THE REGULATION OF PEER-TO-PEER LENDING:

A Summary of the Principal Issues (2014 Update)

April 2014
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Preface

We published our first white paper on the principal regulations applicable to internet lending in March 2013. We thought at that time that internet-based lending platforms - including, in particular, so called “peer-to-peer” or “person-to-person” ("P2P") facilities - would continue to grow rapidly and that prospective new entrants might benefit from an overview of the many federal and state regulations that apply. Certainly our view of the industry’s prospects has been validated by the events of the past 13 months. The substantial growth in loan volumes achieved by existing platform operators; the substantial equity investments made in those operators by prominent institutions; the actual or expected commencement of operations by new P2P lenders; the increasing interest of institutional investors in P2P loans as an asset class; the completion of the first securitizations of internet-originated loans; and last, but not least, the announcement by the largest P2P operator that it expects to undertake an initial public offering in 2014, all suggest that peer-to-peer lending has a bright future. The SEC’s adoption of final rules permitting the use of general solicitation and advertising in private placements of securities and its publication of draft crowdfunding rules have also focused attention on the potential for internet platforms to revolutionize the financial markets.

It nonetheless remains the case that any prospective operator of a P2P platform must be careful to plan and operate its business in compliance with applicable regulations. Regulatory costs have proven to be a significant barrier to entry into this industry; such costs will remain a significant expense for those platforms that commence operations and any failure by a platform operator to comply with applicable regulations can result in civil or criminal penalties, litigation expense, adverse publicity or, in an extreme situation, the termination of its business.

In view of the past year’s developments, and the fact that regulatory compliance remains central to the successful start-up and operation of any P2P platform, we have decided to update (and in some respects expand) our earlier discussion of the principal regulations that apply to P2P lending. As before, this article is intended only to identify such regulations and is not intended to provide detailed guidance on the steps required to comply with any particular law.
Background

A number of internet-based lenders are currently in operation in the United States. Each such site generally focuses on a single market segment; i.e., consumer loans, small business loans, student loans or microfinance (small loans directed to individual third-world entrepreneurs). The consumer sites have attracted the most media attention as these sites generally are thought to have the greatest potential to revolutionize an existing financial market. In particular, the consumer sites have created a marketplace in which consumers can not only lower their financing costs but can also, in some instances, obtain credit when bank financing would have been denied. The remainder of this section therefore describes the structure of consumer-oriented platforms in order to provide the reader with an overview of P2P platform operations.¹

The goal of any P2P platform operator (hereinafter, an “Operator”) is to create a user-friendly internet-based platform that permits an efficient matching of investors having capital to deploy with consumers seeking credit. To that end, the Operator will establish and manage a website that permits investors to register as prospective lenders and individuals to register as prospective borrowers. Each registered borrower that satisfies certain criteria fixed by the Operator may from time to time request the Operator to post loan requests on the website for viewing by prospective lenders.² Each borrower must disclose or make available to the Operator, and through the Operator to prospective lenders, certain financial and other information including, among other items, the borrower’s credit score (as determined by a credit reporting agency), self-reported income range, debt-to-income ratio, employment status, homeownership status, number of existing credit lines, intended use of funds and number and/or amount of recent payment defaults and delinquencies. The platform may permit the borrower to post certain non-financial information that the borrower believes may be relevant to prospective lenders (e.g., a narrative description of the reasons that the loan is being sought). Borrowers may not, however, disclose their identities to prospective lenders or post information that would permit their identities to be determined. The identities of lenders similarly are not disclosed to borrowers as the platform posts all loan requests and reports all transactions only under the borrower’s or lender’s screen name. The Operator will use the information reported by each borrower to assign a proprietary credit rating to the requested loan and to fix the interest rate for the loan. The Operator will include in the website posting for each loan request the relevant borrower-reported information, the Operator’s proprietary credit rating of the loan and the yield to lenders (i.e., the fixed interest rate on the loan net of the Operator’s servicing fees). Prospective lenders may view the posted information for each loan request and determine whether they wish to fund the loan or any portion of it. No borrower may request a loan in excess of a specified maximum (e.g., $35,000) or have outstanding multiple loans that, in the aggregate, exceed the maximum. A lender who chooses to invest in a loan may offer to fund any portion of the loan that equals or exceeds a specified minimum (e.g., $25). In order to minimize credit risk through diversification, it is in fact typical for lenders (other than certain institutional investors) to fund only a small portion of each loan in which they invest and to acquire over time investment portfolios comprised of partial

¹ The remainder of this section summarizes the structures employed by the two leading operators of consumer-oriented platforms - LendingClub Corporation (“LendingClub”) and Prosper Marketplace, Inc. (“Prosper”). The discussion is not, however, intended to provide a complete description of the LendingClub and Prosper structures or to identify all of the differences that may exist between them. We further note that LendingClub has recently begun to originate small business loans but such loans are currently only available for investment by select institutional investors.

² The Operator may, for example, choose to arrange loans only for borrowers having credit scores that exceed a specified minimum and/or debt-to-income ratios that are lower than a specified maximum.
interests in many different loans.3 A loan will fund if before the funding deadline stated in the loan request lenders subscribe for the full amount of the loan or, if the borrower has indicated that he or she will accept less than full funding, lenders subscribe for not less than the minimum amount of funding set forth in the loan request. The funding deadline for each loan request will be fixed according to the rules of the platform (e.g., 14 days after the request is posted) rather than by the borrower. The platform similarly will prohibit loans from funding at any level less than a specified percentage (e.g., 70%) of the requested principal amount. Each loan will have a fixed term (typically, one, three or five years) and will amortize through equal monthly payments to its maturity date.

The Operator will maintain with a bank (the “Deposit Bank”) a segregated deposit account on behalf of the lenders (the “Funding Account”). Each lender must have deposited in the Funding Account, at the time it offers to fund any loan, an amount that is both sufficient to provide that funding and is not committed to the funding of any other loan. The lender will be required to maintain this amount on deposit in the Funding Account until either the relevant loan is funded or the related loan request is withdrawn (e.g., because lenders did not commit to fund the loan at a level equal to or exceeding the minimum funding amount). The principal amount of each funded loan (hereinafter, a “Borrower Loan”) will be advanced by a bank (the “Funding Bank”) not affiliated with the Operator. The Funding Bank and the Deposit Bank may be different institutions. The Funding Bank will deduct from the funds it provides to the borrower (and will pay to the Operator as its transaction fee) a specified percentage of the principal amount of the Borrower Loan. The amount deducted may vary with the credit rating assigned to the Borrower Loan by the Operator. At or shortly after the funding of the Borrower Loan by the Funding Bank, the Operator will (i) purchase the Borrower Loan from the Funding Bank at par using funds of the applicable lenders on deposit in the Funding Account, and (ii) issue to each such lender at par a note of the Operator (or an affiliate of the Operator) (a “Platform Note”) representing the right to receive the lender’s proportionate share of all principal and interest payments received by the Operator from the borrower on the applicable Borrower Loan (net of the Operator’s servicing fees). The Platform Notes will be non-recourse obligations of the Operator (except to the extent that the Operator actually receives payments from the borrower on the applicable Borrower Loan). Accordingly, lenders assume all of the credit risk on the applicable Borrower Loan and will not be entitled to recover any deficiency of principal or interest from the Operator if the borrower defaults. The Operator will service the Borrower Loans on behalf of the lenders and may refer any delinquent loan to a collection agency. The relatively low principal amounts of the Borrower Loans, however, generally will make it impracticable for the Operator to commence legal proceedings against defaulting borrowers. The Operator will maintain a segregated deposit account (the “Collections Account”) at the Deposit Bank into which it will deposit all payments it receives on the Borrower Loans. The Operator will deduct its servicing fee from each Borrower Loan payment it receives before forwarding the net amount to the applicable lenders as payments on their Platform Notes.4

3 In recent months institutional investors have become an increasingly important part of the investor base for Platform Notes. In particular, a number of unaffiliated investment managers have organized investment funds for the specific purpose of P2P investing. It is not efficient for dedicated investment funds to purchase fractional interests in individual loans and in response both LendingClub and Prosper have established “whole loan” programs through which participating institutional investors may acquire the entire beneficial interest in specific loans selected by them. These programs have greatly facilitated the growth of the industry by accommodating institutional demand but they also may reduce the opportunities for small investors to purchase interests in certain loans. Increased reliance on whole loan programs is, to some extent, inconsistent with the argument often made that P2P lending can level the playing field between institutional and individual investors and provide the latter with attractive investment opportunities previously denied to them.

4 The servicing fee deducted from each Borrower Loan payment is typically in the range of 1% of the payment amount.
As might be expected in connection with an internet-based lending system, both the notes evidencing the Borrower Loans and the Platform Notes are executed electronically and physical Borrower Loan notes and Platform Notes are not delivered. The Platform Notes are not listed on any securities exchange and are transferable by the lenders only through an electronic trading system operated by a broker-dealer not affiliated with the Operator. The Operators provide no assurances as to the liquidity or value of the Platform Notes. Notwithstanding the associated credit and liquidity risk, potential investors - including investment funds and other institutional investors - may find P2P lending attractive as the available performance data indicate that the risk-adjusted returns on a well-diversified portfolio of Platform Notes can substantially exceed the returns available through alternative investment vehicles such as money market funds and certificates of deposit.
Regulatory Issues

A. Securities Laws

Perhaps the single greatest regulatory challenge facing Operators is securities law compliance. The P2P platforms are subject on a continuing basis to a number of separate federal and state securities laws. These laws are complex and compliance entails substantial costs. The relevant laws include the following:

1. Securities Act

The federal Securities Act of 1933 (the “Securities Act”) requires any issuer engaged in a public offering of its securities to register the securities with the Securities and Exchange Commission (the “SEC”) unless an exemption from registration applies. The registration exemptions in the Securities Act are rather narrow in scope and none of them will be available for a public offering of Platform Notes. An Operator therefore must register its Platform Notes with the SEC before commencing public sales of its securities.

The SEC registration process is not simple. The Securities Act requires each issuer engaged in an offering of registered securities (or the dealer or underwriter selling the securities) to deliver to the investors a prospectus that sets forth specified information concerning the issuer and the securities. Among other matters, the prospectus will need to include a detailed description of the Operator and the Platform Notes, an analysis by the Operator’s management of the Operator’s financial condition and its recent results of operations, specified financial information, a discussion of the applicable risk factors, certain information concerning the issuer’s directors and executive officers, descriptions of any material transactions between the issuer and its directors, officers and/or affiliates, any material legal proceedings affecting the Operator and the plan for distributing the securities. The SEC developed its disclosure guidelines long before internet-based lending became a possibility and accordingly certain of them are not an exact fit for P2P companies. Although each of LendingClub and Prosper has successfully registered its Platform Notes with the SEC, and although the LendingClub and Prosper prospectuses may provide some guidance regarding the disclosure formats and level of disclosures that the SEC will approve, prospective Operators should allow at least several months (and probably more) to complete the SEC registration process and should expect to incur substantial related expenses. The timeline for obtaining approval will largely be driven by the number and

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5 Although certain categories of “notes” are not treated as “securities” under the Securities Act, the SEC determined in an enforcement proceeding in 2008 that Platform Notes don’t fall within those categories but instead create an “investment contract” and are subject to regulation as “securities.” Among other factors that it deemed relevant to this determination, the SEC noted that P2P lenders and borrowers would not connect but for the internet platform; that the lenders would rely entirely upon the Operator to service the loans and manage all aspects of the repayment process; that a “reasonable investor” would likely believe that Platform Notes are “investments”; and that lenders would not be protected under any alternative regulatory scheme if the Platform Notes were deemed not to be “securities.” The SEC ruling leaves no doubt that the Securities Act will apply to Platform Note offerings.

6 As used in this article, the term “Platform Notes” includes loan pass-through obligations issued by any Operator and is not limited to obligations issued by LendingClub or Prosper.

7 Operators that do not issue Platform Notes but rather simply sell whole loans (or participations in such loans) are advised to consider whether such loans (or participations therein) are in fact “securities” under the Securities Act. Among the factors relevant to this determination are whether the loan purchaser is a regulated lender or an investor not principally engaged in lending as a business, the plan of distribution of the loans (i.e., whether the loans will be marketed to many unrelated investors in small denominations in a manner more typical for securities distributions than for lending arrangements), the reasonable expectations of the investors and whether the program will be subject to an alternative regulatory scheme (such as banking and consumer lending laws) that could make the application of the securities laws unnecessary for the protection of investors.
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significance of the comments submitted by the SEC staff on the applicant’s filings - a variable that the applicant can affect but not control through careful preparation of its documents.

At the same time, newly-formed Operators are likely to qualify for certain advantages that the Jumpstart Our Business Startups Act (enacted in April 2012) (the “JOBS Act”) provides to “emerging growth companies”. The JOBS Act defines an “emerging growth company” as an issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year and that, as of December 8, 2011, had not sold any of its equity securities under a Securities Act registration statement. Among other matters, an emerging growth company is permitted to (i) reduce the scale of certain financial disclosures that would otherwise be required in its prospectus, (ii) not provide an auditor attestation of its internal controls over financial reporting procedures (as would otherwise be required by the Sarbanes-Oxley Act), and (iii) choose to implement new or revised accounting procedures (when promulgated by FASB) under the extended transition period available to non-public companies. An emerging growth company (unlike other issuers) also is permitted to submit its initial registration statement to the SEC on a confidential basis so that the issuer can consider and address initial SEC staff comments before any filings become public. An issuer’s status as an emerging growth company does not continue indefinitely but will terminate at specified dates. Of particular relevance to Operators, an issuer will lose its emerging growth company status once it has issued more than $1 billion in non-convertible debt securities in the prior three years.

An Operator that registers its securities will need to use Securities Act Rule 415. This rule permits issuers to file “shelf” registration statements under which they register a specified amount of a generic category of securities (e.g., “notes” or “debt securities”) but don’t specify the maturity dates, interest rates or other negotiated financial terms that will apply to individual securities. When the issuer (or its underwriter) reaches agreement with an investor for an issuance of specific securities, the issuer will take the requisite amount of securities off the “shelf” by delivering to the investor and filing with the SEC a prospectus supplement that specifies the amount of securities sold and the applicable negotiated terms. The alternative approach - under which the issuer files a separate registration statement for each security that it sells - would not work for Operators because of the sheer volume of securities that they will sell. Stated differently, if Rule 415 were not available, each Platform Note - because its underlying borrower, maturity date and interest rate won’t in combination match those of any other Platform Note - would constitute a distinct series of securities and would have to be separately registered. The cost of filing multiple registration statements would be prohibitive. Rule 415 therefore makes registered offerings of Platform Notes possible but, at the same time, the Rule was not specifically designed to accommodate P2P lending. In particular, Operators remain subject to the requirement to file with the SEC separate preliminary or final prospectus supplements for each security offered or sold under the shelf registration. Unlike corporate issuers that utilize Rule 415, and that ordinarily will sell debt securities off their shelf registrations only on an occasional basis, Operators will expect to offer and sell multiple series of Platform Notes to multiple investors every day. An Operator therefore will be required to prepare and file with the SEC each year literally thousands of prospectus supplements. An Operator can significantly reduce the burden of this filing requirement by automating the preparation and filing of the supplements. The filing nonetheless seems to impose an unnecessary expense on Operators (except, of course, to the extent that it enables them to remain in technical compliance with the Securities Act) since P2P investors almost universally will rely upon the platform website and not SEC filings to access the terms of their Platform Notes.
Regulation AB under the Securities Act sets forth the disclosure requirements that apply to registered offerings of asset-backed securities and to certain periodic reports that the issuers of registered asset-backed securities must file. It would be very difficult and/or expensive for an Operator to satisfy Regulation AB as it requires the disclosure of more information concerning the Operator’s assets and asset performance than such Operators have commonly provided. Although Platform Notes could, in one sense, be characterized as “asset-backed” obligations since each Platform Note is backed by the cash flow from a specific Borrower Loan, the SEC has not treated Platform Notes as “asset-backed securities” for purposes of Regulation AB nor should it have done so. Regulation AB 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” (emphasis supplied). As each Platform Note is backed by only a single Borrower Loan and not by a “pool” of financial assets, Platform Notes are not covered by the Regulation AB definition.\(^8\) In addition, Regulation AB limits the concept of “asset-backed security” to securities of an issuer that limits its activities to “passively owning or holding the pool of assets, issuing the asset-backed securities...and other activities reasonably incidental thereto.” An Operator, however, will not limit its activities to “passively owning or holding” the Borrower Loans and issuing the related Platform Notes but will instead be actively engaged in structuring, promoting and operating its proprietary internet-based lending system. The Operator, in other words, should be considered an operating company that is fundamentally different from the securitization trusts and other special purpose issuers that historically have been subject to Regulation AB. However, the fact that Platform Notes are not “asset-backed securities” under Regulation AB does not necessarily mean that they are not “asset-backed securities” under certain other federal securities laws. See “Risk Retention Requirements” below.

Another issue that prospective Operators should consider is the potential for liability to investors for inaccurate disclosures. The Securities Act provides investors with recourse against issuers who sell securities through offering materials that contain an untrue statement of a material fact or omit to state a material fact (the standard of liability can vary in certain respects between registered and unregistered offerings). All issuers therefore face potential liabilities to investors if their offering materials are inaccurate. Most issuers, however, are in a position to verify the accuracy of the information they disclose to investors since the information concerns or derives from the issuer itself. In contrast, Operators may also have liability for inaccurate information submitted to them by prospective borrowers and disclosed to prospective lenders through the platform website. Operators may verify some of the information submitted to them by prospective borrowers, but almost certainly will not have the time or resources to verify all such information. The information so disclosed will be considered part of the Operator’s prospectus for Securities Act purposes and some of the information (e.g., the borrower’s self-reported income range or intended use of proceeds) may be deemed material by investors who fund the related loans. Accordingly, investors who lose money on their Platform Notes and can identify borrower misstatements in the related loan postings possibly could

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\(^8\) It's true that Regulation AB can apply to certain issuers that hold only a single cash-generating asset. For example, single property commercial mortgage-backed securities (“CMBS”) may be viewed as asset-backed securities even though the securities are backed by a single asset (a mortgage loan on the underlying real estate). Such CMBS is not backed by a “pool” of separate mortgage loans but still will have two features that are commonly associated with asset-backed securities: (i) the CMBS will create credit tranches; i.e., the securities will be issued in multiple senior and subordinate classes, and (ii) the CMBS issuer will make payments on each class of its securities from the cash flow paid by a number of different underlying obligors (i.e., the lessees holding separate leaseholds at the mortgaged property). Neither of these features applies to Platform Notes. In other cases, the issuer will hold no material assets other than a single security representing an indirect interest in a pool of financial assets (e.g., the issuer in a credit card securitization may invest in an intermediate trust that in turn invests in an underlying credit card master trust that holds the credit card receivables). It's reasonable to conclude that such issuers are issuing “asset-backed securities” since they are indirectly investing in a broad group of self-liquidating financial assets and will use the cash flow generated by those assets to make the payments on their securities. This is not the case for Platform Notes since each Platform Note is backed by only one Borrower Loan.
bring claims against the Operator under the federal securities laws. However, it is far from certain that any such claims would succeed. The Operator will have disclosed in its prospectus that not all borrower-reported information is verified by the Operator and that investors must assume the risk that such information is inaccurate. A court might well decide that the Operator satisfied its Securities Act disclosure obligations by disclosing this risk. In addition, as most Platform Notes have relatively low principal amounts it generally will be impractical - unless there are grounds for class certification - for investors to initiate legal proceedings against an Operator. The scope of Operator liability for inaccurate borrower information nonetheless has not yet been considered by any court. Prospective Operators should be aware that, in a worst case scenario, they could face liability under the federal securities laws for inaccurate borrower information (including intentional borrower misstatements).

As discussed above, registration of Platform Notes with the SEC is an expensive and time-consuming process. An Operator therefore might choose not to register its securities but to offer them in a private placement exempt from registration pursuant to Section 4(a)(2) of the Securities Act. The SEC has adopted Rule 506 of Regulation D under the Securities Act to provide a “safe harbor” that issuers may follow to ensure that their offerings will be exempted by Section 4(a)(2). It would, until recently, have been difficult for an Operator to conduct a valid private placement under Rule 506 because the exemption was not available to issuers that offered their securities through “general advertising” or “general solicitation”. A securities offering made over the internet - even if sales of the securities were limited to the institutions and high net worth/income individuals that qualify as “accredited investors” under Regulation D – might be deemed by the SEC to involve “general advertising” or “general solicitation” and thus would not qualify for the exemption. In the JOBS Act, however, Congress directed the SEC to revise Regulation D so that offerings made pursuant to Rule 506 of Regulation D are not prohibited from using general advertising or general solicitation if the securities are sold only to “accredited investors.” The SEC has approved implementing rules that became effective in September 2013. Under these rules, Operators are able to sell Platform Notes over the internet to “accredited investors” without incurring the substantial time, expense and paperwork that would be required to register the securities with the SEC. The following section of this article provides details on the Rule 506 amendments.

2. The New Private Placement Rules

The freedom that Operators enjoy under amended Rule 506 to engage in general solicitations of accredited investors without registering their Platform Notes with the SEC should make the path of many start-up companies much easier. Already most internet-based lenders, including various companies engaged in consumer, small business and student lending, accept investments only from accredited investors. A prospective Operator must nonetheless consider whether restricting the sale of its Platform Notes to accredited investors will unduly limit its investor base. In relevant part, the term “accredited investor” includes most institutional investors and individuals who (i) individually, or with their spouse, have a net worth exceeding $1,000,000 exclusive of the value of the person’s primary residence (and subject to certain adjustments for “underwater” mortgages), or (ii) individually had an income in excess of $200,000 in each of the two preceding years, or had a joint income with spouse in excess of $300,000 in each of those years, and have a reasonable expectation of reaching the same income level in the current year. An Operator that expects to sell Platform Notes to individuals will not be able to use amended Rule 506 unless it excludes non-accredited investors. Operators whose business plans require a broader investor base should continue to register their Platform Notes with the SEC. The growing interest of institutional investors in Platform Notes
as an asset class, however, may well reduce the pressure for prospective Operators to register their notes for public sale.

The Rule 506 amendments that made general solicitation possible also added two important conditions to the Rule 506 exemption. First, the Operator will be required to take "reasonable steps to verify" that each purchaser of the Platform Notes is, in fact, an accredited investor. Congress and the SEC have imposed the verification requirement to reduce the risk that general solicitation by Rule 506 issuers will result in sales of securities to non-accredited investors. This concern applies with particular force when sales are made to natural persons. The SEC has not required that issuers employ any specific procedures to confirm that their investors are accredited but, to facilitate compliance, it has listed in the Rule certain non-exclusive procedures that it will deem sufficient to verify a natural person's status. If, for example, the Operator proposes to sell Notes to a natural person who represents that he or she satisfies the income test, the Operator could verify the prospective purchaser's status by (i) reviewing copies of any Internal Revenue Service form that documents such person's income for the two most recent years (e.g., Forms W-2 or 1040), and (ii) obtaining a written representation from such person that he or she has a reasonable expectation of having an income during the current year that is sufficient to satisfy the test. Alternatively, if the prospective purchaser represents that he or she satisfies the net worth test, the Operator could (among other possible approaches) verify the purchaser's status as an accredited investor by reviewing copies of personal brokerage or bank account statements (to confirm assets) and a consumer report from at least one nationwide consumer reporting agency (to confirm liabilities). It will be important for the Operator (or any third party that it engages for the purpose) to perform the verification review diligently as the Operator must have a "reasonable belief" that each of its investors is accredited to qualify for the exemption. An Operator must also consider whether any verification procedures that require natural persons to deliver personal financial information to the Operator (or its agent) will impair the marketability of the Platform Notes.

Second, the SEC has added disqualification provisions to Rule 506 that make the exemption unavailable if the issuer or any of various persons associated with it or the offering (including, among others, its directors, executive officers, other officers participating in the offering and 20% equity holders and any placement agent) has been convicted of specified felonies or misdemeanors or is subject to specified court or regulatory orders (collectively, "Disqualifying Events"). The list of Disqualifying Events includes a broad range of criminal, regulatory and administrative proceedings. As examples, an Operator will be unable to rely upon Rule 506 if it, or any of its relevant associated persons, has within the past ten years (or five years, in the case of the Operator itself), been convicted of any felony or misdemeanor in connection with the purchase or sale of any security, or is subject to any court order or judgment entered within the past five years that enjoins the Operator or such person from engaging in any practice arising out of the business of an underwriter, broker, dealer or investment adviser, or is subject to a final order of any state securities, banking or insurance commission that bars such person from engaging in the business of securities, banking or insurance. It should not be difficult for an Operator to monitor its own status under the disqualification provisions but, if it engages any placement agent to assist it in the sale of the Platform Notes or of other securities offered under

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9 Private placements that use general solicitation will be made pursuant to Rule 506(c) of Regulation D. Alternatively, it remains possible for issuers to undertake Regulation D private placements without using general solicitation pursuant to Rule 506(b). In such event, the issuer still must have a "reasonable belief" that each accredited investor is, in fact, accredited, but in the absence of general solicitation the issuer is not required to take additional actions to verify the investor's status as described herein. An Operator that offers its Platform Notes over the internet to accredited investors with whom it does not have a pre-existing relationship could be deemed to be engaged in "general solicitation" and therefore subject to the verification requirement.
Rule 506, it must also confirm (and monitor on an ongoing basis) that the placement agent and its associated persons are not subject to any Disqualifying Event.

A final point to consider in relation to Rule 506 offerings is the potential application of broker-dealer registration requirements. Any company that makes direct offers of securities through an internet platform (rather than through a broker-dealer registered with the SEC and in the applicable states) potentially is subject to registration as a broker-dealer at both the federal and state levels. To address this issue Congress included in the JOBS Act (codified as Section 4(b) of the Securities Act) an exemption from broker-dealer registration for persons who maintain a platform or mechanism (which may include a website) to offer securities if (i) the securities are offered only under Rule 506, and (ii) and certain other conditions are satisfied. Among such other conditions, neither that person nor any person associated with it may receive any compensation in connection with the sale of the securities. The SEC interprets the term "compensation" broadly and the Section 4(b) exemption narrowly. The SEC would likely view the origination fees payable to the Operator in connection with new Borrower Loans as "compensation" for these purposes. The SEC has in fact stated that "the prohibition on compensation makes it unlikely that a person outside the venture capital area would be able to rely upon the [Section 4(b)] exemption." Other elements of Section 4(b) also indicate that the exemption is meant for platforms through which third-party issuers undertake Rule 506 offerings rather than for issuers engaged in offering their own securities. Accordingly, although at first glance Section 4(b) appears to be helpful to Operators that undertake Rule 506 offerings, such Operators will in fact need to look elsewhere for exemptions from broker-dealer registration. See "Securities Exchange Act" below.

3. Blue Sky Laws

In addition to registering its securities under the Securities Act, an issuer must register its securities in every state in which the securities are offered for sale to the public unless an exemption from registration applies. Platform Notes generally will not qualify for any exemption from registration under the state securities laws (the so-called “Blue Sky” laws) other than an exemption available in every state for the sale of securities to specified classes of institutional investors (the categories of exempt institutions vary between the states but typically include banks, insurance companies, investment companies, pension funds and similar institutions). Accordingly, any Operator that intends to engage in a broad public offering of Platform Notes must register its securities in multiple states and pay the associated filing fees.

In many states, the state securities commission has authority to apply “merit” regulation and to deny registration to any securities it deems unsuitable for sale. A number of states - often citing the novel nature of Platform Notes and/or the Operator’s failure to provide lenders with fully verified borrower information - have in fact refused to permit the sale of Platform Notes to retail investors. Alternatively, a state may agree to register the Platform Notes but only subject to suitability criteria that will limit the scope of the offering therein. A state could, for example, limit sales of Platform Notes to investors whose annual income and/or net worth exceed specified amounts or limit the dollar amount of Platform Notes that any single retail investor may purchase. The Operator must observe these restrictions in the applicable state even though the SEC has not imposed any equivalent restrictions at the federal level. In addition, prospective Operators should note that the Blue Sky laws contain provisions that may impose civil liability on the Operator for (i) disclosure violations (in much the same manner as previously discussed in relation to the Securities Act), or (ii) any failure to maintain required registrations in effect. In particular, the Blue Sky laws generally permit investors to rescind their investments and recover the full purchase price from the issuer (plus interest) if the issuer sold them unregistered, non-exempt securities. In view of the fact that most Blue Sky registrations
must be renewed annually, it will be very important for Operators to monitor their Blue Sky filings and timely renew each registration before it expires.

The Securities Act does preempt the right of the states to require the registration of certain categories of securities offerings. In particular, the states are not permitted to require the registration under the Blue Sky laws of any securities that are offered in a private placement pursuant to Rule 506 of Regulation D (although the states may require the issuer to submit certain notice filings and pay associated filing fees). Accordingly, an Operator that offers Platform Notes solely to accredited investors in a Rule 506 private placement (as described above) will be entitled to offer the securities in all of the states and the states may not impose suitability criteria or otherwise restrict the categories of eligible investors.

The Securities Act also prohibits the states from requiring the registration of any securities listed on the New York Stock Exchange or the Nasdaq National Market System ("Listed Securities") or of any securities of a listed issuer that are senior or equal in rank to the Listed Securities. LendingClub is widely expected to undertake an initial public offering in 2014 and some market commenters expect that Prosper may soon follow. Some commenters also have stated that an Operator that lists its common stock will have no further Blue Sky related restrictions because its Platform Notes will be "senior" securities. However, that statement might not be correct. The Blue Sky laws historically have included exemptions for the securities of listed companies because such companies (i) must satisfy stock exchange listing standards (which can, to some degree, be used as a proxy to identify "quality" companies), and (ii) are subject to ongoing regulation under both stock exchange and SEC rules. The exemption nonetheless does not extend to any subordinate securities of a listed issuer (i.e., securities of the issuer that would be subordinate to its listed common stock in the event of an issuer insolvency) as these securities, by definition, entail a higher degree of risk than the Listed Securities. It follows that the Platform Notes of a listed Operator will be exempt from Blue Sky registration requirements only if, in the event of the Operator's insolvency, the Operator's assets would be applied to pay the Platform Notes before any distributions are made to the common stockholders (or, at a minimum, if the assets would be distributed between the noteholders and the stockholders on a pari passu and pro rata basis). Platform Notes generally do not satisfy that requirement since they are not full recourse obligations. Specifically, the noteholders would have at most a claim, in any insolvency proceeding, only to the proceeds of the specific Borrower Loans allocated to their notes and could not make a claim against other Operator assets that might remain available for distribution to the common stockholders. Some states therefore may take the view that Platform Notes are not "senior-to-list" or "equal-to-list" securities and that Blue Sky filings must continue to be made notwithstanding the Operator's status as a public company.

4. Securities Exchange Act

Any issuer that sells securities under a registration statement declared effective under the Securities Act automatically becomes subject to certain ongoing reporting requirements pursuant to Section 15(d) of the

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10 The Blue Sky laws in most states for many years included exemptions for listed securities. In 1996 Congress effectively codified these exemptions, on a nationwide basis, by amending the Securities Act to preempt the application of state securities registration requirements to all listed securities and all securities of the same issuer of equal or senior rank.

11 It would not be possible for an Operator to obtain Blue Sky exemptions for the Platform Notes by listing the notes on the New York Stock Exchange since, among other issues, the principal amount of each note would be far too small to satisfy the listing criteria. Also, as discussed under "Bankruptcy Considerations" below, an Operator may elect to isolate its noteholders from Operator insolvency risk by issuing the Platform Notes through a wholly-owned subsidiary. Under this structure, the issuers of the Listed Securities (i.e., the Operator) and of the Platform Notes (i.e., the subsidiary) will be different companies and Blue Sky preemption definitely will not apply.
Securities Exchange Act of 1934 (the “Exchange Act”). Any Operator that sells registered Platform Notes therefore will be required to file various reports with the SEC including Annual Reports on Form 10-K and Quarterly Reports on Form 10-Q. These reports must contain such information concerning the Operator (including financial statements) as the SEC shall specify by rule. The preparation of these reports - particularly the Form 10-K - will require significant effort.12

The Exchange Act also requires “brokers” and “dealers” to register with the SEC. The term “broker” means “any person engaged in the business of effecting transactions in securities for the account of others.” The term “dealer” means “any person engaged in the business of buying and selling securities for such person’s own account.” An issuer selling its own securities is not required, solely by reason of such sales, to register as either a broker or a dealer. The exemption does not necessarily extend, however, to employees of the issuer who represent the issuer in effecting the securities sales particularly if the employees receive transaction-based compensation. An Operator that sells its Platform Notes directly to investors (rather than through a registered broker-dealer) therefore should observe the terms of a safe harbor that the SEC has adopted under the Exchange Act to provide an exemption from “broker” registration for issuer employees and, in particular, should not pay its own employees compensation that is directly tied to the number or principal amount of Platform Notes that are sold.

The need for broker registration must also be carefully considered if the Operator does not itself issue the Platform Notes but instead (i) organizes an affiliate to issue the Platform Notes (an option that the Operator could consider to address certain issues discussed under “Bankruptcy Considerations” below) and, as the affiliate’s manager, supervises or otherwise participates in its sale of the Platform Notes, or (ii) organizes an investment fund to invest in Borrower Loans and, as the fund’s general partner or managing member, places interests in the fund with unaffiliated investors. In these situations the Operator potentially could be viewed as a “broker” that is placing securities on behalf of an issuer other than itself. At the same time, any person or company is much less likely to be deemed a “broker” if it does not receive transaction-based compensation. An Operator therefore will greatly strengthen its argument that SEC registration is not required for either it or its employees if, to the extent that the Operator has organized an affiliated issuer or investment fund, it does not take transaction-based fees from such issuer or fund and does not pay transaction-based compensation to its own employees.

An Operator may wish to facilitate secondary trading in its Platform Notes by establishing an electronic marketplace on which outstanding Platform Notes may be resold. Any such marketplace must be operated by a registered broker-dealer and will likely have to be registered with the SEC under the Exchange Act as an “alternative trading system”. Such registration does not provide an exemption from Securities Act

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12 Prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) in 2010, the reporting obligations of any issuer subject to Section 15(d) automatically were suspended as to each fiscal year (other than the fiscal year in which the registration statement became effective) if, at the beginning of such fiscal year, each class of the issuer’s registered securities was held of record by fewer than 300 persons. The Dodd-Frank Act amended Section 15(d) to provide that issuers of asset-backed securities (“ABS”) no longer qualify for automatic suspension. At the same time, revised Section 15(d) permits the SEC to specify by rule the circumstances under which ABS issuers may suspend reporting. Pursuant to this authority, the SEC has adopted rules that generally permit an ABS issuer that offers securities under a shelf registration statement to suspend its reporting obligations only if none of the registered securities are held by non-affiliates of the depositor. As discussed below, Platform Notes may constitute “asset-backed securities” for purposes of Section 15(d) and the implementing rules. The Dodd-Frank Act therefore may have narrowed the circumstances under which Operators can suspend their Exchange Act reporting obligations. As a practical matter, however, even if the Platform Notes are deemed to be ABS the change will affect only Operators that (i) register their Platform Notes with the SEC, and (ii) are unable for some period of time to generate a significant number of transactions. All other Operators will have outstanding Platform Notes held of record by more than 300 persons and thus, in any event, would not have been entitled to suspend their reports.
registration requirements and, given the restrictions that the Securities Act imposes on resales of securities that were originally sold in a private placement, it will be difficult to establish an electronic marketplace that permits broad resales of Platform Notes unless the Operator originally sold the Platform Notes in a registered public offering.

Finally, each Operator should also consider the potential application of state broker-dealer registration requirements. In contrast to Blue Sky securities registration requirements, state laws requiring the registration of broker-dealers and/or sales personnel are not preempted by federal law in either offerings by listed companies or Rule 506 offerings. A breach of the requirements will expose the Operator to civil and/or criminal penalties and may entitle each purchaser of Platform Notes in the relevant state to rescind its investment. Most states exempt issuers from registration as broker-dealers but a small number do not.

5. Investment Company Act

The Investment Company Act of 1940 (the “Investment Company Act”) requires “investment companies” to register with the SEC before selling any of their securities to the public. The Act defines an “investment company” (in relevant part) as any person engaged in the business of investing in or holding “securities” and that (subject to certain adjustments) owns “securities” having a value exceeding 40% of the value of its total assets. Although the Borrower Loans funded through an internet-based platform will not constitute “securities” for purposes of certain of the federal securities laws, the Investment Company Act definition of “securities” is very broad and will include the loans. The value of the Borrower Loans held by an Operator typically will greatly exceed 40% of the value of its total assets. Accordingly, absent an exemption, the Operator could be subject to registration as an investment company. As a practical matter, however, Operators cannot register as investment companies - even if they were otherwise prepared to do so - because the Investment Company Act imposes certain restrictions on registered investment companies (including restrictions on affiliated party transactions and permitted levels of aggregate indebtedness) that would make it impossible for the Operator to conduct its business. An exemption from registration therefore is needed.

Operators may in fact qualify for several different exemptions. Section 3(b)(1) of the Investment Company Act, for example, exempts from registration as an “investment company” any issuer primarily engaged in a business or businesses other than that of investing in, holding or trading securities. An Operator could reasonably take the position that its primary business (even if the Borrower Loans are “securities”) is not investing in or holding loans but is, instead, the operation of an internet-based financing platform intended to match consumers needing credit with third-party lenders. In this regard, it is significant that the Operator, unlike a traditional investment company, does not purchase assets with a view to earning investment returns in the form of interest payments or capital gains but instead is compensated for its services through the one-time origination fees paid by borrowers and the servicing fees paid by lenders. Certain Operators might also claim exemption under Section 3(c)(4) of the Investment Company Act. Section 3(c)(4) exempts from registration any person “substantially all of whose business is confined to

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13 In June 2013 the Ohio Division of Securities initiated enforcement proceedings against an online platform that was facilitating small business lending for multiple alleged violations of the Ohio Securities Act, including the platform’s failure to register itself as a dealer under the Ohio Securities Act.

14 The registration requirement applies to the investment company itself, rather than to its securities, and the investment company remains obligated also to register the securities under the Securities Act. In practice, the investment company will be able to file a single registration statement with the SEC that covers both investment company and securities registration.
making small loans”. The SEC deems the term “small loans” to include only consumer loans made to individuals for consumption (and not business) purposes. The availability of Section 3(c)(4) to consumer-oriented platforms is, however, not entirely clear because the platform technically does not “make” loans to consumers but instead purchases bank loans that indirectly are funded by the third-party lenders.15

A further exemption may be available to Operators that issue their securities in a private placement pursuant to Rule 506 of Regulation D (as discussed above). Section 3(c)(7) of the Investment Company Act exempts from registration any issuer whose securities are held only by “qualified purchasers” and that does not make a public offering of its securities. As previously discussed, private placements made pursuant to Rule 506(c) of Regulation D are not be deemed “public offerings” for Securities Act purposes. The SEC has stated that it similarly will not deem Rule 506(c) offerings to constitute “public offerings” under Section 3(c)(7). Accordingly, Operators who sell Platform Notes only to investors who are both “accredited investors” and “qualified purchasers” should be able to claim the Section 3(c)(7) exemption. As a practical matter, however, Section 3(c)(7) will be useful only to Operators who intend to solicit only large institutional investors and high net worth individuals. In particular, individuals generally will qualify as “qualified purchasers” only if they beneficially own at least $5,000,000 in “investments” (as defined by the SEC).

Another private placement exemption under the Investment Company Act, Section 3(c)(1), may be useful to Operators who organize investment funds to invest in Borrower Loans (as discussed below). Specifically, Section 3(c)(1) provides an exemption for issuers not engaged in a public offering of securities and that have fewer than 100 securityholders (subject to certain exceptions not relevant here). An investment fund that invests in Borrower Loans may qualify for this exemption if it appropriately limits the number of its investors. The Operator itself, however, will not be able to use Section 3(c)(1) to issue Platform Notes because it will expect, at any one time, to have substantially more than 100 holders of its Platform Notes.

The SEC to date has not required Operators to register as investment companies as, indeed, it could not unless it intended to shut down the industry. A prospective Operator nonetheless should carefully consider the Investment Company Act implications of any changes it proposes to make (relative to established programs) in the securities that it offers, the manner in which it offers the securities or the classes of assets that it finances.

6. Investment Advisers Act

The Investment Advisers Act of 1940 (the “Advisers Act”) requires “investment advisers” to register with the SEC unless an exemption applies. The Advisers Act defines an “investment adviser” as any person who for compensation engages in the business of advising others as to the value of securities, or as to the advisability of investing in, purchasing or selling securities, or who issues reports or analyses concerning securities as part of a regular business. Registered investment advisers are subject to a detailed regulatory regime that governs, among other matters, required disclosures to clients, procedures for handling client assets, recordkeeping and reporting requirements and the content of investment adviser advertisements. Although the related expense would not be insignificant, an Operator required to register as an investment

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15 Commercial loan-oriented platforms may qualify for an exemption under Section 3(c)(5) of the Investment Company Act if they are primarily engaged in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, loans, accounts receivables, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.
adviser likely could comply with most of the applicable regulations. At the same time, investment advisers are deemed to be fiduciaries to their clients and, as such, are required at all times to act solely in the client’s best interests. As discussed below, an Operator that manages an investment fund formed to invest in Borrower Loans will be deemed an investment adviser and, as such, will need to resolve the conflicts that may exist between its fiduciary duty to the fund and its duties to other purchasers of Platform Notes.

As previously described, to help prospective lenders evaluate their options, an Operator may prepare and post a proprietary rating of each loan request. These ratings disclose the Operator’s view of the expected credit quality and loss ratio of each loan. It could be argued that in posting these ratings the Operator is acting as an investment adviser. In particular, registration could be required if (i) the ratings are deemed to provide advice as to the value of, or the advisability of investing in, “securities”, and (ii) the Operator is compensated for providing such advice. There are grounds to argue both that these requirements are satisfied and that they are not. As a practical matter, the SEC to date has not required Operators to register as investment advisers solely because they post proprietary loan ratings and that policy is likely to continue.

The result will not be the same for Operators (or their affiliates) who manage investment funds. As discussed under “Bankruptcy Considerations” below, an Operator may choose to organize an investment fund that will invest in Borrower Loans generated by the platform. These funds provide a mechanism for investors to purchase indirect interests in Borrower Loans without also having exposure (as may the holders of Platform Notes) to the credit risk of the Operator. As an example, the Operator could form an affiliated investment fund that will use investor capital to purchase indirect interests in Borrower Loans generated through the platform. To avoid the possible characterization of the Borrower Loans and the Operator’s associated servicing commitments as an “investment contract” for purposes of the Securities Act, the fund will not purchase the Borrower Loans directly from the Operator but instead will purchase certificates or similar interests (“Certificates”) in a special purpose entity that in turn purchases the Borrower Loans. Each Certificate will be backed by a specific Borrower Loan. The Operator will service the Borrower Loans, act as the fund’s investment manager and receive related servicing and management fees. As investment manager, the Operator will determine the specific Certificates that the fund will purchase (and thus will determine the Borrower Loans in which the fund will indirectly invest). The Certificates will constitute securities for purposes of the Advisers Act, and in receiving compensation for selecting and managing the fund’s Certificates the Operator (or, if applicable, an affiliate thereof formed to be the general partner/manager of the fund) will be acting as an “investment adviser”.

It is important to note that not all Operators who act as investment advisers will be required, or indeed eligible, to register with the SEC. The Advisers Act establishes a bifurcated regulatory scheme under which larger investment advisers register with the SEC and smaller advisers (unless an exemption applies) register with the states in which they provide advice. In general, an investment adviser may not register with the SEC unless it has at least $100,000,000 of assets under management. An Operator that manages investment fund(s) and/or managed accounts that invest in Borrower Loans, but that does not satisfy the $100,000,000 threshold, should consider the possible application of state registration requirements. In this regard, the Operator generally will be permitted to treat each of its managed funds as a single client and will not be deemed, for purposes of the state requirements, to be providing advice in each state in which fund investors are located. It should also be noted that the Operator will be deemed a “private fund adviser” for purposes of the Advisers Act if any of the funds it manages relies upon Section 3(c)(1) or 3(c)(7) of the Investment Company Act (which very likely will be the case). Investment advisers who advise such funds,
so-called “private fund advisers”, are subject to certain reporting and recordkeeping requirements that the SEC has promulgated pursuant to the Dodd-Frank Act to help it monitor their private fund activities. At the same time, United States private fund advisers having less than $150,000,000 in assets under management may qualify for a specific exemption from SEC registration.

As previously noted, investment advisers must act as fiduciaries to their clients. An Operator that manages an investment fund therefore must endeavor in selecting the fund’s investments to act solely in the fund’s best interests. To the extent, however, that the investment fund and self-directed investors who purchase Platform Notes directly through the platform are competing to fund a limited supply of desirable loans, the Operator will face a clear conflict of interest between its duty to select for the fund the best possible investments (determined in view of the fund’s stated investment strategy) and its obligation to treat the direct investors fairly. As the Operator will enjoy certain advantages over the direct investors in any such competition (it will, for example, have more information than the direct investors concerning the borrowers, the loans and the total amount of lender funds available for investment and generally will be more financially sophisticated), this conflict will not be easily resolved if the Operator is allowed complete discretion to select specific loans for the fund. It therefore likely will be necessary for the investment fund to purchase Certificates only under a predefined investment strategy that restricts both the amount of fund capital that may be employed at any one time and the total amount that may be invested in specific ratings categories of loans. The goal will be to develop parameters that will permit the fund to attract investors but will also provide direct investors with continued access to the most attractive loans. The investment fund must of course fully disclose these parameters in its offering materials.

7. Risk Retention Requirements

Much of the blame for the “Great Recession” has been placed on the “originate-to-distribute” model of asset securitization. Certainly it’s reasonable to believe that asset originators who transfer all of the credit risk on the securitized assets may have incentives that won’t necessarily advance investor protection. Accordingly, the Dodd-Frank Act requires the SEC, the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”), the Federal Deposit Insurance Corporation (the “FDIC”), the Federal Housing Finance Agency (“FHFA”) and the Office of the Comptroller of the Currency (the “OCC” and, together with the SEC, the FDIC, the Federal Reserve Board and FHFA, the “Agencies”) jointly to prescribe regulations that (i) require a securitizer to retain not less than five percent of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells or conveys to a third party, and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that it is required to retain.16 The risk retention requirement is intended to create economic incentives for securitizers to structure transactions carefully and to monitor the quality of the securitized assets. The ultimate goal is to help align the interests of securitizers with those of investors.

In March 2011 the Agencies published for comment proposed regulations to implement the risk retention requirement. These regulations attracted substantial comments from market participants. In response to these comments, the Agencies substantially revised their draft and published new draft regulations for comment in August 2013 (the “Proposed Regulations”). The comment period on the Proposed Regulations expired in October 2013. Comments on the Proposed Regulations also were quite heavy and the

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16 The Dodd-Frank Act instructs the Agencies to exempt securitizations of certain assets (most significantly, “qualified residential mortgages”) from the risk retention requirement. Platform Notes will not qualify for any of these exemptions.
Agencies have not yet approved final regulations. A number of provisions in the Proposed Regulations remain controversial (including, in particular, the scope of the exemption to be allowed for “qualified residential mortgages”) and the timing for the approval of final regulations remains uncertain. Once final regulations are approved most securitizers will be permitted a two-year grace period before compliance with the regulations becomes mandatory. Operators should carefully consider the potential impact of the Proposed Regulations since, as discussed below, if an Operator’s Platform Notes are deemed to be “asset-backed securities” subject to the risk retention requirements both the structure and the profitability of the Operator’s program could be significantly affected. The requirements will apply to both public and private offerings of asset-backed securities and securitizers therefore cannot avoid the requirements by selling their securities only in private placements exempt from Securities Act registration.

As previously discussed, Platform Notes do not constitute “asset-backed securities” for purposes of Regulation AB under the Securities Act because (i) each Platform Note is backed by a single Borrower Loan and does not represent an investment in a “pool” of assets, and (ii) the Operator is not a “passive” issuer as contemplated by Regulation AB. The risk retention requirements therefore would not apply to Platform Notes if Congress had incorporated the Regulation AB definition of “asset-backed security” in the Dodd-Frank Act. In fact, however, the Dodd-Frank Act amended the Securities Exchange Act to include a new (and broader) definition of “asset-backed security” that will govern the retention requirements. Under this definition, an “asset-backed security” will include any “fixed-income…security collateralized by any type of self-liquidating asset (including a loan….or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset.” It follows that a Platform Note will constitute an “asset-backed security” for purposes of the risk retention requirements if (i) it is “collateralized” by a loan, and (ii) the holder’s right to receive payments depends primarily on the cash flow from such loan. Platform Notes appear to satisfy both clauses of this test. In regard to the first clause, the Proposed Regulations state that an asset “collateralizes” a security (whether or not the issuer grants the investors a security interest over the asset) if the asset provides the cash flow that the issuer will use to make payments on the securities. The Borrower Loans do of course provide the cash flow that the Operator will use to make payments on the Platform Notes. In regard to the second clause, payments on the Platform Notes will depend not only “primarily,” but in fact solely, on such Borrower Loan cash flow. In contrast to Regulation AB, the Securities Exchange Act definition does not require the “asset-backed security” to be backed by the cash flow from a “pool” of financial assets. Another aspect of the Proposed Regulations - the definition of “issuing entity”, as discussed below - may nonetheless reimpose the pooling requirement and provide a basis to exempt Platform Notes from risk retention.

The Proposed Regulations apply the risk retention requirement to “sponsors” and define “sponsor”, in relevant part, as “a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly,….to the issuing entity.” The sponsor will be required to retain not less than five percent of the credit risk associated with each asset that it securitizes. The Funding Bank arguably is a “sponsor” for these purposes since it does transfer assets (i.e., the Borrower Loans) to the issuing entity. If this is the case, the Funding Bank would be required to retain credit risk and would not be permitted to sell 100% of any Borrower Loan to the Operator. Any such result would substantially increase the economic and regulatory capital costs that the Funding Bank incurs in funding Borrower Loans. However, under the Proposed Regulations the retention requirement applies only if assets are transferred to an “issuing entity”

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17 A one-year grace period is allowed for any residential mortgage securitizations that are not otherwise exempted.
and the asset-backed securities are issued in a "securitization transaction" (which similarly requires that the asset-backed securities be issued by an "issuing entity"). Although the Operator (or an Affiliated Issuer or a Trust (as further discussed under “Bankruptcy Considerations” below) unquestionably is the issuer of the Platform Notes, it may not be an "issuing entity." The Proposed Regulations define "issuing entity" as the entity that (i) owns or holds the pool of assets to be securitized, and (ii) issues the asset-backed securities in its name (emphasis supplied). Each Platform Note is backed not by a pool of underlying assets but by a single Borrower Loan. It therefore may be reasonable to conclude that, although Platform Notes are "asset-backed securities" for purposes of the Proposed Regulations, they are not issued by an "issuing entity" in a "securitization transaction" and therefore are not subject to risk retention requirements.\footnote{In view of the financial impact that risk retention would have on platform operations and the need, of course, to maintain compliance with applicable laws, both Operators and Funding Banks should review the final regulations (once they are available) and consider whether the Agencies should be asked to provide interpretive relief that the regulations will not apply to Platform Notes. In this regard, it’s worth noting that the Agencies have interpreted their mandate broadly and have drafted the Proposed Regulations to apply to certain market participants who arguably should not be covered (e.g., open market CLO managers and sponsors of fully-supported asset-backed commercial paper programs).

In addition to risk retention, the Operator and/or Funding Bank will be subject to certain other obligations if the Platform Notes constitute “asset-backed securities” under the Securities Exchange Act. As an example, the Operator typically will undertake in its prospectus to repurchase the Platform Notes from investors under certain narrow circumstances (e.g., if the underlying Borrower Loan was funded pursuant to verifiable identity fraud). If the Platform Notes are “asset-backed securities”, and if the Operator’s repurchase commitment is viewed as a covenant to repurchase an “underlying asset,” the Operator would be required to file periodic reports with the SEC disclosing the amounts of any repurchase demands that it receives from investors (or from the indenture trustee on behalf of investors) and of any such repurchases that it makes. Although the cost of complying with this reporting requirement and certain other applicable obligations would likely not be prohibitive, Operators should review with their counsel the specific obligations that will apply under the federal securities laws if the Platform Notes are treated as “asset-backed securities”.

8. Securitization

Most market participants expect securitization to play an important role in the future growth of P2P lending. A securitization entails the creation of asset-backed securities ("ABS") that represent the right to receive the cash flow from a pool of segregated financial assets. The goal in the securitization is to create ABS whose credit risk derives solely from the credit quality and payment characteristics of the asset pool, and is not tied to the credit standing of the asset originator. Asset classes that are currently financed through securitizations include trade receivables, commercial and residential mortgages, credit card receivables and auto loans and leases. A number of market participants are planning to add internet-originated loans to the list of assets that are commonly securitized (and the first of such securitizations in fact closed last year). If and when they succeed (and it’s very likely that they will), the securitization of internet-originated loans will create a new asset class through which investors can obtain exposure to a diversified pool of consumer or

\footnote{Although in certain circumstances the SEC has deemed pass-through securities backed by a single asset to constitute "asset-backed securities" within the meaning of Regulation AB (notwithstanding the pooling requirement in Regulation AB), there are reasons to differentiate those securities from Platform Notes and to view them as not controlling. See footnote 7 above.}
small business loans having credit and payment characteristics that are quite distinct from those of the asset classes that have traditionally been securitized.

The first step in the securitization process is to establish a special purpose issuer. A "special purpose" issuer is an entity (an “SPE”) formed specifically for purpose of issuing ABS. The SPE will not engage in any business other than issuing ABS to finance its purchase of the financial assets to be securitized. Its organizational documents and contracts will contain operating restrictions and covenants intended to make it very unlikely that it will ever become subject to bankruptcy proceedings. The SPE may be organized as a limited liability company, as a statutory trust or, particularly if it is organized in an offshore tax haven jurisdiction, as a corporation. In all cases, however, the SPE must be completely isolated from the potential insolvency of any associated companies, and in particular, the originator and/or seller of the securitized financial assets (who is sometimes referred to as the ‘sponsor’ of the securitization). If the securitization is structured properly, the credit risk on the securitized assets is segregated from the sponsor’s own credit risk. Securitizations thus allow investors to evaluate the credit risk associated with the underlying financial assets independently of the sponsor’s overall business.

The sponsor’s sale of financial assets to an SPE doesn’t eliminate the need for someone to continue to service the assets. Accordingly, in most P2P securitizations the SPE will appoint the Operator as the loan servicer and the Operator will continue to collect payments on the loans, pursue delinquent borrowers and otherwise interact with borrowers in much the same manner as if the securitization had not occurred. Appointing the Operator as the servicer, however, could leave investors exposed to Operator credit risk since the Operator’s ability to perform its duties as servicer will, to a large extent, depend upon its continuing solvency. A properly structured securitization therefore will include robust back-up servicing arrangements under which a pre-approved back-up servicer will assume the servicing function should the Operator become insolvent or otherwise unable to service the P2P loans. The market will ultimately dictate the back-up servicing requirements for P2P securitizations but it is expected that “hot” backup servicing arrangements will be more common especially with respect to securitizations of loans originated by an Operator with a short operating history.

Another key concept in securitizations is credit enhancement which can be achieved through a number of means. Most typically, the SPE will issue multiple classes of ABS with different levels of seniority. The more senior classes will be entitled to receive payment before the subordinate classes if the cash flow generated by the underlying assets is not sufficient to allow the SPE to make payments on all of the classes of ABS. Naturally, the senior classes of ABS will carry higher credit ratings whereas the subordinated classes will carry higher interest rates. In any securitization of P2P loans careful thought will need to be given to the amount of credit enhancement to be provided for the senior classes of ABS through the sale of subordinated or equity tranches. At the outset of P2P securitizations credit enhancement levels are likely to be higher than they ultimately will be after the market matures. Credit enhancement can also be provided by monoline insurers or other financial institutions that “wrap” the securities and effectively guarantee scheduled payments of principal and interest on the most senior class of ABS.

Securitizations of P2P loans will likely grow significantly in both number and volume once the principal rating agencies are prepared to assign ratings to ABS backed by P2P loans. Although the Dodd-Frank Act required federal regulators in many instances to replace references to securities ratings in federal banking and securities regulations with alternative metrics, many institutional investors by law or policy continue to be limited in their ability to purchase unrated debt securities. At present, the limited performance
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history available for P2P loans (including default, prepayment and recovery characteristics) creates challenges for any rating agency asked to provide a rating. Among others, the factors that rating agencies will likely consider before rating any P2P securitizations include (i) default correlation among borrowers, (ii) the limited operational history of Operators, (iii) whether Operators are able to detect fraud among potential borrowers, (iv) the lack of secondary liquidity in P2P loans, (v) the unique aspects of servicing consumer loans and the adequacy of the back-up servicing arrangements, and (vi) the number and depth of the credit tranches contemplated by the proposed structure.

In addition, two proposed federal regulations may have a significant impact on the growth of P2P securitizations. The first is the federal risk retention rules discussed above. The second is proposed amendments to Regulation AB (so-called "Reg AB II") which, if adopted, would for the first time impose specific disclosure requirements in most private placements of asset-backed securities. Among the new provisions in Reg AB II is a requirement to disclose asset-level data points such as a borrower’s geographic location, credit score, income and debt. These enhanced disclosure requirements could increase the cost of securitizing P2P loans. Many commenters also have expressed concern that the asset-level data requirements may allow the identification of individual borrowers and thereby violate U.S. federal and foreign consumer privacy mandates. On February 25, 2014, the SEC re-opened the comment period for Reg AB II expressly to solicit comments on a proposed new approach to the dissemination of potentially sensitive asset-level data (the comment period currently is scheduled to end on April 28, 2014).

B. Lending Laws and Lender Registration/Licensing

The extension of consumer credit is regulated in the United States at both the federal and state levels. An Operator that conducts a nationwide business therefore may be subject to regulation by multiple jurisdictions. The Funding Bank likewise will be subject to both federal and state regulation but may, in certain instances, be able to rely upon federal law to preempt state laws that otherwise would apply. As discussed below, federal preemption will be particularly important to the Funding Bank in connection with state usury laws.19

The following two sections of this article (Sections B and C) briefly discuss some of the principal banking or lending regulations, licensing requirements and consumer protection laws that may apply to the Operator and/or the Funding Bank.20

1. Usury Laws

Most states limit by statute the maximum rate of interest that lenders may charge on consumer loans.21 The maximum permitted interest rate can vary substantially between states.22 Some states impose a

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19 It cannot be assumed that federal laws governing consumer lending activities will preempt state laws that impose additional or different requirements. The analysis of the application of the federal preemption doctrine to any particular market participant, transaction or contract must be fact-specific and careful attention must be paid to the identities of the parties involved, the terms of the applicable statutes and any relevant regulatory or judicial interpretations.

20 This article is not intended to (and does not) identify all such laws and regulations that will be applicable to the Operator and/or the Funding Bank in connection with the platform operations or discuss all of the obligations that will be imposed by those laws and regulations that are identified. Prospective Operators are advised to consult with counsel for a more complete statement of the applicable requirements.

21 State usury laws also may limit or restrict other fees and loan terms and the length of loans.

22 The application of state usury laws to commercial loans also varies from state to state but, as a general matter, state usury laws have less application to commercial loans than to consumer loans.
fixed maximum rate of interest while others link the maximum rate to a floating rate index. Absent an exemption, these laws would be binding on the Funding Bank as the lender on the Borrower Loans and would have to be observed by the Operator in setting the interest rate for each loan. Given the nature of a P2P platform, it could be difficult for an Operator conducting business in multiple states to fix different maximum rates for the Borrower Loans based on the borrower’s state of residence. Doing so would prevent the Operator from conducting its business on a uniform basis across jurisdictions.

Of greater importance, however, is the fact that the Operator may often need to set interest rates that exceed the maximum rate that the applicable state usury laws would permit. One of the stated goals of internet-based lending is to provide broader access to credit to certain borrowers who are unable to obtain bank loans. Although the Operator may require each borrower on the platform to have a specified minimum credit score (and may set the minimum score at a relatively high level), many of these borrowers - despite having acceptable credit scores - may have other attributes indicating that they are less creditworthy than their credit scores, considered alone, would suggest. In order to induce lenders to make loans to these individuals, the Operator will need to set interest rates high enough to offset expected losses.

A solution to these difficulties is provided by the so-called “rate exportation rules” that may be utilized by insured state banks. These are a set of federal laws, interpretative letters and court decisions that remove most state usury law restrictions for the benefit of certain categories of lenders. The Depository Institutions Deregulation and Monetary Control Act of 1980 (“DIDA”) permits federally-insured state-chartered banks to charge loan interest at rates not exceeding the higher of (i) the maximum rate allowed by the state in which the loan is made, and (ii) the maximum rate allowed by the bank’s home state. Of greater importance, however, is the fact that the Operator may often need to set interest rates that exceed the maximum rate that the applicable state usury laws would permit. One of the stated goals of internet-based lending is to provide broader access to credit to certain borrowers who are unable to obtain bank loans. Although the Operator may require each borrower on the platform to have a specified minimum credit score (and may set the minimum score at a relatively high level), many of these borrowers - despite having acceptable credit scores - may have other attributes indicating that they are less creditworthy than their credit scores, considered alone, would suggest. In order to induce lenders to make loans to these individuals, the Operator will need to set interest rates high enough to offset expected losses.

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23 National banks rely on 12 U.S.C. § 85 in order to export the interest rate allowed by the laws of the state, territory, or district where such bank is located. Until the passage of the Dodd-Frank Act, an operating subsidiary of a national bank could also utilize rate exportation in reliance on OCC Chief Counsel interpretative opinions.

24 Prospective Operators evaluating potential Funding Banks should be aware of the potential application of the so-called “most favored lender” doctrine. The latter doctrine, if applicable, permits a depository institution to fix as its interest rate ceiling for any category of loans the highest interest rate that the relevant state permits to any lender for such category. As an example, if a particular state permits finance companies to make consumer loans at a higher interest rate than it permits to banks, a national or state bank making loans in that state could rely upon the most favored lender doctrine to make loans at the higher rate permitted to finance companies. The so-called state “parity” laws also may be of use in internet lending. These laws, where available and in relevant part, may permit banks chartered in a particular state to extend credit in that state on the same terms as are permitted to national banks. The most favored lender doctrine and the state parity laws, when applied in conjunction with the rate exportation rules, may permit Funding Banks to fix the interest rates for Borrower Loans at rates significantly higher than the usury laws would otherwise permit. In any case, reliance on the most favored lender doctrine and state parity laws should not be necessary where, as with WebBank, the Funding Bank is FDIC-insured and located in a state that does not cap the interest rate that banks may charge on consumer loans.

25 Loans made by state-chartered institutions in states that opt out will remain subject to the state’s usury laws. At this time, only Iowa and Puerto Rico have opted out of the Federal rate exportation rules for state-chartered depositories. An election by any state to “opt out” under DIDA will be effective as to loans “made” in that state; however, it may not be entirely clear in which state the loan should be deemed to be “made” when the borrower and lender are located in different states. However, proper structuring can influence where the loan is “made.”
2. Bank Secrecy Act Regulations

Operators not organized as banks will not be subject to direct supervision by federal bank or financial institution regulators such as the FDIC, the OCC or the Federal Reserve Board. Each Funding Bank, however, will remain obligated to comply with applicable laws in funding the Borrower Loans. In this regard, to ensure its own compliance with applicable laws the Funding Bank will likely require the Operator to agree by contract to comply with laws that are binding on banks but may not be directly applicable to the Operator. Accordingly, financial institution laws and regulations - in addition to the consumer protection laws discussed below - will have a significant impact on the platform structure and operations.

A full discussion of the financial institution regulations that will affect P2P businesses and of the extent to which specific regulations will apply to specific persons is beyond the scope of this article. However, one example of this type of law is the federal Bank Secrecy Act and related laws that will require any bank making a loan, and therefore, the Funding Bank in the case of P2P loans, and in some cases, the Operator, to adopt policies and procedures to monitor and enforce the following:

- Verify the true identities of users (both borrowers and lenders) in accordance with Section 326 of the USA Patriot Act;
- Determine whether users are on any list of known or suspected terrorists or terrorist organizations issued by federal agencies such as the Office of Foreign Assets Control (OFAC) and reject any borrower or lender whose name appears on such list;
- Report suspicious account activity that meets the thresholds for submitting a Suspicious Activity Report under the Bank Secrecy Act; and
- Implement an anti-money laundering and information sharing program to assist in compliance with Sections 314 and 352 of the USA Patriot Act.

The Operator will need to cooperate with the Funding Bank in the implementation of these policies and procedures and also adopt internal procedures to establish compliance with those regulations to which it is directly subject.

3. Issues Related to Third-Party Use of Bank Charters

As described above, it is often desirable that Operators utilize the services of a Funding Bank in order to operate a P2P platform, in particular, to establish preemption of various state usury laws. Bank regulatory agencies have permitted banks to contract with third parties to provide services to customers noting that doing so may give banks a competitive advantage by allowing the banks to enhance product offerings and diversify assets among other benefits. However, similar funding arrangements - when employed by payday loan marketers and debit card issuers - have sometimes been characterized as ‘renting-a-bank charter’. As used in this article, payday loans are small-dollar (e.g. $500), short-term (e.g. two weeks), unsecured loans that borrowers promise to repay out of their next paycheck or regular income payment. In addition to charging borrowers a stated rate of interest, payday loans are usually priced with a fixed-dollar fee (e.g., $3 for every $25 dollars borrowed), which represents the
perceived improper use of a bank charter by these entities has been challenged, both by governmental authorities and private litigants. These claims assert that payday loan marketers use bank lenders solely to evade compliance with state usury limitations and consumer protection laws imposed by the states where such payday loan marketers do business. In some cases, the litigation has sought to re-characterize the payday loan marketer as the ‘lender’ for purposes of state consumer protection law restrictions. If successful, such litigation could, in addition to penalties, render certain payday loans voidable or unenforceable. In 2001, the OCC issued a bulletin warning banks that certain payday lending relationships with third-parties may expose the bank to “substantial financial loss and damage to its reputation” and “may constitute an abuse of the national bank charter.” The OCC also warned banks to “be extremely cautious before entering into any third-party relationship in which the third party offers products or services through the bank with fees, interest rates, or other terms that cannot be offered by the third party directly.”

28 Bank regulators have in fact required banks to exit third-party programs they determined to be an unsafe and unsound practice.

To our knowledge, there have not been any claims against existing Operators alleging an improper use of bank charters or unauthorized lending. As further discussed below, Congress was aware of the P2P lending market at the time it drafted the Dodd-Frank Act and directed the Government Accountability Office to conduct a study to determine how the federal government could best regulate the industry. See Consumer Protection Laws - The Dodd-Frank Act and Consumer Protection below. However, third-party relationships entered into by financial institutions are subject to increased regulatory scrutiny. An Operator can expect some challenges in finding Funding Banks willing to take on the regulatory risk of third-party relationships, will be subject to due diligence by those institutions and can expect the institution to take an active role in establishing, approving and monitoring the program since the institution remains responsible for its credit policies, loan forms and compliance with applicable law. Accordingly, Operators are advised to take note of this issue and to consult with counsel when appropriate concerning third-party programs with financial institutions as well as to potential changes in regulatory attitudes.

4. State Licensing Requirements

The federal laws that permit state-chartered banks to "export" interest rates apply only to the interest rates and some related fees charged by the lender and do not preempt state licensing laws, non-financial loan terms or most other state consumer credit regulations. Accordingly, the states will retain significant jurisdiction to regulate the Operator in connection with loan origination and servicing activities. For example, certain states require the registration of “lenders” and/or “loan brokers” and may define “loan broker” to include any entity that, for compensation, arranges for the extension of credit for others. An Operator will fall within this broad definition and, absent an exemption, will need to comply with any associated licensing requirements imposed by the applicable states. States may also require Operators who undertake collection activities to be licensed as “collection agents”. Additional state level requirements that may be applicable to Operators that service Borrower Loans are described in “Consumer Protection Laws - Debt Collection Practices” below. An Operator subject to state licensing requirements must also comply with any associated recordkeeping, financial reporting, disclosure, minimum net worth, surety bond or similar requirements imposed by state law, must observe any limitations that applicable state laws impose on the finance charge to the borrower. Because payday loans generally have a short term to maturity, the total cost of borrowing, expressed as an annual percentage rate, can typically be in excess of 400%.

business activities or practices of licensed entities (including any limits imposed on permitted rates or fees) and will be subject to examination by the applicable state regulators.29

C. Consumer Protection Laws

P2P platforms must comply with a number of different federal and state consumer protection laws. Generally, these laws (i) require lenders to provide consumers with specified disclosures regarding the terms of the loans and/or impose substantive restrictions on the terms on which loans are made, (ii) prohibit lenders from discriminating against consumers on the basis of certain protected classes, and (iii) restrict the actions that a lender or debt collector can take to realize on delinquent or defaulted loans. In addition, the Dodd-Frank Act has significantly changed the regulation of the consumer credit market by establishing the Consumer Financial Protection Bureau. The remainder of this section briefly discusses some of the principal consumer protection laws that Operators will need to consider for program compliance purposes.

1. Truth in Lending Act

The federal Truth in Lending Act (“TILA”) and its implementing Regulation Z require lenders to provide borrowers with standardized and understandable information concerning certain terms and conditions of their loans and certain changes in terms of the loans.30 The TILA disclosure requirements will apply to the Funding Bank as the lender of each Borrower Loan. In addition, borrowers are generally permitted to assert claims for TILA violations against any assignee of a loan which could result in the assignee (in a P2P situation, the Operator) becoming liable for TILA violations. As described above, the predominant P2P platform structures provide that the Operator will purchase and take assignment of each Borrower Loan from the Funding Bank using funds received from the issuance of the related Platform Notes. Each Operator and its Funding Bank therefore will need to ensure that the disclosures made to borrowers contain the information and are made in the format that TILA requires.

TILA and Regulation Z also impose certain substantive restrictions and significant disclosure requirements in relation to certain other categories of loans.31

2. FTC Act, UDAP Laws and the CFPB

Operators must comply with Section 5 of the Federal Trade Commission Act (“FTC Act”) which declares unlawful any unfair or deceptive act or practice in or affecting commerce. Of particular importance is the Credit Practices Rule that the Federal Trade Commission has adopted thereunder to protect consumers

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29 Loan broker and collection agent registration and licensing requirements (as well as other requirements imposed on loan brokers and collection agents) vary from state to state. Careful consideration of applicable laws is required before arranging or servicing loans in any given state.

30 Different disclosures are required for closed end (installment) loans than for open end (revolving) loans. Disclosures for closed end loans include the amount financed (i.e., the amount that the borrower will actually have use of - but not necessarily the amount of the loan), the applicable annual rate of interest expressed as an APR or an annual percentage rate, certain other fees and charges that may be applied and the repayment terms such as the dollar amount of each payment and the number of payments.

31 For example, subpart F of Regulation Z mandates special disclosure requirements for loans the proceeds of which will be used to pay for postsecondary educational expenses (a “Private Education Loan”). Furthermore, once a Private Education Loan is offered and its terms have been adequately disclosed, the lender must allow the borrower 30 calendar days to decide whether to accept such loan. Unless an Operator is establishing a P2P lending platform specifically targeted at the student loan market and is prepared to comply with the additional disclosure requirements and to allow the borrower a 30-day window in which to accept any proffered funding, the Operator should require each borrower to represent that he or she will not use his or her loan to pay for tuition, fees, required equipment or supplies, or room and board at a college, university or vocational school.
against abusive terms and conditions in credit contracts. Amongst other requirements, the Credit Practices Rule prohibits loan agreements from including terms that:

- require the borrower to generally waive the right to notice and an opportunity to be heard in the event of a lawsuit (confessions of judgment clauses);
- require the borrower to waive the benefit of any laws that protect the consumer’s real or personal property from seizure or sale to satisfy a debt (waiver of exemption);
- assign to the creditor the borrower’s wages or earnings unless (1) the borrower may revoke the assignment at any time, (2) the assignment is a pre-authorized payment plan established at the time the debt is incurred, or (3) the assignment applies only to wages or earnings already earned at the time of the assignment; or
- pyramid late charges (i.e., impose multiple late charges based on a single late payment).

Operators will need to confirm that the loan agreements used to document the Borrower Loans conform to the applicable requirements of the Credit Practices Rule.

Operators and Funding Banks may also be required to comply with certain state laws that prohibit unfair and deceptive acts and practices (“UDAP Laws”). Some provisions of UDAP laws that may be applicable to Operators include specific disclosure requirements related to the terms of loans, prohibitions of excessive prepayment penalties and the availability to borrowers of certain causes of action and remedies.

As further discussed below, the Dodd-Frank Act also mandated the establishment of the Consumer Financial Protection Bureau (“CFPB”) and authorized the CFPB to adopt rules prohibiting deceptive and abusive practices within the consumer finance market under (amongst other laws) the TILA, the ECOA, the FCRA, the FDCPA and the EFTA (as defined below). The CFPB has not issued regulations regarding unfair, deceptive or abusive practices to date, but has articulated certain standards to assist entities in identifying whether an act or practice is unfair, deceptive or abusive. The CFPB has also been active in revising rules applicable to consumer lending (particularly as they relate to credit card issuers), residential mortgage lending and debt collection practices.

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32 While Section 5 of the FTC Act does not apply to banks, Regulation AA adopted by the Federal Reserve Board imposes on banks restrictions substantially similar to the Credit Practices Rule.

33 A contractual waiver is not prohibited if it is restricted to property pledged as collateral for the debt.

34 The Dodd-Frank Act provides that state consumer financial laws shall be deemed preempted in relation to national banks only if the applicable state law (i) discriminates against national banks in comparison to its effect on banks chartered in that state, (ii) is preempted by a federal law other than the Dodd-Frank Act, or (iii) “prevents or significantly interferes with the exercise by a national bank of its powers.” The standard may make it difficult for national banks to challenge UDAP Laws on the basis of federal preemption unless a federal statute provides for preemption. In this regard, each of TILA, the Equal Credit Opportunity Act and the Electronic Funds Transfer Act includes its own standard for preemption of state laws.

35 The CFPB has indicated that an act or practice is unfair if: (1) it causes or is likely to cause substantial injury to consumers; (2) the injury is not reasonably avoidable by consumers; and (3) the injury is not outweighed by countervailing benefits to consumers or to competition. A representation, omission, act or practice is deceptive if: (1) the representation, omission, act or practice misleadingly or is likely to mislead the consumer; (2) the consumer’s interpretation of the representation, omission, act or practice is reasonable under the circumstances; and (3) the misleading representation, omission, act or practice is material. An abusive act or practice: (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service or (2) takes unreasonable advantage of (i) a lack of understanding on the part of the consumer of the material risks, costs or conditions of the product or service; (ii) the inability of the consumer to protect its interests in selecting or using a consumer financial product or service; or (iii) the reasonable reliance by the consumer on a party to act in the interests of the consumer.
3. Fair Lending and Other Laws

The Equal Credit Opportunity Act ("ECOA") prohibits lenders from taking any action related to any aspect of a credit transaction, including the making of any credit determination, on the basis of the applicant’s race, color, sex, age (except in limited circumstances), religion, national origin, marital status, or the fact that all or part of the applicant’s income derives from any public assistance program or the fact that the applicant has in good faith exercised any right under the federal Consumer Credit Protection Act or any applicable state law ("Prohibited Bases"). The ECOA applies during all aspects of the credit transaction including advertising, the application and approval process and servicing and collection activities. For example, credit scoring systems must not be discriminatory. If an applicant is denied credit, the lender must provide an adverse action notification. Since an Operator is very much involved in many aspects of the credit transaction, Operators must structure and operate their P2P platforms in compliance with the ECOA and applicable state law counterparts.36

When reviewing a loan application, an Operator will typically rely on a “consumer report” as defined in the federal Fair Credit Reporting Act ("FCRA"). The FCRA specifically applies to users of consumer reports and if an Operator uses consumer reports, the FCRA will be applicable. Operators must review the FCRA requirements and should consult legal counsel as to what obligations under the FCRA may be applicable. FCRA requirements include certain restrictions on obtaining and/or using consumer reports, specific notice requirements if the terms of a loan are less favorable than the terms provided to other borrowers (risk-based pricing notice), restrictions on sharing customer information with affiliates and third parties and implementation of an identity theft prevention program. Similar to the ECOA, the FCRA also (i) requires a lender who rejects a borrower’s loan application for any reason to send the borrower an “adverse action” notice that discloses specified information and (ii) imposes certain requirements that lenders must observe in reporting loan delinquencies or defaults to credit rating agencies.

When servicing a delinquent loan, an Operator should also consider the potential application of the Servicemembers Civil Relief Act ("SCRA"). The SCRA limits the interest rate that may be charged on loans made to borrowers on active military duty and may require a rate adjustment on loans that were made to borrowers prior to the borrower entering active military duty.

4. Debt Collection Practices

Any third-party collection agents that an Operator employs must comply with the federal Fair Debt Collection Practices Act ("FDCPA") and similar laws in the applicable state when attempting to collect overdue payments from delinquent borrowers. Such laws prohibit abusive and harassing debt collection practices, limit certain communications with third parties and impose notice and debt validation requirements. The Operator - if it acts as its own collection agent in respect of any Borrower Loans - will not be directly subject to the FDCPA but as a matter of prudence should comply with its provisions and will be subject to mandatory compliance with similar laws in certain states. The Operator also will be directly subject

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36 As an example, the ECOA and Regulation B thereunder generally will prohibit Operators from requesting certain types of information from borrowers including the borrower’s race, color, religion, national original or sex ("Prohibited Information"). To reduce the risk of violations of the ECOA (or similar state laws), Operators should prohibit prospective borrowers from posting Prohibited Information in their loan requests and should require lenders to represent that they will not base any funding decisions on Prohibited Bases. Operators similarly should adopt internal policies intended to ensure that they do not assign proprietary credit scores, make loan servicing decisions or take any other actions affecting lenders or borrowers on the basis of Prohibited Bases.
to FDCPA if it acts as a collection agent for an affiliated issuer or fund. See ‘Bankruptcy Considerations’ below. In the event a borrower files for bankruptcy, becomes the subject of an involuntary bankruptcy petition or otherwise seeks protection under federal bankruptcy law or similar laws, an Operator and its third party collection agents must comply with the Bankruptcy Code automatic stay and immediately cease any collection efforts. Finally, Operators must consider provisions of the SCRA that permit courts to stay proceedings and the execution of judgments against service members and reservists who are on active duty.

It is noted that the CFPB has adopted rules setting forth its authority to supervise non-bank debt collectors that generate annual revenue in excess of $10 million from consumer debt collection activities. Even Operators whose revenues from collection activities are not sufficient to make them subject to direct CFPB supervision should consider voluntary compliance with the standards that the CFPB has established for debt collectors regulated by it.

5. Privacy Laws

Because of the personal and sensitive nature of the information that is collected from prospective borrowers, it is imperative that Operators comply with applicable laws and regulations governing the security of nonpublic personal information. In particular, the federal Gramm-Leach-Bliley Act (‘GLBA’) limits the disclosure by a financial institution of nonpublic personal information about a consumer to nonaffiliated third parties and requires financial institutions to disclose certain privacy policies and practices including with respect to the sharing of such information with both affiliates and/or nonaffiliated third parties. If a financial institution chooses to share information with nonaffiliated third parties, borrowers and lenders must be given the right to opt-out of such information sharing. States also have enacted privacy laws that may be applicable to Operators. Operators are advised to consult with legal counsel to determine which, if any, state privacy laws may be applicable.

The GLBA also requires financial institutions to establish an information security program to ensure the security and confidentiality of customer records and information, protect against anticipated threats or hazards to the security or integrity of those records and protect against unauthorized access to or use of those records or information. In order to assist financial institutions in developing an appropriate information security program, the related federal agencies published the Interagency Guidelines Establishing Standards for Safeguarding Customer Information (‘Security Guidelines’). Due to the inherent risks associated with maintaining information that is accessible over the internet, Operators should review the Security Guidelines in connection with the development of their information security program.

Finally, the GLBA requires financial institutions to develop and implement a response program designed to address incidents of unauthorized access to customer information maintained by the institution or its service provider. The related federal agencies have also published the Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice. Currently, 46 states also have laws that would require an Operator to notify customers of a breach of security in which personal information is reasonably believed to have been acquired or accessed by an unauthorized person. As these laws vary from state to state in their applicability, the type of information that is covered and the

37 See the previous section on the FCRA which also contains requirements with respect to privacy and information sharing.

38 The GLBA governs ‘financial institutions’ which is defined to mean any institution the business of which is engaging in financial activities as described in section 4(k) of the Bank Holding Company Act of 1956 (which includes the lending of money). An Operator will most likely be deemed a “financial institution” for these purposes.
notification requirements, Operators are advised to consult legal counsel to determine the appropriate course of action should a data breach occur.

6. Electronic Commerce Laws

It goes without saying that P2P platforms execute borrower/lender registration agreements and process credit transactions in electronic (i.e., paperless) form and that virtually all payments are processed through the Automated Clearing House (“ACH”) electronic network. Accordingly, Operators need to comply with the federal Electronic Signatures in Global and National Commerce Act (“E-Sign Act”) and similar state laws (particularly the Uniform Electronic Transactions Act), both of which authorize the creation of legally binding and enforceable agreements utilizing electronic records and signatures and set forth certain disclosure and consent requirements. Specifically, the E-Sign Act provides that a borrower can consent to receive electronic records only if the consent is provided electronically in a manner that reasonably demonstrates that the borrower can access the information in the electronic form that will be used to provide the information. In addition, any information required by law to be provided in writing can be made available electronically to a borrower only if the borrower affirmatively consents to receive the information electronically and the Operator clearly and conspicuously discloses certain required information to the borrower prior to obtaining his or her consent.

With respect to electronic payments, since Operators are not typically organized as banks, they must rely on eligible financial institutions (such as FDIC-insured depository institutions) to both fund the Borrower Loans and to receive payments over the ACH network. The Electronic Funds Transfer Act (“EFTA”) and its implementing Regulation E establish the rights, responsibilities and liability of consumers who use electronic fund transfers and of financial institutions and certain other parties that offer these services. They contain disclosure and dispute resolution requirements and require a party that wishes to automatically debit a consumer account for a payment to obtain written authorization from the consumer for such automatic transfers.

7. The Dodd-Frank Act and GAO Study

As previously discussed, the SEC is currently the principal regulator of the P2P industry. There are, however, at least two potential issues created by SEC regulation. First, the existing securities laws were not designed to accommodate P2P lending and therefore may in some cases impose compliance costs that are not justified. Second, the SEC focuses on investor (i.e., lender) protection and is not required to ensure that borrowers are treated fairly. Although borrowers will have the benefit of the consumer protection laws discussed in the preceding sections, the absence of a single federal regulator focused on P2P lending (from both a lender and borrower standpoint) has created concerns that the existing regulatory structure may not adequately protect borrowers. Congress was aware of these issues at the time it considered the Dodd-Frank Act and, in fact, Congress considered transferring primary regulatory authority for the P2P industry from the SEC to the CFPB. The Dodd-Frank Act ultimately did not require any such change but did direct the Government Accountability Office (the “GAO”) to conduct a study of the manner in which P2P lending is currently regulated and to make a recommendation to Congress for an optimal federal regulatory structure.

The GAO published its study in July 2011. The GAO noted that either the SEC or the CFPB logically could be designated as the primary federal regulator. It stated that leaving jurisdiction with the SEC would have at least two advantages - first, the P2P industry already is operating under SEC regulation and has
developed procedures to meet its expectations. Second, the SEC, in contrast to the CFPB at that time, already is a fully-functioning federal agency that has the staff, resources and rules to function as the regulator. At the same time, the GAO noted that, because the existing federal regulatory structure does not assign to any single agency the duty to develop rules to protect P2P borrowers, it could make sense to consolidate federal regulation under the CFPB. As previously discussed, the CFPB has authority to adopt rules prohibiting deceptive and abusive practices within the consumer finance market. It also is mandated to supervise compliance with federal consumer financial laws by nondepository financial services providers, including those involved in residential mortgage lending, private student lending and payday lending or that otherwise offer consumer financial products or services. Certainly the CFPB has jurisdiction to regulate consumer P2P loans in tandem with SEC regulation.39 In its report, however, the GAO noted that before the CFPB could become the industry’s primary regulator it would need to be fully staffed and to develop rules tailored to the industry. The GAO stated that changing primary regulators would create uncertainty which itself could impair the industry’s growth. In addition, it noted that the CFPB might not give high priority to developing P2P rules given the need to develop rules for other, larger industries. In fact, the CFPB to date has not proposed any regulations directly related to P2P lending but has focused on other products (in particular, residential mortgages) more directly connected to the recent financial crisis.

In the end, the GAO report only discussed some of the advantages and disadvantages of different regulatory structures and didn’t make a recommendation for an optimal structure. Since the Dodd-Frank Act specifically states that the establishment of the CFPB does not limit the authority of the SEC to continue to regulate any person currently regulated by it, it’s likely that that the SEC will continue to be the industry’s primary regulator for the foreseeable future and that the CFPB may over time consider adopting specific rules for the protection of P2P borrowers.

D. Bankruptcy Considerations

As Platform Notes are pass-through obligations of the Operators, and not direct obligations of the borrowers under the related Borrower Loans, holders of Platform Notes are exposed to the Operator’s credit risk. An Operator that becomes subject to bankruptcy proceedings may be unable to make full and timely payments on its Platform Notes even if the borrowers under the related Borrower Loans timely make all payments due from them. A number of different aspects of the bankruptcy proceedings could result in investor losses. First, other creditors of the Operator may seek access in the bankruptcy proceeding to payments made on the Borrower Loans. Second, a bankrupt Operator may no longer have the financial capacity to continue to service the Borrower Loans and/or may reject its servicing agreement as an executory contract. Third, the investors will be subject to the Bankruptcy Code “automatic stay” and therefore will be prohibited from taking legal action against the Operator to enforce their rights to payment. Fourth, the bankruptcy court may not recognize investor claims for interest that accrued on the Platform Notes after the bankruptcy proceedings commenced. An Operator could endeavor to mitigate some of these risks by granting the indenture trustee a security interest over the Borrower Loans, the Collections Account and the proceeds thereof. It may also enter into a “back-up” servicing agreement with an unaffiliated company pursuant to which the back-up servicer agrees to service the Borrower Loans if the Operator can no longer do

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39 We note that the issue of who is the primary regulator of an industry like P2P lending is different from compliance with applicable regulations of any relevant agency. Even if another agency like the SEC oversees the industry, P2P programs and their participants, be they Operators or Funding Banks, must still comply with applicable regulations including those of non-primary regulators like the CFPB and the other federal banking regulators. The consumer protection laws discussed above will apply no matter who is the industry’s primary regulator.
so. Any such measures, however, will provide the holders with less than complete protection. The holders of secured Platform Notes, for example, will remain subject to the automatic stay. It’s also not certain that the Bankruptcy Court would require that the proceeds of each Borrower Loan pledged as collateral be applied to the payment only of the related Platform Notes. If, instead, the Bankruptcy Court (which has broad discretionary powers under the Bankruptcy Code) permitted the proceeds of the Borrower Loans to be applied on a pari passu basis to pay all amounts due on the Platform Notes, holders of Platform Notes could incur losses by reason of defaults on Borrower Loans other than the specific loans that they had elected to fund. Similarly, a back-up servicer - particularly if it has not been appointed under a “live” back-up servicing arrangement - may be unable immediately to service the loans if the Operator stops servicing them. Any lag that occurs between the termination (or withdrawal) of the Operator as servicer and the back-up servicer’s assumption of full servicing duties could significantly reduce loan collections and cause related losses on the Platform Notes.

The risks to the Platform Note holders will be particularly acute if, as may be the case, the Operator does not pledge the Borrower Loans to secure the Platform Notes and is permitted by its governing documents to incur other indebtedness that is not subordinated to the Platform Notes and/or is permitted to pledge the Borrower Loans to secure indebtedness other than the Platform Notes. In this situation the holders may see some or all of the collections on the Borrower Loans paid to other creditors of the Operator if the Operator becomes bankrupt. The risk to investors also is heightened if the Operator is thinly capitalized and/or has exposure to significant potential liabilities (e.g., pending litigation claims). It seems likely that many retail investors in Platform Notes - notwithstanding any related prospectus disclosures - will not fully appreciate the scope of the Operator credit risk that they have assumed. Institutional investors, however, are well aware of these risks and have insisted that Operators address them as a condition to committing significant capital to Borrower Loans. In response to this pressure, Operators have implemented two different operating structures that are intended to isolate investors from Operator credit risk.

The first of these structures provides for the Operator to form a wholly-owned subsidiary (the “Affiliated Issuer”) that will assume the rights and obligations of the Operator under its agreements with the Funding Bank, the indenture trustee, other service providers and the borrowers and lenders. The Affiliated Issuer will purchase the Borrower Loans from the Funding Bank and issue the Platform Notes in its own name. The Affiliated Issuer also will license or purchase the Operator’s proprietary technology and become the website operator. Simultaneously, the Affiliated Issuer will appoint the Operator to provide back office services, to perform (or supervise the performance of) all of the Affiliated Issuer’s obligations to third parties, to service all of the Borrower Loans and to manage both platform operations (including the issuance of Platform Notes) and the website as its agent. The Affiliated Issuer will pay the Operator a servicing fee tied to the amount of servicing fees that it receives from investors. The Affiliated Issuer will have no employees and the Operator will perform its servicing duties through its own employees. The Operator will remain the sole lessee under all office and equipment leases. The Affiliated Issuer will not incur any indebtedness other than the Platform Notes and will not accept liability for any claims made against the Operator including, if applicable, any pre-existing litigation claims. The Affiliated Issuer’s governing documents will prohibit it from engaging in any business other than the issuance of Platform Notes and related activities and otherwise will impose limitations on its activities intended to reduce the likelihood that it will become subject to voluntary or involuntary bankruptcy proceedings. The structure therefore (i) makes the Operator solely responsible for the platform’s operating expenses (other than the servicing fees payable to the Operator itself), (ii) isolates the Affiliated Issuer from the Operator’s pre-existing or future liabilities, and (iii) provides for the
issuance of the Platform Notes through a special purpose, bankruptcy-remote entity (i.e., the Affiliated Issuer) that will have no significant liabilities other than the Platform Notes.

The issuance of Platform Notes through an Affiliated Issuer will not benefit investors, however, if the Operator becomes bankrupt and the Bankruptcy Court uses its equitable powers to order “substantive consolidation” of the Affiliated Issuer and the Operator. Substantive consolidation is a judicially developed doctrine that, if applied, disregards the separate legal existence of a bankruptcy debtor and one or more of its affiliates, resulting in a combination of assets and liabilities and the elimination of intercompany claims between the entities being consolidated. Creditors of each entity become creditors of the combined entity. Although the court decisions that have ordered substantive consolidation have not always used the same analysis, in general a Bankruptcy Court could decide to consolidate two entities if (i) creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, or (ii) their financial affairs are so entangled that consolidation will benefit all of their creditors. The Bankruptcy Court may also consider whether the benefits of substantive consolidation would outweigh the harm it would impose on any particular creditors. In the context of P2P lending, substantive consolidation of an Affiliated Issuer with a bankrupt Operator could make the Affiliated Issuer’s assets (i.e., the Borrower Loans) available for the payment of the Operator’s liabilities (although, as discussed above, the risk that creditors other than investors would have access to payments on the Borrower Loans may be mitigated if the Affiliated Issuer grants a security interest in the Borrower Loans and the Collections Account). Any such result would make the Affiliated Issuer structure pointless since holders of the Platform Notes would remain exposed to the Operator’s credit risk.

An Operator that forms an Affiliated Issuer therefore must structure its program carefully to reduce the risk of substantive consolidation. The fact that the Affiliated Issuer will engage the Operator to manage the website and oversee the performance of the Affiliated Issuer’s contractual duties does not by itself mean that substantive consolidation would (or should) be ordered if the Operator were to become bankrupt. It is instead common in securitization transactions for the transaction sponsor and the special purpose issuer that it forms and services to address substantive consolidation risk by making certain “separateness covenants” intended to ensure that the parties will maintain separate legal identities and to make clear to investors that neither party is liable for the other’s debts. Although P2P lending does not involve traditional asset securitization, Operators and any Affiliated Issuers should follow the same approach. To that end, among other covenants the Affiliated Issuer should undertake to (i) conduct its business only in its own name, (ii) strictly comply with all organizational formalities required to maintain its separate existence, (iii) maintain its own separate books, records and bank accounts, (iv) prepare its own financial statements and tax returns, (v) pay its liabilities only out of its own funds, (vi) maintain adequate capital in light of its contemplated business purpose, transactions and liabilities, (vii) not hold out its credit or assets as being available to satisfy the obligations of others, and (viii) maintain an arm’s-length relationship with the Operator and its other affiliates. Without limitation to the foregoing, the Affiliated Issuer should operate the P2P website in its own name (rather than that of its parent) and should execute in its own name all contracts with borrowers and lenders. If these and similar steps are taken (and the parties in fact observe their respective undertakings), there should be little risk that a Bankruptcy Court overseeing Operator bankruptcy proceedings would substantively consolidate the Operator and the Affiliated Issuer.40


40 It should be noted, however, that if the Affiliated Issuer structure is used, because of the nature and extent of the Operator’s continuing involvement in managing the website, evaluating proposed loan postings, assigning proprietary credit ratings, participating in the loan origination process with the Funding Bank and servicing the Borrower Loans, the SEC may deem the Operator to be offering “management rights” or an “investment contract” (see footnote 6) that constitute a security that must
The second approach that Operators have utilized to address Operator credit risk also entails the formation of a special purpose entity to issue pass-through securities but differs from the first approach insofar as the Operator itself continues to issue Platform Notes. Specifically, under the second approach the Operator forms (i) an investment fund that offers partnership interests or similar securities to institutional and/or high net worth investors on a private placement basis (the “Fund”), (ii) a subsidiary that acts as the Fund’s general partner and investment manager (the “Manager”), and (iii) a business trust or similar special purpose company that purchases Borrower Loans (or portions thereof) from the Operator (the “Trust”). The Fund will use its members’ capital contributions to purchase certificates (“Certificates”) from the Trust and the Trust in turn will use the Certificates’ purchase price to purchase the Borrower Loans from the Operator. Each Certificate will represent the right to receive all principal and interest payments (net of servicing fees) made on the related Borrower Loan. The Trust will appoint the Operator to service all Borrower Loans that it purchases. Although all Borrower Loans will continue to be funded through the website and initially will be purchased by the Operator from the Funding Bank, this structure largely eliminates Operator credit risk for the Fund investors by enabling them indirectly to invest in pass-through securities issued by a special purpose entity (i.e., the Trust) rather than in Platform Notes issued by the Operator.

The establishment of Funds rather than an Affiliated Issuer may offer the Operator greater flexibility in tailoring investment opportunities to specific investor interests. Stated differently, the Operator may be able to broaden its appeal to different institutional investors by forming multiple Funds that differ from one another in investment periods, management fees, minimum commitments and/or investment strategies. An Operator that uses an Affiliated Issuer will not have such opportunities. At the same time, the use of Funds can have some disadvantages. As an initial matter, unless the Fund registers its interests under the Securities Act (and incurs the substantial related expenses), it will be permitted to offer its interests only to institutional and/or high net worth investors. The Operator accordingly will want to continue to sell Platform Notes through its website. The purchasers of the Platform Notes, however, will continue to have exposure to Operator credit risk. The Fund structure therefore can result in retail investors who purchase Platform Notes having greater exposure to such credit risk than institutional investors who acquire Fund interests. In addition, the Manager (i) may need to register as an investment adviser, and (ii) will need to develop an investment strategy that fairly allocates the Borrower Loans available for investment (or portions thereof) between the Fund and direct purchasers of Platform Notes. See “Investment Advisers Act” above. Finally, although Fund investors may find it convenient to invest in Borrower Loans through the Fund (and thereby rely upon the Manager rather than their own efforts to identify specific Borrower Loans for investment), the management fees that they pay to the Fund may exceed the servicing fees that Platform Note purchasers pay to the Operator.

As a final point, it should perhaps be noted that neither of the two structures fully eliminates the servicing risks associated with an Operator bankruptcy. In particular, a bankrupt Operator may be entitled to reject its servicing agreement as an executory contract and/or may need to obtain bankruptcy court approval be separately registered under the Securities Act. Because such an approach results in prospective lenders being offered two separate securities by distinct but affiliated issuers in order to make an investment in Platform Notes, and therefore may arguably be confusing to investors as to whether they are looking to the Operator or the Affiliated Issuer, or both, as the party responsible to them for specific aspects of their investment, the substantive consolidation analysis becomes more complex. Under these circumstances, in addition to strict adherence to the “separateness covenants”, the manner in which the respective roles and obligations of the Operator and the Affiliated Issuer are presented in the disclosure in the offering materials, as well as the context in which each appears on the website, becomes critical if potential confusion as to which entity is responsible for what (which could provide an argument in favor of substantive consolidation) is to be avoided.
to transfer its servicing duties to a backup servicer. Any such rejection or delay would not by itself expose investors to claims by the Operator’s creditors but could result in collections on the Borrower Loans being delayed or reduced. The funds available for distribution to investors similarly would be reduced if the backup servicer charges higher servicing fees than the Operator had charged.

E. Tax Considerations

The appropriate treatment of Platform Notes for U.S. federal income tax purposes is uncertain and the related rules are complex. Among other possibilities, the Platform Notes could be characterized for tax purposes as debt instruments of the Operator (the "Debt Approach"), or as loan participations, or even as an equity interest in the Operator. The tax consequences to both the Operator and investors can vary substantially depending upon the characterization chosen. In the absence of guidance from the Internal Revenue Service (which has not yet been publicly provided), it’s not possible to be certain which characterization is "correct." Both LendingClub and Prosper, however, have opted for the Debt Approach, and this choice does appear to be among those best suited to the economic substance of Platform Notes. The remainder of this section therefore focuses on the consequences of the Debt Approach. Prospective Operators are nonetheless reminded that they must carefully review with their counsel the tax treatment of any Platform Notes that they issue.

Under the Debt Approach, the Operator generally will recognize as income all interest that accrues on the Borrower Loans and will take a corresponding deduction for all interest amounts payable on the Platform Notes. Accordingly, the Operator will recognize as taxable income only those amounts (such as its servicing fee) that will not be paid through to the investors. The Debt Approach also requires that the Operator and the investors treat the Platform Notes as debt instruments issued with original issue discount, or “OID.” In subjecting the Platform Notes to reporting under the OID rules, investors effectively are required to report income for federal income tax purposes with respect to Platform Notes on an accrual rather than a cash method of accounting. Accrual accounting does, in general, more clearly reflect the investor’s economic income -- but it also requires the investor to forego the otherwise potentially tax-advantageous income deferral which cash method accounting might allow.

While the application of the OID rules to the Platform Notes is complex, the rules generally will require each investor to include in income for each taxable year an amount equal to the accrued, constant yield earned with respect to its Platform Note, determined on the basis of the Platform Note’s projected payments (net of Operator servicing fees, but without regard to any potential default on the underlying Borrower Loan) and the Platform Note’s issue price (generally, its principal amount). This treatment will cause all stated interest on the Platform Note to be reported as OID, which (like interest) would constitute ordinary income; payments of interest and principal on the Platform Note would be treated first as a payment of accrued OID, and then as a payment of principal. A variety of special rules address and modify this baseline treatment in the event of payment delays on the underlying Borrower Loan (generally requiring a continuing accrual of Platform Note OID, notwithstanding late payment or non-payment of the related

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41 Platform Notes treated as debt instruments, and treated as issued by the Operators, would be subject to the OID rules to the extent that interest on those notes is not regarded as “unconditionally payable” -- a reasonable assumption given that interest is payable only to the extent received on an underlying Borrower Loan.

42 Illustrative discussions of these modifications and other related Platform Note tax consequences (e.g., market discount and premium) may be found in the tax discussions set forth in the disclosure documents for Prosper and LendingClub.
underlying cash), Platform Note prepayment (or extension), Platform Note worthlessness, and Platform Note sale.

Operators will be required under the Debt Approach to provide each investor with an annual statement on Form 1099-OID (or other applicable form) reporting the aggregate amount of OID accrued on the investor’s Platform Notes. The Operator also must file a copy of each such statement with the Internal Revenue Service. As investors typically will purchase multiple Platform Notes representing partial interests in a substantial number of different Borrower Loans, an Operator must implement procedures to aggregate the OID accrual information for each investor across multiple investments and to prepare and timely file the related reports. An Operator that fails to do so could be subject to financial penalties imposed by the Internal Revenue Service for deficient information reporting.

The fact (as discussed above) that the Debt Approach is not the only possible tax characterization of the Platform Notes does leave the investors at some risk of economic disruption if the Internal Revenue Service later requires a different characterization. Any such change in tax characterization could significantly affect the amount, timing and character of the income, gain or loss that an investor will recognize for tax purposes from an investment in Platform Notes. Equity for tax treatment of the Platform Notes — i.e., treatment as Operator stock -- in particular could be adverse as the Operator could no longer claim interest or OID deductions for payments or accruals made on the Platform Notes, and non-U.S. holders of the Platform Notes could become subject to 30% withholding tax (i.e., the Operator would be required to withhold 30% of each interest or OID payment due to the non-U.S. holder, remitting the same to the Internal Revenue Service in satisfaction of the holder’s presumed U.S. tax liability in respect of such payments). In general, tax withholding on payments to non-U.S. holders would not be required if (as contemplated by the Debt Approach) income on the Platform Notes is properly treated as interest or OID. In order to limit the risk to investors that would result from equity recharacterization, an Operator might choose to offer its Platform Notes only to U.S. persons.43

F. Crowdfunding Rules

The term "crowdfunding" is often used broadly to include any internet platform that matches multiple investors with natural persons and/or companies seeking debt or equity financing. In this sense, peer-to-peer platforms engage in crowdfunding. So also do sites that permit interested persons to contribute funds to a company or project without any expectation of earning a financial return.44 There is yet another category of crowdfunding, however, that has long been anticipated and has generated great interest among small investors but that has yet to get underway: small business equity or debt securities offerings. Specifically, Congress in 2012 concluded that the federal securities laws unduly impeded small business

43 Prosper, for example, does not permit non-U.S. residents to register as members on its platform. LendingClub restricts only non-U.S. borrower members, while evidently allowing non-U.S. residents to purchase Platform Notes, but its disclosure documents indicate that the percentage of such notes held by such persons from inception through December 31, 2012 amounted to just 3% (by principal) — and the disclosure informs investors that those sales could result in fines and penalties (which may refer to penalties for failure to withhold tax). Further, neither Operator provides assurances or comfort in their tax disclosure regarding the tax consequences of an investment in Platform Notes to non-U.S. investors, perhaps shifting (or, at least, allowing for shifting by allowing for withholding) the withholding risk introduced by any such investors.

44 These latter sites include such well-known venues as Kickstarter and Indiegogo. The companies or projects that obtain funding through these sites may provide their backers with non-financial "perks" (e.g., samples of the company’s products) but they don’t transfer ownership interests to the backers and don’t undertake to repay the backer’s contribution with interest. As the sites don’t entitle the backers to any financial return on the contributed funds they are not deemed to offer “securities” and therefore are not subject to securities or broker-dealer registration requirements under the federal securities laws.
capital formation and, accordingly, in the JOBS Act directed the SEC to provide an exemption from securities registration to small businesses that engage in crowdfunding in compliance with specified criteria. The SEC released its proposed crowdfunding rules (the "Proposed Rules") in October 2013. Although the comment period on the Proposed Rules has expired the SEC has not yet approved final rules. The remainder of this section discusses the key provisions of the Proposed Rules.

Section 4(a)(6) of the Securities Act (as added by the JOBS Act) will exempt from Securities Act registration any sale of equity or debt securities made by a company in compliance with the final SEC crowdfunding rules. The company therefore would not be required to register its securities with the SEC or sell them in a Regulation D private placement but would instead be permitted to sell the securities through a crowdfunding platform to any investor regardless of the investor's annual income or net worth. It's worth noting, though, that Section 4(a)(6) and the Proposed Rules can be used to provide financing only to companies and not to individuals. The Proposed Rules therefore do not provide an alternative exemption from federal securities registration for prospective Operators of P2P platforms that provide individuals with credit. The Proposed Rules also cannot be used by certain other categories of companies, including any company that files periodic reports with the SEC under the Securities Exchange Act (thus excluding any public company and many large private companies), any investment company, hedge fund or similar vehicle, or any foreign company. Those companies that are eligible to use the Proposed Rules must observe a number of important conditions, including the following:

- The aggregate amount of securities sold by the issuer in reliance upon the Section 4(a)(6) crowdfunding exemption may not exceed $1,000,000 in any 12-month period. Securities sold by the issuer in offerings registered with the SEC or pursuant to other exemptions will not count against the $1,000,000 limit. An issuer therefore could undertake simultaneous Regulation D and Section 4(a)(6) offerings and could, in theory, sell unlimited amounts of the securities to accredited investors under Regulation D and not more than $1,000,000 of securities to other investors under Section 4(a)(6). Since, however, issuers may not advertise crowdfunding securities (except to the limited extent discussed below), issuers and crowdfunding platforms must take certain precautions if the issuer will undertake concurrent Rule 506(c) and Section 4(a)(6) offerings as any general solicitation that the issuer uses in the Regulation D offering could otherwise be deemed an unlawful advertisement for the crowdfunding securities.

- Investors are strictly limited in the amount of securities that they may purchase under Section 4(a)(6) in any 12-month period. Investors having both an annual income and net worth of less than $100,000 may purchase not more than the greater of $2,000 or 5% of the greater of the investor's annual income or net worth, and investors having an annual income and/or a net worth of $100,000 or more may purchase not more than the lesser of $100,000 or 10% of the greater of the investor's annual income or net worth. Note that these caps are applied against the aggregate amount of securities that the investor purchases from any issuer through any crowdfunding platform and therefore any purchase of crowdfunding securities by an investor will reduce the amount of other crowdfunding securities that the investor may purchase during the following 12 months.
• Neither the issuer nor certain associated persons may be subject to specified criminal convictions or other disqualifying events. The relevant events are substantially similar to those that now apply under Rule 506. See “The New Private Placement Rules” above.

• The issuer must conduct its offering through a single intermediary that is registered with the SEC as either a broker-dealer or a “funding portal.” The funding portal concept is new to the securities laws. It permits crowdfunding intermediaries - who otherwise would likely be subject to mandatory registration as broker-dealers - to register with the SEC under a simpler process and to avoid most of the ongoing compliance costs associated with broker-dealer registration. However, the Proposed Rules impose significant restrictions on funding portal operations. Among other matters, the funding portal may not offer investment advice or recommendations, solicit purchases, sales or offers to buy the securities displayed on its platform, pay transaction-based compensation to its employees or agents or hold, manage or possess investor funds or securities. The funding portal also may not (absent suspicion of fraud) deny access to its website to an issuer based on the portal’s evaluation of the merits of the offering. The portal may, however, apply objective criteria to screen issuers (for example, the portal could choose to list only issuers that are involved in a particular industry, or are located in a particular geographic region, or are offering common stock or other particular kind of security). The funding portal must maintain communication channels by which investors can communicate with one another and issuer representatives regarding each offering on the platform. The portal also must become a member of the Financial Industry Regulatory Authority (FINRA), provide investors with certain educational materials and comply with certain FINRA rules and applicable privacy laws, anti-money laundering laws and recordkeeping requirements.

• The issuer must make specified disclosures. Among other items, the issuer must provide the intermediary and investors with descriptions of its business, ownership, capital structure and financial condition, the names and backgrounds of its officers and directors, statements of its anticipated business plan and of any material risk factors, the target offering amount and the intended use of proceeds and the offering price or method for determining the price. If the offering amount (including the amount of any other securities offered by the issuer under Section 4(a)(6) in the preceding 12-month period) is $100,000 or less, the issuer must further provide the issuer’s income tax returns for its most recently completed year and financial statements certified by its principal executive officer; if such offering amount is more than $100,000 but not more than $500,000 the issuer must provide financial statements reviewed by an independent public accountant; and if such offering amount is more than $500,000, it must provide financial statements audited by an independent public accountant. The issuer must file the disclosure information with the SEC before commencing the offering and must make certain other filings during the course of the offering.

• The issuer may not advertise its offering except for notices that direct investors to the intermediary’s platform and contain only limited categories of information as specified in the Proposed Rules. The issuer nonetheless may communicate with investors regarding the offering through the communication channels maintained by the intermediary as described above.

• If the issuer succeeds in selling its securities it must thereafter file annual reports with the SEC containing information specified in the Proposed Rules until such time as (i) the issuer becomes a
reporting company required to submit periodic reports under the Securities Exchange Act, (ii) the issuer or another party repurchases all of the crowdfunded securities, or (iii) the issuer liquidates or dissolves its business.

Any securities sold by an issuer pursuant to Section 4(a)(6) will also be exempt from registration under state securities (Blue Sky) laws.

The Section 4(a)(6) crowdfunding exemption will not be available until the SEC approves final rules. The SEC has not announced its timetable for doing so. In view, however, of the lapse of time between passage of the JOBS Act and the publication of the Proposed Rules, it’s widely expected that the SEC will approve final rules by mid-2014 and that the final rules will not differ materially from the Proposed Rules.

Many commenters have praised the crowdfunding exemption as an important step toward the "democratization" of finance since it can, in theory, permit small investors to make early stage investments in promising companies that previously would have been funded only by venture capitalists and other accredited investors. At the same time, there is certainly reason to question whether crowdfunding will meet the expectations of its strongest proponents. The percentage of start-up enterprises that become successful public companies or otherwise achieve a profitable exit is quite small. Although the Proposed Rules provide an exemption from Securities Act registration they impose significant compliance costs that don’t apply in Regulation D offerings (particularly in respect of the need for ongoing SEC filings and, depending on the offering size, independent accountant reviews or audits). The offering expenses incurred by an issuer will therefore often be greater under crowdfunding than under Regulation D and this, in turn, suggests that crowdfunding may be of particular interest to smaller, and frequently more risky, companies that are unable to obtain financing from traditional venture capital providers. It will be interesting to see whether Section 4(a)(6) crowdfunding, over the longer term, provides a net benefit to small investors.

More Information

If you would like further information concerning any of the matters discussed in this article, please contact Peter Manbeck or Samuel Hu of Chapman and Cutler LLP at the addresses below, or contact any other Chapman and Cutler attorney with whom you regularly work.

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45 Broker-dealers and funding portals are permitted under the Proposed Rules to provide issuers with assistance in the preparation of disclosure materials. An intermediary may be able to help issuers reduce their offering costs by developing automated procedures for the preparation of initial drafts of the disclosure materials and related filings.