange Commission Forms List*, SEC, <http://www.sec.gov/about/forms/secforms.htm> (last visited Nov. 3, 2011).

¹¹⁸ See *Prosper.com – Don't Mislead Investors*, FRED93'S BLOG: A LENDER'S VIEW OF PROSPER.COM (Sept. 24, 2009), <http://fred93blog.blogspot.com/2009/09/prospercom-dont-mislead-investors.html> (comparing Prosper CEO interview statement with his own research); cf. *Person-to-Person Lending Online Gathers Steam*, MSNBC.COM (Nov. 27, 2007, 6:53:02 ET) available at <http://www.msnbc.msn.com/id/21993720/> ("Prosper's default rate hovers at about 2.7 percent, Larsen said. . . ."). Compare *Prosper.com – Don't Mislead Investors supra* (finding 17% default rate, or 3.23% by unreasonably charitable assumptions), with Eileen Ambrose, *Prosper.com Helps Regular Folks Become a Bank and Make Loans*, SUN, Apr. 1, 2007, at 1C ("Larsen says the default rate . . . is about 0.50 percent.").

home page suggests that potential lenders “[i]nvest & [e]arn 9.68% returns.”¹¹⁹ Lending Club calculates this figure by considering the average net annualized return for its entire loan portfolio.¹²⁰ This presentation is likely to understate defaults and overstate returns because, as a growing company that issues more and more new loans, the loan portfolio contains a disproportionately large set of young loans.¹²¹ Young loans have not had time to default, but may do so in time.¹²² As such, Lending Club’s figure will probably underestimate the effect of defaults upon returns. This is the financial equivalent of counting eggs before they hatch.

Unlike Lending Club’s figure, the headline return rate on Prosper’s home page excludes any loans originated less than 10 months ago, presumably making the figure more accurate.¹²³ Such a time restriction allows Prosper to claim average returns above 9.85%.¹²⁴ However, Prosper also excludes data for the significant portion of loans originated prior to its registration statement’s effective date, June 15, 2009. This excludes a period in which 35% of loans defaulted,¹²⁵ and investor returns were negative.¹²⁶ However, Prosper’s choice to

¹¹⁹ LENDINGCLUB, <http://www.lendingclub.com/home.action> (last visited Jan. 30, 2011).

¹²⁰ *How We Measure Net Annualized Return*, LENDINGCLUB, <http://www.lendingclub.com/public/lendersPerformanceHelpPop.action> (last visited Oct. 30, 2011).

¹²¹ See *Loan Growth*, LENDINGCLUBSTATS.COM, <http://lendingclubstats.com/stats/loan-growth> (last visited Jan. 30, 2011) (showing that about half of LendingClub’s loans as of January 2011 were originated between March 2010 and January 2010).

¹²² See *Lates By Payment*, ERIC’S CREDIT COMMUNITY, <http://www.ericccc.com/stats/lates-by-payment> (last visited Mar. 20, 2011) (stating that only half of defaults occur within the first nine months).

¹²³ PROSPER, <http://www.prosper.com/> (last visited Nov. 1, 2011) (“Net Annualized Returns represent the actual returns on Borrower Payment Dependent Notes (Notes) issued and sold by Prosper since July 15, 2009. To be included in the calculation of Net Annualized Returns, Notes must be associated with a borrower loan originated more than 10 months ago; this calculation uses loans originated through August 31, 2010. To calculate Net Annualized Returns, all payments received on borrower loans corresponding to eligible Notes, net of principal repayment, credit losses and servicing costs for such loans, are aggregated then divided by the average daily amount of aggregate outstanding principal for such loans. To annualize this cumulative return, the cumulative number is divided by the dollar-weighted average age of the loans in days and then multiplied by 365. Net Annualized Returns are not necessarily indicative of the future performance of any Notes. All calculations made as of June 30, 2011.”).

¹²⁴ *Prosper Risk Management Drives Best P2P Returns*, PROSPER BLOG (Jan. 24, 2011), <http://blog.prosper.com/2011/01/24/prosper-risk-management-drives-best-p2p-returns/> (comparing LendingClub returns of 5.34% during a similarly defined period).

¹²⁵ See *Bankruptcy Update*, *supra* note 112.

¹²⁶ *Full Q&A With Prosper Marketplace CEO Chris Larsen*, AM. CONSUMER NEWS

exclude this data was probably not all marketing: Prosper's lending methodology substantially differed during that period. Still, platforms' ability to manipulate accounting methods creates potential for misrepresentation.

Platforms also implicitly subsidize glowing reviews by users who blog.¹²⁷ Both Lending Club and Prosper pay referral fees to blogs and webpages that recruit customers.¹²⁸ As a result, these sites have an incentive to overstate the rewards of P2P lending, and many of them do.¹²⁹

Lenders are not the only consumers implicated in P2P lending. Borrowers also face special risks in a P2P environment. Any credit transaction can implicate unfair lending and collections processes. A bevy of laws constrain lenders, with particular emphasis on safeguarding privacy.¹³⁰ Inherently, P2P transactions contemplate a

(June 8, 2010), <http://www.americanconsumernews.com/2010/06/full-qa-with-prosper-marketplace-ceo-chris-larsen.html> ("To date, the median return across all Prosper lenders who bid from the time we launched in February 2006 to the time we entered our SEC registration quiet period in October 2008 was negative 3.2%.").

¹²⁷ Platforms can offer to the media a technically true estimated return, and profit when the reporter prints the figure without explaining the methodology. Compare Nancy Trejos, *Peer-to-Peer Lending Catches On With Borrowers, Investors*, WASH. POST, Sept. 20, 2009 ("Prosper's default rate is about 5 percent."), with Prosper Marketplace, Inc., Prospectus (Form 424/b/3) 18 (July 13, 2009), available at http://www.sec.gov/Archives/edgar/data/1416265/000141626509000033/prosper_s-1a6d7d13d2009.htm ("As of March 31, 2009 . . . 5,840 loans or 20.1% had defaulted.").

¹²⁸ See generally Ellen P. Goodman, *Peer Promotions and False Advertising Law*, 58 S.C. L. REV. 683 (2007) (investigating peer promotions and advertising law).

¹²⁹ See, e.g., Millie Kay G., *Prosper Review: Top P2P Lending Site*, THE DIGERATI LIFE, <http://www.thedigeratilife.com/blog/prosper-review-top-p2p-lending-site/> (last visited Nov. 1, 2011) (offering positive review, nor mention of risks, as well as sponsored, affiliate links).

¹³⁰ See, e.g., Consumer Credit Protection Act, 15 U.S.C. § 1671 (2006) (restricting garnishment of compensation due for personal services); Fair Credit Reporting Act, 15 U.S.C. § 1681 (2006) (requiring fair and accurate credit reporting determined via reasonable procedures); Servicemembers Civil Relief Act, 50 U.S.C. App. § 502, 518 (2006) (protecting servicemembers by temporarily suspending "judicial and administrative proceedings and transactions that may adversely affect the civil rights of servicemembers during their military service," including terms to protect credit); Graham-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (resolving to "enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers, and for other purposes"); Equal Credit Opportunity Act (Regulation B), 12 C.F.R. § 202 (2010) (requiring creditors to provide appraisal reports); Truth in Lending Act (Regulation Z), 12 C.F.R. § 226.6 (2010) (requiring disclosure of finance charges and terms for open-end credit); GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 3-7 (discussing various state and federal regulators that oversee parts of P2P lending).

more permeable privacy. At least superficially, borrower privacy and lender knowledge are a zero-sum game. Whereas most credit transactions pit consumer privacy against an intermediary, P2P platforms inevitably face tradeoffs among consumer constituencies.

In order to solicit interest from lenders, P2P borrowers share personal information on the platform's website. This information is available to anyone who ventures online, including thousands of tenacious lenders. Both Lending Club and Prosper censor personally identifying information from member profiles and borrower listings, in the hopes that borrowers do not fully disclose their identities.¹³¹ However, lenders sometimes can discern the identity of a given borrower from the little information they provide.¹³²

Moreover, privacy is in tension with P2P lending's emphasis on transparency and community. Many P2P users are attracted to a social background for their transactions, and platforms emphasize the direct, rather than intermediated, contact between borrower and lender. Still, platforms discourage lenders and borrowers from communicating, except anonymously through the platform. Despite these efforts, P2P investors and borrowers do interact, and phone and email conversations are not uncommon.¹³³ Sometimes Prosper lenders even coerce some degree of borrower disclosure as a condition for authorizing a bid. Thus, while risky, compromising the veil of complete privacy can help borrowers obtain a loan.

Under relaxed privacy, lender-borrower relationships may entail dynamics rarely observed in modern, intermediated lending. One Prosper lender known as "Investar" takes a hands-on approach to his loans.¹³⁴ He requires his potential borrowers to endure a lengthy interview, scrutinizing their financial records far beyond the vetting required for a simple loan request on Prosper. Investar views Prosper as an extension of a debt counseling service he used to run, which was

¹³¹ *The Simpsons: Loan-a-Lisa* (NBC television broadcast Oct. 3, 2010) (showing that Lisa decided to lend through a Kiva-like site. Although theoretically anonymous, she quickly realizes that her ex-boyfriend Nelson is applying for a loan. She becomes privy to embarrassing details about his home life and situation in lending to him. She is later upset by finding the effect that the loan had had on his educational goals. Transparency holds many risks).

¹³² See *supra* Part I.B (describing Wolcott investigation).

¹³³ Author's personal interaction with INVESTAR Lenders, one of several thousand structured sub-communities, or groups, authorized within Prosper Marketplace (<http://www.prosper.com/connections/>; <http://www.prosper.com/groups/>) and correspondence with its recognized Group Leader, Investar.

¹³⁴ *Id.*

public spirited and intended for the borrower's benefit.¹³⁵ Investar helps borrowers make realistic plans to service loans within their means and eventually emerge from the cycle of debt. Investar's efforts have earned him respectable loan returns,¹³⁶ but these returns pale in comparison to his investment of time and emotion.

Not all lenders are so benevolent. An unhappy investor might decide to take debt collection into her own hands, to the detriment of both herself and the borrower. State and federal statutes, however, protect borrowers from unreasonable debt collection.¹³⁷ Some investors, though, may be unaware of or uninterested in these laws, causing them to engage in harassing or intimidating collections activities. Thus, P2P lending poses certain inherent risks to borrowers: by operating directly or socially, it exposes borrowers to the scrutiny of strangers for better and for worse.

II. P2P LENDING AND PROBLEMS WITH THE SEC

Even despite the risks and challenges discussed above, P2P lending potentially offers tremendous benefits, and an ideal regulator would strive to expand and improve the industry. Where regulation proves necessary, the ideal regulator would consider the costs of intervention, calibrating the regulation to mitigate risks without creating new problems for consumers or platforms.

The SEC is not the ideal regulator. Soon after Prosper's February 2006 launch, it requested a no-action letter from the SEC, seeking confirmation of its legal structure and business model. Prosper later retracted the request, but the SEC was unwilling to offer assurance that it would not bring action against the platforms for securities violation.

On November 24, 2008, the SEC issued a Cease and Desist Order to Prosper ("Order").¹³⁸ The SEC argued that Prosper was selling

¹³⁵ INVESTAR, HANDBOOK FOR MEMBERS AND SUPPORTING LENDERS 10 (2010) ("For several years I engaged in intense one-on-one financial counseling with individuals plagued by poor household budgeting and negative cash flow. We sat together weekly. I loaned them whatever was necessary to keep them treading water and they began living on the severely strict budget we created together. I took possession of their credit cards, held their checkbook and began paying their bills on time. I pacified bleating creditors, negotiating on their behalf. I showed them how to effectively manage money even when there wasn't enough.").

¹³⁶ 2010 *Annual Report*, Investar Lenders 5 Star Watch (Dec. 31, 2010) (26.1% weighted annual return on investment).

¹³⁷ See GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 32-37.

¹³⁸ Prosper Marketplace, Inc., Exchange Act Release No. 8984, 2008 WL 4978684, at *1 (Nov. 24, 2008), available at <http://www.sec.gov/litigation/admin/2008/33->

securities as defined in section 2(a)(1) of the Securities Act, a claim this Article discusses below.¹³⁹ The Order asserted that Prosper should have registered as a public company with the SEC and should only have sold notes through a prospectus with an effective registration statement.¹⁴⁰ The SEC did not offer policy justifications for this position. Prosper consented to the entry of the order and began the road to SEC registration.

Prior to the SEC's Order, Prosper effected transactions in the following manner: when borrowers and lenders matched, Prosper would signal WebBank, a Utah-chartered industrial bank, to make the loan to the borrower.¹⁴¹ WebBank would assign the note to Prosper, which then assigned it to the lender.¹⁴² This process connected borrowers and lenders.

After the Order, all P2P platforms either registered with the SEC¹⁴³ or folded.¹⁴⁴ The major platforms currently file annual and quarterly

8984.pdf.

¹³⁹ *Id.* at *3.

¹⁴⁰ *See id.* at *5.

¹⁴¹ Lending Club used the same structure with the same partner, WebBank. LendingClub, Prospectus (Form 424/b/3) 7 (Aug. 15, 2011), available at https://www.lendingclub.com/extdata/Clean_As_Filed_20110815.pdf ("From the launch of our platform in May 2007 until April 7, 2008, the operation of our platform differed from the structure described in this prospectus, and we did not offer Notes. Instead, our platform allowed members to purchase, and take assignment of, member loans directly. Under that structure, members were assigned anonymized, individual promissory notes corresponding in principal amount to their purchase price, subject to our right to service the member loans."); *id.* at 8 ("Each member loan is originated through our website and funded by WebBank at closing. WebBank is an FDIC-insured, Utah-chartered industrial bank that serves as the lender for all member loans originated through our platform."). Platforms worked with WebBank to avoid state lending registration requirements and interest rate caps.

¹⁴² *See* ANDREW VERSTEIN, FILENE RESEARCH INST., PEER-TO-PEER LENDING: UPDATE AND REGULATORY CONSIDERATIONS 24 (2008) (explaining the mechanics of P2P as of 2008).

¹⁴³ Lending Club actually began registration several months prior to the cease and desist order. *See* LendingClub Corp., Registration Statement (Form S-1) (June 20, 2008), available at <http://www.sec.gov/Archives/edgar/data/1409970/000089161808000318/f41480orsv1.htm>.

¹⁴⁴ *See, e.g.,* John Chappell, *Loanio Files Amendment to S-1 with SEC; Cedes Code for Cash*, P2P LENDING NEWS (Aug. 23, 2009), <http://www.p2plendingnews.com/2009/08/loanio-files-s-1-amendment-sells-source-code> (selling its source code for \$375,000 while waiting for regulatory approval); Sara Lepro, *Virgin Money Closes Shop in the U.S., Victim of Bad Timing*, U.S. BANKER (Dec. 2010), <http://www.americanbanker.com/bulletins/-1029613-1.html> ("The peer-to-peer lending business model also has faced its share of regulatory hurdles."); Matthew Paulson, *Pertuity Direct Shuts Down Unexpectedly*, P2P LENDING NEWS (Aug. 26, 2009), <http://www.p2plendingnews.com/2009/08/pertuity-direct-shuts-down-suddenly/>

reports¹⁴⁵ and sell their notes by prospectus. Those notes remain the platform's own obligation, payable contingent upon borrower repayment. Accordingly, when the lender signals interest in a prospective borrower, and WebBank lends to the borrower, the platform permanently retains ownership of the borrower indebtedness. The platform then sells its debt instrument to the lender, who becomes a creditor of the platform rather than the borrower.

This "borrower payment dependent note" obliges the platform to pay an amount derived from borrower payments. A lender holding an interest in a borrower's loan paying 10% to the platform has a right to 10% (less the servicing fee) from the platform. But the lender has privity only with the platform, rather than the borrower. Further, the loan is unsecured and nonrecourse to any other assets of the platform.¹⁴⁶ When everything functions well, this structure is economically equivalent to the old P2P lending model, but there are many cases where this structure is substantially different.¹⁴⁷ Most importantly, the lender now must consider the creditworthiness of the platform, too.

The SEC predicated its involvement on defining P2P notes as "securities." The Securities Act of 1933 defines a security to include "unless the context otherwise requires . . . any note . . . [or] investment contract."¹⁴⁸ While it is plausible that P2P notes were either "investment contracts" or "notes" for the purposes of the Securities Acts, there is a strong case that they were neither. Subpart A presents the case against securities characterization and shows the weaknesses in the SEC's analysis.

Because of the strong arguments presented in Subpart A against securities characterization, the SEC could have justified continued observation, declining action on the P2P lending industry as it had

(shutting down after period of inactivity on site and closure of its underlying mutual fund to new members).

¹⁴⁵ Issuers with more than \$1 million in assets and more than 500 owners must register with the SEC. Securities Exchange Act of 1934, 15 U.S.C. § 78(l)(1) (2006). They are subject to periodic reporting requirements. 15 U.S.C. § 78m(a) (subjecting § 12 registrants to reporting requirements).

¹⁴⁶ Note that calling the P2P a non-recourse loan to the platform actually understates the risks to the lender because the lender has no priority interest in the underlying borrower debt. See *infra* Part II.B.

¹⁴⁷ See *infra* Part II.B.

¹⁴⁸ Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2006). The 1934 Act definition is nearly identical. In a sense, this Part argues that "the context otherwise requires." *Id.* Subpart A shows the legal context by highlighting arguments the SEC does not seem to have addressed, and Subpart B shows the practical context in terms of damage done by securities characterization.

done for years, and the presense of colorable arguments on either side of securities characterization would allow it to do so for legal and policy reasons. For the SEC to have dedicated its scarce resources to bringing P2P lending within the securities regime, it must have believed that requiring P2P loans to register as securities was both more appropriate than explicit exclusion from the securities acts and better than inaction. However, SEC regulation of P2P lending was both unnecessary and harmful.

Subpart B discusses the negative, foreseeable (but perhaps unforeseen) consequences of SEC regulation, some of which could have been avoided even under the securities regime. The securities regime decreased, rather than enhanced, the protection of lenders — the individuals whom the SEC intended to protect by regulating P2P loans. By forcing P2P lending into the machinery of the Securities Acts, the SEC also increased borrower risk and threatened the innovative potential of this young industry.

Given the arguments against intervention, Subpart C seeks to understand why the SEC nevertheless asserted its authority and moved to regulate P2P lending. The SEC would have done better to exclude P2P loans from securities regulation, or to have simply done nothing. This Part provides an interpretive and normative argument that the SEC overreached by affirmatively asserting that P2P loans were securities.

A. Regulatory Overreach

The Securities Act of 1933 defines a security to include “any note . . . [or] investment contract.”¹⁴⁹ *SEC v. W.J. Howey Co.* is the seminal case defining an investment contract.¹⁵⁰ Likewise, *Reves v. Ernst & Young* is the central case defining a note.¹⁵¹ Using definitions from both *Reves* and *Howey*, the SEC argued in the Order that the P2P notes constituted regulated securities, with the platforms as issuers. The SEC, however, provided no other legal argument or policy considerations whatsoever in applying the securities regime to P2P lending.

Under *Howey*, an investment contract exists if there is “an investment of money in a common enterprise with profits to come solely from the efforts of others.”¹⁵² This three-part test, thus, requires:

¹⁴⁹ § 2(1). The 1934 Act definition is nearly identical.

¹⁵⁰ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-300 (1946).

¹⁵¹ *Reves v. Ernst & Young*, 494 U.S. 56, 56-58 (1990).

¹⁵² *Howey*, 328 U.S. at 301.

(1) investment of money with the expectation of profits, (2) commonality, and (3) the entrepreneurial efforts of others. In applying *Howey* to P2P notes, the SEC overstated its case in the third prong.¹⁵³

The SEC overstated its case by including past efforts and ministerial activities as satisfying the third prong, a point upon which courts are divided.¹⁵⁴ Prior to selling notes to lenders, P2P platforms screen borrowers. After sale, P2P platforms also assist with ongoing low-level tasks, such as collecting payments from lenders. Although investors may rely on these efforts, they are likely insufficient to satisfy the entrepreneurial functions in the third *Howey* prong, at least in one of the two circuits to have looked at similar issues. In assessing *Howey*'s third prong, the D.C. Circuit determined pre-sale efforts¹⁵⁵ and post-sale, ministerial activities¹⁵⁶ have little to no influence on whether an arrangement constitutes an investment contract.¹⁵⁷ It is post-sale

¹⁵³ The platforms also have a workable argument against the commonality prong. The SEC argued that lenders had a common interest because all would be harmed if Prosper were unable to operate the platform. But any time a party contracts with several parties for any service or sale, all counter-parties would all be harmed by her future non-performance. By analogy consider a mortgage broker who routinely assists many banks and borrowers meet one other. If that broker were to disappear, many banks and borrowers would be inconvenienced. But their legal interests remain distinct and unaffected. Lenders may have trouble finding future borrowers, but they still own their claim on prior borrowers. If horizontal commonality is to mean anything at all, it must involve some joint or mingled interest, and it must involve some common plight other than coincident inconvenience of service customers. Thus, the *Howey* Court emphasized that investors' profits were drawn from their pro rata share of the pool, rather than from the sale of their own oranges.

P2P notes do not exhibit commonality because each lender owned particular notes and their legal interest remained distinct. Prior to SEC intervention lending structure prior SEC intervention, Prosper posed no credit risk to lenders. Its success or failure did not affect the legal rights of the lenders. One lenders' returns were legally independent of all other lenders' notes, would survive Prosper's disappearance, and varied tremendously from investor to investor.

¹⁵⁴ Compare *SEC v. Mut. Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005) (declining to use pre/post test), with *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996) (making distinction between pre-purchase and post-purchase efforts).

¹⁵⁵ Cf. *Noa v. Key Futures, Inc.*, 638 F.2d 77, 79 (9th Cir. 1980) (per curiam) (holding that pre-purchase brokering and purchase, and post-purchase storage and offer to repurchase, do not satisfy *Howey* test).

¹⁵⁶ Cf. *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974) (noting that efforts of others are only "undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise" (citing *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973))).

¹⁵⁷ *Life Partners*, 87 F.3d at 548 ("While we doubt that pre-purchase services should ever count for much, for present purposes we need only agree with the district court that pre-purchase services cannot by themselves suffice to make the profits of an investment arise predominantly from the efforts of others, and that ministerial

entrepreneurial activity upon which investors must rely. Likewise, in *SEC v. Life Partners Inc.*, the defendant engaged in extensive pre-purchase activities¹⁵⁸ and post-purchase¹⁵⁹ maintenance similar to that which P2P platforms provide. Nevertheless, the D.C. circuit ruled that these interests did not implicate *Howey*'s third entrepreneurial efforts prong.¹⁶⁰

SEC v. Life Partners, Inc. analyzed whether brokered, fractional interest in soon-to-mature life insurance policies, or rights to money when an old or ill individual dies, constituted securities.¹⁶¹ The court explained that the length of the insured's life is the key factor for profits, not the efforts of the promoters.¹⁶² As a result, *Life Partners* did not satisfy the third prong from *Howey* and, therefore, no investment contract existed. Prior to sale, the promoters worked to find and vet insurance policies, but after sale it was only the insured (and perhaps the insurance company) that influenced investor returns. Investors did not rely on the continued entrepreneurial activity of the promoter to influence their profits.

Parallel to *Life Partners*, P2P lender profits almost entirely depend on the underlying borrower's willingness and ability to pay. The borrower's efforts — to keep their job, to save diligently, to make payments in a timely manner — determine the investors' returns. P2P lenders do not rely on continued entrepreneurial activity of the platform for their profits, and therefore, P2P notes should not constitute investment contracts under *Life Partners*.

It is not surprising that the Order to Prosper does not reflect the importance of *Life Partners*. After *Life Partners*, the SEC continued to pursue viatical settlement companies and eventually persuaded the 11th Circuit to treat pre- and post-sale efforts as similar for the purposes of *Howey*.¹⁶³ The SEC likely will emphasize the more

functions should receive a good deal less weight than entrepreneurial activities....").

¹⁵⁸ *Id.* at 539 (vetting terminally ill individuals, soliciting interest in their policies, and estimating the value of these policies).

¹⁵⁹ *Life Partners* was expected to hold the policy, monitor the insured's health, pay premiums, convert group policies to individual policies, pay premiums, collect and distribute death benefits, assist investors who wished to resell their interest. *Id.* at 545-47. *Life Partners* appeared as the owner of record and had the power to change the policy beneficiary. *Id.*

¹⁶⁰ *Id.* at 545-48.

¹⁶¹ *Id.* at 548-49.

¹⁶² *Id.* at 548.

¹⁶³ *SEC v. Mut. Benefits Corp.*, 408 F.3d 737, 743-45 (11th Cir. 2005). Note, however, that Mutual Benefits often delayed medical examinations of patients until after sale to investors. Therefore, although the Eleventh Circuit rejects the *Life*

favorable case law as it seeks to preserve enforcement options.¹⁶⁴ However, *Life Partners* remains good law, leaving circuits split with respect to *Howey*. Because there was genuine uncertainty regarding the existence of an investment contract, the SEC was not compelled to act and should not have acted, given the likely results of action.¹⁶⁵

The SEC could have sidestepped *Life Partners* had it alleged that P2P platforms' borrowers, rather than the platforms themselves, are issuers. P2P investors "solely" depend on the borrower's willingness and ability to repay.¹⁶⁶ It is a borrower's continuing performance, and not that of the platform, that determines the returns for the investor. In that respect, the third prong of *Howey* would be met for a borrower-issuer. The first two *Howey* prongs would be met in the same manner as the platform: there is investment with expectation of profit, and there is commonality among lenders and between lender and borrower. If the borrowers had been ordinary businesses, the SEC may have deemed them issuers and called the platforms underwriters.

However, deeming P2P borrowers as issuers is a non-starter because it would impose costs and liability that no consumer-borrower would bear. New Zealand currently regards the borrower as the issuer, and that fact alone obliterates any hopes for a P2P industry there.¹⁶⁷ Several U.S. states employ a similar approach, which leaves their citizens without access to P2P investments.¹⁶⁸ Worse, if the SEC had

Partners pre-/post- distinction, it does so in a case where it could have accepted the distinction and still found for the SEC.

¹⁶⁴ Indeed, the SEC may have viewed P2P as an opportunity to reassert positions that it hopes to use in its continuing effort to reign in viatical settlements. Paula Dubberly, *Testimony Concerning "Recent Innovations in Securitization,"* SEC (Sept. 24, 2009), http://www.sec.gov/news/testimony/2009/ts092409pd.htm#P51_20651 (discussing *Mutual Benefits* and *Life Partners*, and concluding that "[i]n the event that possible securities law violations are present in sales of securities through life settlement securitizations, we stand ready to pursue those case vigorously").

¹⁶⁵ See *infra* Part II.B.

¹⁶⁶ See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946). *Howey* defines the third prong in terms of expectations of profits *solely* from the promoter or third party, though subsequent cases have liberalized that requirement. See, e.g., *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) (declaring that "a close reading of the language employed in *Howey* and the authority upon which the Court relied suggests that, contrary to the view of the district court, we need not feel compelled to follow the 'solely from the efforts of others' test literally").

¹⁶⁷ MINISTRY OF ECON. DEV., *supra* note 18, at 26, available at <http://www.med.govt.nz/upload/73375/discussion-document.pdf> ("[P2P] services are not practical in New Zealand because the borrower is an "issuer" for the purposes of the Securities Act and Financial Reporting Act.").

¹⁶⁸ See e.g., MARK R. HEUERMAN, OHIO DIV. OF SEC., *PEER-TO-PEER (P2P) LENDING AND INTERNET PLATFORMS: OHIO SECURITIES ACT IMPLICATIONS* (2008), available at

concluded that borrowers were issuers, it would have exposed them to liability for the notes already issued without registration.¹⁶⁹ Even if the P2P notes could be more coherently characterized as borrower-issued, the SEC would have found it unattractive to impose on thousands of cash-strapped consumers the burdens and liabilities usually reserved for large companies.¹⁷⁰ No doubt realizing the absurdity of this result, the SEC's Order does not ask whether the borrower is an issuer. Instead, it only makes the weaker case that the platform is an issuer.

The SEC also argued that platforms issued securities under the *Reves* analysis.¹⁷¹ The Securities Act defines "any note" to be a security,¹⁷² "unless the context otherwise requires."¹⁷³ *Reves* provides insight into "context" where a note might not also be a security. *Reves* specifically enumerates five nonsecurity notes and provides a "family resemblance" test to exclude some unspecified notes.¹⁷⁴ The SEC

<http://com.ohio.gov/secu/docs/Conference2010/MarkHeuermanP2P.pdf>; Rob Garcia, *Is Lending Club Available in My State?*, LENDING CLUB BLOG, (July 6, 2011) <http://blog.lendingclub.com/2011/06/10/is-lending-club-available-in-my-state/>, June 10, 2011 (explaining why P2P fails to satisfy Ohio securities laws). See generally *Is Lending Club Available in My State?*, LENDING CLUB BLOG (June 10, 2011, 7:31 AM), <http://blog.lendingclub.com/2011/06/10/is-lending-club-available-in-my-state/> (providing maps to indicate which states allow residents to use Lending Club services); Stefan Padfield, *Peer-to-Peer Lending: Who is the Issuer?*, BUSINESS LAW PROF BLOG (June 16, 2011), http://lawprofessors.typepad.com/business_law/2011/06/peer-to-peer-lending-who-is-the-issuer.html (stating that P2P business model still does not satisfy securities laws of several states).

¹⁶⁹ See Prosper Marketplace, Inc., Exchange Act Release No. 8984, *supra* note 138, at *1; Prosper Marketplace, Inc., Prospectus (Form 424/b/3) 76 (July 13, 2009), available at http://www.sec.gov/Archives/edgar/data/1416265/000141626509000034/prosper_s-1a6d7d13d2009.htm (discussing Prosper's liability for pre-registration note sales).

¹⁷⁰ Of course P2P borrowers are not unique in knowing that their notes will be restructured and resold, with investors relying on their repayment. Commercial, consumer, and mortgage loans also rarely come to rest with the initial lender. Any argument that P2P borrowers are issuers would have introduced many other types of borrowers into the ambit of securities regulations — a result not contemplated in the Securities Act of 1933. See Jonathan Macey et al., *Helping Law Catch Up to Markets*, 34 J. CORP. L. 789, 809-10 (2009) (arguing that subprime mortgages could be regulated as securities). Although they conceived of borrowers as securities buyers, we could just as easily conceive of them as security issuers where they know that the originating bank will not hold their mortgage.

¹⁷¹ See Prosper Marketplace, Inc., Exchange Act Release No. 8984, *supra* note 138, at *1.

¹⁷² Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2006).

¹⁷³ *Id.*

¹⁷⁴ See *Reves v. Ernst & Young*, 494 U.S. 56, 66-67 (1990) ("[T]he version of the 'family resemblance' test that we have articulated here: A note is presumed to be a 'security,' and that presumption may be rebutted only by a showing that the note bears

argued that P2P notes fail *Reves*' family resemblance test and, therefore, constitute a security. However, the SEC analysis incorrectly applies *Reves*. The analysis did not consider whether P2P notes fall within the enumerated exclusion. The family resemblance test does not apply if P2P notes are simply consumer financing notes, which *Reves* enumerates as excluded from the Securities Acts. The SEC thus ignored one of the platforms' best arguments and misconstrued the *Reves* holding.

Reves excludes "note[s] delivered in consumer financing" from the definition of a security.¹⁷⁵ This exclusion is consistent with the Securities Acts, which does not contemplate that consumers "issue a note" when they borrow for consumption.¹⁷⁶ Ordinary consumer lending does not create a security, but rather creates a note given in consumer financing.¹⁷⁷ While the resulting note is a salable asset, the lender is not an *investor* in *securities* and no one is an *issuer*. This remains true even if the lender assigns her payment right to a purchaser; the lender does not become an issuer upon assignment, nor does the note become a security. P2P borrowers are individuals borrowing for household and consumer purposes. If P2P notes were to come to rest with Prosper, there would be no question that this was an ordinary lending transaction with no securities involved. Thus, P2P

a strong resemblance (in terms of the four factors we have identified) to one of the enumerated categories of instrument. If an instrument is not sufficiently similar to an item on the list, the decision whether another category should be added is to be made by examining the same factors.")).

¹⁷⁵ *Reves*, 494 U.S. at 65; see also Michael J. Kaplan, Annotation, *Promissory Notes as Securities Under § 2(1) of the Securities Act of 1933 and § 3(a)(10) of the Securities Exchange Act of 1934*, 39 A.L.R. FED. 357, Part.II, § 3[a] (1978) ("'[G]arden-variety' common-law promissory notes, especially those issued by individuals in conjunction with consumer transactions, have been held not to be within the purview of the [Securities] Acts.").

¹⁷⁶ BLACK'S LAW DICTIONARY 1020 (9th ed. 2009) (defining "consumer loan" as "a loan that is given to an individual for family, household, personal, or agricultural purposes and that is generally governed by truth-in-lending statutes and regulations").

¹⁷⁷ It may be erroneously assumed that "consumer financing" refers only to lending arranged by the seller of consumer goods to facilitate the sale. This is certainly one common type of consumer financing. See, e.g., *Resolution Trust Corp. v. Stone*, 998 F.2d 1534, 1537 (10th Cir. 1993) (noting that enhanced automobile receivables, car loans resold from automobile dealers, are not securities). However, there is no indication that the *Reves* court intended to limit the existing meaning of this term, which includes loans from financial institutions to consumers for non-business purposes. See, e.g., *SEC v. Arkansas Loan & Thrift Corp.*, 294 F. Supp. 1233, 1235 (D.C. Ark. 1969) (noting that Arkansas Loan & Thrift "was organized in 1964 as an Arkansas corporation for the purpose of engaging in consumer finance business" with no indication of intent to facilitate sales).

notes likely constitute notes delivered in consumer financing upon creation and, therefore, were not *Reves* securities.¹⁷⁸

Of course, even if P2P lending notes were consumer financing upon creation, the question must be whether any subsequent modification was sufficient for them to lose that exempt status. Consumer financing notes are frequently assigned without becoming securities but the SEC might have believed that the notes ceased to be notes given in consumer financing once Prosper assigned them to lenders, thus requiring family resemblance to avoid securities characterization. Nevertheless, if the SEC had applied the family resemblance test evenhandedly, it would have seen that the results were not clear, and therefore, the agency's intervention could not be compelled on legal grounds alone.

The family resemblance test contains four parts.¹⁷⁹ The first *Reves* factor considers the motivations of the buyer and seller.¹⁸⁰ For buyers, a profit motive makes an instrument more likely to be a security.¹⁸¹ An investor buying a corporate bond is more likely to show a profit motive than a zero-interest loan from a parent to a child. The SEC argued that the "buyers" (the individuals who think of themselves as lenders) possess a profit motive. The SEC then summarily concluded that P2P notes fail the first factor of the *Reves* test.¹⁸²

¹⁷⁸ See *Exch. Nat'l Bank of Chi. v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (2d Cir. 1976) ("[A] bank's unsecured short-term personal loan to an individual, [is] the very archetype of what the securities laws were not intended to cover."); *C.N.S. Enter., Inc. v. G. & G. Enters.*, 508 F.2d 1354, 1359 (7th Cir. 1975) ("In one sense every lender of money is an investor since he places his money at risk in anticipation of a profit in the form of interest. Also in a broad sense every investor lends his money to a borrower . . . [B]uying shares of the common stock . . . where the impetus for the transaction comes from the person with the money, is an investment; borrowing money . . . to finance the purchase of an automobile, where the impetus for the transaction comes from the person who needs the money, is a loan.").

¹⁷⁹ The SEC contended that all four factors leaned away from resemblance. See *Prosper Marketplace, Inc.*, *supra* note 138, at *5-6.

¹⁸⁰ *Reves*, 494 U.S. at 66 ("If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security.'"). However, "If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, the note is less sensibly described as a security." *Id.*

¹⁸¹ *Id.*

¹⁸² The SEC acknowledged that some lenders lend for social reasons. See MICHAEL K. HULME, SOC. FUTURES OBSERVATORY, INTERNET BASED SOCIAL LENDING: PAST, PRESENT AND FUTURE 10 (2006). However, it found that compatible with a general profit motive. *Id.*

The SEC's analysis, however, is blinkered because it does not so much as mention the motivation of the "seller." Both parties' motives are important in determining security status. The *Reves* court considered borrower purposes, asking whether sellers raise money for general business use or to finance investments, as opposed to "some other commercial or consumer purpose."¹⁸³

Resolution Trust Corp. v. Stone further highlights the importance of the SEC's omission.¹⁸⁴ There, a company called PAC bought auto dealer-to-customer loans, packaging them into "enhanced automobile receivables" ("EARs") for resale. PAC serviced the loans and provided some enhancements and guarantees. The question was whether EARs had a strong family resemblance to nonsecurity notes, given PAC's bundled services and enhancements. In finding that the "motivations" factor did not indicate a security, the court stated:

PAC was not selling the EARs to raise money for general investments in PAC; rather, it was selling its stock-in-trade Although the buyers obviously hoped to profit from the inherent value of the product purchased, that expected profit was not tied to the profitability of PAC.¹⁸⁵

PAC's motive in selling the loans was not to raise money to expand its business. Rather, selling loans was PAC's business, and buyers knew that. Thus PAC's EARs did not implicate the first family resemblance factor. Like PAC, Prosper issued notes to serve as its stock-in-trade, rather than to finance business expansion. While Prosper lenders hoped to profit from the inherent value of the borrower notes, that profit was not tied to Prosper's profitability any more than the EARs were to PACs. The SEC's two sentence treatment of the first *Reves* factor did not even consider seller's motives, let alone consider cases like *Resolution Trust*, and was plainly inadequate.¹⁸⁶

The second *Reves* factor inquires into the lenders' plan of distribution. *Reves*' plan of distribution factor examines whether there is "common trading for speculation or investment."¹⁸⁷ Common trading for speculation of investment, or offering notes to the general

¹⁸³ *Reves*, 494 U.S. at 66.

¹⁸⁴ *Resolution Trust Corp. v. Stone*, 998 F.2d 1534, 1539 (10th Cir. 1993).

¹⁸⁵ *Id.*

¹⁸⁶ It could be argued that the "seller" is not Prosper, but rather the underlying borrower. After all, she is the debtor on the note that is then sold and resold. In that case, the "motivations" prong is even stronger, as the borrower's objective is obviously a consumer purpose.

¹⁸⁷ *Reves*, 494 U.S. at 66.

public and allowing secondary sales, often indicates securities characterization. For example, bank certificates of deposit ordinarily are not securities,¹⁸⁸ but they can become securities when the issuer sells them with a promise to maintain a secondary market for otherwise illiquid assets.¹⁸⁹ Prosper's P2P notes were not eligible for resale at the time of the Order, which tends against the common trading factor.

Although the *Reves* court clarified that "common trading" can occur without trading on exchanges, it did not recognize common trading where there is no trading at all. Each of the Court's examples specifies only the lack of *exchange* trading, rather than the lack of trading in general.¹⁹⁰ The Court did not consider the possibility of an asset incapable of any resale or redemption at all. P2P notes, however, are quite different from the typical security, where value fluctuates in part with its potential sale price. Lack of a secondary market tends to imply family resemblance because it makes the note less of a typical security, so P2P platforms may not have had "common trading." Although it is clear that the notes were initially offering to the broad public, it is not clear that P2P satisfied the *Reves* common trading prong.¹⁹¹

The SEC may argue that it issued the Order shortly after Prosper announced its intention to develop the secondary market for P2P notes,¹⁹² and that the agency was only responding to the notes'

¹⁸⁸ *Marine Bank v. Weaver*, 455 U.S. 551, 559 (2d Cir. 1982).

¹⁸⁹ *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 240 (1985).

¹⁹⁰ *Reves*, 494 U.S. at 68 (referencing *United States v. Landreth Timber*, 471 U.S. 681 (1985) to explain that "stock of closely held corporation not traded *on any exchange* held to be a 'security' " because only need "offer[] and s[ale] to a broad segment of the public" to "establish 'common trading' in an instrument") (emphasis added); *id.* (referencing *SEC v. W.J. Howey Co.*, 328 U.S. 293, 294-95, 298-300 (1946) to explain that "units of citrus grove and maintenance contract 'securities' although not traded *on exchange*" was considered a security because only need "offer[] and s[ale] to a broad segment of the public" to "establish 'common trading' in an instrument" (emphasis added)); *id.* (referencing *Tcherepnin v. Knight*, 389 U.S. 332, 389 (1967) to explain that "nonnegotiable *but transferable* 'withdrawable capital shares' in savings and loan association held to be a 'security' " because only need "offer[] and s[ale] to a broad segment of the public" to "establish 'common trading' in an instrument") (emphasis added); *see also* *Tcherepnin v. Knight*, 389 U.S. 332, 337 (1967) ("[S]hares can be transferred 'by written assignment accompanied by delivery of the appropriate certificate or account book.' "). Investors also had a limited right to withdraw their investments.

¹⁹¹ *Cf. Banco Espanol de Credito v. Sec. Pac. Nat'l Bank*, 973 F.2d 51 (2d. Cir. 1992) (noting lack of common trading in non-security loan participations).

¹⁹² Platforms operated without secondary trading during their early period, so notes were entirely illiquid, at the time.

imminent common trading. Certainly once the notes could be traded, they are more likely to constitute a security because they are more clearly commonly traded. Yet, the Order never expressed concern about secondary trading, but instead announced that Prosper had already been selling securities.

The third and fourth *Reves* factors ask whether investors expect the protection of the securities regime, and whether there is some other regime to protect them.¹⁹³ The SEC argued that the character of the platform's advertisement promising a valuable return on invested funds and comparing them to money-markets¹⁹⁴ demonstrates that the public would expect securities protection. While this is true, it is not obvious that lenders expected the distinctive protections of the SEC. If P2P lending consumers expected protection under the Securities Acts, they have been slow to invoke it. There have been no private securities actions against P2P platforms, before or after the Order, with the exception of one suit focusing on the sale of unregistered securities.¹⁹⁵

Prosper's notes were also compared to depository products over which the SEC has no jurisdiction. P2P investors may have expected or preferred the protection of a bank regulator. As another alternative, some lenders likely regarded themselves as lenders, believed that real risks of P2P lending come from deadbeat borrowers, and expected that their protection would derive from bankruptcy laws and civil suits. Accordingly, lenders would expect justice to come from collections against the borrower, not disclosure and fraud actions against the platform. It may be that lenders expected protection, but outside of the securities regime.

Although there are plausible arguments for applying the securities regime to P2P lending, the SEC ignored strong arguments against securities characterization. Detailed analysis of P2P lending reveals that the SEC overstated its case and reached an unnecessary

¹⁹³ *Reves*, 494 U.S. at 66-67.

¹⁹⁴ See VERSTEIN, *supra* note 142, at 27. Compare *Goldsworthy v. SEC*, No. 3-9339, 2002 SEC LEXIS 1279, at *24 (noting purchasers may still reasonably expect the Securities Acts to protect them, where, among other things, promoter compares return to money market return), with David Futrelle, *Help Strangers, Earn a Cool 15%*, MONEY MAG. (Nov. 20, 2006), money.cnn.com/magazines/moneymag/moneymag_archive/2006/12/01/8395166/index.htm (stating that in answering the question of why anyone would want to lend money to strangers, Prosper CEO Larsen says, "You can earn more than you would in a money-market fund").

¹⁹⁵ *Christian Hellum v. Breyer*, 123 Cal. Rptr. 3d 803, 806-08 (Ct. App. 2011). This claim for Securities Act of 1933 Section 12 liability for sale of unregistered securities (and related state and federal claims) was predicated on the SEC determination that platforms were selling unregistered securities. See *id.* at 806.

conclusion in subjecting P2P lending to SEC regulation. Despite the SEC's arguments,¹⁹⁶ it likely knew that this was a borderline case calling for a more nuanced approach. Instead, the SEC likely thought securities regulation was appropriate for P2P lending and advanced arguments to support that proposition. To bring P2P notes under SEC regulation, the SEC first had to identify a party who could be deemed the issuer of P2P notes. Issued securities must have been issued by *someone*. P2P borrowers, however, make unattractive issuers, so the SEC resorted to denoting the platforms as issuers. This chain of logic succeeded in regulating P2P lending, but only by forcing it into the wrong regulatory overlay. The implications of this overreach are monumentally damaging.

B. Perverse Consequences of SEC Regulation

The Securities Acts, as enforced by the SEC, are an ill-fitting framework for the P2P industry. What the Securities Acts offer — formalistic registration requirements and extensive disclosure — P2P consumers do not need. What P2P consumers need are safe and clear returns and privacy, which the SEC, by virtue of its mission and culture, cannot provide. The P2P market differs dramatically from the traditional securities market. Therefore, SEC regulation is unlikely to fit P2P lending without causing adverse consequences. This section analyzes five problems that emerge from the SEC's distinctive approach.

1. Formalistic Registration

Although there are many ways to run a business, there are only a few ways to register its securities. The SEC makes registration an elaborate process, for which every form is prescribed, in the hope of standardizing and controlling registration requests.¹⁹⁷ The SEC regime intends to protect investors.¹⁹⁸ The great irony is that SEC registration requirements put P2P lenders in a worse position than they started.

¹⁹⁶ Indeed, the author himself has previously written about the possibility that P2P platforms might be made to register as issuers. See VERSTEIN, *supra* note 142, at 24-31.

¹⁹⁷ See *Securities and Exchange Commission Forms List*, *supra* note 117.

¹⁹⁸ See *Important Information About EDGAR*, SEC, <http://www.sec.gov/edgar/aboutedgar.htm> (last visited Feb. 16, 2010) ("EDGAR, the Electronic Data Gathering, Analysis, and Retrieval System, performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies and others who are required by law to file forms with the U.S. Securities and Exchange Commission (SEC).") (stating SEC's mission).

The SEC strong-armed the P2P platforms out of transactional structures that provided superior protection for lenders.

In the early days of Prosper and Lending Club, the platforms made loans to borrowers and assigned those notes to lender-investors.¹⁹⁹ Lenders experienced no credit risk with respect to the intermediary.²⁰⁰ Now, both platforms use a borrower payment dependent note model in which lender-investors hold no ownership or security interest in the borrower notes on which the securities depend.²⁰¹ While P2P lenders once had credit exposure only to the underlying borrower, they are now unsecured creditors of the intermediary platform. Consequently, these lenders now risk platform default, which could leave them vying for a share of the P2P notes against other, more senior, creditors.

P2P investor-lenders' unsecured status is cemented by Securities Act Rule 415. Currently, platforms cannot practicably improve the secured status of these investors because they rely on Rule 415's continuous or "shelf" registration, which allows issuers to register a group of securities well in advance of their issuance.²⁰² An issuer may anticipate needing capital in the future but prefer to register the securities now. Under Rule 415, the issuer can register securities now, but not actually sell them until later when they "take them off the shelf" on which they have been metaphorically waiting. Rule 415 also allows issuers to enjoy economies of scale in registration. It is much cheaper to register a bundle of securities and then take them off the shelf at intervals rather than to begin registration anew with each small security issuance. By allowing issuers to sell securities without a new

¹⁹⁹ See, e.g., PROSPER MARKETPLACE, INC., LENDER REGISTRATION AGREEMENT § 5 (2007), available at <http://www.prospers.org/blogs/media/blogs/Fred93/prosper-mid2007-lra.pdf> ("Prosper agrees to sell and you agree to purchase, from time to time, without recourse, all Notes resulting from the matching of your bids with listings on the Prosper marketplace. . . . Although Prosper will retain the Servicing Rights to all loans, you will hold title to, and ownership of, the Notes . . .").

²⁰⁰ To be sure, lenders have always experienced counterparty risk with respect to the platform. That is, lenders would be harmed if the platform discontinued its business — they would have to find a new servicing party. But that is true of all contractual relationships. Part III, *infra*, proposes mitigating inconvenience for borrowers by requiring platforms to create a "living will."

²⁰¹ Prosper Marketplace, Inc., Prospectus (Form 424/b/3) 2 (July 26, 2010), available at <http://www.sec.gov/Archives/edgar/data/1416265/000141626510000317/prosperprosapp7d26d10.htm> ("The Notes are unsecured and holders of the Notes do not have a security interest in the corresponding borrower loans or the proceeds of those corresponding borrower loans. If Prosper were to become subject to a bankruptcy or similar proceeding, the holder of a Note would generally have a general unsecured claim against Prosper that may or may not be limited in recovery to such borrower payments.").

²⁰² 17 C.F.R. 230.415 (2008).

registration, Rule 415 makes securities regulation more flexible and less costly.

For registered P2P platforms, shelf registration is absolutely essential. Platforms cannot simply sell borrower notes to lender-investors because the SEC requires platforms to register notes prior to sale.²⁰³ Conducting a P2P business would be impossible if the platform must register each note, or even each set of notes, separately. Registration is costly and lengthy. For example, Prosper endured nine months to register its first notes.²⁰⁴ Because borrowers look to online platforms to obtain loans faster than through traditional bank lending, few would be willing to wait for the SEC to approve an individualized registration statement. Thus, pre-authorization for platforms is imperative to effectuate P2P transactions.

Similarly, the cost of registering securities is enormous. Due to the typically small loan amounts in P2P lending, registration costs would dwarf the principal of any individual loan.²⁰⁵ Only by bundling the notes into one shelf registration, with a single issuer — the platform — using advanced registration can P2P lending remain economically feasible.

The SEC made shelf registration essential to P2P platforms, and then leveraged this necessity to force changes in platform operations that disadvantage P2P lenders. In the earliest registration statements, Prosper intended to originate and sell notes to lenders, who would own the loans outright.²⁰⁶ The SEC responded that Prosper's

²⁰³ See *supra* Part II.A.1.

²⁰⁴ Prosper's registration statement was deemed effective on July 10, 2009. Prosper Marketplace, Inc., Notice of Effectiveness (Form S-1) (July 10, 2009), available at http://www.sec.gov/Archives/edgar/data/1416265/999999999509001898/xslEFFECTX01/primary_doc.xml. Lending Club ceased its P2P operations for a shorter period — from April 2008 until October 2008. See Renaud Laplanche, *Lending Club Completes \$600 Million SEC Registration and Offers New Alternative for Consumer Credit*, LENDING CLUB BLOG (Oct. 14, 2008, 5:00 PM), <http://blog.lendingclub.com/2008/10/14/lending-club-sec-registration/> (stating end of quiet period). Compare LendingClub Corp., Prospectus, (Form 424/b/3) (Oct. 13 2008), available at <http://www.lendingclub.com/extdata/prospectus.pdf> (providing example of early prospectus) Renaud Laplanche, *Lending Club Goes Quiet*, LENDING CLUB BLOG (Apr. 7, 2008, 11:15 PM), <http://blog.lendingclub.com/2008/04/07/lending-club-goes-quiet/> (notifying community of Lending Club quiet period commencement), with Renaud Laplanche, *Lending Club Goes Quiet*, LENDING CLUB BLOG (Apr. 7, 2008, 11:15 PM), <http://blog.lendingclub.com/2008/04/07/lending-club-goes-quiet/> (notifying community of Lending Club quiet period commencement).

²⁰⁵ See *infra* Part II.B.2.

²⁰⁶ See e.g., Prosper Marketplace, Inc., Registration Statement (Form S-1) 9 (Oct. 30, 2007), available at http://www.sec.gov/Archives/edgar/data/1416265/000110465907078072/a07-27421_1s1.htm (explaining that "Prosper collects the

registration statement failed in “numerous material respects.”²⁰⁷ As a result, Prosper had to fundamentally rework its structure, prompting the first of two reductions in lender legal status. Specifically, Prosper moved to a borrower dependent note model of origination.²⁰⁸

Prosper sought a lending model that would allow it to shelf register notes, which meant using a sole issuer (Prosper) for all issued notes. Prosper thus inserted itself as an intermediary. As an intermediary, Prosper loaned to borrowers and remained their sole creditor. Prosper issued its own notes, for which only itself was liable, though it limited its liability to the extent that borrowers have paid. As a result, lenders are exposed to the credit risk of the borrower, but also to Prosper. Thus, if the platform defaults, it will impair the interests of lenders, who are now creditors of the intermediary. Under this new model, lenders do not have any special rights to the underlying notes, which the platform now owns. The platform could pledge borrower notes for debts or even sell them. Likewise, the borrowers could pay in full, but lenders may still lose money if Prosper accumulates other substantial debts. As a result of this change, the platform became a credit risk to lenders, who are now essentially investors in Prosper, as well as in the underlying borrowers. Lenders now have to consider the management and financial wellbeing of Prosper for the first time.

Consequently, Prosper attempted to protect lender interests in the underlying borrower notes by giving lenders the equivalent of a security interest in those notes. Prosper sought to do this without actually providing a traditional security interest. Rather, Prosper intended to indirectly provide security interest by giving the indenture trustee a security interest.²⁰⁹ This grant would work for the benefit of Prosper’s lenders, providing indirect access to a security interest.²¹⁰ As

Borrower’s payments on the Notes and forwards the payments received, minus any applicable fees, to the Lenders who own the Notes”).

²⁰⁷ SEC Reply to Prosper’s Registration Statement on Form S-1, SEC (Nov. 1, 2007), available at <http://www.sec.gov/Archives/edgar/data/1416265/000000000008004978/FILENAME1.pdf>.

²⁰⁸ Prosper Marketplace, Inc., Amendment No. 1 to Registration Statement (Form S-1) 2 (Dec. 5, 2008) [hereinafter Prosper Amendment No. 1], available at http://www.sec.gov/Archives/edgar/data/1416265/000110465908074769/a08-29602_1s1a.htm.

²⁰⁹ *Indenture between Prosper Marketplace, Inc. and Wells Fargo Bank*, SEC § 6.12 (May 29, 2009), available at http://www.sec.gov/Archives/edgar/data/1416265/000110465909035890/a08-29602_5ex4d2.htm (granting security interest to Wells Fargo as trustee); Del. UCC Filing No. 20092301817 (filed on July 17, 2009) (granting interest in accounts and proceeds and products in favor of Wells Fargo Bank).

²¹⁰ Prosper Marketplace, Inc., Amendment No. 2 to Registration Statement (Form

such, if Prosper were to default, lenders would retain the right to their borrower income streams regardless of Prosper's other debts. They might also retain some claim to their particular borrower notes, as against other lenders, rather than just a pro rata share of Prosper's total assets.²¹¹ This response would largely mitigate the additional risks of intermediation. Lenders' economic rights and legal protections would, thus, be similar to that under Prosper's original, disintermediated model.

However, the SEC could not accept Prosper's attempts to protect lenders. Although the SEC agreed that granting a security interest would improve investor protection,²¹² it remained uncomfortable allowing shelf registration where the Prosper notes would be "too closely [tied]" to the underlying borrower notes.²¹³ Specifically, SEC officials expressed that Prosper's registration would more clearly fit into existing regulations and interpretations if Prosper eliminated the security interest altogether.²¹⁴ In a related comment letter ("February Comment Letter"), the SEC characterized the notes-plus-security-interest as "intended to be bankruptcy remote."²¹⁵ Although the partially secure notes would have been far from bankruptcy remote,²¹⁶

S-1) 6 (Jan. 16, 2009) [hereinafter Prosper Amendment No. 2], available at http://www.sec.gov/Archives/edgar/data/1416265/000110465909002910/a08-29602_1s1a.htm (specifying that "holders of the Notes do not *directly* have a security interest in the corresponding borrower loan," but that Prosper would "grant the indenture trustee, *for the benefit of the trustee and the holders of the Notes*, a security interest in all present and future rights of Prosper to payment under the corresponding borrower loans and all moneys and property received by Prosper thereon" (emphasis added)).

²¹¹ *Id.* (using the phrase "series of Notes" to refer to the set of Prosper Note sold to investors that correspond to a given borrower loan); see also *id.* at 12 ("We will issue the Notes in a series, with each series of Notes dependent for payment on payments we receive in a specific borrower loan . . .").

²¹² Prosper Marketplace, Inc., Letter Regarding Amendment No. 3 to Registration Statement (Form S-1) 9 (Apr. 14, 2009) [hereinafter Prosper Letter Regarding Amendment No. 3], available at <http://www.sec.gov/Archives/edgar/data/1416265/000110465909024058/filename14.htm>.

²¹³ *Id.* at 7 (quoting SEC).

²¹⁴ *Id.* at 9.

²¹⁵ Letter from Todd Schiffman, Assistant Director, SEC, to Edward Giedgowd, Esq., Chief Compliance Officer & Gen. Counsel, Prosper Marketplace, Inc., (Feb. 24, 2009) [hereinafter February Comment Letter], at 1, available at <http://www.sec.gov/Archives/edgar/data/1416265/000000000009037656/filename1.pdf>. If so, Prosper Lenders would have been insulated from Prosper's credit risk.

²¹⁶ See Prosper Letter Regarding Amendment No. 3, *supra* note 212, at 6-7, 30 (arguing that Prosper notes would not be bankruptcy remote because, *inter alia*, they would be impaired or delayed by Prosper's bankruptcy). One must wonder whether, in February 2009, the SEC's Comment Letters may have been particularly sensitive to the attempt to create bankruptcy remote assets due to concern for securitized assets

the February Comment Letter concluded on that basis that “it is not clear how the offering is a continuous offering under Rule 415.”²¹⁷ The message was clear: reduce lenders’ security interests, or lose essential shelf registration. Prosper acceded, disavowing bankruptcy remoteness and undermining lender protection.²¹⁸

Prosper’s subsequent amendments to its registration statement contained far weaker protections for lenders. Any mention of indirect security interests was struck.²¹⁹ Later amendments also removed all suggestions that P2P lenders might have priority over other lenders to their corresponding borrower.²²⁰ Although Prosper and the indenture trustee may wish to treat each individual lender as the beneficial owner of their corresponding borrower debts,²²¹ the indenture trustee may not have the legal power to respect the borrower-specificity of the borrower payment dependent notes.²²² All lenders might have a pro-rata interest in the pool of all borrower notes, rather than an interest in the borrowers they originally selected. This defies lender

causing havoc elsewhere in the economy, such as the now infamous Collateralized Debt Obligations.

²¹⁷ February Comment Letter, *supra* note 215, at 1.

²¹⁸ See Prosper Letter Regarding Amendment No. 3, *supra* note 212, at 6, 32-34.

²¹⁹ See Prosper Marketplace, Inc., Amendment No. 4 to Registration Statement (Form S-1) 5 (May 29, 2009) [hereinafter Prosper Amendment No. 4], available at http://www.sec.gov/Archives/edgar/data/1416265/000110465909035890/a08-29602_5s1a.htm. Cf. Prosper Amendment No. 2, *supra* note 210, at 2, 6 (“H]olders of the Notes do not *directly* have a security interest in the corresponding borrower loan or proceeds of that loan,” but that Prosper would “grant a security interest in all present and future rights of Prosper to payment under the corresponding borrower loans and all moneys.”) (emphasis added). Prosper struck this emphasized language, which invited the possibility of an indirect security interest, in acquiescence to the SEC’s wishes that they weaken lenders’ claims. Similarly, the January 16 Amendment provided that the trustee’s claim for a given set of lender-held notes would be limited to the corresponding borrower loan, not any other borrower loan. This language, too, will be struck in later Amendments because of SEC pressure, which provides no requirement that the trustee seek to match lender payments to the loans in which they believed they invested. See *id.* at 6.

²²⁰ Compare Prosper Amendment No. 2, *supra* note 210, at 19 (explaining that “Prosper intend[ed] to grant the indenture trustee a first-priority security interest in Prosper’s right to receive payments and in all payments Prosper has received under the corresponding borrower loan *for that series* of Notes.”) (emphasis added), with Prosper Amendment No. 4 *supra* note 219, at 5 (making no reference to the relation of a particular series on a corresponding borrower’s security interest).

²²¹ Prosper Prospectus, *supra* note 115, at 86.

²²² *Id.* at 83 (“In the event of a bankruptcy or similar proceeding of Prosper, the relative rights of the holder of a Note as compared to the holders of other unsecured indebtedness of Prosper with respect to payment from the proceeds of the borrower loan corresponding to that Note or other assets of Prosper is uncertain.”).

expectations and increases uncertainty. It also subsidizes lenders whose notes were underperforming at the expense of savvier lenders.

Security interests matter most when insolvency looms. Currently Prosper's financial status is precarious.²²³ Prosper's loan origination rate hovers far below any sustainable level.²²⁴ Today, Prosper continues to suffer large losses each month.²²⁵ It also faces a class action lawsuit with respect to the sale of unregistered securities.²²⁶ Damages from that suit could exceed \$70 million,²²⁷ and Prosper's insurance company denies coverage.²²⁸ While P2P lending is generally viable, Prosper has had to contend with cumbersome regulation and the fits and starts of being an innovative venture.

While Lending Club's financial prospects are relatively better than Prosper's, it too posted substantial losses for each year of operation.²²⁹

²²³ Prosper Marketplace, Inc., Quarterly Report (Form 10-Q) 5 (Sept. 30, 2010) [hereinafter Prosper Quarterly Report (Nov. 12, 2010)], available at <http://www.sec.gov/Archives/edgar/data/1416265/000141626510000490/p10q9d30d2010.htm> ("Prosper has incurred net losses and negative cash flows from operations since inception, and has an accumulated deficit of approximately \$48.1 million as of September 30, 2010.").

²²⁴ Prosper now originates about two million per month. Most insiders think that a platform requires at least ten times that figure to become viable. See, e.g., Peter Renton, *Interview with Senior Management at Prosper*, SOCIALLENDING NETWORK (Feb. 8, 2011), <http://www.sociallending.net/state-of-the-industry/interview-with-senior-management-at-prosper/> (quoting Jim Catlin, Prosper Executive Vice President: "I think it is safe to say that it will need to be between \$20 million and \$30 million in loans per month depending on the different characteristics of the loans we are doing" in order to break even").

²²⁵ Prosper Quarterly Report (Sept. 30, 2010), *supra* note 223, at 5 ("For the three and nine months ended September 30, 2010, the Company incurred a net loss of \$2.2 million and \$7.5 million, respectively and the Company had negative cash flows from operations of \$7.3 million.").

²²⁶ See Complaint at 1-3, *Hellum v. Prosper Marketplace, Inc.*, CGC-08-482329 (Cal. Super. Ct. Feb. 25, 2011).

²²⁷ Prosper Marketplace, Inc., Annual Report (Form 10-K) 36 (Dec. 31, 2010), available at <http://www.sec.gov/Archives/edgar/data/1416265/000141626511000224/prosper10k12312010.htm> (showing \$4.8 million outstanding principal and loans charged off of \$45 million). Of course, a \$49 million judgment would not be a total loss; Prosper would come to own the disputed notes.

²²⁸ See, e.g., Tentative Statement of Decision Regarding Phase I Trial on Duty to Defend, *Prosper Marketplace, Inc. v. Greenwich Ins. Co.*, CGC 09-491736 (Cal. Dec. 14, 2010) (finding exclusion ambiguous and requiring insurer to defend Prosper). The insurer's denial was entirely a result of the SEC's determination that platforms issue securities. Prosper's coverage excluded actions arising under the 1933 Act. The court has since issued a Stipulated Final Judgment in Prosper's favor, but Greenwich Insurance is appealing.

²²⁹ Compare Lending Club Corp., Quarterly Report (Form 10-Q) 41 (Oct. 31, 2010), available at <http://www.sec.gov/Archives/edgar/data/1409970/000095012310105612/>

As of September 30, 2010, Lending Club earned almost \$100 million in loans, but also accumulated a deficit of \$35.6 million and a stockholders' deficit of \$31.5 million. Currently, non-borrower investor members continue to supply equity financing,²³⁰ backstopping losses in the hopes of future gains.²³¹ However, better financial prospects for the platform do not guarantee better prospects for the investor-lenders because Lending Club has not undertaken efforts to secure lenders.

Unfortunately for P2P lenders, Lending Club did not follow Prosper's efforts to secure its lenders by granting a security interest to the trustee. Instead, Lending Club retained the right to issue debt senior to the lender-investor obligations, secured by the same underlying notes.²³² Lending Club grants security interests to these senior creditors, but not to its lender-investors.²³³ Likewise, in the event of default, Lending Club grants its creditors an irrevocable attorney-in-fact to sign the collateral over to themselves, to terminate adverse claims and security interests, and otherwise sign Lending Club's name for matters involving the collateral.²³⁴ Lending Club

c07844e10vq.htm ("Our net loss for the six months ended September 30, 2010 and 2009, was \$5.5 and \$5.7 million, respectively. We have not been profitable since our inception, and we may not become profitable."), with Prosper Quarterly Report *supra* note 223, at 26 ("We ... have incurred net losses since our inception. Our net loss was \$2,223,016 and \$7,494,302 for the three and nine months ending September 30, 2010, respectively. The net loss for the three and nine months ending September 30, 2009 was \$2,238,138 and \$7,726,455, respectively.").

²³⁰ See Renton, *supra* note 224.

²³¹ And those gains may be forthcoming. Lending Club effectuated over \$13 million in loans in December 2010. See *Lending Club Statistics*, LENDING CLUB, <https://www.lendingclub.com/info/statistics.action> (last visited Nov. 6, 2011).

²³² See LendingClub Corp., Loan and Security Agreement (Exhibit 10.1) 6 (May 18, 2009), available at <http://www.sec.gov/Archives/edgar/data/1409970/000136231009008132/c86041exv10w1.htm>; LendingClub Corp., Amended and Restated Loan and Security Agreement (Exhibit 10.3) 8 (Oct. 7, 2008), available at <http://www.sec.gov/Archives/edgar/data/1409970/000095013408017739/f41480a3exv10w3.htm>.

²³³ Del. UCC Filing No. 20074115894 (filed on Oct. 30, 2007) (current through July 30, 2010) (documenting security interest in in favor offavor of Silicon Valley Bank, granting interest in, among other things, accounts, general intangibles, chattel paper, negotiable instruments, assets, accounts receivable, and proceeds thereof); Del. UCC Filing No. 20080625150 (filed on February 21, 2008 (favoring Gold Hill Venture Lending 03, granting interest in collateral including, but not limited to, accounts, negotiable instruments, chattel paper, general intangibles, assets, accounts receivable, and proceeds thereof; Del. UCC Filing No. 20082955985 (filed on August, 28, 2008) (current through July 30, 2010) (granting lien to Wanda Kraikit and eighteen others, collateral unspecified).

²³⁴ LENDING CLUB CORP., SECURED PROMISSORY NOTE NO. 102, at 1 (signed June 18,

lenders thus hold completely unsecured claims, and remain junior creditors to a rapidly leveraging company. If Lending Club were to default, borrower notes would first abate to satisfy senior creditor claims, decreasing funds available to repay individual lenders. Most lenders likely are unaware of these risks. The disconnect between borrower loans and lender interests defies the expectations of a P2P user community that sought to cut out the middleman.

While platform prospectuses warn investors of potential losses from platform default, other facets of platform behavior obscure risks to lenders.²³⁵ Both Prosper and Lending Club estimate risk-adjusted returns for lenders, accounting for the probability of borrower default. However, neither platform includes the risk of its own default in their estimates. While both platforms use algorithms to estimate the loss rate from lending to a risky borrower, neither platform assigns any risk to lending through a P2P intermediary. Instead, Lenders are encouraged to factor the platform out of the equation, leaving lenders unaware of the risks associated with platform default.

There is strong indication that lenders do not appreciate the risks involved in P2P lending. Lending Club borrowers with excellent credit scores can borrow for as little as 6.02% interest rate.²³⁶ After fees, lenders receive about 5.35% interest.²³⁷ While in some instances it may be rational to lend to a credit-worthy borrower at a 5.35% interest rate, few investors would agree to be a junior creditor of a web-startup on an unsecured basis for 5.35% interest. The risks of such a venture are too high for so small a reward. Yet P2P finance essentially asks lenders to lend to both the borrower and the startup, in the same note. The lender will not be repaid in full if *either* the borrower defaults *or* Lending Club becomes insolvent. As such, lenders endure the risk of borrower and platform default. Accordingly, we would expect P2P

2009) (favoring Mr. Robert Sanderson).

²³⁵ There are reasons to doubt generally that retail investors benefit from disclosure. Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 22 (2003) ("We doubt that disclosure is the optimal regulatory strategy if most investors suffer from cognitive biases.").

²³⁶ *Rates & Fees*, LENDINGCLUB, <http://www.lendingclub.com/public/rates-and-fees.action> (last visited Sept. 28, 2011) (stating that A1 borrowers pay 6.02%, 6.78%, or 7.30% APR). Lending Club reports that its average borrower APR is 11.4%. GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 9.

²³⁷ LendingClub charges a 1% fee to lenders of all borrower payments. A 6.02% loan with a 1% fee pays the same interest and principal to lenders as a 5.35 % loan without any fee. See *Fees*, PROSPER, <http://www.prosper.com/help/contextual/fees.aspx> (last visited Nov. 6, 2011) (describing calculation of fees lenders pay); *How Does Lending Club Make Money?*, LENDING CLUB, <http://www.lendingclub.com/kb/index.php?View=entry&EntryID=90> (last visited Nov. 6, 2011).

interest rates to reflect both the credit risk on the borrower *plus* the risks of venture financing. In that case, lenders would charge as much interest as they would for an unsecured loan to a web startup. For example, Lending Club agreed to pay 8% for a three-year loan *secured by the borrower notes*.²³⁸ Because Lending Club lenders are exposed to vastly more risk than mere borrower default, they should charge 8% interest plus a premium for being an unsecured, junior creditor, *plus* whatever premium is appropriate for the underlying borrower. However, P2P lenders do not appear to understand these risks or impute them into the interest rates they require for use of their money.²³⁹

P2P lending was designed to eliminate the middleman and allow lenders to transact with borrowers directly. By eliminating the middleman, P2P lending removed lender risks of intermediary default. SEC regulation, however, forced P2P platforms to act as an intermediary between P2P borrowers and P2P lenders. This new structure exposes lenders to riskier middlemen than they had in traditional banking, because their interests are subordinated to those of senior creditors. More surprisingly, SEC regulation may have made P2P illegal altogether. P2P lending's new "borrower payment dependent notes" may have constituted illegal off-market, retail swaps under the Commodity Exchange Act ("CEA") as a result of the SEC Order to Prosper.²⁴⁰

Though businesspeople and economists often think about swaps as derivatives in which cash flows are exchanged,²⁴¹ the U.S. Commodity

²³⁸ LENDINGCLUB CORP., SECURED PROMISSORY NOTE NO. 102, *supra* note 234 at 2-3.

²³⁹ There is also indication that lenders have a strong preference for making loans to self-reported borrower-entrepreneurs. These loans should, at the margin, charge a higher interest rate still: lenders are exposed to the platform's default risk, the borrower *qua* borrower risk, and the business risk. However, lenders are much *more* likely to lend to such borrowers, and at a lower rate. For example, on September 23, 2010, I examined Prosper loans that were supposed to end in the next two days. I found that business loans were almost twice as likely to receive funding than non-business loans for all categories.

²⁴⁰ See Verstein, *supra* note 200, at app. B (discussing treatment post-Dodd-Frank). Although the SEC's actions may have caused P2P notes to be illegal under the CEA, subsequent changes, described later in this subpart, explain why that pernicious result is no longer operative. For thoughts and questions related to swaps, I am grateful to Kevin Davis and Lanny Schwartz.

²⁴¹ See, e.g., *Product Descriptions and Frequently Asked Questions*, INT'L SWAPS & DERIVATIVES ASS'N, INC., <http://www.isda.org/educat/faqs.html#10> (last visited Sept. 28, 2011) ("What is a swap? A swap is a bilateral agreement to exchange cash flows at specified intervals (payment dates) during the agreed-upon life of the transaction (maturity or tenor)."). For example, a firm with fixed income from an investment, and costs that vary with the market interest rate, faces a risk that costs might rise above

Future Trading Commission ("CFTC") considers swaps to be economically similar to futures contracts and has often treated them equivalently,²⁴² so that swaps are subject to the same oversight as futures. The CEA makes it unlawful to enter into a futures contract except through regulated contract market,²⁴³ unless some exemption is found. Swap contracts between sophisticated parties are exempt,²⁴⁴ as are some swaps involving retail investors.²⁴⁵ However, no general exemption is available for swaps involving retail investors, and all signs indicate that both Congress and the CFTC consider retail swaps subject to the general prohibition on off-exchange transactions.²⁴⁶ Thus, if P2P notes were swaps, then they were almost certainly retail swaps executed off of an exchange, in contravention of the CEA.

At the time of the SEC's Order, neither the CEA nor CFTC regulations defined futures trading or swaps,²⁴⁷ so it remains uncertain

their income. They might swap their fixed income stream for someone else's variable interest stream, their counterparty happy to obtain fixed income to balance their own fixed obligations. They are swapping something in the most ordinary sense of the word.

²⁴² Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694-01 (July 21, 1989) ("Other commenters have stressed that despite these distinctions in the manner of trading of swaps and exchange products, the economic reality of swaps nevertheless resembles that of futures contracts."). A contract for A and B to swap income streams can be reformulated as a contract for A to deliver its future income and for B to deliver in kind.

²⁴³ 7 U.S.C. § 6(a) (2006).

²⁴⁴ Swap agreements between "eligible contract participants," or ECPs, are generally exempt from the CEA. 7 U.S.C. § 27(d)(1) (2006) (defining "covered swap agreement" as a swap entered into by ECPs); *id.* § 27(e) (excluding covered swap agreements from CEA); *id.* § 27(f) (preserving enforceability of covered swap agreements). ECPs include well-heeled individuals and entities. Commodity Exchange Act of 1936, Pub. L. No. 74-675, 49 Stat. 1491 (1936); 7 U.S.C. § 1(a) (2006) (defining ECP as, among others, individuals having assets exceeding \$10 million or, if the swaps are executed in the ordinary course of business or risk management, just \$1 million). In addition to statutory exemptions, the CFTC exercised its authority by excluding a variety of swaps between "eligible swap participants," a group that similarly excludes retail investors. 17 C.F.R. § 35 (2011).

²⁴⁵ See, e.g., 7 U.S.C. § 2(c)(1) (2006) (swaps involving government securities); *id.* § 2(c)(2)(B) (swaps involving certain foreign currency futures and options).

²⁴⁶ The Commodity Futures Modernization Act required a report to consider the appropriate regulatory structure for retail swaps ("Report"). Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 105(c), 114 Stat. 2763. The subsequent Report implies that retail swaps are not exempt from the CEA. Rather, the Report concludes that, owing to a lack of interest in retail swaps, such retail swaps do not warrant legislative change. COMMODITY FUTURES TRADING COMM'N, SEC, TREASURY & FED. RESERVE, JOINT REPORT ON RETAIL SWAPS 1,7,9 (2001). The implication is clear: retail swaps are regulated, and demand is insufficient to liberalize the regime.

²⁴⁷ Under the swap definition added to the CEA by Dodd-Frank, borrower payment

whether P2P notes constituted swaps. However, the CEA did define “covered swap agreements”²⁴⁸ to include credit swaps and similar swaps based on debt instruments.²⁴⁹ This broad definition seems to cover P2P borrower payment dependent notes because P2P notes’ values are based on the underlying note. If the borrower does not pay the platform, the borrower payment dependent note does not pay the lender. It is as though the platform bought a credit default swap on the borrower note from the lenders. Consequently, P2P notes may have constituted “covered swap agreements” subject to regulation.²⁵⁰

Because the borrower dependent notes likely constituted swaps, they likely were subject to the CEA’s prohibition against off-market trading. P2P lending platforms, however, offer notes outside of a regulated contract market. Therefore, SEC mandated changes may have pushed P2P platforms into non-compliance with the CEA following the Order. As a result, P2P platforms had to seek some kind

dependent notes could clearly be called swaps. *See* Dodd-Frank § 721(a) (21) (defining “swap” as “any agreement, contract or transaction . . . that provides for . . . payment . . . that is dependent on the occurrence . . . of an event or contingency associated with a potential financial, economic or commercial consequence”). Similar definitions are found outside of the CEA, prior to Dodd-Frank. *See, e.g.*, Commodity Futures Modernization Act of 2000 § 301 (adding to Gramm-Leach-Bliley Act § 206A (a)(2) (1999)) (defining swap as agreement that “provides for . . . payment that is dependent on the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence”). *But see* Gramm-Leach-Bliley Act § 206(A)(b)(5) (1999) (excluding note that is security under Section 2(a)(1) of the Securities Act of 1933, or Section 3(a)(10) of the Securities Exchange Act of 1934.).

²⁴⁸ 7 U.S.C. § 27(d) (2006) (including a credit swap or similar swap based on a non-agricultural commodity. An “excluded commodity” is not an agricultural commodity).

²⁴⁹ *Id.* § 1a(13).

²⁵⁰ If it strikes one as odd that P2P instruments might be “swaps,” one need only reflect on the now notorious credit default swaps.

²⁵⁰ In these transactions, party *A* might wish to protect herself against the economic risk of default of a given debt instrument. She could pay party *B* a certain amount every period, and *B* would accept the liability to pay *A* a sum if the instrument were ever to default. *B* could even pay the default-price up front, for later return if the bond never defaults. That account of swap does not fit the lay understanding of swap, but financiers recognize it as a typical swap.

P2P instruments have a meaningful resemblance to credit defaults swaps. The platform pays the lender a monthly sum, and the lender agrees to lose the principal balance on the underlying note, in the case of default. The only difference is that the lender pre-pays the contingent payment so that, in default, she merely loses her right to remaining payments.

of exemption²⁵¹ or only offer notes only through a regulated contract market.

These concerns are now historical: Dodd-Frank provides a blanket CEA exemption for securities.²⁵² But for more than a year P2P lending was forced to operate with tenuous legality under the CEA. Bringing P2P platforms into the ambit of the CEA regulation and its requirement that futures be traded on a regulated contract market was likely an unintended result of SEC regulation.

2. Mandatory Disclosures

Advocates for the securities regime have long argued that many firms produce too little information for investors and that mandatory disclosure can solve an informational market failure.²⁵³ Whatever the merits of mandatory disclosure for large, publicly traded firms are, they do more harm than good in the P2P market.

While most SEC filings report changes in earnings or executive officers, P2P platform filings are overflowing with hundreds of pleas for help, promises to be responsible, and kitchen-table financial planning.²⁵⁴ The SEC determined that P2P platforms must include all material borrower data in public filings. As a result, platforms must file these heartfelt or desperate pleas for P2P loans with the SEC. The SEC construes materiality broadly, requiring platforms to include all borrower information visible on the platform website, no matter how trivial.²⁵⁵ Accordingly, personal pleas and human requests appear on

²⁵¹ Unless some other exemption were found. 7 U.S.C. § 2(f) (2006) excludes qualifying hybrid instruments, instruments with both swap and security qualities. As securities, borrower member dependent notes would seem to exhibit substantial security qualities. 17 C.F.R. § 34.2 (defining hybrid instruments); 17 C.F.R. § 34.3 (2011) (excluding hybrid instruments).

²⁵² 7 U.S.C. § 1b(47)(B)(vii). Yet, at the time of this writing, this provision is still not effective, and so swap-related problems are not yet solved by Dodd-Frank. Pub.L. 111-203, Title VII, §§ 721(a), 754.

²⁵³ See, e.g., John C. Coffee, Jr., *Market Failure and the Economic Case for Mandatory Disclosure*, 70 VA. L. REV. 717 (1984) (arguing for mandatory disclosure system).

²⁵⁴ Borrowers often attempt to demonstrate their ability to service a loan by providing details about their grocery and electricity bills, housing and utility costs, expected vacations and home improvements, and more. These lists often come with promises to be thrifty and hardworking.

²⁵⁵ Letter from Christian Windsor, Special Counsel, SEC, to Renaud Laplanche, CEO, LendingClub Corp. (Oct. 2, 2008), available at <http://www.sec.gov/Archives/edgar/data/1409970/000000000008055622/filename1.pdf> ("Although, in your August 1, 2008 letter to the staff, you state that this 'information should not be material to a lender member's decision to invest in the notes,' and therefore you are not required to include it in your registration statement, your providing it to your members on the

the SEC's EDGAR webpage.²⁵⁶ As an example from a recent filing, a borrower, called bonus-marauder0, shares that she needs a loan because:

[F]amily expenses with my elderly mother and uncle have been sudden and unexpected . . . I don't have the immediate cash on hand therefore, I am seeking out this loan to help with the cost for the family so their needs to [sic] not go unmet, [sic] expecially since they are both senior citizens and unable to adequately meet these expenses on their own.²⁵⁷

In that same filing, we learn that another borrower, magnetic-dedication3, pays \$97 per month for his mobile phone,²⁵⁸ and that "a partner at a major national law firm" wishes to buy an engagement ring.²⁵⁹ Such "soft" information rarely appears in public filings. It is impossible that filing this information serves the important functions contemplated by a regime of periodic filing.

Further, the requirement to file borrowers' narrative and biographical data is repetitive because such information is already publicly available on the platform webpage. If these details really are material, lenders already have up-to-the-minute access.²⁶⁰ Lenders make extensive use of the platform's information and the data analysis tools described above. By contrast, the SEC admits that few people use EDGAR to access information about P2P investments.²⁶¹

Moreover, SEC disclosure requirements are costly.²⁶² Prosper spent about \$2.8 million on professional services fees in 2009, largely

Lending Club website implies to a lender member that it is material to a decision to invest in the notes."); *see also* Letter from Christian Windsor, Special Counsel, Sec. & Exch. Comm'n, to Edward Giedgowd, Chief Compliance Officer & Gen. Counsel, Prosper Marketplace, Inc. 2 (Feb. 18, 2009), *available at* <http://www.sec.gov/Archives/edgar/data/1416265/000000000009037655/filename1.pdf>.

²⁵⁶ *Important Information About EDGAR*, *supra* note 198.

²⁵⁷ Prosper Marketplace, Inc., Prospectus (Form 424/b/3) (Jan. 28, 2011), *available at* <http://www.secinfo.com/d1B726.q2z.htm> (Borrower Payment Dependent Notes Series 492101).

²⁵⁸ *Id.* (Borrower Payment Dependent Notes Series 492089).

²⁵⁹ *Id.* (Borrower Payment Dependent Notes Series 492131).

²⁶⁰ To be sure, it can be valuable to archive information. For example, it may be important for litigation to know what was said about a loan at the time it was sold. EDGAR serves this purpose. *See* GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 26. However, there are other ways to accomplish this end. *See* Verstein, *supra* note 202, app. B.

²⁶¹ *See* GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 26.

²⁶² SEC disclosure requirements may also risk the borrower's privacy. *See infra* Part II.B.4.

comprised of expenses related to registration.²⁶³ Now that their registration statements are effective, Prosper and Lending Club must still register each borrower loan request before they offer it to investors. As a practical matter, this means that the platforms file two to three times per business day.²⁶⁴

The results are astonishing. Prosper tendered about 1700 separate filings to the SEC in the last four years — more than General Motors.²⁶⁵ Lending Club generated about 3200 filings, which is almost double Yahoo and Amazon combined!²⁶⁶ The platforms have largely automated this process, but compliance costs remain high. For example, a recent Prosper quarterly filing reported \$700,000 in professional services expenses for a three-month period.²⁶⁷

Are lenders getting their money's worth from these costs? Likely not. First, as discussed above, lenders seem unable to integrate disclosed risks into their risk pricing. Instead, they lend to platforms at a rate that implies that they are not aware of platform credit risk.²⁶⁸ Worse yet, disclosure can actually help firms to bury the truth or confuse those unaccustomed to reading capital markets documents.

²⁶³ Prosper Marketplace, Inc., Annual Report (Form 10-K) 66, 69 (Mar. 31, 2010), available at [http://www.prosper.com/Downloads/Legal/prosper10k123109%20\(3.31.2010%20final\).pdf](http://www.prosper.com/Downloads/Legal/prosper10k123109%20(3.31.2010%20final).pdf). (showing that Prosper spent about \$2.8 million on professional services, up 37% from 2008, attributable to litigation and registration); see also Robert Schmidt & Jesse Westbrook, *An Online Lender Takes on the SEC*, BLOOMBERG BUSINESSWEEK (June 10, 2010, 5:00 PM EST), http://www.businessweek.com/magazine/content/10_25/b4183025376406.htm ("Prosper had spent \$4 million, even shutting down for nine months, to comply with SEC rules. Larsen claims the company now spends more than \$1 million annually on legal fees and audits, and makes more public disclosures—about two a day—than almost any other company.").

²⁶⁴ See Prosper Marketplace Inc., Prospectus (Form 424/b/3), *supra* notes 257.

²⁶⁵ Compare Online search for Prosper Marketplace, *Full-Text Search*, U.S. SEC. & EXCH. COMM'N (Jan. 30, 2011), http://searchwww.sec.gov/EDGARFSCClient/jsp/EDGAR_MainAccess.jsp (yielding about 1700 filings in the last four years), with Online search for General Motors, *Full-Text Search*, U.S. SEC. & EXCH. COMM'N (Jan. 30, 2011), http://searchwww.sec.gov/EDGARFSCClient/jsp/EDGAR_MainAccess.jsp (yielding 1400 filings in the last four years).

²⁶⁶ Compare Online search for LendingClub, *Full-Text Search*, SEC (Jan. 30, 2011), http://searchwww.sec.gov/EDGARFSCClient/jsp/EDGAR_MainAccess.jsp (yielding about 3200 filings in the last four years), with http://searchwww.sec.gov/EDGARFSCClient/jsp/EDGAR_MainAccess.jsp (yielding 900 filings in the last four years), and Online search for Amazon, *Full-Text Search*, U.S. SEC. & EXCH. COMM'N (Jan. 30, 2011), http://searchwww.sec.gov/EDGARFSCClient/jsp/EDGAR_MainAccess.jsp (yielding 900 filings in the last four years).

²⁶⁷ Prosper Marketplace, Inc., Quarterly Report (Form 10-Q) 2 (Nov. 12, 2010), available at <http://www.prosper.com/Downloads/Legal/Q3%202010%2010-Q%209.30.2010.pdf>.

²⁶⁸ See *supra* Part II.B.1.

Notwithstanding the SEC's passion for disclosure, the Supreme Court remarked that "an avalanche of trivial information . . . is hardly conducive to informed decision making."²⁶⁹ Mandated disclosure can also lend a veneer of regulatory legitimacy, defusing critical suspicions. Notwithstanding pronouncements to the contrary,²⁷⁰ many investors assume that the federal government has vetted SEC-registered firms, or that firms' claims have been proven true or safe.²⁷¹ When a P2P platform estimates a lender's predicted returns and links the investor to a prospectus, the prospectus may not foster the intended cautionary effect. Rather, regulatory filings may serve to suggest that the estimate is accurate, official, and not misleading. Thus, SEC disclosure may give lenders false confidence in P2P platforms.

Securities disclosure requirements concentrate on the interstice of government and security issuer. The SEC vets language in an issuer's prospectus and registration registration. But, the SEC does not evaluate issuers' everyday interactions with investors. While a prospectus requires "plain English,"²⁷² there is no such requirement for platforms' popup advertisements. Neither endorsements from affiliate-blogs nor optimistic promises on the company's own webpage are likely to be noticed by the SEC, let alone trigger an enforcement action.

Crucially the SEC disclosure regime does not provide guidance or standardization for platform claims regarding past and future P2P investor profits.²⁷³ Instead, platforms remain free to derive these figures however they please, so long as platforms adequately disclose their methods.²⁷⁴ The SEC requires disclosures of information that is of little use to lenders — lengthy prospectuses and EDGAR versions of "soft" borrower data that merely recite information available on the

²⁶⁹ *TSC Indus. Inc., v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976).

²⁷⁰ See 17 C.F.R. § 229.501(b)(7) (2011) ("Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense."); Prosper Marketplace, Inc., Prospectus (Form 424/b/3) 1 (Feb. 16, 2011) http://www.prosper.com/downloads/Legal/Prosper_Prospectus_2011-02-16.pdf.

²⁷¹ Coolclay, Comment to *Peer 2 Peer Lending?*, FRIHOST.COM, <http://www.frihost.com/forums/vt-122748.html> (last visited Mar. 18, 2011) ("My biggest concern was that of the company dissolving, but they are registered with the SEC . . .").

²⁷² 17 C.F.R. § 230.421 (a), (d) (2011).

²⁷³ See GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 47.

²⁷⁴ See *id.* ("The disclosure-based approach allows LendingClub and Prosper to report on loan performance and returns on investment differently.").

platform's web page. Nevertheless, the SEC has no formatting or clarity requirement for the information that could reveal costly errors, such as estimates of past returns.²⁷⁵ The disconnect between lender needs and SEC requirements strongly implies a regulatory mismatch and should prompt regulatory change.

3. Difficulty of Private Enforcement

Securities enforcement relies heavily on private enforcement, which is unlikely to be effective for problems with P2P lending. Assume that P2P platforms tempted lenders to invest by promising dizzying returns bolstered by vigilant underwriting and collections. If returns are poor and the platform fails to perform, will the Securities Acts be useful to lenders? Plaintiffs' lawyers play a vital role in securities lawsuits by policing issuer compliance. Despite plaintiffs' lawyers vigilance elsewhere, damages in securities lawsuits are likely too small in the P2P market to tempt plaintiffs or their attorneys to bear the costs of a lawsuit.

This is true for two reasons. First, assembling a class of P2P lenders sufficient for a class action lawsuit would likely be difficult.²⁷⁶ Questions of fact and law will differ, as will the interests of the class members. As P2P platforms adjust their business practices, plaintiffs with distinct complaints emerge. Note assignees from the unregistered years at Prosper could not be represented alongside a recent class, which would complain about some recent material misstatement. These parties would involve different arguments and interests, but would compete for the same limited funds of the platform. Without the power to form a large class, plaintiffs will struggle to secure a lawyer to represent the class for small per-plaintiff damages.

Even where P2P lenders could establish a class, it is difficult to justify remedies of any tempting size. Punitive damages generally are not available in securities fraud lawsuits, so any damages must be compensatory. Moreover, plaintiffs must show actual damages that do not include lost profits.²⁷⁷ While many P2P investors feel that their

²⁷⁵ The SEC believes that it could provide guidance on how companies should report their performance, but it has expressed concerns about the cost of such requirements relative to their benefits, as well as the cost to the SEC of proposing such rules. *See id.*

²⁷⁶ *See* FED. R. CIV. P. 23(a) (listing prerequisites necessary for class members to file suit).

²⁷⁷ Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 78bb(a) (2006); *see also* *Pelletier v. Stuart-James Co.*, 863 F.2d 1550, 1557-58 (11th Cir. 1989) ("The measure of damages in a Rule 10b-5 case is limited to actual pecuniary loss suffered by the

returns are much lower than platforms promised, or that platforms did not honor the terms of their agreement, the majority of platform investors nevertheless experience positive returns.²⁷⁸ Most investors who lose principal do so at a trivial percentage.²⁷⁹ The minority who lose an appreciable percentage of their investment still lose a relatively small amount in absolute terms.

Perhaps those difficulties in forming an effective class explain why the only lawsuits against P2P platforms concern the sale of unregistered securities.²⁸⁰ Such small losses may also explain why Prosper settled with state regulators for so little money.²⁸¹ None of these lawsuits, however, charge the kinds of misdealing or fraud that some critics allege. The absence of such suits — even strike suits²⁸² — implies that the securities laws cannot reduce present or future abuses. Thus, a better system would not rely on private plaintiffs to vindicate their interests in the P2P marketplace. Instead, platforms should appear before regulators, periodically or after consumer complaints, who could press for the welfare of all users.²⁸³

defrauded party, and does not include any speculative loss of profits.”).

²⁷⁸ See, e.g., ERIC'S CREDIT COMMUNITY, <http://www.ericccc.com/stats/lender-return-distribution> (last visited Aug. 7, 2011) (revealing Prosper investors' return distribution).

²⁷⁹ See *id.* Even Prosper's pre-registration days, when underwriting was much weaker, does not significantly weigh down the returns of investors. The average net annualized returns on Prosper from October 2008, to March 31, 2011, are negative 3%. GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 9. That is quite poor, but an average loss of 3% of small portfolios is not a large absolute loss.

²⁸⁰ See, e.g., *Christian Helling v. Breyer*, 123 Cal. Rptr. 3d 803 (Ct. App. 2011) (involving claim against Prosper for sale of unregistered securities in violation of Section 12 and Section 5 of the Securities Act of 1933); *Prosper Marketplace Inc. Enters Settlement with State Securities Regulators Over Sales of Unregistered Securities*, N. AM. SEC. ADMIN. ASS'N (Dec. 1, 2008), <http://www.nasaa.org/5622/prosper-marketplace-inc-enters-settlement-with-state-securities-regulators-over-sales-of-unregistered-securities/> (describing state regulators suit).

²⁸¹ See, e.g., News Release, Dep't of Consumer & Bus. Servs., State Securities Regulators Settle with Prosper Marketplace over Unregistered Securities (Dec. 5, 2008), available at http://www.oregon.gov/DCBS/docs/news_releases/2008/nr_12_5_08_prosper.pdf?ga=t (announcing \$1m settlement, total, for all participating states).

²⁸² Strike suits are largely meritless lawsuits brought with the intention of obtaining a settlement favorable to the plaintiff and their counsel rather than curing a wrong of the corporation. See, e.g., *Rivera v. Clark Melvin Sec. Corp.*, 59 F. Supp. 2d 280, 287 (D. P.R. 1999) (defining “strike suit”).

²⁸³ See *infra* Part III.

4. No Mandate to Help Borrowers

The SEC sees its mandate as protecting retail investors and promoting capital formation.²⁸⁴ There is no mandate to protect borrowers. Typically, investees do not need protection from investors, but P2P borrowers are not ordinary investees.²⁸⁵ The SEC's unidirectional focus on investors deprives platforms of the ability to balance their two constituencies — lenders and borrowers.

As previously discussed, P2P lending contemplates tradeoffs between borrower privacy and lender information.²⁸⁶ P2P platforms may require borrowers to publicly share an unusual degree of personal and financial information as a function of the platforms' marketing efforts. In providing this information, borrowers risk having their identity discovered or their information harvested by identity thieves. Some platforms even encourage borrowers to share information with their online network, leveraging social capital through community, in the search for credit. This information sharing increases the risks that stem from borrower-lender interaction, and warrants borrower protections.

Rather than helping to calibrate protections between legitimate borrower and lender needs, the SEC ossifies a ruthlessly pro-lender bias for P2P disclosure. For example, imagine that a borrower provided personally identifying information in her listing.²⁸⁷ Borrower information available on the platform is now filed with the SEC and posted on EDGAR. When the listing appears on EDGAR, the platform has no power to amend or redact it — even if the borrower receives harassment on the basis of the disclosure. A commonsense solution would be to pull the filing from EDGAR, but retain records in case the

²⁸⁴ See Arthur Levitt, Chairman, "A QUESTION OF INTEGRITY: PROMOTING INVESTOR CONFIDENCE BY FIGHTING INSIDER TRADING" AT THE "S.E.C. SPEAKS" CONFERENCE, SEC (Feb. 27, 1998), available at www.sec.gov/news/speech/speecharchive/1998/spch202.txt ("Investor protection is our legal mandate. Investor protection is our moral responsibility. Investor protection is my top personal priority."); *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 18, 2011) ("The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.") .

²⁸⁵ The average amounts borrowed on Prosper and Lending Club were \$5,886 and \$9,980, respectively. GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 10. These are small borrowers with typical consumer borrowing needs. *Id.*

²⁸⁶ See *supra* Part I.C.

²⁸⁷ The GAO found cases where borrowers could be identified from information available on EDGAR, such as their employer, job title, or city. GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 31.

original text proves important in the future. Yet, there is no basis for doing this under the securities regime. In fact, the filing becomes a permanent public record.

Rather than address nuanced privacy concerns, the SEC addresses borrowers only to the extent necessary to push P2P lending into the scope of federal securities fraud liability. In a comment letter regarding Lending Club's registration statement, the SEC requested Lending Club's opinion regarding potential borrower securities fraud liability for statements made in their listings. For example, borrowers might lie about their expenses, or their religious devotion, to make themselves a more attractive candidate. Would they be subject to liability under Rule 10b-5 of the Securities Exchange Act of 1934, which allows a private right of action under the securities laws, for such misstatements?²⁸⁸ Surprisingly, Lending Club acknowledges that the loan postings and borrower member information *will* be subject to rule 10b-5.²⁸⁹ The SEC accepted Lending Club's response, requiring Lending Club to indicate in its prospectus that investors' recourse against borrowers will be extremely limited.²⁹⁰ That is, the SEC required Lending Club to warn *lenders* that they might recover little in their lawsuits against borrowers, but the SEC did not require any warning to *borrowers* that they were subject to federal anti-fraud lawsuits for their representations.

Though P2P lender recourse is limited under Rule 10b-5, the securities regime imposes further harms on borrowers. Borrower listings often include statements like "I intend to use this money to fix my roof," or "I am an avid cyclist." Despite the dissimilarity between P2P listing statements and traditionally filed information, the SEC categorically requires platforms to file these borrower statements.²⁹¹

²⁸⁸ Letter from Christian Windsor, Special Counsel, SEC, to Renaud Laplanche, CEO, LendingClub Corp. 2 (July 18, 2008) *available at* <http://www.sec.gov/Archives/edgar/data/1409970/000000000008052460/filename1.pdf>. Rule 10b-5 makes it unlawful to make an untrue statement of material fact, or to omit such a fact, in connection with the sale of a security. 17 C.F.R. § 240.10b-5 (2011).

²⁸⁹ LendingClub Corp., Registration Statement (Form S-1) 9 (Aug. 1, 2008), *available at* <http://www.sec.gov/Archives/edgar/data/1409970/000095013408013885/filename16.htm>.

²⁹⁰ See LendingClub Corp., Amendment No. 1 to Registration Statement (Form S-1) 2 (Aug. 28, 2008), *available at* <http://www.sec.gov/Archives/edgar/data/1409970/000000000008052461/filename1.pdf>.

²⁹¹ Lending Club intended to not include soft borrower information because, it said, such information should not be material to a lender's decision to invest in the notes. See LendingClub Corp., Registration Statement, *supra* note 289, at 15. The staff responded, "[Y]our providing it to your members on the Lending Club website implies to a lender member that it is material to a decision to invest in the notes." See

Further, if the borrower is not *really* an avid cyclist, she may be liable under Rule 10b-5, like an executive who falsifies earnings in an annual filing. Accordingly, the SEC extended the federal fraud regime, with its onerous procedures and pro-plaintiff reliance standard, to include such *soft* informational misstatements. Borrowers do not benefit from this expanded jurisdiction; instead they gain new liabilities. Likewise, P2P platforms pass on some increased costs of registration to borrowers, who now pay higher interest rates and fees. Likewise, many more borrowers are now rejected for loan applications, particularly subprime borrowers who had difficulty attracting lenders.

The SEC's disregard for borrower needs frustrated the "open market loan" plan Prosper once intended to implement. Under that program, financial institutions with sympathetic background facts (e.g., a small credit union in a rural county) could have brought loans from their balance sheet to the P2P platform, where investors could bid for interests in them.²⁹² This program would have brought liquidity to small lenders at a time when it was sorely lacking, and would have done so in a more transparent manner than the alternative, pooled-asset securitizations. Lenders would have enjoyed a wider selection of investments, and borrowers from financial institutions would have found readier access to loans from newly liquid lenders. Open market loans, as Prosper proposed them, would have presented meaningful risks as well as significant opportunities.

Rather than weigh the risks against the opportunities, the SEC disallowed open market loans by terse formalism. In a Comment Letter to Prosper's Amendment No. 1, the SEC asserted that financial institutions offering notes on Prosper are co-issuers or co-registrants.²⁹³ As such, the SEC took the position that open market loans would constitute asset-backed securities. Regulation AB of the 1933 Act and 1934 Act defines an "asset-backed security" as a "security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets . . . that by their terms convert into cash within a finite time period"²⁹⁴ The SEC staff stated that the original loan, purchased by Prosper from another financial institution and then linked to borrower payment dependent notes, is "the pool."²⁹⁵ The selling financial institution would be transferring

Letter from Christian Windsor, Special Counsel, SEC, to Renaud Laplanche, CEO, *supra* note 255.

²⁹² Prosper Marketplace, Inc., Registration Statement, *supra* note 206, at 16.

²⁹³ SEC Reply to Prosper's Registration Statement on Form S-1, *supra* note 208, at 2.

²⁹⁴ 17 C.F.R. § 229.1101(c)(1) (2011).

²⁹⁵ Prosper Marketplace, Inc., Amendment No. 2 to Registration Statement, *supra*

assets to the pool and would, therefore, be deemed a co-issuer.²⁹⁶ Thus, the selling financial institution would be an issuer of the borrower payment dependent notes. As such, the institution would be exposed to the registration costs and potential liability under the securities regime.

Importantly, the SEC argued that open market offerings would not qualify for shelf registration (Rule 415 continuous offerings), meaning that each loan would require a unique registration and prospectus, which would add significant expenses to open market loans. No small bank partner would bear this cost in order to sell loans. As a result, Prosper soon gave up on open market loans altogether.²⁹⁷

Prosper's arguments for open market loans paralleled the idea that P2P notes are generally not securities, so it is not surprising that the SEC rejected them. The SEC's rejection of open market loans precluded a potentially valuable activity through mechanical application of securities regulations. Ideally, a P2P lending regulator would have examined the needs and capacities of open market lending participants in deciding whether to allow novel transactions, subject to best-practices and oversight. The SEC does not evaluate investments based on their merits, and therefore was not in a position to consider those issues. Nor, if it were, would its mandate specifically urge the SEC to promote borrower welfare. The structure of the P2P market is not so much a function of the needs and capabilities of market participants as it is the needs and capabilities of the regulators.

5. The Cliff Effect: Disparate Treatment for Similar Risks

Regulation under the Securities Acts creates a cliff effect where some regulated firms face steep compliance burdens but relatively similar firms can avoid all SEC oversight.²⁹⁸ Firms that are not issuers face no

note 210, at 2, 3-4.

²⁹⁶ 17 C.F.R. § 230.191 of the Securities Act of 1933 (2006) (Providing that the depositor for the asset-backed securities will be considered an issuer for those asset-backed securities, and incorporating the Item 1101 definition of "depositor."); 17 C.F.R. § 229.1101(e) ("*Depositor* means the depositor who receives or purchases and transfers or sells the pool assets to the issuing entity." (emphasis added)).

²⁹⁷ Prosper Marketplace, Inc., Amendment No. 4 to Registration Statem, *supra* note 221, at 10-12.

²⁹⁸ See Gelpert & Davis, *supra* note 21, at 1253 ("The current regime also has a discontinuous structure that is prone both to over- and under-regulating hybrids. At the extreme, if a 'peer funder' collects just 1 percent interest, it may be entitled to the full range of costly disclosure, registration, and anti-fraud protections of the U.S. securities laws; in contrast, collecting no interest would make the transaction exempt. This is so even if, in both cases, the ultimate 'peer borrower' pays interest to its

registration requirements at all, even if they pose identical risks to investors' finances. P2P lending gives a unique window into this discontinuity. On one hand, heartland P2P platforms face substantial compliance burdens similar to traditional public company issuers, despite posing different risks and having different needs than most issuers. On the other hand, however, Prosper and Lending Club are quite similar to Kiva, a P2P platform that need not comply with the securities laws. This analysis considers the ways in which the Securities regime treats unlike things alike, and like things differently.

The SEC requires regulated P2P firms to comply with its requirements and obtain approval in the same manner as other regulated firms — yet P2P firms involve significantly distinct innovation and needs than other firms. Among regulated firms, formally equal treatment may not be equal in practice. Take the initial public offering (“IPO”) for example. SEC scrutiny of an IPO has no set deadline and can take months to complete.²⁹⁹ Most firms accept this delay because the IPO is once-in-a-lifetime for a firm, and its benefits are worth a one-time delay. Firms refrain from selling securities in the post-filing, pre-effective period.³⁰⁰ In the meantime, they can continue to operate their businesses.

By contrast, P2P platforms are completely inert while they await registration effectiveness. P2P platforms sell notes that the SEC has deemed securities. Prior to registration, platforms cannot sell these notes,³⁰¹ meaning that platforms cannot do business before registration. Thus, Prosper's business came to a complete halt during the pre-effective periods following the Order. The delay lasted over eight months.³⁰² During the prolonged SEC interrogation, Prosper, the market-leader, lost momentum, from which it may never recover.³⁰³

intermediary at 20 percent, and each funder gets a legal and binding promise to repay the principal and a glossy brochure touting a history of over 95 percent repayment rates.”).

²⁹⁹ While it may appear that a registration statement becomes automatically effective a mere 20 days after filing under the Securities Act of 1933 § 8(a), 15 U.S.C. § 77(h) et seq., (2006), the reality is more convoluted. See HAZEN, *FEDERAL SECURITIES LAWS* 26 n.62 (2003).

³⁰⁰ See Securities Act of 1933 § 5(a)(1), 15 U.S.C. § 77e(a)(1).

³⁰¹ *Id.*

³⁰² Compare Prosper Marketplace, Inc., Notice of Effectiveness, CIK: 0001416265 File No.: 333-147019 (July 13, 2009) available at http://www.sec.gov/Archives/edgar/data/1416265/999999999509001898/xsLEFFECTX01/primary_doc.xml (indicating registration effective in July of 2009), with Prosper Marketplace, Inc., Amendment No. 1 to Registration Statement (Form S-1) (Dec. 5, 2008) available at http://www.sec.gov/Archives/edgar/data/1416265/000110465908074769/a08-29602_1s1a.htm (showing that first amended registration statement filed in December of

SEC regulation continues to present difficulties for P2P platforms even beyond the registration statement's effective date. The securities laws require platforms to amend registration whenever their business substantially changes. Most small businesses, however, do not have to worry about such amendments. If an ordinary consumer lender wishes to halve or double its collections budget, it may do so without regulatory approval or advance public disclosure. This is true even if the consumer lender is a publicly held company.³⁰⁴ By contrast, a P2P platform would find itself selling securities with a prospectus that did not reflect the change. Governed by the securities regime, changes to securities require a new S-1 post-effective amendment before an issuer may employ a new business approach.³⁰⁵ As young, innovative businesses, P2P platforms must decide whether a marginal business improvement warrants the difficulties of completing an S-1 amendment; thus, the SEC hampers the almost continual adjustment and experimentation that is vital to new businesses such as P2P platforms.

Once a platform files an amendment to report a contemplated change, the plan becomes available in the public domain for others to adopt or criticize. Seasoned issuers are accustomed to some degree of intrusiveness, but smaller companies usually have the freedom to experiment with business models before revealing their plans to the world at large. Only P2P firms are called to register with the SEC at such a premature stage. Moreover, even traditional public company lenders need not disclose details of their underwriting standards. P2P platforms, however, must explain exactly what comprises each interest rate assessment to comply with disclosure requirements regarding estimates and ratings methodology. While such transparency may

2008).

³⁰³ Prior to registration, Prosper originated about \$5 million in loans per month, and is only now returning to those levels. GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 7. By contrast, Lending Club moved more swiftly through registration and now originates about \$20 million per month. LENDINGSTATS.COM, <http://www.lendstats.com/> (last visited Aug. 9, 2011).

³⁰⁴ A large enough change, such as a bylaw amendment to discontinue collections, would require a reporting issuer to file a Form 8-K. See SEC Current Report (Form 8-K), Item 5.03, at 16-17, available at <http://www.sec.gov/about/forms/form8-k.pdf> (last visited Nov. 11, 2011). However, budgeting for loan recovery should not arise to that level.

³⁰⁵ See, e.g., Prosper Marketplace, Inc., Post-Effective Amendment No. 5 (Form S-1) (Feb. 15, 2011), available at <http://www.sec.gov/Archives/edgar/data/1416265/000141626511000131/prosperposam52d15d11.htm> (listing "Changes in our interest rates" as the only purpose for which a Post-Effective Amendment was filed).

benefit investors, it both tempts borrowers to manipulate the system and invites free-riding by competitors.³⁰⁶

The costs and delays from SEC regulation of P2P lending resulted in a substantial reduction in the number of P2P platforms. The United Kingdom's leading P2P platform abandoned its efforts to grow into the United States after the SEC issued its Order to Prosper.³⁰⁷ Several other American P2P platforms folded,³⁰⁸ or at least ceased P2P operations,³⁰⁹ including several platforms that intended to assist with student loans.³¹⁰ At a time when P2P companies are multiplying in the United Kingdom and around the world,³¹¹ the US market remains conspicuously barren.³¹² The SEC treated P2P platforms equally to all

³⁰⁶ A borrower seeking a loan can see precisely what details affect the success of prior applicants, and she can design her request accordingly. Some borrowers may use this information to perpetrate more successful fraud. A competitor firm can also read deeply into the platform's strategy. Though investors may find the prospectus difficult to navigate, to a competitor, the platform's filings read like a road map to the P2P business. Disclosing loan information and underwriting criteria provides benchmarks to competitors and lower barriers to entry into the market.

³⁰⁷ Zopa closed its U.S. operations in October 2008. Savaroonny, *Zopa U.S.*, ZOPA BLOG (Oct. 9, 2008, 12:13 PM), <http://blog.zopa.com/archives/2008/10/09/zopa-us/> (explaining that "the US has been adversely affected in a way that just couldn't have been predicted when we launched into the [sic] US and is no way the fault of our partners" and that "[f]or us, a real shame is that we weren't able to launch the original model over there for regulatory reasons").

³⁰⁸ See, e.g., sources cited *supra* note 144.

³⁰⁹ See, e.g., IOU Central, Inc., Request for Withdrawal of Registration (Form S-1) (Mar. 24, 2010), available at <http://www.sec.gov/Archives/edgar/data/1463888/000119312510065910/drw.htm> (requesting withdrawal of registration).

³¹⁰ See, e.g., Larry Chiang, *Profile*, FOUND READ, <http://startitup.indieword.com/person/4091-larrychiang> (last visited Nov. 11, 2011) (stating that Duck9 provides P2P loans to students); Duck9, <http://www.duck9.com/register.html> (last visited Nov. 11, 2011) (links to information about P2P loan no longer lead to P2P information, they lead to main site); *Fynanz Halts P2P Lending: Markets Student Loan Platform to Credit Unions*, PROSPER LENDING REV. (Jan. 3, 2009), available at <http://prosperlending.blogspot.com> ("[T]he first peer-to-peer lender focused exclusively on students, has halted all peer-to-peer lending."); *P2P Lending to Students With Duck9: Heard of It?*, PERSONAL LOAN PORTFOLIO (Feb. 3, 2008), <http://www.personalloanportfolio.com/67/p2p-lending-to-students-with-duck9-heard-of-it/> (inquiring about Duck9 providing P2P loans to students).

³¹¹ See, e.g., RATESETTER, <http://www.ratesetter.com> (last visited Nov. 3, 2011) (providing P2P services in UK); QUACKLE (UK) www.quackle.co.uk/home.do (last visited Nov. 3, 2011) (same); YES-SECURE, <http://www.yes-secure.com/> (last visited Nov. 3, 2011) (same).

³¹² See, e.g., Tom Abate, *State Lets Prosper.com Resume Lending Money*, SFGATE.COM (Apr. 28, 2009), http://articles.sfgate.com/2009-04-28/business/17193540_1_peer-to-peer-lending-lending-club-chief-executive-renaud-laplanche (noting that Jim Bruene, publisher of Online Banking Report and expert internet banking expert says,

traditional issuers, imposing no greater burden than for other types of firms. However, the SEC ignored the nuances of P2P's innovative and peculiar structure. In this climate, many P2P platforms have found it difficult to compete and grow.

While the travails of securities regulation fall heavily on the regulated P2P platforms, not all P2P firms must comply. P2P firms that avoid issuer characterization avoid all meaningful oversight, even though they pose risks similar to the regulated platforms. Consider the case of Kiva.³¹³

More than any other platform, Kiva has inspired millions.³¹⁴ For as little as \$25, lenders can make a difference in the life of an entrepreneur in the developing world.³¹⁵ Lenders can sort by gender, industry and country. They may discover a women's cooperative grocery store in Paraguay hoping to buy their stock for the season,³¹⁶ a Palestinian street performer in need of a new musical instrument,³¹⁷ or a Mongolian taxi driver who needs about \$400 to buy parts.³¹⁸ Each borrower profile page includes a compelling story and a terrific photograph, prepared by Kiva's field partners. As an instant media darling,³¹⁹ Kiva has been endorsed by Oprah, Adrian Grenier, and Bill Clinton.³²⁰

"Assuming all these regulatory woes get behind us it could grow into a multibillion (dollar) industry but it's still a niche"); Ronald Ingram, *The P2P Lending Landscape*, GPLUS (Nov. 11, 2010), <http://www.glgroupp.com/News/The-P2P-Lending-Landscape-51458.html> ("The US presents one of the most challenging regulatory environments. The constraints of U.S. regulation are stifling financial innovation. Bureaucracy and regulatory complexity have forced P2P lenders in Canada and especially the US to invest prodigiously in legal research, restrict availability to select customers and to compromise the integrity of their business models by trying to squeeze them into narrow outdated regulatory confines.").

³¹³ See Davis & Gelpert, *supra* note 298, at 1241, 1253.

³¹⁴ Indeed, while this section uses Kiva to illustrate the blindspots in our regulatory regime, there is no intent to downplay the tremendous good Kiva appears to have done.

³¹⁵ Sometimes the "developing world" is one's own backyard. Kiva now makes loans to the U.S. gulf coast.

³¹⁶ *San Isidro Group*, KIVA, <http://www.kiva.org/lend/272061> (last visited Nov. 3, 2011).

³¹⁷ *Abdallah*, KIVA, <http://www.kiva.org/lend/272204> (last visited Nov. 3, 2011).

³¹⁸ *Enh-Amgalan*, KIVA, <http://www.kiva.org/lend/272130> (last visited Nov. 3, 2011).

³¹⁹ See, e.g., *40 Under 40: Business's Hottest Rising Stars*, CNNMONEY.COM (Nov. 9, 2009), http://money.cnn.com/magazines/fortune/40under40/2009/full_list/ (including Premal Shah, president, and Matthew Flannery, founder); *50 Best Websites 2009: Kiva*, TIME, Aug. 24, 2009, available at http://www.time.com/time/specials/packages/article/0,28804,1918031_1918016_1917950,00.html (ranking KIVA 27th out of the

Kiva users are not making a donation. Like Prosper and Lending Club, and unlike charitable organizations, Kiva strives to return lenders' money. Unlike Prosper and Lending Club, however, Kiva's efforts are unregulated by the SEC under the *Howey* and *Reves* tests.³²¹

Under *Howey*, Kiva lenders know they are not purchasing a security, because they are paid no interest. Kiva notes also are not investment contracts because, although they invest money, they have no expectation of profits.³²² Kiva lenders' philanthropic motivations also suggest that its loans do not constitute notes under the *Reves* family resemblance test. *Reves*'s first factor is "motivation," under which Kiva's lack of interest payment strongly increases family resemblance.³²³ Therefore, Kiva offers neither notes nor investment contracts to lenders, nor any other security for the purposes of the securities laws. Thus, Kiva is not required to make SEC disclosures or warnings of the sort incumbent upon Prosper and Lending Club.³²⁴

top 50 websites of 2009); Alice Rawsthorn, *Winning Ways of Making a Better World*, N.Y. TIMES (Aug. 30, 2009), <http://www.nytimes.com/2009/08/31/fashion/31iht-designweb.html> (showing that Kiva won design prize from Danish government).

³²⁰ *A Conversation with Bill Clinton*, (MSNBC television broadcast Sept. 27, 2007), available at <http://www.msnbc.msn.com/id/21020060/page/2/>; Bill Clinton, *Oprah*, and Kiva – *Changing the World One Loan at a Time*, ECORAZZI (Sept. 4, 2007, 1:00 PM), <http://www.ecorazzi.com/?p=3803>.

³²¹ Cf. Letter from Mark F. Vilardo, Special Counsel, Div. of Corp. Fin., to Poplogix, LLC (Nov. 5, 2010), <http://www.sec.gov/divisions/corpfin/cf-noaction/2010/poplogix110510-2a1.htm> (stating that the Division of Corporate Finance will not recommend enforcement action against Poplogix LLC, which provides a P2P service similar to Kiva); see also Letter from Edwin T. Markham, Attorney Representing Poplogix, LLP, to Office of Chief Counsel, Div. of Corp. Fin., 2 (Oct. 1, 2010), available at <http://www.sec.gov/divisions/corpfin/cf-noaction/2010/poplogix110510-2a1-incoming.pdf> (stating that Poplogix will help lenders to make loans to artists, for which lenders will be paid no interest).

³²² See *SEC v. W.J. Howey*, 328 U.S. 293, 298-99 (1946).

³²³ *Reves v. Ernst & Young*, 494 U.S. 56, 66 (1990). *Reves*'s third factor asks whether investors expect the protection of the securities laws, and Kiva lenders are perhaps less likely to harbor such expectations. They may conceive of their Kiva loans as largely unlike corporate bonds. The fourth factor asks whether there is another regulatory scheme, which is more difficult to apply here. On the one hand, state attorneys general and the IRS both take an interest in non-profits. On the other hand, they do not specialize in addressing the kinds of risks Kiva lenders face. Moreover, it is conceivable that Kiva would structure itself to even avoid those regulators. See *infra* note 336.

³²⁴ Nor can the FTC enforce section 5 of the FTC Act, which prohibits unfair or deceptive acts or practices. The agency lacks authority to challenge an a corporation that does not operate for its profit or the profits of its members. 15 U.S.C. §§ 44, 45(a)(2) (2006); GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 41.

Without regulatory oversight, Kiva can encourage misconceptions about its business. Some of these misconceptions are of the sort that were once associated with needy child sponsorship organizations,³²⁵ only updated for a Web 2.0 world. One commentator neatly summarized most of the misconceptions Kiva allows:

Just today, for example, Kiva listed a loan fepor[sic] Phong Mut in Cambodia and at this writing only \$25 of the needed \$800 has been raised. But you needn't worry about whether Phong Mut will get the loan because it was disbursed last month. And if she defaults, you might not hear about it: the intermediating micro-lender MAXIMA might cover for her in order to keep its Kiva-listed repayment rate high.³²⁶

Other misconceptions abound. Although lenders receive no interest for Kiva loans, the ultimate borrowers pay interest, sometimes disturbingly high, on the loans that Kiva facilitates. These interest payments are not always used to cover Kiva's costs or to reinvest in loans. Rather, these payments often come to rest in for-profit firms, the network of partner firms Kiva uses to find and vet its borrowers.³²⁷

This sleight of hand also obscures borrower default rates, which are misrepresented to be astonishingly low.³²⁸ Kiva or its partners may repay a lender even if a borrower defaults, without ever telling the lender, in order to maintain its good reputation. Kiva's padded default rates give users a sense of financial security and encourage the perception that novel microfinance techniques make borrowers happy to repay Kiva.³²⁹ At its worst, Kiva's accounting exposes investors to the risk of a Ponzi scheme where a microfinance institution ("MFI") uses one loan to patch up another. At some point, however, the MFI bubble could burst, resulting in a sudden write-down of Kiva's loans.

Kiva investors rarely are aware of intermediary credit risks. Kiva obscures that investors may lose investments for reasons independent

³²⁵ Stephanie Storm, *Confusion Over Where Money Lent on Kiva Goes*, N.Y. TIMES, Nov. 8, 2009, <http://www.nytimes.com/2009/11/09/business/global/09kiva.html>.

³²⁶ David Roodman, *Kiva Is Not Quite What it Seems*, DAVID ROODMAN'S MICROFINANCE OPEN BOOK BLOG (Oct. 2, 2009), http://blogs.cgdev.org/open_book/2009/10/kiva-is-not-quite-what-it-seems.php.

³²⁷ *New York Times Article on Microfinance Interest Rates and Profits*, KIVA (Apr. 15, 2010), <http://www.kiva.org/updates/kiva/2010/04/15/new-york-times-article-on-microfinance.html> (noting that 20% of Kiva MFI partners are for-profit, though many have a strong social mission).

³²⁸ *Latest Statistics*, KIVA, <http://www.kiva.org/about/facts> (last visited Nov. 3, 2011) ("Current repayment rate (all partners): 98.90%.").

³²⁹ See Verstein, *supra* note 200, at app. A.

of the MFI or borrower. Kiva's "Risk and Due Diligence" disclosure previously listed and explained only three risks: entrepreneur risk, field partner risk, and country risk.³³⁰ It did not list any risks associated with the platform itself. As with Prosper and Lending Club, all Kiva investments are obligations of Kiva itself, so lenders risk the possibility that Kiva may default. A tort judgment against Kiva, or a rise in administrative costs, could result in Kiva lenders losing money — even if all MFIs and borrowers pay in full. Unlike other P2P firms such as Prosper and Lending Club, Kiva is not subject to SEC regulation and is free to market its services as it pleases.

The obvious potential victims of the Kiva cliff effect are the lenders, who encounter risks and philanthropy very differently than they might expect.³³¹ Although Kiva benefits from this cliff effect, Kiva too might prefer regulation, albeit under a more gradual and rational regulatory regime than that of the SEC.³³² The cliff effect distorts incentives for platforms, causing them to adopt business models that they might otherwise consider inefficient or incompatible simply to obtain regulatory freedom.³³³ In particular, Kiva's founders admit that they initially hoped to be able to reward lenders with some return, but were deterred by the legal obstacles of the securities regime.³³⁴ Interest

³³⁰ *Risks and Due Diligence*, KIVA, <http://www.kiva.org/about/risk> (last visited Oct. 3, 2010). Note that Kiva has recently added a fourth risk, Kiva Related risk. As recently as April, 2011, no such warnings existed.

³³¹ See generally Kevin E. Davis and Anna Gelpern, *Peer-to-Peer Financing for Development: Regulating the Intermediaries*, 42 N.Y.U. INT'L L. & POL. 1209, 1253-54 (2010) (Discussing the potential consequences of the cliff effect on lenders). Philanthropic lenders' risks should not be written off just because they are charitable. Some choose to lend through Kiva rather than donate because they actually count on getting the principal back, and they need it. They might lend less if they have to consider it a donation. Others are ideologically or psychologically opposed to donations but enjoy benevolent lending. These individuals' contributions will dry up if they are made donors instead of creditors, to the detriment of deserving borrowers.

³³² Kiva might be able to attract more lenders if it offered a small amount of interest. It might be happy to accept a small amount of regulation to grow its base substantially. For now, it only has the binary choice of freedom to pay any interest rate, but with securities regulation, or no freedom to pay any interest, but with no securities regulation.

³³³ Only the Kiva cliff effect is discussed, but others could be considered. See, e.g., *Frequently Asked Questions: From Babylon to Babyloan*, BABYLOAN.ORG, <http://www.babyloan.org/fr/FAQ.html#div1> (last visited Nov. 11, 2011) (noting that Babyloan, which wanted to offer 1-3% interest to its borrowers, but was disallowed by French law).

³³⁴ Matt Flannery, *Kiva and the Birth of Person-to-Person Microfinance*, 2 INNOVATIONS 31, 37-39 (2007).

payments to lenders would incentivize more Kiva investment, but the cost of regulation would overwhelm the benefit of a larger user base.³³⁵

Just as interest paying P2P platforms deserve regulation that allows them operate in an innovative fashion, rather than being subject to formulaic registration treatment, Kiva demonstrates that principal-only platforms should not be completely free from regulation.³³⁶

C. Understanding Misregulation

Why did the SEC choose to take a hard line with P2P lending? Presumably the SEC feared that P2P lending was largely unregulated. It may have feared P2P lending's potential to bring investment products into the hands of retail investors. These concerns, however, do not answer all the questions associated with the SEC's usurpation of P2P lending. But why did the SEC turn to P2P lending in November of 2008, amid a growing financial crisis, when its resources could have been used elsewhere?³³⁷ And why did the SEC choose to operate in a manner that harmed the very lenders it sought to protect?

³³⁵ Another way to increase interest in the platforms, and appropriate in any case, is to grant below-market interest loans through Kiva a charitable tax deduction. See Sarah Lawsky, *Money for Nothing: Charitable Deductions for Microfinance Lenders*, 61 SMU L. REV. 1525, 1527 (2008).

³³⁶ Non-profit platforms are regulated by state attorneys general and the IRS. However, it is unlikely that these regulators are attuned to the special risks in P2P. They deal with charities funded by donations, in which donors do not expect to be repaid, and they have no apparatus to control nonprofits' risk disclosures. They are not in the business of scrutinizing the managing and presentation of credit risk, and some may even find it antithetical to their mandate — absent some public disaster, who can imagine a state AG punishing on behalf of their creditors, be they a bank or retail lenders?

Moreover it is not obvious that some future Kiva copycat must choose between SEC oversight and the oversight traditionally associated with nonprofits. A platform could be a for-profit corporation, and exempt from non-profit oversight. The same platform could issue borrower payment dependent notes with 0% interest payments. Investors would not be due securities laws protection since the note is not a security. These lenders would get no protection as either donors or investors, and a for-profit firm could operate with great freedom and a high profit margin.

We may doubt that many investors would be interested in such a transaction, but the Internet allows all kinds of investors to be contacted and taken in. Without disclosure regulation, the platform could be less than forthright in explaining its nature and the relevant risks. See, e.g. *supra* note 325 (GlobalGiving neglected to tell 0% interest lenders that they were lending to a for-profit firm). This would be an easy case for affinity fraud to take some people in. See sources cited *supra* note 98.

³³⁷ Cf. David Voreacos & David Glovin, *Madoff Confessed \$50 Billion Fraud Before FBI Arrest (Update3)*, BLOOMBERG (Dec. 12, 2008, 3:29 PM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aYzclQY1HkVE> (highlighting the contemporaneous \$50

The SEC's action may result from of an agency culture that is inherently insensitive to the risks of misregulating emerging industries. Large organizations, such as the SEC, tend to develop certain cultures and understandings of how to operate. Professor Pritchard and other scholars argue that the SEC suffers from groupthink and confirmation bias, among other vices.³³⁸ As an opinion forms within the agency, dissenting views may disappear, even in the presence of negative outcomes. The SEC oversees thousands of issuers and likely hears many pleas seeking flexible treatment and complaints regarding the intrusiveness of SEC regulation. It seems likely that the SEC would have been initially skeptical of P2P lending's new business model. The SEC likely intervened to prevent potential risks that P2P lending might someday pose; this action, however, ignores the risks of its own regulation.³³⁹

This sort of agency insensitivity leaves the SEC with a long history of trying to fit new pegs into old holes, fundamentally misunderstanding financial innovations in order to apply old frameworks. For example, Professor Romano catalogued the agency's failure of comprehension to futures margin requirements.³⁴⁰ Stocks and stock index futures differ dramatically in their risk profile and the rationale for margin. The margin account for stocks constitutes a down payment on the loan one used to obtain the stocks. The margin account on a stock index future is put up in good faith to protect the counterparty against default. Because the purposes and risks are different for stocks and stock index futures, industry norms demand different margin requirements.³⁴¹ Nevertheless, the SEC fought hard to raise stock index futures margins to those of stock margins.³⁴² This example demonstrates the SEC's inability to address the intricacies of innovative transactions. Either the SEC intentionally misregulates

million fraud committed by Bernard Madoff).

³³⁸ See generally A.C. Pritchard, *The SEC at 70: Time for Retirement?* 80 NOTRE DAME L. REV. 1073 (2005) (discussing groupthink in the SEC). Groupthink is the tendency for members of a group to defer to the group's consensus, narrowing the range of hypotheses considered in addressing a problem. Confirmation bias is the tendency to evaluate and acknowledge evidence in light of prior actions or beliefs.

³³⁹ See generally WILLIAM FIELDING OGBURN, *SOCIAL CHANGE WITH RESPECT TO CULTURE AND ORIGINAL NATURE* (1922) (noting lagging responses to innovations).

³⁴⁰ Roberta Romano, *Regulation of Derivative Securities*, 55 MD. L. REV. 1, 19 (1996).

³⁴¹ *Id.* (stating that industry norms called for 50% margin for stocks and 10% to 15% for futures).

³⁴² *Id.* at 19 n.42 (explaining an SEC-led political fight to raise margin requirements under the first Bush administration that lasted two years).

because of hostility to innovative transactions, or it is unaware of the unique needs of new transaction models.

Alternatively, perhaps the SEC acted rationally according to what it perceived to be its own interests. Public choice theory portrays government actors pursuing their own interests, as they perceive them.³⁴³ These government actors assume regulatory authority or defer to others as their various pressures dictate.³⁴⁴ In deeming P2P notes securities, the SEC likely assumed that it would be blamed if a scandal were to emerge in an unregulated P2P lending market. Regulatory costs are born by consumers and industry, not the regulatory agency. As such, the agency rationally over-regulates as a form of externalizing insurance. At a time when the SEC received criticism for its handling of the financial crisis, it likely wished to appear tough by being firm with providers of largely subprime consumer credit, like P2P platforms.³⁴⁵ Accordingly, P2P lending may be a mere victim of the SEC's institutional needs.

For many bureaucracies, self-interest means growing and preserving the size of the agency and its budget.³⁴⁶ As more individuals access the market through intermediaries like mutual funds, the SEC's wheelhouse of protecting retail investment in securities narrows. The SEC may have chosen to regulate P2P lending in order to grab turf in the event the P2P lending industry grows.³⁴⁷ Alternatively, the SEC may have wished to ensure that P2P lending did not grow, imposing regulatory hurdles to protect existing intermediaries such as banks.

³⁴³ See generally WILLIAM A. NISKANEN, JR., BUREAUCRACY AND REPRESENTATIVE GOVERNMENT 36-42 (1971) (stating that bureaucrats try to maximize budget and power); Jonathon R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265 (applying public choice to federalism).

³⁴⁴ See generally Macey, *supra* note 287 (describing why the federal government chooses to defer to state regulation).

³⁴⁵ This Article is not the first public choice account of P2P. There is good reason to suspect rent seeking when Bangladesh's bank regulators announced that the Nobel laureate Mohammad Yunis must step down as head of Grameen Bank because of a mandatory retirement age law. There is reason to think that the government wishes to increase its control over the successful microfinance group for political purposes. Ruth Davis, *Nobel Winner Faces Calls for Ouster From Grameen Over Age*, BLOOMBERG (Mar. 1, 2011, 7:08 AM), <http://www.bloomberg.com/news/2011-03-01/nobel-winner-yunus-faces-calls-for-ouster-from-grameen-over-age.html>.

³⁴⁶ See generally JAMES Q. WILSON, BUREAUCRACY: WHAT GOVERNMENT AGENCIES DO AND WHY THEY DO IT (1989) (describing bureaucratic behavior).

³⁴⁷ See generally Roberta Romano, *The Political Dynamics of Derivative Regulation*, 14 YALE J. ON REG. 279 (1997) (describing jurisdictional battle between SEC and CFTC).

P2P lending's growth comes at the cost of traditional consumer credit firms.³⁴⁸ Big investment banks help consumer lenders to securitize loans. From Visa to General Motors Acceptance Corporation ("GMAC"), consumer credit rarely comes to rest in the hands of the lender; rather, it is securitized, serviced, held, or sold by major financial institutions. P2P borrowers primarily borrow to refinance existing consumer credit. If P2P lending has a bright future, it comes almost entirely out of the existing consumer credit business model, much of which is under the SEC's watch. Either to defend its perceived interests or because it has been captured by incumbent financial institutions,³⁴⁹ the SEC may have wanted to protect its traditional constituents from innovative competition.³⁵⁰

The SEC's traditional constituents are also Congress's constituents. Just as the SEC may wish to protect its favored companies, Congress may also wish to protect the firms that support its congressional members. Money talks, and, to be sure, incumbant financial institutions are not afraid to exert influence. Essentially, Goldman Sachs has more important friends in Congress than does any P2P company, and thus may better voice its desires.³⁵¹ Moreover, P2P lending represents a trend of stark disintermediation to which some self-interested government actors may feel special hostility.

Intermediaries provide a level of opacity in government action. If policymakers wish to favor allies, they may lean on intermediaries to do so. The Community Reinvestment Act,³⁵² which directs banks to lend to borrowers in their communities, allows the government to direct funds to favored constituents without using government loans or grants. While it may be unfeasible for politicians to directly reward

³⁴⁸ See ZOPA, *supra* note 53.

³⁴⁹ Einer R. Elhauge, *Does Interest Group Theory Justify More Intrusive Judicial Review?*, 101 Yale L.J. 31, 42 (1991) (discussing capture and collecting literature).

³⁵⁰ See generally JAMES Q. WILSON, *THE POLITICS OF REGULATION*, at ix (1980) ("One cannot mention regulatory agencies without adding the observation that, of course, such agencies are likely to be 'captured' by the interests they are supposed to regulate. To suggest that matters are any different from this is to mark oneself as hopelessly naive, or even disingenuous.").

³⁵¹ Prosper's lobbying won it the support of San Francisco Congresswomen Jackie Speier. See Silla Brush, *Online Lender Lobbies Congress for Industry Consumer Regulator*, THE HILL (June 9, 2010, 7:23 PM), <http://thehill.com/business-a-lobbying/102323-online-lender-lobbies-congress-for-industry-consumer-regulator>; see also Eric Lichtblau & Eric Dash, *Goldman and its Lobbyists Spurned in Fight on Bill*, N.Y. TIMES, Aug. 10, 2010, at B1 ("[Goldman's] lobbyists and outside lawyers include Washington luminaries like Richard A. Gephardt, the former House majority leader, and Ken Duberstein, the former Reagan administration official....").

³⁵² See 12 U.S.C. §§ 2901-08 (2006).

influential supporters, a lending mandate may force banks to provide credit to the same supporters. Similar stories may be told about federal support for subprime housing subsidies more broadly; generous subsidies encouraged intermediaries to loosen their underwriting standards for important constituencies.³⁵³ Intermediation also benefits political actors by obscuring blame when things go awry. Where imprudent loans threaten systemic stability, government agents can defuse criticism by using the intermediary as a scapegoat. Politicians may lose elections when opportunistic behavior leads to visible waste or disaster, but not if they can place blame on the “profiteering” intermediary.³⁵⁴ When finance is decentralized and disintermediated, however, politicians will find it more difficult to hide behind pet intermediaries.

Ultimately the SEC’s motives remain inscrutable. Its six-page Order to Prosper remains the agency’s only public comment on P2P lending.³⁵⁵ Further, the Order consists of merely a hasty legal conclusion divorced from practical policy considerations. The SEC points to no actual or anticipated abuses that regulation could solve, nor signals any consideration of the risks it poses in regulating P2P platforms.³⁵⁶ This silence may be the SEC’s most important indictment.

In a rapidly disintermediating world, market participants will demand openness. Web 2.0 consumers are characterized by a high level of participation, and they deserve a modern regulator capable of publicly tackling perceived threats. With evolving market disintermediation, consumers will likely demand explanations for regulatory actions, and they will become frustrated with any regulator that does not deign to explain its policy objectives.

³⁵³ PETER J. WALLISON, FINANCIAL CRISIS INQUIRY COMMISSION: DISSENTING STATEMENT 444 (2011), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_wallison_dissent.pdf (calling U.S. government support for subprime and other risky loans the *sine qua non* of the financial crisis).

³⁵⁴ See, e.g., Lauren Tara LaCapra, *Wall Street Whispers: Will Obama Slay the Fannie and Freddie Beast?*, THE STREET (July 22, 2010, 5:25 PM), <http://www.thestreet.com/story/10814735/1/will-obama-slay-the-fannie-and-freddie-beast.html> (“Dodd and Frank have long been champions of Fannie and Freddie, pushing them deeper into subprime to achieve affordable-housing goals. . . . ‘They were clearly mismanaged, their CEOs were making something like \$30 million a year and they were basically running themselves like a Wall Street bank with taxpayer dollars.’ ”); see also J.W. Verret, *The Bailout Through a Public Choice Lens: Government-Controlled Corporations as a Mechanism for Rent Transfer*, 40 SETON HALL L. REV. 1521, 1550 (2010).

³⁵⁵ However, the SEC has issued a no-action letter to one P2P firm that provides lenders no interest payments. See sources cited *supra* 321.

³⁵⁶ See Prosper Marketplace, Inc., Exchange Act Release No. 8984, *supra* note 138.

III. REFORM PROPOSAL: P2P LENDING UNDER THE CONSUMER FINANCIAL PROTECTION BUREAU

This Part sketches an alternative regulatory proposal, designed to better accommodate consumer needs in P2P lending. P2P notes should be removed from the scope of the Securities Acts and transferred to the control of the new Consumer Financial Protection Bureau ("CFPB"). Prior to the Dodd-Frank Act, Prosper lobbied extensively to gain exemption from the Securities Acts.³⁵⁷ Prosper, instead, hoped for regulation under the CFPB, which Dodd-Frank established as a new the federal agency charged with oversight of consumer financial transactions.³⁵⁸

Prosper's lobbying efforts³⁵⁹ succeeded in achieving a statutory exemption in the House of Representatives version of the bill that would become Dodd-Frank.³⁶⁰ This exemption would have amended Section 3(a) of the Securities Act of 1933 to exclude "any consumer

³⁵⁷ See Brush, *supra* note 351 (stating that "Prosper has had hundreds of meetings on Capitol Hill, and Larsen founded a related association, the Coalition for New Credit Models, which has spent \$150,000 on lobbying with Podesta"); *Lobbying: Prosper Marketplace*, OPENSECRETS.ORG, <http://www.opensecrets.org/lobby/clientsum.php?lname=Prosper+Marketplace&year=2010> (last visited July 25, 2010) (noting that lobbying amounts were substantially greater in 2009 due to passage of Dodd-Frank Act); see also *Financial Start-Ups Form "Coalition for New Credit Models,"* PROGRESO FINANCIERO, http://www.progressfin.com/en/press_releases/financial_start-ups_form_coalition_for_new_credit_models/ (last visited Aug. 4, 2010) (stating that the Coalition for New Credit Models recommends that Congress "[a]dopt legislation classifying person-to-person lending as a consumer banking service, not a securities offering"). But see Brush, *supra* note 351 ("We understand that this is an expensive process, but at the same time [it] provides a level of transparency and provides certainty to both borrowers and lenders," said Jason Altieri, Lending Club's general counsel. "Currently we're fine with the regulation by the SEC. We think they are the appropriate group to manage this nascent industry. They have been very accessible and accommodating. We have been happy with them.").

³⁵⁸ Dodd-Frank Act, Pub. L. No. 111-203, §§1001-1100H, 124 Stat. 1376 (2010).

³⁵⁹ Concerns about the undue influence of special interest and their lobbyists are increased by the reality of a revolving door between government, industry, and lobbying firms. For example, the former director of Prosper who initiated Prosper's lobbying efforts, is now joining the CFPB. See Edward Wyatt, *Advisor to Consumer Agency Had Role in Lending*, N.Y. TIMES, Oct. 26, 2010, at B1. But see Zach Carter, *Raj Date is the Best Thing to Happen to Consumers Since Elizabeth Warren*, ALTERNET (Oct. 27, 2010, 9:42 PM), <http://blogs.alternet.org/speakeasy/2010/10/27/raj-date-is-the-best-thing-to-happen-to-consumers-since-elizabeth-warren/> (praising Raj's pro-consumer work).

³⁶⁰ H.R. 4173, 111th Cong. § 4315 (2009); House Proposed Amendment to Title X, http://democrats.financialservices.house.gov/FinancialSvcDemMedia/file/key_issues/Financial_Regulatory_Reform/Conference_on_HR_4137/Title_X/Title_X_House_Counteroffer.pdf.

loan, and any note representing a whole or fractional interest in any such loan, funded or sold through a person-to-person lending platform.”³⁶¹ With some exceptions, the new consumer protection agency would govern P2P lending and related notes.³⁶² However, Congress did not pass Prosper’s proposal. Nevertheless, the GAO report lists a similar provision as one of the two regulatory options available for P2P lending going forward. The first option provides a continuation of a bifurcated regulatory regime somewhat like that which currently overlays P2P lending, in which lenders are primarily protected by securities regulators, and borrowers are primarily protected by financial services regulators, including the CFPB.³⁶³ The second option would consolidate the protection of lenders and borrowers into a single federal regulator, most likely the CFPB.³⁶⁴ The GAO was unable to provide an overall recommendation as which option Congress should adopt. On the one hand, it cited concerns that the bifurcated regulatory system might be inflexible and inefficient. On the other hand, the GAO acknowledged risks of using a new regulator that is, itself, in its formative stages. Moreover, the GAO highlighted the changing nature of the P2P lending industry as reason for caution and skepticism regarding the government’s ability to design a regime today that will meet the industry needs of tomorrow.³⁶⁵

The GAO correctly asserts that neither the character of the CFPB nor the future of P2P lending is ascertainable in the present. Nevertheless, a unified regulator remains the best available solution. CFPB regulation would be superior to SEC regulation for P2P lending. Part II.B showed how the current regulatory scheme creates costs without protections, fundamentally misunderstanding P2P lending. The SEC lacks the understanding, motive, or power to properly regulate P2P lending. The CFPB does not suffer these deficiencies. CFPB regulation would have comparative advantages in four key areas of reform: disclosure, oversight and enforcement, prudential regulation, and borrowers. While the CFPB or the future of P2P lending may hold uncertainties, we should not allow it to paralyze

³⁶¹ H.R. 4173.

³⁶² Transactions involving multiple loans would remain under the SEC’s purview, presumably to prevent large-scale securitization from eluding the securities regulator. *Id.*

³⁶³ GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 42.

³⁶⁴ *Id.*

³⁶⁵ *Id.*

regulation. Unified regulation under the CFPB would be a substantial improvement to the treatment of this innovative P2P market.

An ideal regulator would allow P2P lenders to obtain dependable estimates of risk and return. Although there is no single “right” way to calculate future profits from past defaults in a new market, P2P lenders require sufficient information to compare platforms and understand the risks associated with P2P lending. The SEC failed to meet this need because it lacks the mandate to police web pages and set substantive advertising standards. Even if the SEC held such authority, it would lack the expertise to engage in such oversight. The SEC generally permits issuers to define terms as they wish, as long as the issuer is explicit about its terminology, thus allowing various and misleading return statistics for P2P lending. Instead, the SEC provides information through thick prospectuses and lengthy, unnecessary disclosures, which contain information already publicly available.³⁶⁶ By contrast, the CFPB would have authority to craft disclosure rules that address misleading advertising and disclosure.³⁶⁷ The CFPB could draw on its experience regulating communications with borrowers to ensure that lenders, too, are given offers that they can understand.

The CFPB can also create safe harbor disclosure formats, which are non-binding but ensure the regulator’s presumptive approval. These disclosure requirements would provide consumers with an accurate understanding of the risks they face, including the past performance of P2P transactions. As P2P firms opt for these safe harbors, inter-platform comparison will become easier. The GAO acknowledged the difficulties P2P lenders currently face in comparing risk and returns among platforms.³⁶⁸ The SEC told the GAO that it currently does not attempt to improve inter-platform comparability, and that doing so would strain the SEC’s limited staff.³⁶⁹ The CFPB would have the staff and expertise to take on the standardizing task that the SEC would not, thereby overcoming the SEC’s hurdles to adopting a more ideal regulatory framework.

³⁶⁶ Even my most critical interview subjects wished for platforms to make clearer statements as to returns and to better honor the policies they promised (particularly with respect to collections and fraud-protection). These are not demands for deeper and greater disclosure. See Pritchard, *supra* note 338, at 1088 (“Disclosure is the tool of choice largely because that is what Congress has given the SEC.”).

³⁶⁷ Dodd-Frank Act, Pub. L. No. 111-203, § 1032, 124 Stat. 1376 (2010).

³⁶⁸ GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 47.

³⁶⁹ *Id.*

To satisfy financial protection objectives in this wired economy, the CFPB will soon develop competence evaluating online financial product advertisements. It could potentially leverage this expertise to adopt rules governing the payment of affiliate fees for references, which would reduce the existence of exaggerated praise of P2P by compensated bloggers. The CFPB could respond to consumer notices of deceptive platform advertising, and sanction the platforms on an ongoing basis.³⁷⁰

In addition to misrepresentation, P2P lending presents unique challenges that an ideal regulator would address. P2P loans are small enough that consumers will not fully protect their own interests. Currently, SEC enforcement actions are extremely rare and ill fit to remedy P2P lending claims. Traditional private plaintiffs enforce the Securities Acts through class action lawsuits, but small P2P loans, with disappointing but generally non-negative gains, will be unlikely to procure plaintiffs' lawyers.

The CFPB, on the contrary, is designed to respond to consumer complaints,³⁷¹ and holds tremendous enforcement capabilities. The CFPB's responsiveness to consumer complaints would allow it to evaluate platforms on an ongoing basis and provide consumer enforcement.³⁷² The CFPB would not be limited to *ex post* loss litigation, but could concern itself with P2P lending's opportunity costs, unfair practices, and prospective modifications. Furthermore, the CFPB can and should meet with industry representatives and users to anticipate and avoid problems before they escalate. The CFPB can be proactive in suggesting or requiring industry changes to make the market safer and more efficient. By contrast, the SEC told the GAO that its role was not to suggest changes but instead to respond to them.³⁷³ As it develops, the CFPB will already have authority to define what constitutes unfair, deceptive or abusive practices with respect to borrowers.³⁷⁴ A unified approach under the CFPB also would allow consideration of practices that might be unfair to lenders.

³⁷⁰ 12 U.S.C. § 5534 (2006) (stating that CFPB will establish a database for collecting and responding to consumer complaints).

³⁷¹ Dodd-Frank Act § 1034.

³⁷² See 12 U.S.C. § 5534 (identifying responsibility of CFPB regarding "[r]esponse[s] to consumer complaints and inquiries).

³⁷³ GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 49. Industry participants and the SEC both acknowledge improving responsiveness to suggested changes, but the SEC has hardly done well in responding to and understanding difficulties with the market before this time. See *id.*

³⁷⁴ 12 U.S.C. § 5532 (2006).

Protecting lenders requires a measure of prudential regulation, requiring some minimum regard for the security of lender interests. The SEC is ill suited to oversee this project due to its role as a disclosure regulator.³⁷⁵ SEC interests in disclosure often cause it to overlook non-disclosure effects of regulation on issuers or investors. As a result, the SEC failed to consider both the cost of disclosure on P2P platforms, as well as the increased risks to lenders from conditioning shelf registration on lenders holding unsecured interests. Instead, the SEC pushed platforms into riskier, more complex lending structures to the detriment of all parties.

If Congress removes SEC authority by clarifying that P2P notes do not constitute securities, P2P platforms would be able to operate without interposing themselves as an intermediary credit risk to their users. Likewise, P2P lenders will be able to directly hold notes, or at least hold a fully secured interest in borrower notes. These changes will greatly reduce risk to lenders, who would no longer suffer a loss if the platform defaults. Removing the risk of intermediary default, however, does not remove all risks associated with platform failure. P2P lenders would still face significant inconvenience if the platform goes out of business. Lenders' fractional interests are small. Though they would have the right to, lenders could not practicably service their loans. For this reason, ideal regulation would require all P2P platforms to develop a plan for a possible failure. These requirements already exist under Dodd-Frank for certain financial institutions, which are required to make resolution plans, or "living wills."³⁷⁶ P2P platforms should have an analogous responsibility. P2P platforms are less complex than larger holding companies, so their resolution plans would be more basic. A simple solution would be for P2P platforms to contract with another P2P platform to take over servicing the loans if the platform were to fail.

The steps proposed here would serve as a marked improvement from the bifurcated regulatory regime of the SEC. The SEC currently

³⁷⁵ See GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 48; *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 18, 2011).

³⁷⁶ Dodd-Frank Act §§ 112(a)(2)(I), 115(b)(1)(D), 115(d)(1). Scholars continue to debate whether these plans will have a salutary effect on systemic risk. See Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 195 (2011); David Zaring, *A Lack of Resolution*, 60 EMORY L.J. 97, 127-29 (2010). However, we are not greatly concerned with systematic risk in the P2P area.

does not take steps to help secure P2P lenders.³⁷⁷ Nor does it want to accept such a task.³⁷⁸ Instead, prescribing steps “to protect lenders in the case of [a] bankruptcy would be inconsistent with the [SEC’s] role” as a disclosure regulator.³⁷⁹ If the SEC sees these operations as inconsistent with its mission, it must fall to another regulator to protect P2P lenders. A unified approach, with the CFPB at the helm, could implement these policies for a more effective, prudential regulation of P2P lending.

P2P lending is as much about borrowing as it is about lending. The SEC does not consider helping borrowers to be a part of its mission, and the results of its P2P lending regulation reflect this prioritization. Borrowers experience less privacy, less access to capital, and a less nuanced approach since the SEC Order. However, P2P borrowers are consumers too, and the promise of P2P lending should not leave them behind.

The CFPB, unlike the SEC, has the authority to balance the risks and concerns inherent in lender/borrower relationships. The CFPB has broad rulemaking authority over federal consumer financial laws.³⁸⁰ It also has supervisory authority over persons providing consumer financial products or services.³⁸¹ Likewise, the CFPB has exclusive authority to enforce federal consumer financial law.³⁸² It, therefore, has wide discretion to balance the concerns of borrowers and lenders. Furthermore, no agency will be better positioned than the new CFPB to imagine new ways in which borrowers and lenders might interact to mutual benefit.

A call for CFPB involvement may revive familiar worries: will the agency be excessively populist or paternalistic — a “supernanny”?³⁸³ The CFPB might pursue immediate consumer benefits that create

³⁷⁷ Indeed, we have seen that the SEC has caused lenders to have far less security than before.

³⁷⁸ GAO-11-613 PERSON-TO-PERSON LENDING, *supra* note 15, at 48 (“[S]taff from SEC’s Division of Corporate Finance said that prescribing steps that a person-to-person lending company should take to protect lenders in case of a bankruptcy would be inconsistent with the role of securities regulation — a role that is intended to ensure adequate disclosures for investors rather than to regulate companies’ operations.”).

³⁷⁹ *See id.*

³⁸⁰ Dodd-Frank Act, § 1022.

³⁸¹ *Id.* § 1002(6)(A) (defining “covered person”); § 1024(a) (stating supervision of nondepository covered persons).

³⁸² *Id.* § 1024(c)(1).

³⁸³ David S. Evans and Joshua D. Wright, *The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit*, 22 LOY. CONSUMER L. REV. 277, 280-81 (2010).

burdens to the businesses they regulate, causing harms that the business will externalize by passing costs on to consumers. As a result skeptics might argue that P2P consumers will find fewer credit-providers, higher prices, and fewer choices under CFPB regulation.

To the contrary, the experience of regulating P2P would allow the CFPB to consider the tradeoffs of a proposed regulation in consumer welfare terms on both sides of the transaction. For example before the CFPB decides that a given type of borrower late fee is unfair, it would have to weigh the fairness in *denying* that fee to a consumer-lender. As such, the CFPB will be a more nuanced and reasonable regulator of P2P lending than many may expect. Moreover, this regulatory experience would better prepare the CFPB for addressing new products outside of the P2P lending domain. A likely resulting perception that the CFPB takes account of the unique needs of P2P users would improve its relationship with regulatees and Congress.³⁸⁴

Not only is the CFPB better situated to understand the tradeoffs of protecting borrowers and lenders, but it is also better equipped to consider P2P lending in the broader context of consumer finance as well. The CFPB should, and no doubt will, hire staff that is technically competent and technologically current. It can leverage its understanding of other consumer financial products to understand the trends that affect consumers. Containing this wide range of regulatory duties under a unified system allows an intra-agency synergy that can adapt to the changing needs of P2P lending.

Unlike the seventy-five year old SEC, the new CFPB approaches P2P lending with a clean slate.³⁸⁵ As a new entity, the CFPB is not entrenched in an institutional culture that would prevent a better tailored regulatory approach. Instead, the CFPB could grow alongside the P2P industry, adapting as the market changes. The CFPB's objectives are to provide consumers with understandable information, protect consumers from unfair practices, address unduly burdensome regulations, enforce consumer financial law to improve competition, and ensure efficient and transparent markets for consumer financial products.³⁸⁶ These objectives, alongside the CFPB's specific authority

³⁸⁴ This perception will also improve CFPB officer prestige. Cf. Nicholas L. Georgakopoulos, *Discretion in the Career and Recognition Judiciary*, 7 U. CHI. L. SCH. ROUNDTABLE 205, 217-18 (2000) (stating prestige feedback effect in judicial hiring).

³⁸⁵ Cf. Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994) (explaining that the SEC is a modern administrative agency that "presents problems of obsolescence and irrelevance").

³⁸⁶ Dodd-Frank Act § 1021(b).

to monitor consumer financial transactions, provide a good start towards addressing the unique needs P2P lending presents.³⁸⁷

CONCLUSION

Disintermediated transactions such as P2P loans create a new core economic function that warrants preserving. Despite the promise of this new industry, regulators have hamstrung it with misguided applications of the Securities Acts. To preserve P2P lending, appropriate legal treatment must sustain and discipline this nascent market. P2P loans are disintermediated financial transactions on a small scale — but with grand ambitions. If properly freed from confines of the Securities Acts, this grand experiment may provide a transparent, consumer-benefiting product where opaque, costly products now dominate.

The economics of the P2P lending industry is capable of delivering efficient and needed service to some of its users, most of whom are retail investors and borrowers. P2P lending is a creative, innovative mode of finance worth preserving, but not without addressing risks and harms endemic to this model of financial transaction. The current regulatory system is a poor match for the needs of consumers and the platforms that connect them. The applicability of the securities laws to P2P lending is debatable. The SEC was not required to assert regulatory control over P2P lending because P2P loans arguably do not constitute securities. Nevertheless, the SEC imposed securities regulation on the P2P lending market, threatening its very existence and increasing risks to both lenders and borrowers. SEC regulation is inflexible and imposes significant costs on P2P platforms, leading to a surprising increase in lender risks. The securities regime is fixated upon formalistic disclosure rather than addressing lender needs. Moreover, it focuses on investors at the expense of borrowers. The SEC's binary approach to regulation means that some firms are almost entirely unregulated, even as their peers are overregulated. Further, private litigation, a staple of the traditional securities regime, is

³⁸⁷ This treatment of the CFPB only sketches some of the benefits of the new regulators' involvement. Far more detailed questions must be answered in order to operationalize this suggestion. For example, what shall be the outer boundaries of this regulated field? Does it include any securitized asset marketed to consumers, such as miniature mortgage backed securities? Does it include any non-intermediated finance scheme, such as loan sharks? Also, what sorts of regulations should the CFPB pursue, and how should it interact with other regulators? These questions are beyond the scope of this Article, but interested readers will find answers in Appendix B. See Verstein, *supra* note 200, app. B.

ineffective in policing abuses within the P2P market due to the small-scale loans inherent to P2P lending.

A new, unified regulatory approach to P2P lending can address the specific needs of P2P users in a way that the SEC has failed to do. The CFPB is better situated to provide lenders and borrowers the protections they need while letting the industry evolve and grow. There are unknowns in such an approach, since the industry is new and the regulator is even newer. Yet, no reform comes without some uncertainty. The best we can hope is a plan that meets current needs and can better adapt to unanticipated changes in the evolution of disintermediation through P2P lending. The CFPB can fulfill that hope for better regulation of P2P lending.