Peer-to-Peer Lending
Update and Regulatory
Considerations

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Yale Law School
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Deeply embedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process.

The Filene Research Institute is a 501(c)(3) not-for-profit research organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance. Through independent research and innovation programs the Institute examines issues vital to the future of credit unions.

Ideas grow through thoughtful and scientific analysis of top-priority consumer, public policy, and credit union competitive issues. Researchers are given considerable latitude in their exploration and studies of these high-priority issues.

The Institute is governed by an Administrative Board made up of the credit union industry’s top leaders. Research topics and priorities are set by the Research Council, a select group of credit union CEOs, and the Filene Research Fellows, a blue ribbon panel of academic experts. Innovation programs are developed in part by Filene i3, an assembly of credit union executives screened for entrepreneurial competencies.

The name of the Institute honors Edward A. Filene, the “father of the U.S. credit union movement.” Filene was an innovative leader who relied on insightful research and analysis when encouraging credit union development.

Since its founding in 1989, the Institute has worked with over one hundred academic institutions and published hundreds of research studies. The entire research library is available online at www.filene.org.
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By George A. Hofheimer, 
Chief Research Officer

In 2006, the Filene Research Institute released a special report entitled “Peer-to-Peer Lending: Back to the Future.” This brief report introduced an emerging trend whereby individuals lend money to other individuals outside the traditional banking system. We urged credit unions to familiarize themselves with this disruptive innovation, and to experiment where possible with the concept of peer-to-peer (P2P) lending. Since 2006, a variety of exciting developments have occurred in the P2P marketplace, including the U.S. launch of Zopa (a P2P lender) in partnership with six U.S. credit unions, and Virgin’s purchase of CircleLending. Both developments prove that P2P lending is here to stay. As the excitement (and interest) surrounding this trend grew, the Filene Research Institute wanted to provide a more in-depth and updated view on P2P lending. To accomplish this we were fortunate to recruit Andrew Verstein, a juris doctorate (JD) candidate at Yale Law School. In this report Verstein explores the P2P lending market’s major players and describes the transactions offered by the industry’s current and future leaders. Next, Verstein explains the economic and consumer value of P2P lending services. Finally, he describes the legal issues with which a P2P lending service must contend.

As we stated in our original report on this topic, credit unions can view P2P lending as either a threat or an opportunity. The data and ideas presented in this report will help you determine which view your credit union should take. Our hope is that at the very least, it will make you aware of an emerging trend that has the potential to impact the way you and your members deliver financial services.
Andrew Verstein
Andrew Verstein is a JD candidate at Yale Law School expected to graduate in May 2009. In addition to his banking and securities law interests, Andrew assists Chinese scholars in researching and advocating for legal reform. Andrew graduated from Dartmouth College in 2005. He was raised in Warrenville, Illinois.
Each year thousands of individuals pursue their PhDs in economics, business administration, and other advanced areas of study (JDs, MBAs, etc.). Of these thousands of individuals, a handful have an interest in credit unions and consumer finance issues. Encouraging this area of study is important to a wide variety of audiences, including the academic community, credit unions, and the Filene Research Institute. This past year, the Institute’s board of directors promoted the idea of funding the research activities of these next-generation leaders. We aim to achieve a number of goals with this new program, including:

- Introducing future academic and business leaders to credit unions.
- Contributing to the study of questions germane to credit unions.
- Providing an outlet for fresh ideas in the consumer finance domain.

Visit www.filene.org/home/research/phd for a list of individuals the Filene Research Institute supports.
CHAPTER 1
Introduction and Update

The peer-to-peer (P2P) lending sector is divided into two categories: P2P exchanges and loan facilitators. P2P exchanges match individual borrowers and lenders through an eBay-style format. Loan facilitators help willing borrowers and lenders who already know each other to formalize their credit relationship.
P2P services can be divided broadly into two categories: P2P exchanges and loan facilitators.

**P2P Exchanges**

P2P exchanges match individual borrowers and lenders through an eBay-style format. This section describes several leading P2P exchanges.

**Prosper**

Founded by the CEO of E-Loan, Prosper (www.prosper.com) is a San Francisco–based company that facilitates small, unsecured personal loans between strangers. To date, Prosper has originated more than 120 million (M) in loans for its 450,000 registered users. While anyone with a social security number and a bank account can join as a lender, Prosper requires an Experian credit score of 520 or better to participate as a borrower.

Borrowers create an eBay-type listing on Prosper’s Web site “selling” themselves as a worthy credit risk. Prosper provides the information it has collected on the borrower, such as homeownership, outstanding lines of credit, income, debt-to-income ratio, and credit grade. Prosper ranks approved borrowers into seven credit grades, from AA to HR (high risk). The rest of the information, such as occupation, is self-reported and not verified by Prosper. Borrowers may request up to $25,000.

Borrowers post pictures of themselves and draft a narrative explaining who they are, why they need the money, and perhaps why their credit report does not accurately represent their riskiness. The following hypothetical example illustrates how credit scores may not tell the whole story:

If I told you about Person X, who had a credit rating of H.R.—“high risk,” the lowest rating—a string of recent delinquencies, and a 20% debt-to-income ratio, you’d probably conclude that she was heading straight to bankruptcy. Lending this person money would be about as profitable as throwing it into a fountain and waiting for your wish to come true. But what if I also told you that this person, Suzy, had accumulated her debt while she was studying at Harvard Law School? And what if I mentioned that she had just graduated with honors, and had accepted a job at a Manhattan firm with a starting salary of $140,000 a year? She only needs a loan to tide her over until she starts work. Now I tell you that she’s willing to pay a 20% interest rate on your money. Would you take a risk on her now?

Prosper borrowers may receive endorsements from “groups”—affinity organizations such as Mac Users, Firefighters, and Harvard Alumnae that vet potential borrowers for lenders. Until recently, these groups’ administrators might be paid a commission for finding, vetting, and recommending loans.

Lenders bid on listings in increments as small as $50. A $10,000 listing could have as many as 200 lenders or as few as 1. Borrowers indicate the maximum interest rate they are willing to pay, and if more lenders are interested than the loan total allows, they will in effect bid the interest rate down against each other.

When a loan is funded, Prosper charges a 1% origination fee to the borrower, makes a loan to the borrower, and then sells that note to the lenders. It charges the lenders 0%–2% per year to service the loan from then on. Late loans are assigned to collection companies for recovery. Between 8% and 18% of late loans are eventually brought current. Defaulted loans are sold to debt purchasing companies for a fraction of their face value. Prosper alerts credit agencies in the case of late payment or default, which affects borrowers’ credit scores. This is enough to incentivize many borrowers to diligent payment.

Lending Club
The social lending phenomenon emerges alongside the broader online social networking phenomenon. As of June 22, 2007 there were no banks, credit unions, or credit card issuers with a presence on Facebook, a social networking Web site with 55 million active

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5 Jim Bruene, “PayPal Launches on Facebook: Who Wants to be the First Bank?,” NetBanker, June 22, 2007, www.netbanker.com/myspace. Since that time, Prosper has also expanded onto Facebook. Prosper was among the first companies to design an application that would interface with Facebook’s open platform. Facebook users can play a game, bidding on Prosper borrowers using fictional money.
In the last year, Americans loaned more than $80M to complete strangers through Prosper, backed by little more than a promise. They lent to a largely subprime pool of borrowers, and their risk-adjusted returns may have beat the S&P 500. Though $100M is a drop in the bucket compared to the $900 billion (B) unsecured consumer credit market, substantial growth is projected. Estimates for the industry’s potential vary: from $1B to $5B in loan originations by 2010, to much more than $89B.

Just as exciting as the potential volume of these transactions is what they mean to the participants. Lenders earn interest on their accounts, but few report purely remunerative intentions. Many are attracted to the “social return” on their investment. P2P gives a window into borrowers’ lives, a sharp contrast to the opaque intermediation of a traditional bank. Borrowers are typically individuals with limited access to credit who are hoping to find their way out of debt. Before Prosper instituted a minimum credit score requirement, more than 60% of potential borrowers had the lowest credit grade or lacked a credit rating altogether. Others want to finance ambitious business propositions banks have overlooked. Lenders report high degrees of satisfaction in “doing good as they do well.” This transparency into the human side commends itself to synergy with two other innovative trends: social networking and microfinance. Gartner, Inc. predicts that social-banking platforms will capture 10% of the worldwide market for retail lending and financial planning by 2010.

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10 Asheesh Advani estimates that there is an $89B market just for family- and-friend loans. (Timothy J. Mullaney, “Lots Of Loans, But No Banks,” BusinessWeek, July 3, 2006, www.businessweek.com/magazine/content/06_27/b3991418.htm?campaign_id=msnbc_it100.) If the market for stranger-to-stranger loans is at all viable, the combined figure would be substantially higher.
11 See, for example, Michael K. Hulme, “Internet Based Social Lending: Past, Present and Future,” Social Futures Observatory, October 2006: 77–90.
users. They were missing out on the opportunity to prove their services and build brand loyalty to a new generation of members—a generation that less and less fits the stereotype of Facebook user who is a poor college student.\textsuperscript{13} Lending Club (www.lendingclub.com) chose to launch via Facebook to capitalize on the social networking features already present.

Lenders using the Facebook application enter their risk tolerance and return preferences, and Lending Club suggests a portfolio of borrowers intended to minimize risk within those constraints—and marks the potential borrowers in terms of information derived from Facebook. For example, though borrowers are not identified by name, Lending Club notes the borrower’s geographic location, alma mater, place of employment, personal interests, and whatever else is on the borrower’s Facebook profile. Lending Club makes an effort to pair lenders and borrowers with common backgrounds and interests. Lenders are presented a menu of anonymous borrowers with which they have something in common, and they are free to accept or veto particular borrowers.

It took Lending Club only two weeks to lend its first $100,000\textsuperscript{14} and 14 weeks to lend $1,000,000.\textsuperscript{15} Lending Club has since introduced new tools with which to connect to the platform, such as partnerships with various alumni associations.\textsuperscript{16}

\textbf{Zopa}

Although their UK model is not currently available in the United States, Zopa (us.zopa.com) recently launched a version designed for American users. Zopa’s strategy and structure involves close partnership with American credit unions. Specifically, all Zopa borrowers and lenders are required to join a credit union. Zopa vets borrowers and rejects those with poor credit. Those approved by Zopa are assured that their loan will be funded. They still create a Prosper-type listing to pitch the merits of their request. Lenders interact with the platform by buying one-year NCUA-insured certificates of deposit.

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(CDs) issued by the credit unions. The rate begins at 5.1%, but lenders are permitted to accept a lower interest rate in order to reduce the monthly payments of a favored borrower. The 5.1% rate includes credit to reduce the payments of one lucky borrower. The borrower and lender both have contractual relations with the credit union, but not with each other. There is a mixture of social and financial interaction implicit in this transaction, but it is mediated.

As regulated banking institutions, credit unions give Zopa access to NCUA-insured CDs. Lenders are able to participate in the social lending function of P2P while limiting their exposure to risk. The decision to protect investors’ principal is in part a legal consideration, discussed in Chapter 3 of this report. It is also consistent with Zopa’s desire to show that P2P need not be risky or speculative. Where Prosper encourages lender risk-bearing, lender vetting, and borrowers with a wide range of creditworthiness, Zopa’s product more closely resembles the risk profile of a traditional CD. But it retains the satisfying element of knowing to whom your money is lent and how it is helping them.

Credit unions were selected as the partnership vehicle in part because of a similarity of ideology. Given the prevalence of anti-bank rhetoric on Zopa’s UK Web site, it would be surprising to see Zopa partner with traditional banks. Credit unions look forward to the infusion of a new, young customer base to supplement their aging demographics. This new group is affluent, savvy, and turned off by the bad service they perceive in anonymous corporate banks. There is another reason credit unions are an attractive partner for Zopa: as nonprofits, credit unions are willing to partner for a smaller cut of the already thin margins typical in consumer finance.

**Kiva and Others**

Disappointed with traditional philanthropic options, a variety of non-governmental organizations (NGOs) and researchers have turned their attention to microfinance, especially since Muhammad Yunus and Grameen Bank won the 2006 Nobel Peace Prize. The cultural awareness of community-based lending, and the academic literature surrounding it, have brought innovative lending back into the public consciousness. Leveraging this phenomenon through the Internet, Kiva (www.kiva.org) works with local partners in the developing world to deliver microloans to entrepreneurs. Lenders in the developed world can view listings prepared by partnering microfinance organizations on behalf of the loan recipient. Typical profiles include a South African man who requires money to open a hostel.

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17 “No banks: Rather than making the fat cats fatter, you borrow from and pay interest to Zopa lenders.” Zopa home page, uk.zopa.com/zopaweb/public/borrowing/borrowing-at-zopa.html.
and a Kenyan woman who wishes to increase the stock for grain for sale at her small store. Interest is charged on the loans in order to cover the costs of the Kiva partners, but lenders do not currently receive interest for their loans. They are at risk for loss of capital for defaults on the loans, but default rates approach 0%, and individual lenders commit to only a fraction of an individual listing.

Celebrity endorsements from Bill Clinton, Oprah Winfrey, and Adrien Grenier recently caused a reverse run on the bank. A flood of lenders flushed the system with cash, satisfying the demand of all vetted borrowers. The total amount loaned at that point exceeded $13M. Kiva has sent its partners back into the field to find another generation of fund recipients. These listing will also go fast: Kiva has begun selling gift certificates—credit for the recipient to participate in Kiva loans—allowing users to introduce their loved ones to social lending.

Another generation of services aims to follow Kiva’s success in partnering with local microfinance institutions to extend credit to the world’s poorest entrepreneurs. Interestingly, these new services hope to go one step further than Kiva by paying interest to lenders. These services operate with the hope that lenders will be sufficiently motivated by interest payments that we may not need to rely on altruism alone to solve credit shortages in the developing world; ordinary capital markets investment will flow to this neglected asset class. Kiva currently pays no interest to lenders, though Kiva’s founders admit that they initially hoped to be able to reward lenders with some return, but were deterred by legal obstacles these new players have potentially addressed.

While some call Prosper the “eBay of Money,” eBay actually has its own microloan arranging service, called MicroPlace (www.microplace.com). MicroPlace launched its Web page in October 2006 and reintroduces one level of intermediation to the P2P process. MicroPlace currently partners with two nonprofit lending organizations: Oikocredit and Calvert Social Investment Foundation. Rather than investing directly in developing world entrepreneurs, investors purchase notes issued by these lending organizations. The notes give the investors claim to a

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Kiva works with local partners in the developing world to deliver microloans to entrepreneurs. Lenders in the developed world can view listings prepared by partnering microfinance organizations on behalf of the loan recipient.

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modest interest rate, typically 1%–3%, which is tied to the success of the entire lending organization, rather than their subfund or the success of an individual borrower. The lending organization uses money raised through these notes to create funds for investment in the developing world. MicroPlace’s partners so far provide only a small portion of their funding; both draw from a pool of hundreds of millions of dollars raised through the efforts of other investors and donors. Oikocredit is in the midst of a 10-year process of raising $44M through MicroPlace to supplement their existing pool of more than $400M in lendable capital. Globe Funder (www.globefunder.com) aims to deliver not just a token interest rate, but rates substantially better than those available through traditional investments. Brian Mullaly, CEO of Globe Funder, is instituting partnerships not just with grassroots borrowers and their organizations, but with large institutional investors that he believes will provide the largest chunk of the loans.

The Federal Reserve estimates that there is more than $89B in outstanding loans between family members or friends, of which less than half are fully documented. Because they assist friends and family who have already agreed to lend and borrow, these loans do not compete as directly with ordinary banking products.

Already operational in its beta test, Dutch service C4 (www.myC4.com) also hopes to leverage first-world capital to developing-world microfinance. Targeting Africa and having made $215,000 in high-interest-paying loans so far, C4 wants to play a crucial role in meeting the UN’s Millennium Challenge. Like Globe Funder, C4 takes loans from both individuals and corporations. It also offers corporations an opportunity to invest institutionally but have individual investment choices managed by employees—involving them in the corporation’s choice to fund loans in Africa.

Loan Facilitators

Loan facilitators help willing borrowers and lenders who already know each other to formalize their credit relationship. The Federal Reserve estimates that there are more than $89B in outstanding loans between family members or friends, of which less than half are fully documented. Because they assist friends and family who have already agreed to lend and borrow, these loans do not compete as

directly with ordinary banking products. Virgin Money (www.virgin-moneyus.com) assists friends and family members in formalizing a variety of credit relationships. Services include drawing up the promissory note and payment schedule, collecting scheduled payments, and arranging reverse mortgages and small business loans. Relations may be more comfortable lending, or more likely to make timely payments, when an impersonal service depersonalizes the financial aspect of the transaction. It is natural for a parent contemplating one of these loans to fear that a child may be lax in repayment, abusing the knowledge that the parent will not foreclose on the mortgage. But that patience and flexibility can also save a sour loan. Virgin Money USA CEO Asheesh Advani suggests that most defaults are caused not by an inability to pay over the next five years, but rather over the next six months. Cashing in some of their social capital, borrowers can negotiate an extension that may save the loan. Lenders can agree, when they judge it fair, in a way that would be more difficult for a bank, since the bank will standardize and securitize the loan for resale, if it hasn’t already. Advani claims that among loans arranged by Virgin, fully documented mortgages default less than 1% of the time, and personal loans 5%—significantly lower than the 14% average default rate for unmanaged loans between related parties.\textsuperscript{25} Incorporated in 2002 as CircleLending and purchased by Virgin in 2007, the company has reached $150M in loan volume.\textsuperscript{26}

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\item \textsuperscript{24} Asheesh Advani, personal communication, May 11, 2007.
\item \textsuperscript{26} Virgin Money, “Our History,” www.virginmoneyus.com/home/aboutvirginmoney/history/tabid/181/default.aspx.
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CHAPTER 2
The Business Model

P2P institutions often provide superior interest rates and consumer experience. These institutions can compete in this arena because of reduced overhead, nontraditional credit discovery, lower compliance costs, and lower default rates.
For many borrower and lenders, P2P lending is a social, philosophical, or personal choice. Borrowers may be intimidated by faceless banks and frustrated that they cannot tell their whole story in a request for a loan. They may feel more comfortable dealing with lenders who provide some personal information and explain their reasons for lending, and who know the borrower’s reasons for borrowing. For lenders, P2P offers a degree of transparency and control that allows them to make personal and ethical choices in their investments. They can lend to people with whose struggles they empathize, gain a window into the life of the borrower, and avoid enriching demonized intermediaries.

But for at least some classes of lenders and borrowers, recourse to a P2P exchange should also provide interest rates and a consumer experience superior to those of the nearest alternative. To the degree that the exchange can bring lenders and borrowers together, it can charge an origination fee for commencing the transaction and a subsequent servicing fee. Prosper currently charges 1%–2% of the loan principal as an origination fee (paid by the borrower) and 0.5%–1% of the outstanding principal per year (paid by the lenders out of their returns).

The exchange can supplement its revenue stream by providing other services to users. In principle, an exchange could provide a variety of banking services, either directly or in partnership, such as check clearing and bill paying. For now, the primary supplemental source of revenue is the direct and indirect marketing of other credit products. Zopa sells third-party lenders the contact information for loan applicants who do not meet Zopa’s stringent credit requirements or who are unable to find a suitable lender.27 Duck9, a P2P lender focused on the college student sector, provides some exchange-type

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P2P lending opportunities but makes the majority of its profits from car loans, renter’s insurance, credit and debit cards, brokerage accounts, and other services. Duck9 counts not only on the effectiveness of marketing to individuals with a given credit profile, but on the goodwill and loyalty created by providing cheap credit and credit recovery services.

In order for the exchange to make money on low-margin transactions or supplemental credit products, the volume of users must be high. Volume is also important because exchanges enjoy auction-like network gains. The more lenders compete for a borrower’s attention, the more likely that borrower is to get the loan funded promptly and at a price he or she likes. The more borrowers have that experience, the more borrowers will flock to the exchange and give lenders better choices. One large exchange is less likely to leave a consumer’s needs unmet than two small exchanges.

In order for an exchange to achieve a critical mass of users and keep them, it must provide a product that serves user needs better than relevant alternatives. For borrowers, that means a more convenient loan application process or a better rate than a bank loan, credit card, or paycheck loan. For lenders, that means a risk-adjusted interest rate superior to that of an equivalent investment product, or a moral or social return on capital.

At this time, the average rate of interest on Prosper for an AA borrower is around 10%, or somewhat above 20% for a borrower with HR credit. These rates are competitive with bank and credit card rates for unsecured loans—presuming borrowers even had access to these sources of capital to begin with. Many borrowers are refinancing away from payday lending operations with fees approaching triple-digit interest rates.

P2P rates may drop as the market becomes more mature. Prosper currently has far more borrowers listing than lenders with capital to lend. Although 9% for an unsecured loan beats most credit card rates, borrowers with sterling credit may think that this rate is still too high to satisfy anything but a short-term credit need. But there may be limits on how low the rates can become for borrowers, given the relatively greater risk aversion of individuals than institutions. The success of P2P exchanges will depend at least in part on

mitigating that risk aversion through portfolio management, and marketing the safety of these types of investments.

The expected return for the investor is more difficult to evaluate, since all loans are three-year notes and none have yet reached maturity. Estimated returns depend on the projected default rates of late and active loans. Default rates depend greatly on the credit grade: from about 1% for AA borrowers to about 20% of HR loans. Risk and fee adjusted returns for lenders matching the market for AA and HR borrowers from June 1, 2006 to October 18, 2007 are 7.88% and –10.59%, respectively. These are not tremendously tempting propositions, but minimal vetting improves the return greatly. A lender who invested in an AA borrower with no delinquencies and less than three credit inquiries on their credit record would have averaged 9.28% over the past two years. Lending Club now advertises an average return of 12% for diversified portfolios.

Although returns are not as easy to predict or calculate as, say, fixed-rate bank CDs, P2P investments have remarkable transparency. Prosper and Lending Club allow users to download enormous volumes of data. Interest rate, default status, and credit rating are available for every loan Prosper has made. A cottage industry has sprouted up analyzing these data. Web sites such as Wiseclerk, Eric’s Credit Community, and LendingStats allow users to view a wide variety of graphs, analyses, and reports prepared by other users who compete to provide the most truthful and helpful representations of the market.

Investors are interested in more than absolute returns. There is some hope that P2P lending exchanges might offer lenders an opportunity to diversify their total portfolios by offering an asset class that would not be affected by the same forces, or to the same degree, as the market as a whole. Early in the credit crunch, there was some optimism because there had been no substantial increase in Prosper borrower default. It seems, however, that P2P exchanges are not immune to market forces. Borrowers are having a more difficult time in social borrowing just as their traditional credit opportunities are drying up. Only 8% of subprime borrowers on Prosper received funding in September 2007, down from almost 25% in September 2006. Lenders found fewer attractive prospects as they ceased to place a premium on the proof of the borrower’s homeownership status. But those loans that cleared did not substantially differ from past loans in terms of rates. And while late and default rates have climbed in recent months, there is no indication that these figures have increased more

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29 Selected Historical Loan Performance Data, Form S-1 Registration Statement. October 31, 2007. 48. Estimate considers loan default rate by dollar volume, though figures do not differ markedly for default rate by number of loans. However, changing the period of estimate, as well as the expected default rate of late loans, does significantly affect these estimates.

quickly than in recent months. The logic of the lending market applies to P2P lending as well, but there is a degree to which lenders have spread their risk exposure into an asset class that has not lost substantial value during this market event.

**Efficiency of the Transaction**

Why might P2P transactions provide both the borrower and the lender with a better interest rate? It makes little sense to say, as often is said, that P2P loans can provide a better rate to both borrowers and lenders because they “cut out the middleman.” It is true that intermediated lenders make money on the premium in between the rate they pay their depositors and the rate they are paid by their borrowers. But P2P exchanges also make money on the spread between lender and borrower. P2P advocates imply that banks are able to charge a wider spread because there has not been an alternative to banks until now, but individual banks always had an incentive to compete with one another. If P2P lending gives the borrower and the lender a bigger piece of pie, it must be because it has more pie to share—either by cutting down on costs or by improving the loans themselves.

**Reduced Overhead**

P2P lending services operate through the Internet with lower overhead than brick-and-mortar banks. In this sense, they join the non-P2P Internet lending phenomenon of lenders such as E-Loan. There is no need for branch locations, thus reducing real estate outlays and staffing costs. Of course, traditional banks bear these expenses in large part because they are perceived to be good investments. Not all individuals trust Internet transactions for their finances. But those who do can share in the savings.

**Credit Discovery**

P2P lending services have been quick to integrate new forms of credit discovery to supplement traditional creditworthiness evaluations. Duck9, an early P2P service, uses nontraditional indications of credit, such as eBay feedback score. Lending Club lenders may be told the city or employer of the borrower, or other information the two have in common. Prosper lenders see photos and read statements made by potential borrowers. These may indicate that although the credit is rated a “D,” the borrower is a “good D.” And Prosper now estimates a borrower’s likelihood of default based on past Prosper borrowers in the same credit class, rather than on people with similar Experian credit scores. Enough information is now available for some degree of reflexive analysis. The informational value of nontraditional

31 Prosper CEO Chris Larsen is the creator and former CEO of E-Loan.
loan evaluation is debatable. Prosper lenders routinely consider “sob stories” that bank loan officers ignore; there may well be reasons Prosper lenders are better able to use this information, but it is important to remember that one reason banks do not consider much of this information is that it can be misleading.

**Lower Default Rate**

Controlling for the high default rates of Prosper’s earliest and least creditworthy loans, the P2P exchanges boast impressively low default rates. Prosper’s default rate hovers around 3% and Zopa’s is less than 0.1%.\(^{32}\) The lower default rates may be partially due to the superior risk profiling described above. By evaluating risk with more parameters, the best borrowers for each credit grade are likely to have their loans picked up by lenders. But P2P services also introduce methods to improve the creditworthiness of their borrowers.

Prosper lenders see photos and read statements made by potential borrowers. These may indicate that although the credit is rated a “D,” the borrower is a “good D.” And Prosper now estimates a borrower’s likelihood of default based on past Prosper borrowers in the same credit class, rather than on people with similar Experian credit scores.

Duck9 sends text messages to borrowers reminding them to pay their bills, even when their payments are not late. State and federal law may prohibit some amount of unconventional repayment encouragement, but it is unlikely that Duck9’s service violates such laws. Duck9’s text reminders are available to all college students, regardless of whether they take a loan from Duck9.

Prosper has from the beginning sought to leverage various kind of microfinance techniques in its business model. Among its ambitions is to create an online civil society of “groups.” Representing real offline communities, such as Harvard alumni, as well as new communities formed through Prosper, groups are intended to bring social forces back into lending. When a borrower defaults, it harms the creditworthiness of the group and so hinders other borrowers. The group leader can contact the defaulting borrower by e-mail and chide him or her on behalf of the rest of the group. And Prosper includes a “community payment” option whereby the group can pitch in to pay the amount in arrears for the deadbeat borrower if its sense of shame or self-interest is sufficiently strong. The groups have an effect on lender behavior: A Stanford Graduate School of Business study finds that Prosper loans recommended by a group leader are almost 35% more likely to receive sufficient bids to fund than similar unrecom-

mended loans.\textsuperscript{33} Thus, a recommended C is as likely to be funded as an unrecommended A.\textsuperscript{34}

Whether social forces have an effect on borrower behavior is less clear. Much of Prosper’s treatment of groups has changed lately under scrutiny of its equity and effectiveness. It is unclear whether defaulting borrowers worry much about the mediated opprobrium of anonymous cyber-colleagues. Terms of use limit contact between borrowers and other users, so shaming may not reach them in their offline communities. Although some groups outperform a general index of the Prosper marketplace, many groups consistently fall short.

Similarly, it is not known whether community payments are used to save genuine groups from the occasional default. Group members can leave tarnished groups and join new ones. Group leaders sometimes used community payments to preserve their group’s reputation in a way that lenders found misleading and objectionable. Part of what makes microfinance successful in the developing world is the social power wielded by existing communities living in close proximity with similar interests.\textsuperscript{35} Some Prosper borrowers join ephemeral, anonymous communities and are unlikely to respond to the same inducements.

Slightly different from social pressures and the fear of sanction is the effect of affinity with the lender. For almost 30 years credit card companies have offered cards that bear the name of an institution with which the consumer may be aligned. Sometimes, but not always, purchases made with the card result in a small contribution to the institution, which may be a charity or the user’s university. There is no pretense that the institution will take the user to task for defaults, or that the institution will even be informed of their default. But when it comes down to paying the bill on either the Chase Manhattan Visa or the Dartmouth College MasterCard, many customers will prioritize the latter. The effect is a write-off rate that is lower than the industry average.\textsuperscript{36}

Prosper, Zopa, and Lending Club lenders are allowed to provide information about themselves. Borrowers are made to know that they have borrowed from individuals rather than institutions. In the

\begin{itemize}
  \item \textsuperscript{33} Joe Ryan, Katya Reuk, and Charles Wang, “To Fund or Not to Fund: Determinants of Loan Fundability in the Prosper.com Marketplace,” paper published by Stanford Graduate School of Business students, 6.
  \item \textsuperscript{34} Though, obviously, they will not necessarily fund at the same interest rate.
\end{itemize}
case of Prosper, borrowers know that these are individuals who have chosen to take a chance on them. In the case of Lending Club, lenders and borrowers are linked by common interests or institutions, or by geography. It is reasonable to believe that some borrowers facing impending repayment difficulties would choose to repay a “real person” who believed in them before paying an institutional creditor. Other borrowers might prefer to pay the institutional lender, thinking that it is more likely to sue or report credit. P2P exchanges must be prepared to change tactics with these borrowers but do so in a way that does not ruin the exchange’s image with other borrowers.

**Regulatory Savings**

Banks and credit unions are subject to costly regulations. Compliance costs, in terms of paperwork alone, are substantial in the banking sector. Furthermore, depository institutions must maintain reserves in order to protect themselves. This amounts to a tax on banking. For each dollar borrowed from depositors, less than a dollar can be loaned. In P2P transactions, the legal cost of compliance should be lower.\(^{37}\) According to Zopa COO Wade Lagrone, being spared the capital cost of regulation amounts to an opportunity to gain for the exchange and its clients.\(^{38}\)

If reserve requirements serve their function of preserving the socially valuable safety and soundness of depository institutions, this savings comes at society’s loss. However, if, as some commentators have suggested, banking reserve requirements are market-distorting and inefficient, taking more transactions off-book may be good for the financial system as a whole. In any case, since P2P exchanges are not banks and do not provide many of the banking services that make banks a social good, and since exchanges generally do not bear default risk, the absence of a reserve requirement does not seem especially problematic. Lenders are free to set aside a percentage of their loan pool to self-insure against uneven repayment relative to consumption, but they may be happy to do so on their own terms rather than have a bank buy treasuries subject to federal stipulation.

**Benefits Forgone and Conclusion**

The advantages of brick-and-mortar, intermediated lending operations are well known, but they bear repeating. Expert loan officers at banks and credit unions use sophisticated statistics to determine the interest rate appropriate to a customer’s risk profile; rarely is the

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choice “lend, or do not lend.” For many loans, the question is one of correct interest rate. Expert loan officers know how to scrutinize potential borrowers; when a borrower presents a bad credit risk, loan officers may have seen the same telltale signs of misrepresentation before. Prosper is at one extreme. Other P2P services do more to set an interest rate for lenders.

Perhaps P2P can someday become even better risk-priced than intermediated lending. Lending Club CEO Renauld Leplanche believes that the market for consumer loans may function like many other markets: Individual investors may not know very much, but many small information trades may adequately price assets. 39 Thus, when a Lending Club lender is presented with a borrower who works for the same company as the lender, the lender may reject that borrower if he or she knows that their company is in turmoil. Even public information, Leplanche argues, may be better disbursed to the market than to individual loan officers. Still, the mechanics of Lending Club suggest that the borrower will probably just get their money from another lender, and at a substantially similar price. In order for P2P to be viable, the savings in terms of overhead, compliance, and reduced defaults must be enough to overcome generally less accurate interest-rate pricing.

P2P is a newcomer to the financial services industry that does not fit perfectly into any legal or regulatory category. Providers are finding their way through this regulatory jungle.
Complex or novel financial products and services face significant technological, economic, and marketing problems. But to even advance to that stage, it is vital that the transaction be feasible within the existing regulatory framework. Legal risks are real: Dutch P2P service Boober was forced by regulators to stop lending.40 Debates within their parliament addressing the concerns of regulators suggest there may soon be a P2P-specific law in the Netherlands.41 American P2P services also face the risk that regulators might shut them down or impose regulatory costs too great to continue.

It is apparent that P2P exchanges take legal obstacles seriously. Lending Club CEO Renaud Leplanche, himself a lawyer by training, said that the “first thing he did” in launching Lending Club was to obtain a legal opinion.42 Prosper CEO Chris Larsen said that law drove their technology, and that their launch was delayed by two years as lawyers and programmers worked together to design a workable product in compliance with laws.43

On the other hand, legal uncertainty remains—so much so that Zopa delayed their U.S. launch to rework their business and legal model. They believed that their launch strategy, designed to be substantially similar to that of Prosper, might bring Zopa into conflict with regulators. They were worried that the SEC had not responded to Prosper’s request, later retracted, for a no-action letter. As a result, Zopa has redesigned their business platform to avoid these issues. Kiva wanted to be a for-profit of the same sort

as MicroPlace, C4, and Globe Funder but was discouraged by the regulatory hurdles.\textsuperscript{44}

Among the legal issues with which a P2P must contend are:

- Money-laundering laws.
- State licensing laws.
- State usury and fee limitations.
- Federal securities and state blue sky laws.
- Truth in Lending Act.
- Fair Credit Reporting Act.
- Federal (Gramm-Leach-Bliley Act) and state privacy laws.
- Data Secrecy Act/USA PATRIOT Act/Office of Foreign Assets Control (OFAC).
- Money transmitter licensing.
- Federal deposit insurance.
- Bankruptcy.
- Tax.
- Web site agreements and disclosures.
- ACH authorization.
- Communications Decency Act.

This chapter considers two of these in greater detail: lending law and securities law.

**Making Loans**

In order to lend within a given state, most states require the registration of persons and organizations in the business of lending. The process of registering in each jurisdiction is costly and tedious, but reliable. Thus, Prosper is a licensed lender in Vermont, a supervised lender in Kansas, and a nonresident regulated lender in Iowa. These nonbanking lending licenses are issued according to state law and govern the behavior of the lending organization. Most importantly, state law governs the interest rates and fees Prosper can charge borrowers. Federal lending laws also govern all lending activity, regardless of state law. For example, a lender in Utah who bids on a borrower in Vermont is instructing Prosper to lend to the
Vermonter and sell the loan to the lender. The maximum interest rate Prosper may charge is set by Vermont, not Utah, since Prosper lends under a Vermont lending license in state.

Lending Club at first followed Prosper in registering with state regulators. But in December 2007, Lending Club announced a partnership with Webbank, a Utah-based industrial bank. Webbank makes loans to borrowers, then assigns the loans to Lending Club, which assigns them in turn to its lenders. At a minimum, this approach satisfies the P2P’s licensing requirement for lending. It carries the additional benefit of preempting state oversight and allowing Lending Club to export interest rates from one state to another. At the present time, Prosper lenders can charge 36% interest to residents of Alabama, but only 6% to residents of Pennsylvania. Each state passes laws to control lending and protect its citizens, and lenders with state licenses must comply with those laws. Under *Marquette Nat. Bank v. First Nat. Bank of Omaha*, nationally registered lenders may charge more than the maximum interest rate of the borrower’s state. This benefit allows Lending Club to engage borrowers otherwise unreachable by Prosper. For instance, Prosper has originated only three loans in the District of Columbia, where rates are capped at 6%.45 Presumably, Prosper lenders are deterred from even reasonable risks because of their inability to achieve a corresponding return. This advantage will be mitigated if, as all signs indicate it will, Lending Club continues to avoid all subprime borrowers.

**Securities Regulation**

The securities acts require the registration of new issues with the Securities and Exchange Commission (SEC). The acts also create private causes of action for investors who believe they have bought or sold securities in the context of misstatement or fraud, or securities that were unregistered. If P2P exchanges were found to be selling unregistered securities, the registration costs going forward and the litigation and sanction costs looking back could be substantial. Some industry leaders believe that these costs could be overcome—fuller disclosure and the addition of costly shelf registration would be costs borne by the industry as a whole and passed on to consumers.46 Others

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45 LendingStats, “Prosper Loan Breakdown by State,” www.lendingstats.com/stateList?pageNum=-1. That comprises less than .03% of the 11,640 originated so far.

think that the margins in the industry are too thin to make such registration feasible.\textsuperscript{47}

A partial answer came in October 2007, when Prosper filed an S-1 registration with the SEC, seeking shelf registration of $500,000,000 in notes in furtherance of the creation of a secondary market for loans facilitated through its Web site. This registration marks a pivotal moment for the P2P industry. Prosper is now in a dialog with regulators, who are now invited to pass judgment on the nascent industry. Two important questions emerge: First, were the notes sold to Prosper lenders prior to this registration “unregistered securities” under the securities acts? Prosper could be exposed to substantial liability or sanctions if they are found to have sold millions of dollars worth of unregistered securities. Lending Club has yet to register any notes and would face the same problems.\textsuperscript{48} Second, how will the SEC receive Prosper’s registration? Prosper’s S-1 registration statement was made pursuant to Rule 415, shelf registration. Prosper seeks to “preregister” the notes that result from its auctions. But shelf registration is typically requested through an S-3 registration by seasoned issuers, not young companies filing for the first time. Ultimately, much lies in the discretionary powers of regulators; if regulators are convinced of the economic and social value of P2P, then it is unlikely they will act in such a way as to disrupt the industry.

There are two categories under which preregistration Prosper loans and current Lending Club loans maybe subject to the securities acts’ registration requirement: first, as notes, and second, as investment contracts. Prosper and Lending Club can make a case that their transactions are exempted from securities laws, but these instruments do not fit into any ready-made category and regulatory risk is substantial.

\textbf{Notes as Securities under Reves}

Prosper sells and assigns promissory notes to lenders. The Securities Act of 1933 defines a security as “any note, stock, bond, debenture, evidence of indebtedness. . . .”\textsuperscript{49} Prosper originates these notes, while Lending Club causes them to be originated by its industrial loan corporation partner. The plainest textual reading thus suggests that Prosper and Lending Club have been selling securities.

\begin{itemize}
  \item \textsuperscript{47} Wade Lagrone, personal communication, June 12, 2007.
  \item \textsuperscript{48} Lending Club partners with an industrial bank. The Securities Act of 1933 exempts securities issued banks. §3(a)(2). Numerous no-action responses have been granted to industrial banks, so Lending Club may well be exempt from registration requirements on other grounds.
  \item \textsuperscript{49} §2(1) Securities Act of 1933.
\end{itemize}
Subsequent jurisprudence has determined that “the phrase ‘any note’ should not be interpreted to mean literally ‘any note,’ but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts.”50 A literal reading of the list is not determinative if “the context otherwise requires.”51 The Reves v. Ernst & Young court endorsed a four-part “family resemblance” test which, when applied to notes of term greater than nine months, determines whether there is sufficient resemblance to one type of instrument that Congress did not intend the securities acts to cover, or evidences the need for a new form.52 Those include, among other things, notes for consumer financing and “character” loans from a bank.53 Examining the four components in the next four sections, it is probable that Prosper’s notes were securities, and it is clear that that they will be after they become salable.

**Purpose of the Buyer and Seller of the Note**

If the note is exchanged to facilitate the purchase of a minor asset, correct the borrower’s cash-flow difficulties, or otherwise advance a consumer purpose, the note is unlikely to be a security.54 Notes to raise money for business expansions are more likely to be securities. Lending Club’s borrower agreement includes an avowal that the loan is for personal and consumer purposes, not commercial purposes. Prosper’s borrower agreement only refers to loan purpose with regards to Wisconsin. Though some Prosper users indicate a desire to expand their businesses, these notes are likely to satisfy the first prong without implicating a security.

The purchaser’s motivation is also considered for this test. Lending out of a desire for profit counts toward the existence of a security. A contract purchased for largely nonfinancial reasons is not considered a security, as when “stock” is purchased in order to live in a co-op.55 It is largely out of concern about this prong that Kiva currently pays its investors no interest. A loan made for no interest is clearly not made out of desire for profit and so reduces the likelihood that a security is present. Whether a 1% or 2% return implicates a security is of great interest to MicroPlace. Despite the fact that Prosper lenders are motivated in part by social or philanthropic goals, the platform as a whole must be seen as dominated by loans for profit.

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54 Reves, 494 U.S., at 66.
Plan of Distribution

The second prong asks courts to “examine the ‘plan of distribution’ of the instrument to determine whether the instrument is commonly traded for speculation or investment.”56 This prong is problematic for P2P exchanges. It may be the introduction of a secondary market that causes Prosper to register its notes. With the introduction of a platform for resale of the notes, Prosper concedes the second prong and that, in combination with the other factors, its notes can no longer maintain resemblance with consumer loans or character loans from banks.

Prior to the registration, Prosper notes were nonsalable except on default. This limits the applicability of this prong. However, in Reves, the Court did not require that the notes be tradable. The factor was met in that case for notes that were “offered and sold to a broad segment of the public, and that is all we have held to be necessary to establish the requisite ‘common trading’ in an instrument.”57 That almost any individual can become a Prosper lender and place loans strongly implies that the notes are marketed to a broad segment of the public.

Whether the Public Reasonably Expects the Protections of the Securities Acts

A note is likely to be a security if the public reasonably believes it to be a security, and thus reasonably believes itself to be protected by securities laws. In some ways, the fact that Prosper refers to note purchasers as “lenders” rather than “investors” as, say, MicroPlace does, serves to alert lenders that this is not an ordinary securities transaction. But it is by no means the only factor that a court would consider in evaluating this prong. The SEC has argued in the past that note purchasers who referred to the transaction as a “loan” might still have reasonably expected the securities acts to protect them.58 In arguing that the notes marketed in one case were securities, the SEC quoted customers who believed that the promissory notes were “more desirable than a ‘money market,’ because of the notes’ more favorable interest rate.” Statements by Prosper customers59 and Prosper

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56 Reves, 494 U.S. 56.
57 Reves, 494 U.S. 56 at 68.
59 Carolyn Said, “Site Hooks Up Lenders, Borrowers,” San Francisco Chronicle, March 6, 2006, sfgate.com/cgi-bin/article.cgi?f=/c/a/2006/03/06/BUGCQHIAEP1.DTL. One customer says, “I think it will be a good way of earning a little more than a money-market savings account interest.”
executives comparing Prosper to money markets will probably be viewed by the SEC in a similar light.

**Whether There Is an Existing Scheme to Protect Investors, Such as Banking Law or Federal Guarantees**

The existence of a competing regulatory scheme would go against SEC claims of regulatory authority. For example, despite attempts by the SEC, courts have not allowed it to exercise regulatory authority over bank CDs, in part because of the FDIC’s regulation of banks. Consumers are protected by another agency and so the SEC is not required.

P2P transactions are covered by other regulatory schemes: state lending law; federal lending law, such as the Truth in Lending Act; and the oversight of the Federal Trade Commission. However, Truth in Lending and the like do not protect lenders, the buyers of the notes. Aggrieved investors in Prosper and Lending Club notes are protected by the securities acts, or else they are protected by nothing more than state law remedies for fraud. No other regulatory scheme looks after them.

**Notes as Securities, as Loan Participations**

A safe harbor has existed for banks reselling notes, even when they provide extensive services alongside the loan, if the bank can characterize the transaction as a “participation.” In the quintessential loan participation, a lead bank makes a loan to a borrower, having vetted and evaluated credit risk. The lead bank then sells interests in the loan to other banks, retaining for itself the task of servicing the loan. The lead bank typically retains an interest in the loan, but in Banco Espanol de Credito v. Security Pacific National Bank, Security Pacific National Bank was engaged in selling all the interests in the loan. Security Pacific provided prospective loan purchasers a list of its customers and the S&P rating of each entry. Purchasers could conduct their own due diligence, but Security Pacific provided no warranty of any kind as to the quality of participations selected from the list. Banco Espanol purchased a participation for which Security Pacific assumed no responsibility.

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responsibility, which later defaulted. Security Pacific customers knew the names of companies in which they would have participatory interests, but they were generally not told any nonpublic information. The court applied the Reves test to the loan participations in *Banco Espanol* and determined that it did not constitute a security. P2P exchanges are similarly engaged in the complete resale of the loan to customers who are supposed to evaluate and select loans from a menu.

In some ways, P2P transactions are even more favorable instances of loan participations than those in *Banco Espanol*. While Banco Espanol participants may have reasonably expected that Security Pacific had the right incentives to make and service only viable loans, the P2P exchanges make perfectly clear that their vetting is minimal. Furthermore, Prosper and Lending Club give lenders an opportunity to select borrowers, so they rely less heavily on the vetting and endorsement of the intermediary.

Although no circuit has ruled that a loan participation constitutes a security, courts have found that some questionable transactions did not in fact evince loan participations. It is plausible that regulators and courts would distinguish P2P transactions from those in *Banco Espanol*. The most important difference between them is that the lenders in a normal P2P transaction are unsophisticated investors, whereas courts do not have to worry about banks’ well-being in the typical bank participation transaction. Justice Eugene Wright’s concurring opinion in *Great Western Bank & Trust v. Kotz* elaborates: “While banks are subjected to risks of misinformation, their ability to verify representations and take supervisory and corrective actions places them in a significantly different posture than the investors sought to be protected through the securities acts.”

Individuals require protection because they cannot supervise or verify what their broker or a company representative tells them. Banks do not require protection because they have the power and expertise to look after their investments. Prosper borrowers are not allowed to list their names, and lenders agree to restrict their contact with borrowers. Yet the exchange knows the name and address and precise income of the individual, and it can and does vet information to its satisfaction. In

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65 Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1261–62 (Wright, J., concurring) (9th Cir. 1976).
Zolfaghari v. Sheikholeslami, the Fourth Circuit ruled that participation interests in a mortgage-backed mutual fund pool were securities—even though Reves identifies mortgage-backed securities as exempted notes. The court relied on the fact that the Iranian immigrants to whom the interests were sold were not sophisticated. In Pollack v. Laidlaw Holdings, Inc., two years after Banco Espanol, the court ruled on a participation sold to an unsophisticated investor. The investor did not have “the capacity to acquire information about the debtor.” And “the broad-based unrestricted sales to the general investing public alleged in the complaint support a finding that these instruments are within the scope of the federal securities laws.” Prosper and Lending Club might reasonably argue that they are exempt as loan participations, and regulators and courts might accept that as an extension of Banco Espanol. But courts might well draw the line with sophistication and find no loan participation. Again, as an application of the Reves test, P2P exchanges have a plausible, but by no means ironclad, argument for exemption from the securities acts.

**Investment Contracts as Securities**

Section 2(a)(1) of the Securities Act of 1933 lists “investment contract” as one of the types of securities. The “touchstone” of a security is “an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.” The questions for P2P services are, first, whether lenders entrust their money to the efforts of the P2P service, and second, whether lenders are sufficiently involved in the process that the managerial efforts of the exchange are not dominant.

P2P exchanges don’t just sell notes; they provide services to lenders that may increase their exposure to securities laws. P2P exchanges do extensive work in facilitating the lending of money between strangers. They vet borrowers by credit score and conduct follow-up inquiries with some borrowers. They assign borrowers a rating on which lenders are encouraged to rely. They may suggest listings to lenders that they ought to consider—Prosper has sent out e-mails lauding “overlooked” loan requests, Lending Club gives a suggested portfolio intended to reduce risk, and Zopa UK actually makes lending decisions on behalf of the lender. Lending Club prepares a menu

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of suggested loans, given a lender’s risk profile and personal characteristics, and Prosper now has a list of “portfolio plans” customized for users with different risk appetites. The exchange services the loan, and the borrower waives the right to enforce their own debts, relying solely upon the exchange to collect on defaulting loans. Although progressively paternalistic advice and control from the exchange may improve lender returns, it adds managerial and service value to the nonsecurities that may result in securities characterization.

Some services are permitted without subjecting a contract to securities regulation. As previously discussed, the lead bank in a loan participation may provide substantial services without incurring a registration requirement. Nor will mere ministerial services indicate the existence of a security. Where along the spectrum courts will find P2P exchanges is not clear.

P2P lenders are not totally passive. Which borrowers they lend to, and at what rate, is the lender’s choice. Savvy lenders achieve substantially better returns than the foolhardy. The further a contract gets from being “solely” dependent on the efforts of the seller, the less likely it is to be a security. Lender vetting may be an important part of the lending process.

However, all the P2P services now allow some form of automated bid selection so lenders need not actively manage their investments. Clearly their participation is not vital. The securities laws are not “easy to evade by adding a requirement that the buyer contribute a modicum of effort,” and courts have found securities even when the buyer of the security must plan meetings and actively endeavor to sell expensive programs. It is impossible to predict whether courts will find that the P2P lender has contributed enough effort to exempt the contract from the securities acts. It is fair to say that Prosper’s active management, though it may endanger a lender’s principal more directly than Lending Club’s suggested

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69 See, e.g., SEC v. Life Partners, Inc., 87 F.3d 536, 545 (“Although the lower courts have given the Supreme Court’s definition of a security broader sweep by requiring that profits be generated only ‘predominantly’ from the efforts of others, they have never suggested that purely ministerial or clerical functions are by themselves sufficient; indeed, quite the opposite is true.”). Campbell, “Stallion Syndicates as Securities,” 70 Ky. L.J. 1131, 1147 (1983) (“The Commission has uniformly taken the position that a share in a stallion syndicate is not a security, provided the syndicate manager does no more than care for the horse and perform certain ministerial functions for the syndicate.”).

diversification portfolio, is less likely to be characterized as an “investment contract.”

Prosper’s decision to register notes with the SEC at the same time as establishing a secondary market is a recognition that although the nonsalable notes have a plausible case for exemption, that case is weakened by the existence of secondary trading. In *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985), Merrill Lynch facilitated their customers’ purchases of CDs. They negotiated for special rates and provided a secondary market for these CDs. Although the sale of CDs does not ordinarily implicate securities laws, the Second Circuit ruled that Merrill Lynch had violated federal securities laws by failing to provide material information to investors. The services bundled with the CDs implicated securities laws. Although Prosper could have tried to distinguish itself from *Gary* in a number of ways, it was perhaps wiser not to chance a confrontation with the SEC.

In *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985), Merrill Lynch facilitated their customers’ purchases of CDs. They negotiated for special rates and provided a secondary market for these CDs. Although the sale of CDs does not ordinarily implicate securities laws, the Second Circuit ruled that Merrill Lynch had violated federal securities laws by failing to provide material information to investors.

**Alternative Arrangements**

Zopa’s U.S. model brings borrowers and lenders together within the framework of a credit union. This model relies on prong four of the *Reves* test, which asks whether another regulatory scheme significantly reduces the risk of the debt instrument, rendering the application of the securities acts unnecessary. Given *Marine Bank v. Weaver*, the fact that lenders’ assets are held in principal-protected, FDIC-insured CDs should count against the need to register corresponding loans made with their funds.

The presence of federally insured deposits in part accounts for the SEC’s willingness to leave the banking sector without their oversight. Zopa should be able to maintain the transparency and the community benefits of P2P but still enjoy the regulatory privilege of the banking sector. Zopa uses CDs to assure its lenders a minimum return. Risk is probably more easily borne by the financial institution than by individual lenders. Of course, some lenders may crave more risk and corresponding returns. And some borrowers may be more likely to default if they know that institutions, rather than individuals, are being harmed. Whether or not borrowers will default more often knowing that the lender’s principal is protected is an empirical
question that Zopa’s officers have no doubt considered. Zopa could probably introduce a product that is lower-risk than Prosper’s notes, but that is still exempt from securities laws. Zopa could make interest rate contingent upon borrower repayment. In *SEC v. Variable Annuity Life Ins. Co. of America (VALIC)*, the Court considered an annuity that paid interest contingent upon market conditions but guaranteed a minimum return. The Court ruled that the variable return did not implicate securities laws, even if there was a risk that the annuity would underperform the market or even fail to keep up with inflation.\(^{71}\)

This *VALIC* reasoning is probably not available to services like Lending Club, where diversification makes the risk of principal very small but not zero.\(^{72}\) Even if the lender bears little risk in that context, Lending Club bears no risk. In order for risk of loss from investments not to strongly imply the existence of a security, the investment manager should substantially bear that risk.\(^{73}\) In any case, regulators may not agree that risks really are so low. This is a new credit product, and it may be difficult to determine the effect of an economic downturn on even a well-diversified pool of borrowers.

**Conclusion**

There is clearly legal uncertainty in the foregoing. The legal strategies implemented by Lending Club and preregistration Prosper may exempt them from registration requirements, but only a confrontation with the SEC would decide this for certain. The viability of the P2P industry depends largely on the ability of P2P services to convince regulators not to attempt to use regulatory powers. The SEC is authorized under the 1933 Act, §3(b) to exercise its discretion to grant additional exceptions to securities laws. And the SEC is busy enough that even without granting an exception, it would be easy for it to simply not engage the P2P exchanges. Prosper’s decision to create a secondary market may have pushed the issue in a way that will require imminent resolution, but it is possible that a collaborative solution will be reached. A dialog is crucially important for the notes Prosper seeks to register. Shelf registration is rarely associated

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\(^{71}\) 359 U.S. 65, at 71 (1959).

\(^{72}\) Note also that Lending Club may have a low risk on the entire asset, but it still has risk on individual assets. There will certainly be capital loss there. If the investor has a direct claim on individual assets, he or she experiences principal loss with every default. Conversely, if the investor is not exposed to principal loss, it must be because he or she owns a pool or fund that contains individual investments. That would complicate securities issues.

with new offerings, but if Prosper is to exist in a regulated environment, it must be able to issue securities in a timely and cost-effective manner. This credit product is new and does not fit neatly into existing categories. Prosper must persuade regulators not just that it more closely resembles something allowed than disallowed. It must show that peer-to-peer should be allowed.
Peer-to-Peer Lending
Update and Regulatory Considerations

Andrew Verstein
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