MEMORANDUM

To: Partner, XYZ LLP
From: Associate ABC
Re: Lending Club

Summary

Under Lending Club’s current business model, the notes may be “securities,” rather than “loans” and therefore subject to registration requirements under Section 5 of the 1933 Securities Act. Lending Club must decide whether to (1) continue under the current model and take the position with the SEC that the notes are not securities, (2) file with the SEC under the existing model, or (3) file with the SEC under the new model in hopes of getting approval for a secondary market trading platform.

This memorandum outlines the legal framework to determine 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 member loans by purchasing promissory notes issued by Lending Club. Under the initial model, Lending Club was the lender on 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 member indirectly funding the loan. As the lender on record, Lending Club was required to comply with lending guidelines, usuary laws and licensing requirements for each state in which it operated. Because complying with these varying rules was administratively cumbersome, costly, and economically infeasible, Lending Club entered into an arrangement with WebBank in December 2007.

WebBank is a state chartered industrial bank registered in Utah. Partnering with


Note: This memorandum was prepared by Anooshree C. Sinha. LL.M. ‘09, Harvard Law School, and Corinne Snow J.D. ‘11, 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.
WebBank allowed Lending Club to provide uniform and advantageous interest rates across all states where Lending Club operates. Under this current lending model, the loans are divided into the notes. WebBank endorses the notes to Lending Club, and Lending Club then assigns each note to the respective lender 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.

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. Lender members pay a 1% service fee during the life of the loan for these services. Under both models, the notes issued by Lending Club are essentially illiquid, because the lender members must hold on to the notes until the principal and interest are discharged by the corresponding borrower member.

Lending Club wants to create a secondary market to provide greater liquidity for these notes. Under the proposed model, 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” (Notes). Lender members purchase Notes issued by Lending Club, which would entitle the lenders to the proceeds of the specific promissory note backed by the Note. The Notes would be registered under Rule 415 of the 1933 Act, and issued in series to lender members. Each series would correspond to a single loan. Lending Club expects these Notes to be traded on a daily basis. The Notes of each series would be pari passu to the Notes of other series. Lending Club would only be required to make payments to the Note holders 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 Notes as securities. Securities regulations places high disclosure requirements, costs, and liabilities on the security issuer. If the notes or Notes are deemed securities, Lending Club wants to ensure that neither WebBank, nor the individual lenders are treated as co-issuers.

**Analysis**

1. **Should Lending Club register with the SEC under the current model?**

   A. Lending Club must register the notes if they are “securities” pursuant to Section 2(a)(1) of the 1933 or 1934 Securities Act.

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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 See SEC Rule 415, 17 C.F.R. 230.415 (2010). The provision for Shelf Registration: registration of a new issue which can be prepared up to two years in advance, so that the issue can be offered quickly as soon as funds are needed or market conditions are favorable.

5 Sections 5(a) and (c) of the 1933 Securities Act prohibit the offer or sale of securities without an effective registration statement or a valid exemption from registration. See 15 U.S.C. § 77a.
The 1933 and 1934 Securities Acts require securities to be registered prior to sale.\(^6\) Both Acts have substantially similar definitions of a security. The 1933 Act defines a security as:

\begin{quote}
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 interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.\(^7\)
\end{quote}

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 \textit{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.”\(^8\) In \textit{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.\(^9\) The Court determined that the contracts and deed created an investment contract within the meaning of Section 2(1) of the 1933 Act.\(^10\) The Court emphasized that economic reality should take precedence over form when assessing the nature of a contract.\(^11\) In \textit{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.\(^12\)

\begin{footnotesize}
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  \item \textsuperscript{7} 15 U.S.C. § 77a(1) (2010).
  \item \textsuperscript{8} 328 U.S. 293 (1946).
  \item \textsuperscript{9} \textit{Id.} at 296–97.
  \item \textsuperscript{10} \textit{Id.} at 300–01.
  \item \textsuperscript{11} \textit{Id}.
  \item \textsuperscript{12} \textit{Id}.
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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 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.¹³ In contrast, the CDs in *Gary Plastic Packaging Corp. v Merrill Lynch, Fenner & Smith Inc.*, were securities because of Merrill Lynch’s repackaging actions.¹⁴ 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.”¹⁵

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.¹⁶ The Court explained that the arrangement with the Weavers was a unique contract and a private transaction, whereas the transaction in to *Howey* involved an offering to a large number of investors.¹⁷ The Court defined a security as an instrument which is “commonly traded,” has an equivalent values to most persons, and could be traded publicly.¹⁸ 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.”¹⁹

In *Gary Plastic*, Merrill Lynch investigated issuers, marketed, and then created a secondary market for its CDs.²⁰ Unlike ordinary CDs, which are not freely redeemable prior to maturity and carry substantial penalty for early redemption, the 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 agents, and investors expected profits derived solely from the efforts of Merrill Lynch.²¹ Investment was motivated by the expectation of a return of cash investment, the potential for price appreciation due to interest rate fluctuations, and the liquidity of these highly negotiable

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¹³ 455 U.S. 551 (1982).
¹⁴ 756 F.2d 230 (2nd Cir. 1985).
¹⁵ *Weaver*, 455 U.S. at n. 11.
¹⁶ Id. at 560.
¹⁷ Id.
¹⁸ Id.
¹⁹ Id. at 558–59.
²⁰ See *Gary Plastic*, 756 F.2d at 232–35.
²¹ Id. at 240.
instruments. The court therefore concluded that the CDs were securities.\textsuperscript{22}

The notes in Lending Club’s current model may meet \textit{Howey’s} definition of an investment contract. Under the current model, lending members invest of money by purchase a loan. The lenders bear the risk of loss because the loans are uncollateralized. Like the investors in \textit{Howey}, lending members lack of direct contact or control over borrower members.\textsuperscript{23} As in \textit{Howey}, the lending members hope to gain profit from the efforts of others.

Under the \textit{Howey} test, Lending Club must be engaged in a “common enterprise.” To determine whether or not a “common enterprise,” exists, court focus on whether the promoter’s activities (here, Lending Club) is the controlling factor in ensuring the success or failure of the investment.\textsuperscript{24} These courts emphasize the “efforts” undertaken by the promoters.\textsuperscript{25} Unlike Merrill Lynch in \textit{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 dependant ultimately on the borrower members repaying the underlying loans. The profits earned by lender members are not be dependent on the entrepreneurial or managerial efforts of Lending Club. Instead, repayments come from the activities of the borrower members.

Other courts determine that a common enterprise exists when promoters and investors to share the risk of the investment.\textsuperscript{26} Risk sharing arises most commonly when investors rely on the expertise of intermediaries, and those intermediaries earn commissions irrespective of whether the investor makes or loses money. 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 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 Notes, Lending Club’s additional efforts will make their model look more analogous to the CDs issued in \textit{Gary Plastics} than those in \textit{Marine Bank}. Lending Club could still argue that the \textit{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 selection which Notes to fund. Unlike the investors in \textit{Howey}, who recovered profits on a pro rata basis, lending members receive profits from the individual loan that they specifically select. The Notes proposed under the new model closely resemble securities issued by Merrill Lynch.

\textsuperscript{22} \textit{Id.}
\textsuperscript{25} SEC v. ETS Payphones Inc., 408 F.3d 727 (11th Cir. 2005).
C. Has Lending Club created a “note”?

In Reeves v. Ernst & Young, Inc., a farmer’s cooperative sold promissory notes to raise money for its general business operations. 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. Reeves specifically identified several types of non-securities, including notes (1) delivered in a consumer financing, (2) 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. 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.

The Court then established a four-part “family resemblance” test for notes outside of the categories explicitly mentioned in Reeves. In assessing these notes, courts should consider: (i) 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’,” (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. The Court held that the notes at issue in Reeves 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 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. When applying the Reeves 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 Reeves the instrument was

28 Id. at 65.
29 Id.
30 Id. at 64–65.
31 Id. at 66.
32 Id. at 66–67.
33 Id. at 67–69.
advertised as a “valuable return on an investment, which undoubtedly includes interest.” 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 member’s motivations will vary from loan to loan. Lending Club could many of the loans are “consumer finance” and therefore a non-security as for “general business” purposes. Their model promissory note does stipulate that the loans are for personal finance rather than commercial purposes. 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 Reeves test and concluded that the notes were not securities. In Banco Espanol, Security Pacific extended a line of credit permitting Integrated to obtain short term unsecured loans. Security Pacific then sold these loans to various institutional investors. The court looked to the second factor in the Reeves 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.” 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. This wide dissemination and solicitation to the public may lead the SEC to conclude that the notes are securities.

The third part of the Reeves test assesses whether the reasonable public views the notes as an investment or a loan. The lender members seek a 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.

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. The SEC may determine that there are currently no appropriate regulatory

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34 Id. at n. 4.
35 See Tufano, Jackson & Ryan, surpa note 1 at Exhibit 9.
36 973 F.2d 51 (2nd Cir 1992).
37 Id. at 53.
38 Id. at 55 (internal citations omitted).
39 See the discussion under Regulation D of the ’33 Act, infra Part III.
40 See Reeves, 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.”).
41 Bass v. Janney Montgomery Scott Inc., 210 F. 3d 577, 585 (6th Cir. 2000) (notes not securities in part because
safeguards for the lending members against misleading statements by a borrower member about the his 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, 42 Equal Credit Opportunity Act and Regulation B, 43 Fair Credit Reporting Act, 44 Fair Debt Collection Practices Act and similar state debt collection laws. 45 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. 46

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 more in the nature of 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. 47 A viatical settlement is an investment contract where 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

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44 15 U.S.C. § 1681 (regulating the use and reporting of information related to each Borrower’s credit history).
45 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).
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 investors' profits. The court distinguished between pre-investment and post-investment services.  

II. If the notes are 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 member lenders 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 of WebBank would withdraw from the present arrangement. Providing the financial details for every member borrower would be administratively difficult, would increase the chances of liabilities arising from misstatements and discourage member borrowers 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 . . . the person by whom the equipment or property is or is to be used . . . 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.  

The term “person” includes corporations. 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 member borrower. Rather than give these promissory notes to borrowers, 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, Lending Club is an issuer under either model if the notes are 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. 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. Guarantors, on the other hand, were not considered co-issuers, although they must still fulfill filing lesser requirements. Under this model, Lending

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48 408 F.3d 737 (11th Cir 2005).
50 United States v. Rachal, 473 F.2d 1338 (5th Cir. 1973).
51 326 F.2d 383 (3d Cir. 1964).
52 Id.
53 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).
Club could argue that the Notes are analogous to the separate accounts, and the WebBank and the lending members are more analogous to the guarantors. Like the separate accounts, the value of the Notes are 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 responsible for repaying bond holders. 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.54

Even if Lending Club can demonstrate that its product looks similar to IDRBs, there is still a substantial risk that the SEC will be unwilling to treat the Notes like IDRBs. First, the Securities Act gives municipal securities special status, exempting them from registration requirements.55 The primary purpose of the securities law is to protect investors. Because municipal securities are backed 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 respected return on their investment. The government entity can provide this certainty, so there is less concern with who the additional parties (such as Company A) might be. The same is not true when the issuer is a private company, like Lending Club.56

III. 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 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 issuer or co-issuers.

There are several alternatives to SEC registration. First, Lending Club could take a “wait and see” approach, forego the secondary market, and continue to operate under the current lending model. This 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 of the Securities Acts.57 Any violation of a cease and desist order is punishable by a civil penalty in...

54 See Louis Loss, Joel Seligman and Troy Paredes, SECURITIES REGULATION 23–24 (4ed. 2008).
56 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.”).
57 See Cox, Hillman, and Langevoort, supra note 24 at 814.
addition to a mandatory injunction directing compliance with the order. The SEC has further powers under Section 12(j) of the Act to suspend trading of a security. The SEC also has the authority under paragraph (k) to summarily suspend trading in a security whether registered or not for a period of up to 10 days if in the SEC’s opinion public interest and investor protection so requires. The SEC may issue a series of such 10 day suspensions but after giving the respondent notice and a hearing. 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 the present case. A no action letter would only provide partial certainty: the letters indicate the SEC’s intentions, but are not binding on the courts. If Lending Club requests a letter, it also risks drawing the SEC’s attention to its current practices.

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

Lending Club could also adopt the new model and register on its own with the SEC. This decision carried 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. Though our client does stipulate minimum credit scores for its borrower members, loans obtained via the client’s platform are more accessible than loans offered by financial institutions which may require better credit scores, more documentation and collateral. Should the notes be deemed securities, the registration and compliance requirements may substantially increase overheads and costs of the business which may drive up the fees charged by our client, ultimately hurting the viability of the business.

Section 5 of the Act restricts the ability of issuers and its underwriters to promote the offering or soliciting purchase offers until the registration statement is filed with the SEC (quiet period) and it bars any sale of securities till the registration statement becomes effective. Any activity which is likely to promote investor interest in the offering is likely to violate Section 5.58 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 20 days after it is filed with the SEC, the registration statement is subject to review and comments from the SEC which may substantially lengthen the process. 59 Under Section 8 of the Act the SEC may refuse to permit a registration

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58 See Cox, Hillman, and Langevoort, supra note 24 at 147, 159.
statement from becoming effective, or issue a stop order, or institute any public proceeding or examination arising out of any deficiencies or misleading information in the registration statement. 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 Section 10b-5 of the Securities Exchange Act of 1934 for information provided in the statement and on its website. This poses a challenge for our clients because the federal Gramm-Leach-Bliley Act (“GLBA”) limits the disclosure of nonpublic personal information about a consumer to non-affiliated third parties and requires financial institutions to disclose certain privacy policies and practices with respect to information sharing with affiliated and nonaffiliated entities as well as to safeguard personal customer information. A number of states have similarly enacted privacy and data security laws requiring safeguards to protect the privacy and security of consumers’ personally identifiable information and to require 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 will become a public company. This will result in significant legal, accounting, and other expenses 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 and disclosure controls and procedures. This would require our client to put in place systems that meet the Act’s requirements incur substantial accounting expense, expend significant management time on compliance-related issues, and hire additional accounting and financial staff with appropriate public company experience and technical accounting knowledge. Failure to do so would subject our clients to sanctions or investigations by the SEC or other regulatory authorities.

Regulation D of the 1933 Act offers safe harbor provisions, which may lessen the burden on Lending Club. Regulation D exempts certain private placements from SEC registration and imposes lesser reporting requirements. Regulation D’s safe harbor provisions are available in three circumstances. Rules 504 and 505 limit dollar sizes of the offerings. Rule 506 has no such limitations, but limits the kind of investors that may purchase the securities. Under Rule 506, sales can be made to any number of accredited investors plus up to 35 non accredited investors. Accredited investors include individuals

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64 $1 million and $5 million, respectively, less sales during the 12 months before the start of the offering. See Rule 504 and 505, 17 C.F.R. §230.504–05 (2010).
65 A non accredited investor must either be sophisticated or use a sophisticated purchaser representative not
with more than $1 million net worth or joint network with a spouse, or with more than $200,000 in each of the two most recent years or joint income with spouse of $300,000 during the same period, who reasonable expects income in excess of such amounts in the current year. Lending Club must assess whether their targeted lender members qualify as accredited investors. To use the exemption, our client would also have to ensure that there was no general solicitation and no general advertising for potential purchasers for the offering.

Registration with the SEC also creates the risk of further litigation. Loans made from commencement of their business until registration with the SEC may be considered an unregistered and unqualified offering of securities, entitling lender members to rescind their purchase and be paid their unpaid principal amount of the loans plus statutory interest. This situation may also pose a significant risk of a class action lawsuit.

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.