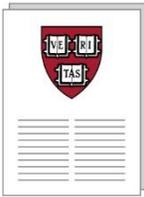




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under the supervision of Howell Jackson**

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Financial Regulation Case Study Lending Club

Case Study

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Memorandum

FROM: Associate ABC

TO: Partner, XYZ LLP

RE: Lending Club

Date: January 2008

Summary

Lending Club is an online peer-to-peer lending (P2P lending) site. It is currently in the process of considering changes in its current business model, and a question has arisen whether its funding of consumer loans may result in issuance of “securities” rather than “loans” and therefore be subject to registration requirements under Section 5 of the Securities Act of 1933 (“1933 Act”).¹ Before moving ahead with any changes in its business model, Lending Club seek clarity regarding the application of federal securities laws to its operations. This memorandum outlines the legal framework to determine if a product is a security, and if so, who is the issuer of the security. It also discusses the risks associated with Lending Club’s options.

Background

Lending Club is an online peer-to-peer lending (P2P lending) site. Lending Club’s initial business model allowed qualified borrower members to obtain unsecured loans from its lender members. Lending members could indirectly fund specific loans to borrower members by purchasing promissory notes from Lending Club. Under the firm’s first model, Lending Club was the lender of record. Borrowers executed promissory notes directly to Lending Club, and then Lending Club immediately assigned the rights to payment under these promissory notes to the lending members indirectly funding the loan. As the lender of record, Lending Club was required to comply with lending guidelines, usury laws, and

¹ Securities Act of 1933, 15 U.S.C. § 77a et seq. (2008).

Note: This memorandum was prepared by Anooshree C. Sinha, LL.M. '09, Harvard Law School, and Corinne Snow J.D. '12, Harvard Law School, under the supervision of Professor Howell E. Jackson of Harvard Law School. The memorandum is intended solely for educational purposes and does not represent an opinion of law. Please do not duplicate or distribute without express permission.

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licensing requirements for each state in which it operated. Because complying with these varying rules was administratively cumbersome, costly, and economically infeasible, Lending Club established its current funding model with WebBank in December 2007.²

WebBank is a state-chartered industrial bank organized under the law of Utah. Partnering with WebBank allowed Lending Club to provide uniform and advantageous interest rates across all states where Lending Club operates.³ Under this current lending model, WebBank issues loans to borrower members and then endorses the promissory notes underlying those loans to Lending Club. Lending Club then assigns each note to a number of lender members. Lending Members are entitled to a pro rata share of the proceeds of the underlying promissory note from the borrower members. Borrowers enter into a loan agreement with WebBank. WebBank processes the loans, manages the money coming in from the lender members to fund the loans, and remits the monies to the corresponding borrower members. Funds from lending members go, in this way, to borrowing members.

Under both the initial and current lending models, Lending Club is responsible for screening borrowers, determining loan terms, computing interest rates, and servicing the loans.⁴ Lender members chose in which loans that want to participate and pay a 1% service fee during the life of the loan for these services. Under both models, the notes held by lending members are essentially illiquid, because lender members must retain the notes until the principal and interest are repaid by the corresponding borrower member.

Looking into the future, Lending Club now wants to create a secondary market to provide greater liquidity for these notes. Under the proposed model that the firm is now exploring lender members would not make loans directly to borrower members. Instead, Lending Club would hold the promissory notes from borrower members, and then issue “Member Payment Dependent Notes” (MPD Notes). Lender members purchase MPD Notes issued by Lending Club, which would entitle the lender members to the proceeds of the specific

² Lending in certain states was essentially impossible because the states stipulated very low thresholds for interest rates. See Peter Tufano and Howell Jackson, LENDING CLUB CASE STUDY, Harvard Business School N9-210-052, 12 December 17, 2010, web.archive.org/web/20071015042928/www.usurylaw.com/state [perma.cc/5XPS-4VAY]

³ See *Marquette National Bank v. First of Omaha Service Corporation*, 493 U.S. 299 (1978) (allowing Nebraska bank to “export” higher interest rates to credit cardholders in Minnesota despite the host state’s usury laws). The “exportation doctrine” has been expanded through legal changes, administrative decisions and case law.

⁴ Though Lending Club requires minimum credit scores for its borrower members, loans obtained via the Lending Club platform are more accessible than loans offered by financial institutions, which typically require better credit scores and more documentation and often additional forms of collateral.

promissory note backing the MPD Notes. These Notes would be issued in series to lender members. Each series would correspond to a single loan. Lending Club expects these MPD Notes to be traded on a daily basis. Lending Club would only be required to make payments to holders of the MPD Notes when it received payments on the corresponding loan.

Lending Club is concerned that the Securities and Exchange Commission (SEC) may treat the existing notes or new MPD Notes as securities. Securities regulations places high disclosure requirements, costs, and liabilities on the security issuer. If the notes or MPD Notes are deemed securities, Lending Club wants to ensure that neither WebBank nor the individual borrowers are treated as co-issuers.

Analysis

Should Lending Club register with the SEC under the current model?

A. Does the Lending Club Business Model create “securities” for purposes of the Federal Securities laws?

The 1933 Act and the Securities Exchange Act of 1934 (“1934 Act”)⁵ have substantially similar definitions of a security. The 1933 Act defines a security as:

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or

⁵ Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. (2008).

interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.⁶

Traditional financial instruments like stocks and bonds are well established “securities” under federal law. The definition of a security evolves, however, with the introduction of each new financial product. The SEC may determine that Lending Club’s promissory notes are either “investment contracts” or “notes” and therefore securities.

B. Has Lending Club created an investment contract?

In *S.E.C v. W. J. Howey Co.*, the Supreme Court held that an investment contract exists when there is “an investment of money in a common enterprise with profits to come solely from the efforts of others.”⁷ In *Howey*, the defendant offered units of a citrus grove development. The investors had no right of entry into, or management of, their specific units or to specific fruit. Instead, they were entitled to receive a share of the net proceeds of the grove on a pro rata basis.⁸ The Court determined that the contracts and deed created an investment contract within the meaning of Section 2(1) of the 1933 Act.⁹ The Court emphasized that economic reality should take precedence over form when assessing the nature of a contract.¹⁰ In *Howey*, the primary purpose of the contracts was to determine each investors’ share of the profits; the rights to the land were purely incidental. The “economic reality” of the arrangement was therefore akin to a profit seeking business where the investors brought in capital and shared in the profits, but did not manage, control, or operate the enterprise.¹¹

Whether or not an instrument is an investment contract depends on both the nature of the instrument and the circumstances surrounding its sale. As a result, the exact same instrument may be a security in some circumstances, but not in others. For example, in *Marine Bank v. Weaver*, the Court held that a certificate of deposit (CD) was not a security because it was unique, would have different value to different investors, and was unsuitable for public trading.¹² In contrast, the CDs in *Gary Plastic Packaging Corp. v Merrill Lynch, Fenner*

⁶ 15 U.S.C. § 77a(1) (2010).

⁷ 328 U.S. 293 (1946).

⁸ *Id.* at 296–97.

⁹ *Id.* at 300–01.

¹⁰ *Id.*

¹¹ *Id.*

¹² 455 U.S. 551 (1982).

& *Smith Inc.*, were securities because of Merrill Lynch’s repackaging actions.¹³ As the Court explained in *Marine Bank*, “not all certificates of deposit invariably fall outside the definition of a ‘security’ as defined by the federal statutes. Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.”¹⁴

In *Marine Bank*, the Weavers pledged a CD in exchange for a share in Columbus Packing Company’s net profits, the right to use Columbus’ barn and pasture, and veto rights on future borrowings by Columbus.¹⁵ The Court explained that the arrangement with the Weavers was a unique contract and a private transaction, whereas the transaction in *Howey* involved an offering to a large number of investors.¹⁶ The Court defined a security as an instrument that is “commonly traded,” has an equivalent values to most persons, and could be traded publicly.¹⁷ The Court also emphasize that the Weaver’s investment was already protected under existing laws, “[there are] important differences between a certificate of deposit purchased from a federally regulated bank and other long-term debt obligations . . . the purchaser of a certificate of deposit is virtually guaranteed payment in full, whereas the holder of an ordinary long term debt obligation assumes the risk of the borrower's insolvency.”¹⁸

In *Gary Plastic*, Merrill Lynch investigated a firm that marketed and created a secondary market for its CDs¹⁹ Unlike ordinary CDs, which are not freely redeemable prior to maturity and carry substantial penalty for early redemption, Merrill Lynch allowed investors a high degree of liquidity by giving them the option of selling the CDs back to Merrill Lynch if prevailing interest rates dropped. Merrill Lynch was therefore engaged in activities that were significantly greater than that of an ordinary broker or sales agent, and investors expected profits derived solely from the efforts of Merrill Lynch.²⁰ Investment was motivated by the expectation of a return of cash investment, the potential for price appreciation due to

¹³ 756 F.2d 230 (2nd Cir. 1985).

¹⁴ *Weaver*, 455 U.S. at n. 11.

¹⁵ *Id.* at 560.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.* at 558–59.

¹⁹ See *Gary Plastic*, 756 F.2d at 232–35.

²⁰ *Id.* at 240.

interest rate fluctuations, and the liquidity of these highly negotiable instruments. The court therefore concluded that the CDs were securities.²¹

The instruments issued under Lending Club’s current model may meet *Howey*’s definition of an investment contract. Under the current model, lending members invest money through the purchase of a loan. The lenders bear the risk of loss because the loans are uncollateralized. Like the investors in *Howey*, lending members lack direct contact or control over borrower members.²² As in *Howey*, the lending members hope to gain profit from the efforts of others.

Under the *Howey* test, Lending Club must be engaged in a “common enterprise.” To determine whether or not a “common enterprise” exists, the court focuses on whether the promoter’s activities (here, Lending Club) is the controlling factor in ensuring the success or failure of the investment.²³ These courts emphasize the “efforts” undertaken by the promoters.²⁴ Unlike Merrill Lynch in *Gary Plastics*, Lending Club merely provides intermediate services to facilitate borrowing between members. Lending Club’s services are not instrumental in enabling the lender members to earn a profit, which is ultimately dependent on the borrower members repaying the underlying loans. The profits earned by lender members are not dependent on the entrepreneurial or managerial efforts of Lending Club. Instead, repayments come from the activities of the borrower members.

Other courts have determined that a common enterprise exists when promoters and investors to share the risk of the investment.²⁵ Risk sharing occurs most commonly when investors rely on the expertise of intermediaries, and those intermediaries earn commissions irrespective of the investor’s gains or losses. Lending members, rather than Lending Club, bear almost all of the risk if the borrowing member defaults on their note. However, Lending Club charges a 1% servicing fee, but does not receive this fee if the borrower defaults on their

²¹ *Id.*

²² Ashta, Arvind and Assadi, Djamchid, *Do Social Cause and Social Technology Meet? Impact of Web 2.0 Technologies on Peer-to-Peer Lending Transactions* (October 9, 2008), available at ssrn.com/abstract=1281373 [perma.cc/YYN9-SMEZ].

²³ See James D. Cox, Robert W. Hillman, and Donald C. Langevoort, *SECURITIES REGULATION CASES AND MATERIALS*, 38 (6th ed. 2008).

²⁴ SEC v. ETS Payphones Inc., 408 F.3d 727 (11th Cir. 2005).

²⁵ SEC v. Alliance Leasing Corp, 2000 US Dist LEXIS 5227 (S.D. Cal. Mar. 17, 2000).

payments. As a result, both Lending Club and the lending member bear some risk if a borrowing member defaults.

If Lending Club creates a secondary market for the MPD Notes, Lending Club's additional efforts will make their model look more analogous to the CDs issued in *Gary Plastics* than those in *Marine Bank*. Lending Club could still argue that the *Howey* test is too simplistic to apply to the notes in P2P lending because P2P lending is not designed solely to generate profits for lending members. Instead, P2P provides optimal rates both to lenders and borrowers. Lending Club could also emphasize the active role lending members play in selecting which Notes to fund. Unlike the investors in *Howey*, who recovered profits on a pro rata basis, lending members receive profits from the individual loan that they specifically select. Still the MPD Notes proposed under the new model closely resemble securities issued by Merrill Lynch.

C. Has Lending Club created a “note”?

In *Reves v. Ernst & Young, Inc.*, a farmer's cooperative sold promissory notes to raise money for its general business operations.²⁶ The notes were uncollateralized, uninsured, and paid a variable rate of interest. The Court held that the notes were securities, and explained that there is a rebuttable presumption that a note is a security, unless it fits into a specific category of non-securities.²⁷ *Reves* specifically identified several types of non-securities, including (1) notes delivered in a consumer financing, (2) notes secured by a mortgage on a home, (3) short-term notes secured by a lien on a small business or its assets, (4) short-term notes evidenced by accounts receivable, (5) notes evidencing “character” loans to bank customers, (6) notes formalizing open account debts incurred in the ordinary course of business, and (7) notes evidencing loans from commercial banks for ordinary operations.²⁸ The Court held that a note is a security unless it falls into one of these categories, or bears a “strong family resemblance” to the notes in one of these categories.²⁹

The Court then established a four-part “family resemblance” test for notes outside of the categories explicitly mentioned in *Reves*. In assessing these notes, courts should consider: (i)

²⁶ 494 U.S. 56 (1990).

²⁷ *Id.* at 65.

²⁸ *Id.*

²⁹ *Id.* at 64–65.

motivations of the buyer and seller—a note is more likely to be a security when the sellers’ purpose is to raise money for the general use of the business, or to finance substantial investments, and the buyers’ interest is in the profit of the business. Conversely, if the note’s purpose is to “facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller’s cash-flow difficulties, or to advance some other commercial or consumer purpose . . . the note is less sensibly described as a ‘security;’”³⁰ (ii) the plan of distribution to determine whether there is common trading for speculation or investment; (iii) the reasonable expectations of the investing public; and (iv) the existence of an alternate regulatory regime.³¹ The Court held that the notes at issue in *Reves* were securities because the seller’s motivation was to raise capital, the investors sought a profit from their investment, the notes were offered and sold to a broad segment of the public, and they were advertised as “investments,” which created a general perception of a security. Finally, the uncollateralized and uninsured notes had no risk-reducing factors to suggest that they were not securities.³² When applying the *Reves* test, courts also consider whether notes are offered to sophisticated buyers or members of the general public.

Lending Club’s products do not fall into any of the enumerated categories of non-security notes, and may fail the family resemblance test. To analyze the expectations of the lending members, courts consider what a reasonable lender would believe about the character of the transaction. The manner in which a transaction is projected in advertisements or on the client’s website can influence expectations. For instance, in *Reves*, the instrument was advertised as a “valuable return on an investment, which undoubtedly includes interest.”³³ Lending members are motivated by the desire to obtain a better return on their money. Lending members may therefore view their funding activities as an investment rather than a loan. Lending Club can argue that its own purpose is merely to facilitate a lending platform, and that the money raised from lender members is used to finance general business purposes. Borrower members’ motivations will vary from loan to loan. Lending Club could argue that many of the loans are “consumer finance” and therefore a non-security for “general business” purposes. Their model promissory note does stipulate that the loans are

³⁰ *Id.* at 66.

³¹ *Id.* at 66–67.

³² *Id.* at 67–69.

³³ *Id.* at n. 4.

for personal finance rather than commercial purposes.³⁴ Lending Club's online marketing, however, does not limit itself to such a closed group. Instead, it reaches out to the general public. Lending Club's intention to create a secondary market available to the general public may further exacerbate this issue.

In *Banco Espanol de Credito v. Security Pacific National Bank*, the Second Circuit applied the *Reves* test and concluded that the notes were not securities. In *Banco Espanol*, Security Pacific extended a line of credit permitting Integrated Resources, Inc. to obtain short term unsecured loans.³⁵ Security Pacific then sold these loans to various institutional investors.³⁶ The court looked to the second factor in the *Reves* test and concluded that the plan of distribution was a limited solicitation to sophisticated financial or commercial institutions and not to the general public that specifically prohibited resales of the loans without the express written permission of Security Pacific. This limitation prevented the loan participations from being sold to the general public, thus limiting eligible buyers to sophisticated investors capable of acquiring information about the debtor.³⁷ In contrast, Lending Club offers its products over the internet to the public at large. The current model does not stipulate any special level of financial sophistication, expertise, or high income level akin to that of an accredited investor in order for a person to qualify as a lender member.³⁸ This wide dissemination and solicitation to the public may lead the SEC to conclude that the notes are securities.³⁹

The third part of the *Reves* test assesses whether the reasonable public views the notes as an investment or a loan. The lender members seek higher returns on their investment in the notes. However, Lending Club promotes itself as a social lending network where members can borrow and lend money among themselves and Lending Club explains to lender members that our client does not itself guarantee the notes.

³⁴ See Tufano, Jackson & Ryan, *surpa* note 1 at Exhibit 9.

³⁵ 973 F.2d 51 (2nd Cir 1992).

³⁶ *Id.* at 53.

³⁷ *Id.* at 55 (internal citations omitted).

³⁸ See the discussion under Regulation D of the '33 Act, *infra* Part III.

³⁹ See *Reves*, 494 U.S. at 68 (the notes "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.").

The absence of regulation, collateral, or insurance to protect against the risks associated with an instrument is an important factor in determining that an instrument is a security.⁴⁰ The SEC may determine that there are currently no appropriate regulatory safeguards for the lending members against misleading statements by a borrower member about his or her employment and income, identity, or against misleading statements by our client with respect to marketing or issuance of the notes.

Lending Club is already subject to substantial regulation. Applicable state laws regulate interest rates and charges, and require certain disclosures. In addition, state laws, public policy, and general principles of equity relating to the protection of consumers, unfair and deceptive practices, and debt collection practices apply to the origination, servicing and collection of the notes. The notes are also subject to federal laws, including the federal Truth-in-Lending Act and Regulation Z,⁴¹ Equal Credit Opportunity Act and Regulation B,⁴² Fair Credit Reporting Act,⁴³ Fair Debt Collection Practices Act, and similar state debt collection laws.⁴⁴ Failure to comply with the laws and regulatory requirements subjects our client to damages, lawsuits, administrative enforcement actions, and civil and criminal liability. However, these laws aim to protect the borrower members but not the lender members in respect of the risks associated with the notes. WebBank is an FDIC-insured state-chartered industrial bank. State licensing statutes impose a variety of regulatory compliances such as (1) recordkeeping, (2) restrictions on loan origination and servicing practices, (3) disclosure, examination, and financial reporting requirements, (4) restrictions on advertising, and (5) review requirements for loan forms.⁴⁵

Lending Club can also argue that the services it provides bear a closer semblance to the activities of banking institutions rather than those of an investment company. The current lending model is more akin to providing a lending platform, and the promissory notes are

⁴⁰ Bass v. Janney Montgomery Scott Inc., 210 F. 3d 577, 585 (6th Cir. 2000) (notes not securities in part because they were collateralized with assets and stock of borrower and its subsidiary).

⁴¹ 15 U.S.C. § 1601 (2010); 12 C.F.R. § 226 (2010) (requiring certain disclosures to the Borrowers regarding the terms of the notes).

⁴² 15 U.S.C. § 1691 (2010); 12 C.F.R. § 202 (2010) (prohibiting discrimination on the basis of age, race, color, sex, religion, marital status, national origin, receipt of public assistance or the exercise of any right under the Consumer Credit Protection Act, in the extension of credit).

⁴³ 15 U.S.C. § 1681 (regulating the use and reporting of information related to each Borrower's credit history).

⁴⁴ 15 U.S.C. § 1692 (regulating debt collection practices by "debt collectors" and prohibit debt collectors from engaging in certain practices in collecting, and attempting to collect, outstanding consumer loans).

⁴⁵ See 12 U.S.C. § 1813 (2010).

more similar to loans rather than securities. This argument will be weakened under the proposed model, as a secondary market will make Lending Club appear more like an investment company.

Lending Club could also analogize its product to viatical agreements. In *SEC v. Life Partners Inc*, the viatical agreements were not securities.⁴⁶ A viatical settlement is an investment contract in which an investor acquires an interest in the life insurance policy of a terminally ill person. When the insured dies, the investor receives the benefit of the insurance. The investor's profit is the difference between the discounted purchase price paid to the insured and the death benefit collected from the insurer, less transaction costs, premiums paid, and other administrative expenses. Life Partners, Inc. (LPI), arranged these transactions and performed certain post-transaction administrative services. The court concluded that LPI's contracts were not securities because LPI's efforts did not have a predominant influence on investor profits. The court distinguished between pre-investment and post-investment services.⁴⁷

If Lending Club's funding model creates securities, who is the issuer?

Securities regulations place high disclosure requirements, costs, and liabilities on the issuer of a security. It is important to determine whether WebBank or borrower members will be treated as "co-issuers" under the current or proposed lending models. It is unlikely that WebBank would be agreeable to act as a co-issuer and there is a substantial risk that WebBank would withdraw from the present arrangement. Providing the financial details for every borrower member would be administratively difficult, would increase the chances of liabilities arising from misstatements, and discourage borrower members from participating in the business.

The 1933 Act defines an "issuer" as:

- "Every person who issues or proposes to issue any security . . .",
- "the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued . . .",

⁴⁶ 87 F.3d 536, 537–39 (D.C. Cir. 1996).

⁴⁷ 408 F.3d 737 (11th Cir 2005).

- “the person by whom the equipment or property is or is to be used . . .”, and
- “the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering . . .”.⁴⁸

The term “person” includes corporations.⁴⁹ Ordinarily, an issuer sells ownership in itself in order to raise capital. Under the current and proposed models, Lending Club holds the promissory notes from the borrower member. Rather than giving these promissory notes to lending members, Lending Club gives lending members a note which entitles them to the principal and interest from the specific loan that they chose to fund. As a result the firm hopes Lending Club would be an issuer under either model should the notes be deemed securities.

In *Prudential Ins. Co. v. SEC*, an insurer set up separate accounts to fund variable annuities, which it then offered to the public.⁵⁰ The value of the annuity was dependent on the value of the securities in these separate accounts. Even though the accounts were not separate business entities, the court held that they were still “investment companies” and “co-issuers” of the securities under the 1940 Act.⁵¹ Guarantors, on the other hand, were not considered co-issuers, although they must still fulfill lesser regulator’s requirements.⁵² Under its new approach, Lending Club could argue that the Notes are analogous to the separate accounts, and that WebBank and the borrowing members are more analogous to the guarantors. Like the separate accounts, the value of the Notes is dependent on the value, or repayment, of the underlying loans.

Lending Club can also analogize its product to a form of municipal securities known as industrial development revenue bonds (IDRBs). IDRBs are government-issued bonds used to raise capital for private sector companies who are undertaking specific projects that the government wants to see financed. These bonds are tradable on secondary markets. For example, a city could issue bonds for Company A to build a bridge. The city issues bonds to investors, and uses the capital to fund Company A’s work on the bridge. The city is then

⁴⁸ 15 U.S.C. § 77b(a)(4) (exemptions omitted).

⁴⁹ *United States v. Rachal*, 473 F.2d 1338 (5th Cir. 1973).

⁵⁰ 326 F.2d 383 (3d Cir. 1964).

⁵¹ *Id.*

⁵² Guarantors must sign and include their financial statements in the registration statement but are not required to make periodic reports. See *American Home Assurance Company*, SEC No-Action Letter (Oct. 17, 2005).

responsible for repaying bond holders, but its obligation to repay the bonds is limited to proceeds received from the bridge's operations. The SEC treats the city, rather than the private company undertaking the project, as the sole issuer of the bonds. Just as IDRBs allow citizens to invest in a specific project (the bridge), lending members can invest in a specific loan.⁵³

Even if Lending Club can demonstrate that its product looks similar to IDRBs, there is still a risk that the SEC will be unwilling to treat the MPD Notes like IDRBs. First, the Securities Act gives municipal securities special status, exempting them from registration requirements.⁵⁴ The primary purpose of the securities law is to protect investors. Because municipal securities are overseen by a government entity, the law has far greater confidence in the trustworthiness of the issuer, and the likelihood that the investor will get the expected return on their investment. The same is not true when the sponsoring entity is a private company, like Lending Club.⁵⁵

Assessing the Registration Risks

The decision to register with the SEC involves a number of risks and costs which could impact the competitiveness of Lending Club's business model. Registration under the federal securities law may provide investors with greater confidence in Lending Club's product and structure. Registration, however, also entails substantial initial and on-going costs for compliance, as well as the risk of litigation regarding notes already issued prior to registration. If Lending Club registers, it also risks that the SEC will treat WebBank or lending members as issuers or co-issuers.

There are several alternatives to SEC registration. First, Lending Club could take a "wait and see" approach, forgo the secondary market, and continue to operate under the current lending model. This option carries with it a risk of sanctions if the SEC determines that the notes under the current model are unregistered securities. The SEC has broad-ranging powers to issue cease-and-desist orders and to impose civil monetary penalties for violations

⁵³ See Louis Loss, Joel Seligman and Troy Paredes, *SECURITIES REGULATION* 23–24 (4ed. 2008).

⁵⁴ 15 U.S.C. § 77(c)(2) (2010).

⁵⁵ See Robert S. Amdursky, *Creative State and Local Financing Techniques*, 249 PLI N4-4429, 347 (1984) ("Traditionally, municipal securities have been considered the most secure category of investments second only to obligations of the federal government.").

of federal securities laws.⁵⁶ Any violation of a cease-and-desist order is punishable by a civil penalty in addition to a mandatory injunction directing compliance with the order. The SEC has further powers to suspend trading of a security or stop further issuances of new securities. As a result, Lending Club will face substantial legal and business costs should the SEC decide to proceed against it.

Lending Club could also apply to the SEC for a no-action letter indicating whether the staff will recommend that the Commission undertake enforcement action against our client. These letters are sent in response to requests made when the legal status of an activity is not clear, as is arguably the present case. A no-action letter would only provide partial certainty: the letter indicates the SEC's intentions, but is not binding on the courts. If Lending Club requests a letter, it also risks drawing the SEC's attention to its current practices.

Another option is to make a joint representation to the SEC with other P2P lenders operating in the United States, arguing that the notes issued under the P2P lending business models should be exempt from registration requirements under Section 5 of the 1933 Act. While this strategy would allow Lending Club to continue to use its current lending model, it may prevent Lending Club from creating a secondary trading platform for the MPD Notes. A joint representation to the SEC may help lay industry standards, save considerable costs and compliance burdens—should they get the exemption. However, coordinating a joint effort may be time consuming and our client could lose out on the significant competitive advantage as a “first mover” gained by acting independently and successfully registering with the SEC.

Lending Club could also adopt the new model and register on its own with the SEC under the 1933 Act. This decision carries substantial regulatory risks and costs, and there is no industry precedent to serve as a benchmark for the probability of the SEC approving our client's registration. Should the notes be deemed securities, the registration and compliance requirements may substantially increase overhead and business costs, which may drive up the fees charged by our client, ultimately hurting the viability of the business.

⁵⁶ See Cox, Hillman, and Langevoort, *supra* note 24 at 814.

In addition Section 5 of the 1933 Act restricts the ability of issuers and its underwriters to promote the offering or soliciting of purchase orders until the registration statement is filed with the SEC (quiet period) and it bars any sale of securities until the registration statement becomes effective. Any activity that is likely to promote investor interest in the offering is likely to violate Section 5.⁵⁷ Lending Club would have to stop allowing lender members to fund any loans and any borrowings sanctioned during the quiet period. Though the Act states that the registration statement becomes effective within a limited number of days after it is filed with the SEC, the registration statement is subject to review and comment from the SEC, which may substantially lengthen the process.⁵⁸ Under Section 8 of the 1933 Act, the SEC may refuse to permit a registration statement from becoming effective,⁵⁹ or issue a stop order, or institute any public proceeding or examination arising out of any deficiencies or misleading information in the registration statement.⁶⁰ The process may take several rounds of correspondence and amendments, especially given the unique nature of Lending Club's business and the Notes.

After filing a registration statement, Lending Club will become subject to anti-fraud liability under federal securities law for information provided in the statement and on its website. This poses a challenge for our client because the federal Gramm-Leach-Bliley Act ("GLBA") limits the disclosure of nonpublic personal information about a consumer to nonaffiliated third parties, requires financial institutions to disclose certain privacy policies and practices with respect to information sharing with affiliated and nonaffiliated entities, and obligates financial institutions to safeguard personal customer information. Several states have similarly enacted privacy and data security laws requiring safeguards to protect the privacy and security of consumers' personally identifiable information and requiring notification to affected customers in the event of a breach. However, some of the information regarding the member borrowers may require investigation and disclosure in order to comply with the anti-fraud provisions of the Act.

Once the securities are offered pursuant to Section 5 of the 1933 Act, Lending Club would become a public company. This will result in significant legal, accounting, and other expenses

⁵⁷ See Cox, Hillman, and Langevoort, *supra* note 24 at 147, 159.

⁵⁸ See 15 U.S.C. § 77a(8)(a) (2010).

⁵⁹ See 15 U.S.C. § 77a(8)(b) (2010).

⁶⁰ See 15 U.S.C. § 77a(8)(d) (2010).

that Lending Club did not incur as a private company. A substantial amount of time would need to be allocated towards public company compliance requirements. Some of these may include obtaining better coverage for D&O liability insurance, given that the liability of directors and executive officers of the company would increase. As a public company, Lending Club will be subject to the Sarbanes-Oxley Act. The Sarbanes-Oxley Act requires effective internal controls over financial reporting, disclosure controls, and procedures.⁶¹ This would require our client to put in place systems that meet the Act's requirements, incurring substantial accounting expense, expending significant management time on compliance-related issues, and hiring additional accounting and financial staff with appropriate public company experience and technical accounting knowledge. Failure to do so would subject our client to sanctions or investigations by the SEC or other regulatory authorities.

Conclusion

Lending Club faces legal risks under all three proposed courses of action. Registering with the SEC under either the current or proposed model appears to be the safest, but also the most costly, solution. Please be prepared to discuss the relative merits of the various options.

⁶¹ See Sarbanes Oxley Act, 15 U.S.C. § 7201 (2002).