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Peer-to-Peer Lending in the United States: Surviving After Dodd-Frank

I. INTRODUCTION

The idea for Peer-to-Peer¹ (P2P) lending spawned from microcredit principles and has attracted widespread publicity over the past decade.² Generally, microcredit institutions utilize small, short-term loans to provide credit access to impoverished entrepreneurs and others ignored by commercial lenders.³ With acknowledgments in mainstream media publications, including Money Magazine,⁴ CBS Evening News,⁵ and even a recent episode of The Simpsons,⁶ P2P lending is no longer an obscure financial experiment, but a widely recognized financial concept.

P2P lending is the designation given to financial transactions that bypass conventional intermediaries by directly connecting borrowers and lenders.⁷ The P2P lending industry emerged in 2005, attempting to provide borrowers with an alternative to traditional lending institutions,⁸ especially as typical

1. Also referred to as Person-to-Person lending.

2. Rajdeep Sengupta & Craig P. Aubuchon, *The Microfinance Revolution: An Overview*, FED. RES. BANK OF ST. LOUIS REV., Jan-Feb 2008, at 9, 9, available at <http://research.stlouisfed.org/publications/review/08/01/JanFeb08Review.pdf>.

3. *Id.*

4. Alexis Jeffries & Donna Rosato, *5 Ways to Pump Up Your Income*, MONEY MAG., Dec. 2009, at 82.

5. *CBS Evening News: New Way to Borrow Money* (CBS television broadcast Feb. 9, 2007), available at <http://www.cbsnews.com/video/watch/?id=2457856n&tag=related;photovideo> (reporting the experiences of individual borrowers and lenders using Prosper Marketplace, Inc.).

6. *The Simpsons: Loan-a-Lisa* (Fox television broadcast Oct. 3, 2010) (portraying the basic concepts of P2P lending).

7. See Alan B. Krueger, *In Credit Crisis, Some Turn to Online Peers for Cash*, N.Y. TIMES BLOG (Oct. 14, 2008, 9:17 AM), <http://economix.blogs.nytimes.com/2008/10/14/in-credit-crisis-some-turn-to-online-peers-for-cash/> (“P2P lending is a way to link lenders to borrowers without intermediation by a bank . . .”).

8. Ian J. Galloway, *Peer-to-Peer Lending and Community Development Finance 2* (Cmty. Dev. Inv. Ctr., Fed. Reserve Bank of S.F., Working Paper No. 2009-06,

credit markets became inaccessible during the recent credit crisis.⁹ During the credit freeze, traditional lenders often denied potential borrowers who posed reasonable credit risks and these borrowers were able to turn to P2P lenders for loans.¹⁰

P2P lending companies provide online platforms for individual borrowers and lenders to make small, unsecured loans.¹¹ Prior to widespread internet access, connecting individual borrowers and lenders in an efficient loan marketplace was simply not practical.¹² While the emerging P2P lending industry is only a small fraction of the world financial system, its potential significance has not gone unnoticed.¹³ Chris Larsen, the CEO of Prosper Marketplace, Inc. (Prosper),¹⁴ one of the two largest P2P lending companies in the United States,¹⁵ recently suggested that the industry could grow over \$5 billion in the span of a year.¹⁶ Although estimations of such extensive growth turned out to be overly optimistic, Prosper and Lending Club, the second of the two largest U.S. P2P lending companies, each had originated nearly

2009), available at

<http://www.frbsf.org/publications/community/wpapers/2009/wp2009-06.pdf>.

9. Krueger, *supra* note 7.

10. *Id.* (discussing statements by Devin Pope, an economist at The Wharton School of Business at the University of Pennsylvania, who pointed out that the fraction of borrowers with higher credit scores increased at Prosper during the preceding year).

11. Mingfeng Lin et al., *Social Networks as Signaling Mechanisms: Evidence from Online Peer-to-Peer Lending 1* (Oct. 2009) (unpublished paper), available at http://pages.stern.nyu.edu/~bakos/wise/papers/wise2009-p09_paper.pdf.

12. *See id.* at 6-7 (stating that the internet enables efficient online markets, bringing buyers and sellers together).

13. *See* Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., *Speech at the Global Financial Literacy Summit in Washington, D.C.: Community Development Financial Institutions: Challenges and Opportunities* (June 17, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090617a.htm> (noting that peer-to-peer lending entities “hold promise”).

14. Prosper was the first for profit P2P lending company in the United States and remained the largest P2P lender in terms of originated loans until Lending Club surpassed them in January 2011. *Institutional Investment Through Prosper*, PROSPER, <http://www.prosper.com/about/institutional/> (last visited Jan. 31, 2011).

15. *See* Silla Brush, *Online Lender Lobbies Congress for Industry Consumer Regulator*, THE HILL (June 9, 2010, 6:23 PM), <http://thehill.com/business-a-lobbying/102323-online-lender-lobbies-congress-for-industry-consumer-regulator>.

16. Galloway, *supra* note 8, at 2 (referencing the Prosper CEO’s comments that research studies indicated the P2P lending industry could grow from \$647 million in 2009 to \$5.8 billion in 2010).

\$218 million in loans as of January 2011.¹⁷ And, growth forecasts remain positive, with a recent study forecasting that the industry could grow to \$5 billion in outstanding loans by 2013, up over sixty-six percent.¹⁸

For this new industry to survive and grow in the U.S. market, the current regulatory scheme must undergo some significant changes.¹⁹ The stringent SEC registration requirements should be relaxed, with regulatory oversight reduced to levels necessary to maintain consumer confidence in the sector.²⁰ Additionally, P2P lenders must explore alternative methods for increasing revenue, including ad sales, third party business referrals, or expanded social networking options.²¹

This Note will analyze the future of the P2P lending industry as it emerges under the new Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).²² More specifically, this Note will evaluate the current regulation of the P2P lending industry, analyzing the SEC's decision to consider the notes as securities.²³ Then, this note will explain the need for changes in P2P lending regulation, the impact of Dodd-Frank with respect to those changes, and suggestions for regulatory reform critical to the future success of the industry.²⁴

Part II will briefly cover the emergence of P2P lending, noting the microfinance characteristics that still pervade the novel industry.²⁵ This discussion will include the potential benefits of

17. *Statistics: Performance Data Nov. 1, 2005 - Jan. 31, 2011*, PROSPER, <http://www.prosper.com/invest/performance.aspx> (enter the dates indicated above under "Loan origination date") (last visited Jan. 31, 2011); *Lending Club Statistics: Total Loans Funded*, LENDINGCLUB, <https://www.lendingclub.com/info/statistics.action> (last visited Jan. 31, 2011).

18. Robert Schmidt & Jesse Westbrook, *An Online Lender Takes on the SEC*, BLOOMBERG BUSINESSWEEK, June 14, 2010, at 25 (citing Gartner research firm's prediction in January 2010 that P2P lending will grow to \$5 billion in outstanding loans by 2013).

19. *See infra* Part IV.

20. *See infra* Part IV.

21. *See infra* Part IV.

22. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of U.S.C.); *see infra* Part III.C-D.

23. *See infra* Part III.B.

24. *See infra* Parts III-IV.

25. *See infra* Part II.

P2P lending, including high returns for investors, low default rates, and community development.²⁶ Further, this section will review the lending models employed by the two largest P2P lending companies in the United States.²⁷

Part III will deal with the regulation of the industry, explaining the relaxed regulatory atmosphere enjoyed at the industry's inception, examining regulation under the SEC, and assessing potential changes to the regulatory scheme under Dodd-Frank.²⁸

Finally, Part IV will expand upon the previous section, inspecting the reality of the situation in the P2P lending sector and suggesting changes to the company practices and regulatory scheme that will benefit companies and consumers in the industry.²⁹

II. THE EMERGENCE OF PEER-TO-PEER LENDING

Microfinance ideals have been utilized for centuries in countries such as Ghana, India, Mexico, Sri Lanka, and Bolivia.³⁰ More formal microfinance institutions emerged later, with the Irish Loan Fund created in the early 1700s in an effort to aid impoverished citizens in Ireland.³¹ Over time, the Irish Loan Fund became a larger organization, charging interest on small, short-term loans and eventually reaching twenty percent of all Irish families annually.³²

Similarly, the modern microfinance movement began as an initiative to aid people living in poverty.³³ Muhammad Yunus, founder of the Grameen Bank in Bangladesh, was awarded the Noble Peace Prize in 2006 for his efforts to use microcredit³⁴ as a

26. *See infra* Part II.A.

27. *See infra* Part II.B.

28. *See infra* Part III.

29. *See infra* Part IV.

30. Floyd Mann, *The History of Microfinance*, GLOBALENVISION.ORG (Apr. 14, 2006), <http://www.globalenvision.org/library/4/1051/>.

31. *Id.*

32. *Id.*

33. Sengupta & Aubuchon, *supra* note 2, at 9.

34. *Id.* at 9-10 (distinguishing microcredit from microfinance, which is inclusive of microcredit).

catalyst to end the cycle of poverty for many borrowers.³⁵ It is estimated that there are between 1000 and 2500 microfinance institutions in over 100 countries worldwide serving over 67 million people.³⁶ While there have been failures, many of these institutions have been highly successful.³⁷ And, although the majority of microfinance institutions are nonprofit organizations with the primary goal of aiding the impoverished,³⁸ the benefits realized by microfinance institutions have attracted for-profit companies to the sector as well,³⁹ including Prosper and Lending Club.⁴⁰

A. *Potential Benefits of P2P Lending*

Perhaps the most widely advertised benefit for lenders interested in P2P lending is the possibility of higher returns than those achievable with investments available in traditional markets.⁴¹ Additionally, P2P lending offers a new asset class, allowing investors to further diversify their portfolios.⁴² Although

35. *Id.* at 9.

36. *Id.* at 9.

37. See *Grameen Bank Annual Report 2009*, GRAMEEN.COM, <http://www.grameen.com/> (follow “Annual Report 2009” hyperlink under “Data & Reports”) (last visited Jan. 31, 2011) (reporting substantial profitability and a loan recovery rate of 97.46 percent – recovery rate determined by dividing the “loan loss provision” by “total outstanding loans,” Tk.1.428 mil./ 56.359 mil.); Molly Richardson, Note, *Increasing Microlending Potential in the United States Through a Strategic Approach to Regulatory Reform*, 34 J. CORP. L. 923, 928 (2009) (listing the profitability of the Grameen Bank as \$20 million and Bank Rakyat of Indonesia as \$200 million in 2006).

38. B. Seth McNew, *Regulation and Supervision of Microfinance Institutions: A Proposal for a Balanced Approach*, 15 LAW & BUS. REV. AM. 287, 296 (2009) (discussing that the majority of microfinance institutions still rely on donations or governmental support).

39. Jane J. Kim, *Peer-to-Peer Lender Relunched*, WALL ST. J., Apr. 28, 2009, at D5 (detailing some of the benefits of P2P lending, including higher interest rates for lenders and accessible credit for borrowers).

40. The author would like to give special thanks to Robert E. (Ricky) May, Jr., a Lending Club lender member, for providing a firsthand look at the lending platform and the information available to member lenders when making investment decisions.

41. See Peter J. Brennan, *Peer-to-Peer Lending Lures Investors With 12% Return (Update2)*, BLOOMBERG (July 16, 2009, 4:24 PM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aXH29ZSVg31E>.

42. See *Online Investing and Peer-to-Peer Lending: A Great Way to Diversify While Investing in Real People*, PROSPER, http://www.prosper.com/invest/about_investing.aspx (last visited Jan. 31, 2011).

some lenders may have achieved high returns, for the average lender this may not yet be an advantage, with an average annual return of only 2.8% at Prosper as of April 2009 due to a high level of defaulting borrowers.⁴³ However, the average return for lenders has increased as credit history information has improved, reaching 4.8% at Prosper between March 2007 and April 2009.⁴⁴ As of January 8, 2010, Prosper estimated an average return of 7.58%⁴⁵ on AA-B⁴⁶ rated investments originated between July 2009 and June 2010. This estimate could prove to be overly optimistic, as historical market performance data indicates returns on this class of investment have been around 5.43%, but the increase in estimated returns is still encouraging.⁴⁷ More impressively, Lending Club claimed an average annual return of 9.67% between June 1, 2007 and October 15, 2010.⁴⁸ Even Prosper's 5.43% average annual return for that period seems rather impressive though, given that the S&P 500 lost 23.83% over the same time period.⁴⁹ While the financial markets were experiencing extremely atypical movements during that time period, the gradual increase in average lender return offers promise that a high return will eventually be a realistic attraction for P2P lenders.⁵⁰

43. See Kim, *supra* note 39 (explaining that defaults were the reason for such low average returns).

44. *Id.* (suggesting that additional information on borrowers was the reason for the improvement in returns between March 2007 and April 2009).

45. *Marketplace Investor Performance: July 2009 – June 2010 Loans*, PROSPER, <http://www.prosper.com/welcome/marketplace.aspx> (last visited Jan. 31, 2011).

46. Prosper Marketplace, Inc., Annual Report (Form 10-K), at 2-5 (Dec. 31, 2009) [hereinafter Prosper Annual Report] (describing the factors that go into Prosper's borrower risk rating system, AA being the highest and HR being the lowest).

47. *Marketplace Investor Performance: Loans Originated Nov. 2005 – June 2009*, PROSPER, <http://www.prosper.com/welcome/marketplace.aspx> (last visited Jan. 31, 2011) (follow "click here" hyperlink to view additional performance data) (showing lender yield and credit loss on AA-B rated investments as 9.00% and 3.57%, respectively, yielding a return of 5.43%).

48. *How Lending Club Works: A More Efficient Model*, LENDINGCLUB, <http://www.lendingclub.com/public/more-efficient-model.action> (last visited Jan. 31, 2011).

49. Return was calculated using the closing prices of the S&P 500 Index on Oct. 31, 2005 (1207.01) and June 30, 2009 (919.32), index prices obtained using finance.yahoo.com. But see *How Lending Club Works, A More Efficient Model*, *supra* note 48 (noting that the S&P only lost 2.26% over the time period used to calculate the average annual return at Lending Club).

50. See *S&P 500: Total and Inflation-Adjusted Historical Returns: Annual*

Another alleged benefit of P2P lending is the low default rate. However, the low default rate claims of other microfinance lenders, including Grameen Bank, have been called into question.⁵¹ Further, non-profit microcredit initiatives in the United States have been less successful than similar institutions in developing countries.⁵² Be that as it may, the P2P lending industry is currently attracting an increasing number of borrowers with more attractive credit risk.⁵³ This only adds to the industry's promise of growth and could potentially lead to far lower default rates in the future.⁵⁴

Another notable benefit of P2P lending is that it provides small business owners and individual entrepreneurs with access to lending services when they may otherwise be excluded from traditional loan sources.⁵⁵ Additionally, loans to low-income borrowers will often be at lower interest rates than are available through traditional sources, as P2P lending largely cuts out the financial intermediary.⁵⁶ This can create benefits for entire communities, providing low-income individuals with opportunities

Averages per Decade, SIMPLESTOCKINVESTING.COM, <http://www.simplestockinvesting.com/SP500-historical-real-total-returns.htm> (charting the annual real total return of the S&P 500 as 7.0% between 1950 and 2009).

51. Kenneth Anderson, *Microcredit: Fulfilling or Belying the Universalist Morality of Globalizing Markets?*, 5 YALE HUM. RTS. & DEV. L.J. 85, 98 & n.38 (2002) (citing that loan default rates at the well-known Grameen Bank are much higher than claimed); Sengupta & Aubuchon, *supra* note 2, at 19 (citing Jonathan Morduch's study on the accounting standards of the Grameen Bank, which calculates loan delinquency rates based on "the value of loans overdue (for more than one year) divided by the *current portfolio*," thus, generating much lower delinquency rates than if the percentage had been calculated based on "*the size of the portfolio when the overdue loans were issued*") (emphasis added).

52. See Richardson, *supra* note 37, at 929-34 (explaining issues such as higher default rates, saturated entrepreneurial markets, and formalized credit markets as factors hindering microlending in the United States).

53. Krueger, *supra* note 7; *Marketplace Investor Performance: Originations by Year Based on Credit Score*, PROSPER, <http://www.prosper.com/welcome/marketplace.aspx> (last visited Jan. 31, 2011) (showing 84% of the loan originations in 2008 were by borrowers with a credit score greater than 640, versus only 58% in 2006).

54. See *supra* Part II.A.

55. McNew, *supra* note 38, at 294.

56. Brad Slavin, *Peer-to-Peer Lending – An Industry Insight*, BRADSLAVIN.COM 3-4 (June 21, 2007), <http://cdn.bradslavin.com/wp-content/uploads/2007/06/peer-to-peer-lending.pdf>.

to build businesses, establish financial independence, and engage in neighborhood development projects.⁵⁷ In turn, activities like these tend to result in community-wide improvements in health, education, and overall well-being.⁵⁸

B. *Lending Models*

Neither Prosper nor Lending Club offers a pure P2P lending model, which would allow lenders to loan directly to borrowers absent any intermediation.⁵⁹ Instead, each service has a hand in facilitating the lending transactions, both basing their business models around fees generated from loan service and origination.⁶⁰ Prosper charges a 0.5% origination fee for its highest rated borrowers,⁶¹ an origination fee of 3.0% for moderately risky borrowers, and an origination fee of 4.5% for the riskiest borrowers.⁶² Also, Prosper charges borrowers a \$15 late payment fee and charges lenders a 1.0% annual loan-servicing fee.⁶³

Similarly, Lending Club has its own borrower rating system, assigning borrowers to a rating based on credit scores,⁶⁴

57. Galloway, *supra* note 8, at 9.

58. See McNew, *supra* note 38, at 294.

59. Galloway, *supra* note 8, at 1.

60. Carl E. Smith, *If It's Not Broken, Don't Fix It: The SEC's Regulation of Peer-to-Peer Lending*, 6 BUS. L. BRIEF 21, 21 (2009), available at http://www.wcl.american.edu/blb/documents/AU_BLBFall09_Smith.pdf?rd=1.

61. *How to Invest: Prosper Ratings*, PROSPER, <http://www.prosper.com/invest/how-to-invest/prosper-ratings/> (last visited Jan. 31, 2011) (identifying AA as the highest Prosper Rating and estimating an annual loan loss rate of 0.0%-1.99% for these borrowers). The Prosper Rating is a proprietary rating system based on a borrower's credit score as well as the Prosper Score, which is based on the number of trades, delinquent accounts, credit inquiries, recently opened trades, available credit line, and bankcard utilization. *Id.*

62. *Id.* (identifying C-HR as high risk borrowers and estimating an annual loan loss rate between 6.0% and greater than 15.0%). As of January 31, 2011, Prosper was no longer offering loans to borrowers with an HR Prosper Rating. *Fees and Charges: Fees Borrowers Pay*, PROSPER, <http://www.prosper.com/help/topics/other-fees.aspx> (last visited Jan. 31, 2011).

63. *Fees and Charges: Fees Borrowers Pay*, *supra* note 62 (explaining that the fee is either \$15 or 5% of the outstanding payment due, and that the collection of this particular fee is passed on to lenders; also adding that lenders will be charged collection agency fees if anything is recovered from a delinquent borrower after thirty days). The current charge is 17% of the recovery amount. *Collection Agencies*, PROSPER, http://www.prosper.com/help/topics/lender-collection_agencies.aspx (last visited Jan. 31, 2011).

64. *Rates and Fees: Borrower Origination Fee*, LENDINGCLUB,

with the highest rated borrowers paying a 2.0% origination fee, moderately risky borrowers paying a 4.0-5.0% origination fee, and higher risk borrowers paying a 5.0% origination fee.⁶⁵ Just as Prosper does, Lending Club charges borrowers a \$15 late payment fee and charges lenders a 1.0% annual loan servicing fee.⁶⁶ The fee structures at Prosper and Lending Club are very similar, and although the lending models of the companies originally varied, Prosper has recently changed its lending model to resemble the model utilized at Lending Club.⁶⁷

Lending models are considered direct when individual users can contribute directly to a loan.⁶⁸ For example, if a lender is able to contribute to a specific loan without the lending service's participation, then the funding of the loan is direct.⁶⁹ With regards to pricing, that aspect of the loan is considered direct when the borrower establishes the maximum interest rate at which he would accept the loan.⁷⁰ Alternatively, when the lending company establishes the interest rate for a loan the pricing of the transaction is considered intermediated.⁷¹

Lending Club's platform simulates a direct funding model, but an intermediate model with respect to pricing.⁷² This means that when a borrower applies for a loan, Lending Club assesses the

<https://www.lendingclub.com/public/rates-and-fees.action> (last visited Jan. 31, 2011) (explaining that Lending Club also considers factors in addition to the credit score in the ultimate borrower rating).

65. *Id.* (charting the different borrower ratings, which are divided into A-G categories, and then subdivided within each of those categories (1-5) to determine the interest rate the borrower pays).

66. *Id.* (adding that there are additional collection fees on amounts recovered from delinquent borrowers, as well as explaining that late payment fees are passed on to lenders and can amount to as much as 5% of the outstanding payment due).

67. As of December 2010, Prosper had changed its lending model significantly from prior months. Prosper now sets interest rates just as Lending Club does, rather than allowing lenders on the platform to bid down the maximum interest rate set by the borrower. This is a significant change from the auction style platform that Prosper originally developed and had in place during the majority of 2010. Mark Calvey, *Prosper Shelves Auctions Amid Criticism*, S.F. BUS. TIMES, Dec. 24, 2010, <http://www.bizjournals.com/sanfrancisco/print-edition/2010/12/24/prosper-shelves-auctions-amid-criticism.html>.

68. See Galloway, *supra* note 8, at 2.

69. See *id.*

70. See *id.*

71. See *id.*

72. *Id.* at 3.

borrower's creditworthiness and determines an appropriate rate based on the borrower's risk of default.⁷³ Following this, Lending Club posts the loan as a note on its network, where investors can then choose to fund a portion of the principal based on the established interest rate and credit grade.⁷⁴ The model seems to be working for members, with Lending Club boasting of an average lender return of 9.67% over the last three years, as previously mentioned.⁷⁵

Although the Lending Club platform simulates direct funding of the borrower loans by the lenders, the funding portion of the transaction is actually intermediated.⁷⁶ To avoid the need for individual state lending licenses and to provide loans to borrowers uniformly throughout the United States, each borrower loan is made from WebBank, an industrial bank based in Utah, as a typical consumer loan.⁷⁷ WebBank furnishes the loan proceeds in exchange for a corresponding promissory note from the borrower.⁷⁸ Lending Club then provides WebBank with the aggregate funding received from lenders for the specified loan in exchange for the assignment of the borrower's promissory note.⁷⁹ Following the assignment from Webank, Lending Club collects the monthly payments from its borrowers and distributes the proceeds to the lenders based on each lender's pro rata investment in the loan after deducting Lending Club's one percent service charge.⁸⁰

Originally, Prosper employed a slightly different model, although it has always used WebBank to facilitate the loan

73. *See id.* at 5.

74. *See Investing: Diversification*, LENDINGCLUB, <http://www.lendingclub.com/public/how-peer-lending-works.action> (last visited Jan. 31, 2011).

75. *How Lending Club Works, A More Efficient Model*, *supra* note 48 (comparing Lending Club returns to the S&P 500 (-4.46%), Morningstar U.S. Corporate Bond Index (7.11%), NASDAQ (0.16%), and others over the same period).

76. *See generally* LendingClub Corp., Registration Statement (Form S-1) (June 20, 2008) [hereinafter LendingClub Registration Statement] (noting that the industrial bank which serves as an intermediary between borrowers and lenders is a legal formality used for uniformity and to avoid state lending license requirements).

77. *Id.* at 25.

78. *Id.* at 3.

79. *Id.* at 3.

80. *Id.* at 6.

transactions in the same manner as Lending Club.⁸¹ Instead of setting loan interest rates based on credit ratings, Prosper used an auction process to set interest rates for member loans.⁸² Now, Prosper has adjusted its lending model to look very similar to the model used by Lending Club, with Prosper setting the interest rates instead of letting an auction process determine them.⁸³ Borrowers must have a credit score of at least 640 and then they are assigned a Prosper Rating that is the basis for the interest rate Prosper sets for the loan.⁸⁴ Over a fourteen-day period, lenders “bid” on the loan incrementally until the borrowers total loan request is filled.⁸⁵ Prosper also takes advantage of more traditional microfinance techniques, creating social pressure to encourage repayment, thus lowering default rates in a manner similar to the community lending practices utilized by the Grameen Bank.⁸⁶ Borrowers and lenders are able to provide detailed profiles, increasing the social aspects of the online loan transaction.⁸⁷ Further, Prosper encourages borrowers and lenders to join together in groups with tight affiliations in an additional effort to foster a sense of community, bolstering the social elements of the loans.⁸⁸

81. Prosper Annual Report, *supra* note 46, at 4.

82. See *How Prosper Works*, PROSPER, http://www.prosper.com/welcome/how_it_works.aspx (last visited Jan. 31, 2011).

83. *Borrower Tutorial: Create Your Listing*, PROSPER, <http://www.prosper.com/help/tutorials/listing-1.aspx> (last visited Jan. 31, 2011).

84. *Prosper Borrower Help: Who Can Borrow Money on Prosper?*, PROSPER, <http://www.prosper.com/help/borrowing.aspx> (last visited Jan. 31, 2011); *Invest: Prosper Ratings*, PROSPER, <http://www.prosper.com/invest/how-to-invest/prosper-ratings/> (last visited Jan. 31, 2011).

85. *Borrower Tutorial: Lenders Choose to Invest in Your Loan*, PROSPER, <http://www.prosper.com/help/tutorials/listing-2.aspx> (last visited Jan. 31, 2011). Prosper still uses the word “bid” in describing lender investment in a loan, but the recent changes to its model have ultimately removed the bidding process from the platform. See *Borrower Tutorial: Create Your Listing*, *supra* note 83 (explaining that Prosper determines the interest rate on each loan based on the Prosper Rating).

86. Galloway, *supra* note 8 (stating that Prosper hopes borrowers will feel more obligated to repay their loans by organizing online social groups, linked by interests or alma mater); Sengupta & Aubuchon, *supra* note 2, at 11-12 (explaining that most economists credit the success of the Grameen bank to its group lending contracts which put social pressure on borrowers to repay loans).

87. See *How to Create a Successful Borrower Listing*, PROSPER, http://www.prosper.com/help/topics/borrower-create_successful_listing.aspx (last visited Jan. 31, 2011); Sengupta & Aubuchon, *supra* note 2, at 11-12.

88. See *Prosper Groups*, PROSPER,

III. REGULATION OF THE P2P LENDING INDUSTRY

The P2P lending industry is a young and emerging industry, but already it has seen significant regulatory changes in the United States.⁸⁹ Prosper and Lending Club began operations in 2005 and 2007, respectively, largely unregulated.⁹⁰ However, all of that changed November 23, 2008 when the SEC issued a cease-and-desist order against Prosper.⁹¹ While SEC regulation adds a significant burden to P2P lending companies, additional oversight was certainly needed.⁹² The relaxed regulatory approach allowed lender members to enter into risky loans without adequate information, resulting in enormous default rates, with more than twenty-four percent of Prosper borrowers defaulting in the period between the commencement of operations and the shut-down of operations on October 16, 2008, just prior to the issuance of the SEC cease and desist order.⁹³ The high number of defaults at Prosper was in direct contradiction to the low default rates that are often cited as a significant benefit of microfinance.⁹⁴ Further, the high default rates alarmed the SEC as to the safety of these

http://www.prosper.com/groups/?search_string= (last visited Jan. 31, 2011) (showing member groups based on similar purposes for Prosper involvement, school affiliations, employers, etc.).

89. See *infra* Part III.

90. See Prosper Annual Report, *supra* note 46, at 34 (explaining that the notes were not registered under the Securities Act from February 2006 through October 16, 2008); LendingClub Corp., Annual Report (Form 10-K), at 44 (March 31, 2009) [hereinafter LendingClub Annual Report] (stating that the original platform did not list securities in compliance with the Securities Act).

91. Prosper Marketplace, Inc., Cease-and-Desist Order, Securities Act of 1933 Release No. 8984, 94 SEC Docket 1913 (Nov. 24, 2008) [hereinafter Prosper Cease-and-Desist Order].

92. See *id.* (concluding that additional safeguards are needed because there is no other regulator to protect lenders from the risks presented by the Prosper platform). *But see* Smith, *supra* note 60, at 21 (“[T]he SEC should have allowed the status quo to continue to permit the maturation of both the peer-to-peer lending market and its products.”).

93. See *Statistics: Performance Data Feb. 1, 2006 - Oct. 15, 2008*, PROSPER, <http://www.prosper.com/invest/performance.aspx> (enter the dates indicated above under “Loan origination date”) (last visited Jan. 31, 2011) (charting data on loan originations between February 2006 and October 15, 2008, and showing an aggregate default rate of 23.83%).

94. See *supra* Part II.A.

investments for consumers, and it also hurt the growth potential of Prosper as many people became skeptical of the concept.⁹⁵

A. *Regulating Microfinance In General*

There is no question that microfinance institutions as a whole need some regulatory oversight.⁹⁶ Too much, though, and the cost of compliance becomes so high as to preclude real development in the sector.⁹⁷ At a minimum, all microfinance entities, and certainly for-profit P2P lenders, must have regulations to protect “borrowers against abusive lending and collection practices, and [to] provid[e] borrowers [and lenders] with truth in lending.”⁹⁸ The challenge for regulators is finding a balance between sufficient regulation for borrower and lender protection without overburdening the industry.

It is unlikely that uniform global regulation of microfinance institutions is practical, or even possible, given the varying roles of microfinance in different parts of the world.⁹⁹ Looking specifically at P2P lending entities in the United States,¹⁰⁰ however, it is evident that there have already been clear successes and failures in terms of implemented regulation. The minimal regulation

95. See Mark Gimein, *You Are Unlikely to Prosper*, THEBIGMONEY.COM (Jan. 18, 2010, 10:23 PM), <http://www.thebigmoney.com/articles/money-trail/2010/01/18/you-are-unlikely-prosper> (identifying the obvious risks of P2P lending and even mentioning a forum called Prosper.org which allows frustrated lenders to share their stories); Felix Salmon, *The Problem With Peer-to-Peer Lending*, BLOG.REUTERS (Jan. 19, 2010, 12:05 PM), <http://blogs.reuters.com/felix-salmon/2010/01/19/the-problem-with-peer-to-peer-lending/>. *But see An Open Letter to The Big Money: Retract Your Story*, PROSPER BLOG (Jan. 19, 2010), <http://blog.prosper.com/2010/01/19/an-open-letter-to-the-big-money-retract-your-story/> (contending that many of Mr. Gimein’s comments were erroneous and overstated).

96. The catastrophic implications of having absolutely no regulations are not hard to imagine: fraud, money laundering, thwarted consumers to name a few.

97. McNew, *supra* note 38, at 288 (adding that too much regulation takes away the flexibility microfinance institutions require to be successful).

98. ROBERT PECK CHRISTEN ET AL., MICROFINANCE CONSENSUS GUIDELINES: GUIDING PRINCIPLES ON REGULATION AND SUPERVISION OF MICROFINANCE 7 (CGAP/ The World Bank Grp., 2003), *available at* http://www.cgap.org/gm/document-1.9.2787/Guideline_RegSup.pdf.

99. *See id.* at 6.

100. The focus throughout this note is on the two largest U.S. P2P lending companies, Prosper and LendingClub.

employed at the onset of this fledgling industry demonstrated the problems of such a regulatory absence, with “adverse selection” resulting in high default rates and deterrence of potential lenders.¹⁰¹ The occurrence of “adverse selection” is a result of the high-risk borrowers that P2P lenders tend to attract, primarily because the target consumers are those borrowers turned away by traditional lenders.¹⁰² Further, many Prosper lenders were not satisfied with the original effort to collect from borrowers on defaulted loans.¹⁰³ And, because the loans were unsecured,¹⁰⁴ there was no additional recourse for lenders if Prosper was unsuccessful in its collection efforts.

B. Regulation Under the SEC

Perhaps the industry would have corrected some of its problems even if the SEC had not stepped in. Notably, as the credit crisis worsened and traditional lenders denied an even greater range of potential borrowers, better credit risks entered the P2P lending sector,¹⁰⁵ significantly decreasing the number of defaults at Prosper.¹⁰⁶ However, the cease-and-desist order issued by the SEC shut down Prosper’s operations in the midst of the credit crisis, impairing growth in the industry during the period.¹⁰⁷

101. Krueger, *supra* note 7 (“The sites tend to attract high-risk borrowers who are unable to obtain credit at lower rates from traditional sources like a bank.”).

102. *Id.*

103. Sam Rose, *The Prosper Lender Rebellion and the U.S. Credit/Borrowing Black Hole*, P2P FOUNDATION (August 16, 2007, 6:07 PM), <http://blog.p2pfoundation.net/the-prosper-lender-rebellion-and-the-us-creditborrowing-black-hole/2007/08/16>.

104. CHRISTEN ET AL., *supra* note 98, at 10 (noting the benefits to “borrowers, lenders, and the national economy” when loans are backed with collateral).

105. Krueger, *supra* note 7 (suggesting that the credit crisis is also a likely factor in the increase of P2P borrowers).

106. *Compare Statistics: Performance Data Nov. 1, 2005 - Nov. 1, 2007*, PROSPER, <http://www.prosper.com/invest/performance.aspx> (enter the dates indicated above under “Loan origination date”) (last visited Jan. 31, 2011), *with Statistics: Performance Data Nov. 1, 2007 - Jan. 31, 2011*, PROSPER, <http://www.prosper.com/invest/performance.aspx> (enter the dates indicated above under “Loan origination date”) (last visited Jan. 31, 2011) (showing the decrease in charge-offs during the last four years of Prosper’s operations from the first two years).

107. Prosper Cease-and-Desist Order, *supra* note 91.

The SEC's cease-and-desist order referenced the Supreme Court's precedents in *SEC v. W.J. Howey Co.*¹⁰⁸ and *Reves v. Ernst & Young*,¹⁰⁹ concluding that Prosper's notes were securities.¹¹⁰ Once the notes were determined to be securities, they were correspondingly considered unregistered securities, as Prosper had not registered any of its loans with the SEC.¹¹¹ Consequently, the SEC concluded that Prosper had violated Sections 5(a)¹¹² and (c)¹¹³ of the Securities Act and ordered the company "[p]ursuant to Section 8A¹¹⁴ of the Securities Act, . . . [to] cease and desist from committing or causing any violations and any future violations of Sections 5(a) or (c) of the Securities Act."¹¹⁵ To comply, Prosper shut down its lending platform until July 13, 2009.¹¹⁶ Lending Club, preferring not to fight with the SEC, had already closed its lending platform, shutting down from April 7, 2008 until October 13, 2008, so that it could file a registration statement and come into compliance with SEC rules.¹¹⁷

108. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946) (defining an investment contract as "the placing of capital or laying out of money in a way intended to secure income or profit from its employment" (citing *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 56, 177 N.W. 937, 938 (1920))).

109. *Reves v. Ernst & Young*, 494 U.S. 56, 65-66 (1990) (explaining that an instrument is probably a security when the "seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate").

110. Prosper Cease-and-Desist Order, *supra* note 91, at 5-6 (concluding that Prosper notes are securities because lenders are motivated by an expected return, the loans are offered to the general public, reasonable investors expect that the loans are investments, and there is no other regulator reducing the risks to investors).

111. *Id.*

112. Securities Act of 1933 § 5(a) & (c), 15 U.S.C. § 77e (2006) (providing that it is illegal for a person "to make use of any means or instruments of transportation or communication in interstate commerce or of the mails" in order to sell an unregistered security).

113. *Id.* (stating that it is illegal for a person directly, or indirectly, to offer to sell or offer to buy an unregistered security using any means of transportation or communication in interstate commerce or the mail).

114. 15 U.S.C. § 77h-1 (2006) (authorizing the SEC to require any person found in violation of any portion of the subchapter to cease and desist from any action "that is violating, has violated, or is about to violate any provision of the subchapter").

115. Prosper Cease-and-Desist Order, *supra* note 91, at 6.

116. Smith, *supra* note 60, at 23.

117. *Id.*

1. The SEC's Application of *Howey* is Unnecessary

Under the precedent established by the Supreme Court decision in *SEC v. W.J. Howey Co.*¹¹⁸ the SEC determined that Prosper notes are investment contracts, characterized as securities under Section 2(a)(1) of the Securities Act.¹¹⁹ An investment contract is defined as “[i] an investment of money in [ii] a common enterprise with [iii] profits to come solely from the efforts of others.”¹²⁰ In the SEC’s evaluation of the notes offered by Prosper, they found that all three elements of an investment contract were present.¹²¹ The SEC concluded that (i) there is an investment of money when the lenders purchase a loan; (ii) a common enterprise exists because borrowers and lenders are dependent on Prosper to make loans available for investment, to ensure timely loan repayments, and to diversify loan funding among multiple lenders; and (iii) the profits for lenders come solely from Prosper’s collection of borrower repayments.¹²²

The SEC is clearly justified to find that Prosper notes satisfy the first element of an investment contract, as established in *Howey*.¹²³ Lenders provide capital to fund the notes and bear all of the risk of loss in the case of borrower default.¹²⁴ Likewise, Prosper notes clearly meet the third element of an investment contract established in *Howey*, with lenders providing capital for borrower loans due to profit incentives.¹²⁵ Lenders are prohibited from making direct contact with borrowers, and thus, completely rely on the efforts of Prosper in order to collect borrower repayments and to recognize any profits.¹²⁶ However, to find that the investment of money was “in a common enterprise,” the

118. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

119. Prosper Cease-and-Desist Order, *supra* note 91, at 3.

120. *W.J. Howey Co.*, 328 U.S. at 301.

121. Prosper Cease-and-Desist Order, *supra* note 91, at 4.

122. *Id.*

123. *See id.* (outlining the requirement of an investment of money, which is clearly present with Prosper notes).

124. *Id.*

125. *See How Lending Club Works, A More Efficient Model*, *supra* note 48; *How Prosper Works*, *supra* note 82 (explaining how each platform can provide investors with better returns by avoiding traditional intermediation).

126. Prosper Cease-and-Desist Order, *supra* note 91, at 4.

second element of an investment contract in *Howey*, is less consistent with established precedent.¹²⁷

The SEC reasoned that a common enterprise exists at Prosper because borrowers and lenders depend on Prosper to service and originate loans, Prosper charges fees for those services, and most loans are funded by multiple lenders.¹²⁸ Conversely, the aspects of a common enterprise referenced in *Howey* are notably different.¹²⁹ In *Howey*, promoters offered an investment opportunity in which investors contributed money in return for a portion of the profits generated by a large citrus fruit operation.¹³⁰ Lenders at Prosper are not actually investing in the Prosper business; rather, they are investing in individual borrowers with the assistance of Prosper.¹³¹ The venture capital firms that make equity investments in Prosper are providing capital that more closely fits the definition of an “investment . . . in a common enterprise” as established in *Howey*.¹³² The individual lender investments in notes through Prosper’s platform entitle lenders to the stated returns on the loans that they have funded, not to profits earned by Prosper for its loan servicing and origination services.¹³³

Although it is certainly arguable that the *Howey* analysis applies because multiple lenders typically fund each loan, it seems that the SEC’s characterization of Prosper notes as investment contracts is forced and unnecessary. Prosper notes are more like bonds than investment contracts, as Prosper’s platform creates a marketplace for individual borrowers to receive financing from lenders in return for repayment of the principal loan plus interest payments, in essence securitizing the debt of the individual borrowers.¹³⁴ Furthermore, the Supreme Court rejected the application of the *Howey* test to notes, stating that doing otherwise

127. See *infra* Part III.B.1.

128. Prosper Cease-and-Desist Order, *supra* note 91, at 4.

129. See *infra* Part III.B.1.

130. SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

131. See *How Prosper Works*, *supra* note 82.

132. See *W.J. Howey Co.*, 328 U.S. 293.

133. See *How Prosper Works*, *supra* note 82.

134. *Id.*; Peter Renton, *Corporate Bonds vs Lending Club Notes*, SOCIALLENDING.NET (Dec. 6, 2010), <http://www.sociallending.net/investing-lending/corporate-bonds-vs-lending-club-notes/>.

would conflict with the intent of Congress when it enacted the 1933 Securities Act and 1934 Act.¹³⁵ Nevertheless, the SEC's ultimate determination that Prosper notes are securities is clearly appropriate based on the precedent established in *Reves v. Ernst & Young*.¹³⁶

2. Prosper Notes Are Securities Under *Reves*

The SEC also found that Prosper notes fall into the category of securities under the precedent established by the Supreme Court's opinion in *Reves v. Ernst & Young*.¹³⁷ *Reves* provides that a note is "presumed to be a security unless it bears a strong resemblance . . . to one of a judicially crafted list of categories of instrument that are not securities."¹³⁸ Because the notes offered by Prosper do not fall on the non-security list,¹³⁹ the four part "family resemblance" test must be satisfied in order to rebut the presumption that a Prosper note is a security.¹⁴⁰ The four part test identifies the following factors in determining whether a note is a security: (i) buyer and seller motivations; (ii) the plan of distribution; (iii) the investing public's reasonable expectations; and (iv) the possibility of an alternative regulatory scheme.¹⁴¹

Considering the first element of the family resemblance test, Prosper notes resemble securities based on buyer and seller motivations. Prosper lenders are generally motivated to fund borrower notes because of the high rate of return achievable through the investment.¹⁴² *Reves* indicates that when the buyer of a note is primarily interested in the profit expected from investing

135. *Reves v. Ernst & Young*, 494 U.S. 56, 56-57 (1990).

136. *See id.*

137. Prosper Cease-and-Desist Order, *supra* note 91, at 4.

138. *Reves*, 494 U.S. at 56.

139. *Id.* at 66 (listing a note delivered in consumer financing, a note secured by a home mortgage, a short-term note secured by a lien on a small business, a character loan to a bank customer, and a short-term note secured by accounts receivable as examples of notes that are not classified as securities); Prosper Cease-and-Desist Order, *supra* note 91, at 4.

140. *Reves*, 494 U.S. at 56.

141. Prosper Cease-and-Desist Order, *supra* note 91, at 5.

142. *Id.*

in the note, it is probably a security.¹⁴³ Prosper's website portrays the notes offered over its platform as alternative investments that provide an opportunity for portfolio diversification and high returns.¹⁴⁴ So, in the case of Prosper notes the motivation of the lenders is clearly investment for profit as with a typical security, and even if some investors are partially motivated by some form of altruism, the primary motivation is still profit.¹⁴⁵

Secondly, Prosper notes resemble securities with regard to the plan of distribution. While the Prosper notes are not traded on an exchange, they are offered to the general public over the internet.¹⁴⁶ Prosper lenders are not necessarily sophisticated investors and rely on information provided by Prosper in order to make investment decisions.¹⁴⁷ All that is required for notes to be considered securities under the second element of the test is "common trading" in the instrument.¹⁴⁸ By offering the notes for sale over the internet to a broad segment of the public, the "common trading" criteria is met.¹⁴⁹

Third, Prosper lenders reasonably expect that the purchase of notes on the platform is an investment. *Reves* states that the "fundamental essence of a 'security' [is] its character as an 'investment.'"¹⁵⁰ The notes in the *Reves* case were advertised as investments, and the court held that "there were no countervailing factors that would have led a reasonable person to question this characterization."¹⁵¹ Likewise, Prosper advertises its notes as investments on its website, comparing the returns on the notes to returns with more traditional investments.¹⁵² Because Prosper lenders reasonably expect the notes to be investments and

143. *Reves*, 494 U.S. at 66.

144. Prosper Cease-and-Desist Order, *supra* note 91, at 3.

145. *Id.* at 5.

146. See *Online Investing and Peer-to-Peer Lending*, PROSPER, http://www.prosper.com/invest/about_investing.aspx (last visited Jan. 31, 2011).

147. Prosper Cease-and-Desist Order, *supra* note 91, at 5.

148. *Reves*, 494 U.S. at 70.

149. *Id.*

150. *Id.* at 68-69.

151. *Id.* at 69.

152. See *How Does Lending on Prosper Measure Up Against the Stock Market?*, PROSPER, <http://www.prosper.com/invest/about-investing/stock-market/> (last visited Jan. 31, 2011).

anticipate a return on their investment, the third factor of the family resemblance test also indicates that Prosper notes are securities.¹⁵³

Finally, at the time of the SEC cease-and-desist order, there was no alternative regulator that was capable of overseeing Prosper's operations in order to protect potential investors.¹⁵⁴ Prior to the cease-and desist-order, lenders were completely reliant on the statements from Prosper and individual borrowers in making investment decisions, with no regulatory supervision.¹⁵⁵ Therefore, it was necessary for the SEC to categorize the Prosper notes as securities in order to provide the essential regulation needed to reduce the risk to investors.¹⁵⁶

After evaluating Prosper notes with respect to the four factors of the family resemblance test it is clear that the notes were properly designated as securities under the precedent in *Reves*.

Dodd-Frank has changed the analysis of Prosper notes with respect to the fourth element of the test, as the new Bureau of Consumer Financial Protection (BCFP) could provide an alternative regulatory scheme for the notes without characterizing them as securities.¹⁵⁷ However, even with the possibility of an alternative regulator the notes do not pass the family resemblance test, still resembling securities under the other three elements of the test.¹⁵⁸ Therefore, the regulation under the SEC will remain in effect for P2P notes unless Congress specifically designates the BCFP as the primary regulator of financial instruments like the notes offered on Prosper's platform.

3. Lending Club Decides Not to Fight, P2P Companies Incur Increased Costs

Instead of taking on the SEC as Prosper did, once notified that their notes should be registered, Lending Club decided to

153. Prosper Cease-and-Desist Order, *supra* note 91, at 5.

154. *Id.*

155. *Id.*

156. *Id.* at 6.

157. *See infra* Part III.C.

158. *See* Prosper Cease-and-Desist Order, *supra* note 91, at 6.

cooperate and filed a registration statement with the SEC on June 20, 2008.¹⁵⁹ The decision benefited Lending Club, as they were able to come into compliance more quickly than Prosper, reopening operations in October of 2008 and capturing market share in the sector.¹⁶⁰

Compliance with SEC regulations is costly with Prosper spending more than \$1 million annually in addition to the \$5 million spent completing the registration process,¹⁶¹ in order to comply with SEC rules.¹⁶² Although Lending Club maintains that it is happy with SEC regulation, the company is burdened by the same expensive filing requirements mandated by the SEC.¹⁶³ The burdensome filing requirements levied on the P2P lenders require each loan to be filed with the SEC as a separate security.¹⁶⁴ In fact, Prosper and Lending Club make more disclosures to the SEC than almost any other company, a substantial statistic considering their relative size.¹⁶⁵ Each day, Prosper and Lending Club file supplements to the prospectuses already on file with the SEC, detailing each of the new loans issued that day.¹⁶⁶ These supplements include the principal amount, anticipated yield, risk of loss, monthly payment, and an entire borrower credit profile for each new loan.¹⁶⁷ Because Prosper and Lending Club must include each loan originated on their lending platforms in the prospectus in accordance with section 12 of the 1934 Securities Exchange

159. LendingClub Registration Statement, *supra* note 76 (the official filing date was later changed to Oct. 10, 2008).

160. Brush, *supra* note 15.

161. *Id.*

162. Schmidt & Westbrook, *supra* note 18.

163. Brush, *supra* note 15.

164. Schmidt & Westbrook, *supra* note 18 (noting that Prosper makes more disclosures to the SEC than almost any other company).

165. *Id.*

166. See Prosper Marketplace, Inc., Prospectus (Supplement No. 28) (Jan. 7, 2011), available at http://sec.gov/Archives/edgar/data/1416265/000141626511000022/listing_20110107-1742.htm.

167. *Id.* Each borrower credit profile includes the Prosper Score, credit scores, delinquent accounts, credit inquiries, credit lines, revolving credit balance, homeownership, debt/income ratio, occupation, employment status, and state of residence. *Id.*

Act,¹⁶⁸ the company also has to file quarterly and annual reports in accordance with section 13 of the Securities Exchange Act.¹⁶⁹

The costs of compliance with these regulations are significant for a company already reporting a net loss in excess of \$5 million for the six months ending on June 30, 2010.¹⁷⁰ Further, these costs create substantial barriers to entry in the industry.¹⁷¹ Zopa, a P2P lending service with operations in the UK, Italy, and Japan, decided not to launch services in the United States, citing the SEC's registration requirements for P2P companies as a major factor in the decision.¹⁷² Although Prosper was hopeful that Dodd-Frank would bring regulatory change to the P2P industry, it does not appear that Dodd-Frank will provide any significant changes to the current regulation, as discussed further below.

C. *Dodd-Frank Title X – The Bureau of Consumer Financial Protection*

When Dodd-Frank was finalized on July 21, 2010, Title X¹⁷³ contained the provision that established the BCFP,¹⁷⁴ a novel entity P2P lenders hoped would become the new regulator for the P2P industry.¹⁷⁵ This new agency's "main goal will be to protect consumers."¹⁷⁶ Exploring the pertinent language of this section provokes some interesting questions about the future of regulation

168. Securities Exchange Act of 1934 § 12, 15 U.S.C. § 78l (2006) (establishing the illegality of a "member, broker, or dealer to effect any transaction in any security on a national exchange" unless there is effective registration with the SEC).

169. *Id.* § 13 (outlining filing periodic filing and book keeping requirements for issuers of securities registered with the SEC).

170. Prosper Marketplace, Inc., Quarterly Report (Form 10-Q), at 2 (June 30, 2010) [hereinafter Prosper Quarterly Report].

171. Smith, *supra* note 60, at 23.

172. *Id.* at 24 (discussing the Zopa CEO's comment on the SEC regulation as being a "key reason why [Zopa] didn't... launch in the United States").

173. The discussion of Dodd-Frank in this note begins with Title X because Prosper's intense lobbying efforts were targeted toward the assignment of the new BCFP as the primary regulator of the P2P lending industry.

174. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1011, 124 Stat. 1376, 1964 (2010) (to be codified at 12 U.S.C. § 5491) (establishing the Bureau of Consumer Financial Protection).

175. See Brush, *supra* note 15.

176. Melanie H. Brody & Stephanie C. Robinson, *Consumer Financial Services Industry, Meet Your New Regulator*, K&L GATES (July 7, 2010), <http://www.klgates.com/newsstand/detail.aspx?publication=6527#cover>.

in the P2P lending industry. Section 1002 defines a “consumer financial product or service” as:

any financial product or service that is described in one or more categories under – (A) paragraph (15) and is offered or provided for use by consumers primarily for personal, family, or household purposes; or (B) clause (i), (iii), (ix) or (x) of paragraph (15)(A), and is delivered, offered, or provided in connection with a consumer financial product or service referred to in subparagraph (A).¹⁷⁷

Paragraph 15 goes on to define a “financial product or service,” and most notably includes:

(i) extending credit and servicing loans, including acquiring, purchasing, selling, brokering, or other extensions of credit; . . . (iv) engaging in deposit-taking activities, transmitting or exchanging funds, or otherwise acting as a custodian of funds or any financial instrument for use by or on behalf of a consumer; . . . [and] (x) collecting debt related to any consumer financial product or service.¹⁷⁸

The services provided by Prosper and Lending Club fall within the established definition of “financial product or service,” outlined above.¹⁷⁹ P2P lending companies plainly broker extensions of credit, transmit and exchange funds, and otherwise act as custodians of funds and financial instruments.¹⁸⁰

At first glance, it seems that the BCFP would “regulate the offering and provision of consumer financial products or

177. Dodd-Frank Act § 1002 (to be codified at 12 U.S.C. § 5481).

178. *Id.*

179. *See id.*

180. Prosper Annual Report, *supra* note 46, at 35 (noting that Prosper is a licensed lender or loan broker in a number of states).

services,”¹⁸¹ including P2P lenders as established by the definition of “financial product or service.”¹⁸² The authority for the BCFP to regulate the industry would be established by Section 1022.¹⁸³ Exactly what this would entail is not completely clear, but it is probable that any Bureau rules would regulate these consumer financial products and services so that the “markets for [these products] operate transparently and efficiently to facilitate access and innovation.”¹⁸⁴

Efficiently operating P2P markets, allowing for access and innovation, are some of the regulation characteristics Prosper CEO Chris Larsen pleaded for throughout the legislation process, arguing that the current SEC regulations drive costs up and detract from innovation in the sector.¹⁸⁵ California Congresswoman Jackie Speier, champion of the provision in the House bill which originally designated the BCFP as the primary regulator for P2P companies, declared that the original House proposal “ensure[d] that both consumers and small lenders [were] fully and appropriately regulated, and that individuals’ financial privacy [was] protected.”¹⁸⁶

Despite the efforts of Prosper and Representative Speier, the final bill contains a critical exclusion in Title X with regards to entities currently regulated by the SEC.¹⁸⁷ Section 1027 (i) (1) expressly states:

no provision of this title may be construed as altering, amending, or affecting the authority of the [SEC] to adopt rules, initiate enforcement proceedings, or take any other action with respect to a person regulated by the Commission. The Bureau shall have no authority to exercise any power to

181. Dodd-Frank Act § 1011 (to be codified at 12 U.S.C. § 5491).

182. *Id.* § 1002 (to be codified at 12 U.S.C. § 5481).

183. *Id.* § 1022 (to be codified at 12 U.S.C. § 5512).

184. *Id.* § 1021 (to be codified at 12 U.S.C. § 5511).

185. See Brush, *supra* note 15 (quoting Chris Larsen, Prosper CEO) (“Every month that goes by, P2P lending is getting pulled away from what it could be: the purest form of community banking . . .”).

186. *Id.*

187. Dodd-Frank Act § 1027 (to be codified at 12 U.S.C. § 5517).

enforce this title with respect to a person regulated by the [SEC].¹⁸⁸

Although, the bill does state that:

the [SEC] shall consult and coordinate, where feasible, with the [BCFP] with respect to any rule (including any advance notice of proposed rulemaking) regarding an investment product or service that is the same type of product as, or that competes directly with, a consumer financial product or service that is subject to the jurisdiction of the [BCFP] under this title or under any other law.¹⁸⁹

So, under section 1027, the SEC clearly remains the primary regulator of P2P companies, as the BCFP is not granted regulatory authority with respect to entities already governed by the SEC.¹⁹⁰ While only a small consolation for Prosper, it does appear that section 1027 includes a provision that may provide the BCFP some, even if minimal, input with regard to future rules within the P2P lending sector.¹⁹¹ On the contrary, input from the BCFP may only create additional regulatory oversight in the sector, beyond the registration requirements already in place by the SEC.¹⁹² To the dismay of P2P lenders, P2P companies receive little reprieve from the current SEC regulation through Title X of Dodd-Frank.¹⁹³

188. *Id.* § 1027(i)(1).

189. *Id.* § 1027(i)(2).

190. *See id.* § 1027(i)(1).

191. *Id.* § 1027(i)(2).

192. *See id.*

193. *See supra* Part III.C. *But see* Brush, *supra* note 15 (quoting Jason Alteieri, General Counsel of Lending Club) (“Currently we’re fine with the regulation by the SEC.”).

D. *Dodd-Frank Title IX – Comptroller General P2P Industry Study*

Although no relief is granted for P2P lenders in Title X, there is still a possibility of some regulatory relief. Under Title IX, entitled “Investor Protections and Improvements to the Regulation of Securities,” new regulations increase securities investor protections, enlarge the powers of the SEC, and improve enforcement of current securities laws.¹⁹⁴ Specifically, Dodd-Frank has given Prosper some hope of major regulatory reform under section 989F.¹⁹⁵ Section 989F gives the Comptroller General until July 22, 2011 to study the P2P industry in order to “determine the optimal Federal regulatory structure.”¹⁹⁶ The study will involve “Federal banking agencies, the [SEC], consumer groups, outside experts, and the person to person lending industry.”¹⁹⁷ Generally, the study will examine the current regulation of the industry under the SEC, other regulators currently overseeing P2P lenders, recent studies of the industry, consumer privacy and anti-money laundering safeguards needed, and uses of P2P lending.¹⁹⁸ Ultimately, the report by the Comptroller General will suggest regulatory alternatives for the P2P industry, considering changes to the current SEC approach with regard to P2P lenders as well as possible participation of other Federal agencies in the regulatory scheme.¹⁹⁹ The report will then be submitted to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services.²⁰⁰

194. Dodd-Frank Act §§ 901-91 (to be codified in scattered sections of U.S.C.); MAYER BROWN LLP, UNDERSTANDING THE NEW FINANCIAL REFORM LEGISLATION: THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 101 (2010), *available* at http://www.mayerbrown.com/dodd_frank_act/article.asp?id=9360&nid=13007.

195. *See* Dodd-Frank Act § 989F.

196. *Id.* (identifying the date by which the Comptroller General must complete the study of the P2P industry as one year from the effective date of Dodd-Frank, which is established as July 22, 2010 in section 4).

197. *Id.* § 989F(a)(1).

198. *Id.* § 989F(a)(3).

199. *Id.* § 989F(b) (outlining the content to be reported to the appropriate congressional committees).

200. *Id.* (covering the details of the submission of the report).

Until Congress reviews the study, the impact of Dodd-Frank on the P2P lending industry is relatively open ended.²⁰¹ By July 22, 2011, there will be additional information for Congress to consider in determining future changes to the regulatory scheme.²⁰² SEC regulation will continue in the interim, costing participants in the industry substantial compliance fees every day.²⁰³ And although section 989F mandates a study on current P2P lending regulation, there is a significant possibility that no regulatory changes will be implemented, as there is no provision in Dodd-Frank requiring further action from Congress.²⁰⁴ Nonetheless, if this nascent industry is to survive even ten years into the future, substantial regulatory changes will be needed to both lower costs and allow for substantial expansion of loan origination in the sector.²⁰⁵ Less stringent registration requirements will drastically reduce compliance costs.²⁰⁶ Simultaneously, a new regulator will need to provide enough oversight to build confidence in the sector so that more borrowers and lenders will use P2P lending platforms.²⁰⁷ A growing number of loan originations teamed with reduced compliance costs would facilitate profitability for P2P companies, a vital element to achieving sustainability in the industry.²⁰⁸

201. See Dodd-Frank Act § 989F (implementing a study on alternative regulation, but offering no guarantee of change).

202. See *id.* (including past and current expert studies of the P2P lending industry in the report to be submitted to congressional committees).

203. See LendingClub Annual Report, *supra* note 90, at 26 (covering Lending Club's continuous effort to comply with government regulation); Prosper Annual Report, *supra* note 46, at 34 (covering Prosper's continuous effort to comply with government regulation).

204. See Dodd-Frank Act § 989F (establishing the requirements and timeline for the study, but only requiring submission of a report containing regulatory recommendations to certain congressional committees, and not obligating Congress to act based on the findings in the report).

205. See Prosper Annual Report, *supra* note 46, at 50 (identifying risks inherent to dealing with Prosper, including risk of failure if unable to increase transaction volumes and risk of overburdening regulation on the ability to continue service); LendingClub Annual Report, *supra* note 46, at 36 (explaining that for the Lending Club platform to be successful, there must be an increased volume of loan transactions).

206. See generally Schmidt & Westbrook, *supra* note 18 (identifying the substantial costs incurred due to SEC regulations).

207. See *infra* Part IV.

208. See Prosper Annual Report, *supra* note 46, at 61 (explaining the expectation

IV. THE FUTURE OF P2P LENDING

There is potential in the P2P lending industry, with support from notable figures such as Federal Reserve Chairman Ben Bernanke and increasing public interest in the advantages of microlending.²⁰⁹ However, P2P lenders like Prosper and Lending Club face an arduous road if they want to emerge from relative obscurity, ultimately providing socially beneficial services to consumers and becoming capable players in the financial sector.²¹⁰ The continuance of SEC regulation in the sector could overburden the industry, making it difficult to operate profitably.²¹¹

In the three months ending on June 30, 2010, Prosper reported a net loss of \$2.6 million and Lending Club reported a net loss of \$2.5 million.²¹² Although individual lenders remain interested in funding borrower loans, and Prosper and Lending Club have been relatively successful in raising fresh capital from venture capital firms,²¹³ continuing to operate with such high losses could significantly limit the time frame in which these companies are able to survive.²¹⁴

P2P lenders should continue their efforts to seek regulation under a less burdensome regulatory scheme, encouraging the Comptroller General to research the benefits of such a scheme

for growth in the number of borrowers and lenders resulting in increases in transaction and servicing fees).

209. See Bernanke, *supra* note 13.

210. See generally Prosper Annual Report, *supra* note 46, at 48 (denoting the company's operating losses since inception and the anticipation that they will continue through 2010); LendingClub Annual Report, *supra* note 90, at 37 (commenting on the lack of profitability since inception, expected increase in operating expenses, and potential to never attain profitability).

211. See Prosper Annual Report, *supra* note 46, at 50 (noting the extensive federal, state, and local regulation that could potentially affect Prosper's ability to continue operations).

212. Prosper Quarterly Report, *supra* note 170, at 2; LendingClub Corp., Quarterly Report (Form 10-Q), at 3 (June 30, 2010) [hereinafter LendingClub Quarterly Report].

213. See Prosper Annual Report, *supra* note 46, at 70-71 (outlining the recent capital raising activities of Prosper); LendingClub Annual Report, *supra* note 90, at 45 (discussing the continuing public offering of up to \$600,000,000, which had raised approximately \$71 million as of March 31, 2010).

214. See Prosper Quarterly Report, *supra* note 170, at 1 (showing approximately a \$45.9 million accumulated deficit); LendingClub Quarterly Report, *supra* note 212, at 2 (showing approximately a \$32.7 million accumulated deficit).

during the Dodd-Frank mandated study of P2P lenders.²¹⁵ Registering every individual borrower loan as a security is a tedious and costly process that will hinder the long-term growth and profitability of P2P companies.²¹⁶ In fact, without dramatic changes, it is possible that both Prosper and Lending Club will be forced to cease operations in the fairly near future.²¹⁷

Equally important when considering regulatory reform, is maintaining necessary protections for consumers involved with these companies.²¹⁸ Prosper had significant difficulties with defaulting borrowers in its infancy, and while default rates are improving, they are still too high to substantiate a dramatic increase in loan origination.²¹⁹ As previously mentioned, because P2P loans are unsecured, there is little to encourage borrower repayment other than damaged credit ratings.²²⁰ Further, because the credit standards for P2P borrowers have increased, the growth of loan originations has slowed due to fewer qualifying borrowers.²²¹ In turn, these companies are seeing lower than expected revenues, as transaction and service fees provide the primary source of income.²²²

The viability of these companies is an important concern for the individual lenders because lenders rely on Prosper and

215. See generally Schmidt & Westbrook, *supra* note 18 (commenting on the general expense of compliance with the SEC).

216. See *id.* (noting that Prosper makes more disclosures to the SEC than almost any other company).

217. See Prosper Quarterly Report, *supra* note 170, at 2; LendingClub Quarterly Report, *supra* note 212, at 3 (showing a \$45.8 million accumulated deficit at Prosper and a \$32.6 million accumulated deficit at Lending Club, along with continuing quarterly losses).

218. See Schmidt & Westbrook, *supra* note 18 (quoting Donald Langevoort, a securities professor at Georgetown University) (“[L]oans of hundreds of dollars [signals a] targeting of very unsophisticated people.”).

219. See *Statistics: Performance Data Feb. 1, 2006 - Oct. 15, 2008*, *supra* note 93 (charting data on loan originations between February 2006 and October 15, 2008, and showing an aggregate default rate of 23.83%).

220. Prosper Annual Report, *supra* note 46, at 37-38 (explaining the risk of borrower default and lack of securitization for the loans); LendingClub Annual Report, *supra* note 90, at 30 (explaining the risk of borrower default and lack of securitization for the loans).

221. See *Marketplace Investor Performance, Originations by Year Based on Credit Score*, *supra* note 53 (showing 84% of loan originations in 2008 to be by borrowers with a credit score greater than 640, versus only 58% in 2006).

222. See Prosper Annual Report, *supra* note 46, at 17.

Lending Club to collect payments on the outstanding loans.²²³ Therefore, beyond borrower default rates, lenders face additional risks from the potential cessation of operations by companies in the industry, whether it be due to continued operational losses, liabilities from pending litigation, changes in regulatory treatment, or increases in competition in the sector or from traditional lenders.²²⁴ Both companies acknowledge that in the event of bankruptcy proceedings, there is a lot of uncertainty with regard to the lenders' ability to retrieve funds already distributed to borrowers as well as those held in lenders' accounts.²²⁵ Currently, funds not disbursed in loans but deposited with Prosper or Lending Club are held in trust by an outside financial institution and are insured by the FDIC.²²⁶ Although the trust is kept for the benefit of the lender members, these members could possibly be required to pursue legal action through the bankruptcy courts in order to withdraw funds deposited with Prosper or Lending Club in the event of insolvency.²²⁷

In addition to the substantial risks created by factors other than potential borrower default, Prosper also has a large contingent liability for securities law violations from securities issuances dating from the initiation date in February 2006²²⁸ until October 2008.²²⁹ Prosper estimates the maximum potential liability for these violations at a startling \$57.7 million.²³⁰ This would only

223. *See id.*

224. *Id.* at 47-57 (observing general risks of lender member loss due to risks outside of those inherent to borrower default); LendingClub Annual Report, *supra* note 90, at 36-45 (recognizing the general risks of lender member loss due to risks outside of those inherent to borrower default).

225. Prosper Annual Report, *supra* note 46, at 52 (identifying uncertainties in the event Prosper filed for bankruptcy); LendingClub Annual Report, *supra* note 90, at 38-39 (referencing that funds held in trust for holders of notes could still potentially be at risk).

226. Prosper Annual Report, *supra* note 46, at 15 (identifying uncertainties in the event Prosper filed for bankruptcy); LendingClub Annual Report, *supra* note 90, at 10 (referencing that funds held in trust for holders of notes could still potentially be at risk).

227. Prosper Annual Report, *supra* note 46, at 52 (identifying uncertainties in the event Prosper filed for bankruptcy); LendingClub Annual Report, *supra* note 90, at 38-39 (referencing that funds held in trust for holders of notes could still potentially be at risk).

228. Prosper Annual Report, *supra* note 46, at 33.

229. Prosper Quarterly Report, *supra* note 170, at 22.

230. *Id.* (“[T]he occurrence of the contingency is reasonably possible but not

be fully assessed if the courts found Prosper entirely liable to the lenders who accrued losses between February 2006 and October 2008, providing those lenders with the right “to rescission of the unpaid principal, plus statutory interest.”²³¹ It is almost certain that a liability of that magnitude would be more than Prosper’s strained balance sheet could take, much less the Prosper shareholders who have already seen rapid growth in the accumulated deficit.²³² While insolvency is far from a certainty for Prosper, it is a real possibility.²³³ The insolvency of one of the major players in the U.S. P2P market would likely shake the entire sector and undermine lender confidence in the remaining P2P companies. The priority of regulators should be to protect consumers involved with the P2P industry, but these regulators should try to do so in manner that concurrently reduces the financial stresses imposed on P2P companies by overly stringent regulation. Upon completion of the Dodd-Frank mandated study, the Comptroller General should recommend several regulatory elements that are critical to the safety of borrowers and lenders engaged in P2P lending, as well as to the future success of P2P companies.

First, P2P lending companies must increase lender confidence in the safety and creditworthiness of borrowers.²³⁴ Without lender confidence, it is unlikely that the loan originations and revenue streams will increase for P2P lending companies. While substantial steps have been taken toward improving lender confidence, many mandated by SEC regulation,²³⁵ there are still several safeguards that Prosper and Lending Club could

probable . . .”).

231. *Id.*

232. See Prosper Annual Report, *supra* note 46, at F3 (showing the Prosper balance sheet and the \$40.6 million accumulated deficit).

233. See *id.* at 48 (stating that Prosper is dependent on raising additional capital in order to carry out the present business plan).

234. See generally *id.* at 4-5 (discussing borrower listings, the information provided by credit rating agencies, and the unverified information provided by individual borrowers); LendingClub Annual Report, *supra* note 90, at 4-6 (revealing that borrower reported information such as income, employer, or tenure are not verified).

235. See Prosper Annual Report, *supra* note 46, at 2-3 (outlining the minimum credit requirements for Prosper borrowers); LendingClub Annual Report, *supra* note 90, at 4-5 (outlining the minimum credit requirements for Lending Club borrowers, notably more stringent than Prosper minimums).

implement and that regulators should require to boost lender confidence.²³⁶

Prosper and Lending Club should verify the information of every borrower that uses their services.²³⁷ Prosper and Lending Club typically do not “verify the income, employment and occupation or any other information provided by borrower members in listings.”²³⁸ The lack of verification of borrower information is analogous to practices employed by many banks and mortgage lenders leading up to the mortgage crisis with the issuance of “no doc” loans.²³⁹ Lender members do have some verifiable information, typically provided from a single credit agency, when deciding whether to contribute to the financing of a borrower’s loan.²⁴⁰ However, lenders are essentially providing “low doc” loans absent borrower information that even charitable microfinance entities require when making loans.²⁴¹ And to make matters worse, these loans are also unsecured.²⁴² The combination of “low doc” and unsecured loans opens up vast avenues for abuse of the P2P lending platforms and the lender members.²⁴³

An obvious concern with this suggestion is the possibility of losing potential borrowers as platforms increase documentation requirements, possibly lowering the number of loans originated and thus reducing revenues for P2P lending companies.²⁴⁴

236. See *infra* Part IV.

237. See generally Gimein, *supra* note 95 (stating that the results at Prosper indicate it is a microcosm of failing economy, not a solution).

238. See Prosper Annual Report, *supra* note 46, at 4 (discussing borrower listings, the information provided by credit rating agencies and the unverified information provided by individual borrowers); LendingClub Annual Report, *supra* note 90, at 4 (revealing that borrower reported information such as income, employer, or tenure are not verified).

239. See generally Tami Luhby, *Senate Votes to Ban Liar Loans*, CNNMONEY.COM (May 13, 2010, 2:40 PM) http://money.cnn.com/2010/05/13/news/economy/senate_mortgage_rules/index.htm (reporting on the Senate’s decision to ban “liar loans”).

240. See Prosper Annual Report, *supra* note 46, at 9-12.

241. See McNew, *supra* note 38, at 304 (stating that a simple assessment of the borrower’s cash flow may be enough for microloan issuance).

242. See Prosper Annual Report, *supra* note 46, at 37-38.

243. See generally *id.* (discussing the risks related to borrower default including the absence of collateral for any of the loans listed on Prosper).

244. See generally *supra* Part II.A (indicating that P2P companies predominantly attract borrowers who have been denied by traditional lenders).

However, if borrowers were only required to send the P2P lending companies verifiable tax documents, including information such as length of employment and annual income, the value to lenders would probably outweigh the costs.²⁴⁵ An improvement in default rates due to an increase in the quality of credit risks would raise the value of loans to lenders, giving the P2P lending companies the ability to charge higher servicing fees, offsetting any decrease in originations.²⁴⁶ Further, the increased validity of information in the marketplace should attract more lenders, increasing their willingness to fund loans and their ability to identify profitable credit risks.²⁴⁷

Secondly, regulators should relax the stringent registration requirements that require each and every consumer loan issued by Prosper or Lending Club to be included in a supplement to the most recent prospectus.²⁴⁸ Loosening these registration requirements would dramatically reduce compliance costs, helping this young industry to attain profitability in the future.²⁴⁹ Moreover, if the P2P lenders are required to verify borrower employment and income information, along with other relevant factors, as previously mentioned, the lender members would be protected from transparency problems and possible borrower abuses.²⁵⁰ Then, less frequent inspections of P2P companies' security issuances, by either the SEC or a new regulatory agency

245. See generally *Marketplace Investor Performance*, PROSPER, <http://www.prosper.com/welcome/marketplace.aspx> (last visited Jan. 31, 2011) (showing the increasing percentage of borrowers with improved credit ratings, which has correlated with a declining default rate).

246. See generally *id.* (indicating that the estimated lender yield minus the estimated loss equals the estimated return, giving rise to the conclusion that improved information, lowering the uncertainty of the estimated loss, would provide lenders with the same estimated returns with less variance and less risk, making the loans better investments).

247. See *Risk vs. Return*, NEW YORK LIFE (Jun. 8, 2009), <http://www.newyorklife.com/> (search "Risk vs. Return").

248. See Schmidt & Westbrook, *supra* note 18 (explaining that Prosper currently files about two public disclosures per day); Prosper Marketplace, Inc., Prospectus (Supplement No. 28) (Jan. 7, 2011), available at http://sec.gov/Archives/edgar/data/1416265/000141626511000022/listing_20110107-1742.htm.

249. See Schmidt & Westbrook, *supra* note 18.

250. See Prosper Annual Report, *supra* note 46, at 37; LendingClub Annual Report, *supra* note 90, at 31 (listing risks to lender members resulting from inaccurately reported borrower information).

such as the BCFP, would be sufficient to protect consumers but at a much lower cost to the companies.²⁵¹

Finally, as long as Prosper and Lending Club are in a state of relative financial instability, lenders are going to be somewhat apprehensive about loaning money on the platforms due to the inherent risks created by the potential insolvency of the companies.²⁵² Both Prosper and Lending Club have made arrangements with third party loan servicing companies in the case of company insolvency in an effort to assure lenders that their outstanding loans will continue to be collected in the event of bankruptcy.²⁵³ However, the companies' annual reports warn that insolvency escalates the risk of loss to lenders beyond the inherent risk from the notes.²⁵⁴ Any future P2P regulatory scheme, whether enforced by the SEC or BCFP, should allow P2P companies to engage in activities outside of the primary P2P lending business in order to increase revenues. There are many prospective activities that could generate positive cash flows, including selling ad space on the companies' websites, referring customers to services of affiliated businesses, and even developing additional services to provide to customers on the companies' social networks.²⁵⁵ By increasing the financial stability of P2P companies, lender confidence would likely increase as the risks attributed to potential company insolvency declined, attracting more lenders to invest in borrower notes.²⁵⁶ As a result of decreases in risk, P2P companies

251. See generally Brush, *supra* note 15 (mentioning that the BCFP could better regulate the consumer data transmitted to P2P companies, perhaps allowing lenders too see more borrower information when deciding to extend a loan).

252. See Prosper Annual Report, *supra* note 46, at 47-48; LendingClub Annual Report, *supra* note 90, at 36-37.

253. See Prosper Annual Report, *supra* note 46, at 50; LendingClub Annual Report, *supra* note 90, at 38 (noting that a third party servicing arrangement has been established in the case of insolvency, although there is a risk of delay and increased costs).

254. See Prosper Annual Report, *supra* note 46, at 51; LendingClub Annual Report, *supra* note 90, at 37.

255. See Efraim Turban et al., *Zopa, Prosper, and P2P Lending: Will They Disrupt Banking?*, in ELECTRONIC COMMERCE: A MANAGERIAL PERSPECTIVE, ONLINE SUPPLEMENT 9-1 (2010), http://wps.prenhall.com/wps/media/objects/8362/8562891/additional_online/Online_Files_Ch09.pdf (indicating that P2P lenders will likely adjust their revenue models to take advantage of website advertising and the sale of associated products).

256. See Prosper Annual Report, *supra* note 46, at 50; LendingClub Annual

could expect a higher number of loan originations, leading to revenue growth.²⁵⁷

V. CONCLUSION

The GAO study mandated by section 989F of Dodd-Frank leaves the door open for potential changes in the regulation of the U.S. P2P lending industry, but this provision far from guarantees reform.²⁵⁸ Without significant regulatory changes, the prospects of success and growth in this new industry are bleak.²⁵⁹ While borrower default rates are improving due to new regulations by the SEC, the unstable financial condition of Prosper and Lending Club adds other significant risks that any potential lender member should consider before investing.²⁶⁰

If the Comptroller General aims to encourage sustainability in the P2P lending industry with the GAO study, recommendations should include future regulations that require P2P companies to verify additional borrower information.²⁶¹ Secondly, although close oversight of the industry is essential, regulators must reduce the expensive registration requirements currently imposed on P2P lenders so that costs may be reduced to reasonable levels.²⁶² And finally, P2P lending companies must find alternative ways to increase their revenue streams.²⁶³ Without significant changes, for-profit P2P lending companies like Prosper and Lending Club will likely disappear in the United States, leaving non-profit organizations and charities to cover the underserved U.S. microlending sector and thereby eliminating a

Report, *supra* note 90, at 37.

257. *See Risk vs. Return, supra* note 247 (explaining that typically greater risks result in greater returns; this leads to the conclusion that a reduction in risk in P2P notes, with the expected return remaining constant, will make the notes more attractive to investors).

258. *See supra* Part III.D.

259. *See supra* Part IV.

260. *See supra* Part IV.

261. *See supra* Part IV.

262. *See supra* Part IV.

263. *See supra* Part IV.

legitimate source of capital otherwise available to many borrowers for whom traditional institutional lenders are often inaccessible.²⁶⁴

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264. *See supra* Part IV.