Note

Square Pegs in a Round Hole: SEC Regulation of Online Peer-to-Peer Lending and the CFPB Alternative

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Over the last decade, online person-to-person lending, also called peer-to-peer or P2P lending, emerged as an alternative form of consumer borrowing and investing. It grew throughout the recession, even as consumer credit markets faltered, and it continues to grow today. P2P lending platforms match individuals looking to borrow with individuals looking to lend in anonymous online marketplaces. They offer attractive interest rates, debt consolidation, access to liquidity, and inexpensive diversification. Despite its growth, however, the P2P lending market faces significant challenges. In 2008, the Securities and Exchange Commission ("SEC") declared that notes issued by P2P lending platforms to be unregistered securities. This forced the platforms—as web startups—to register for initial public offerings. SEC regulation now creates substantial compliance costs, barriers to entry, and risks to consumers in the P2P lending market. P2P lending should therefore be exempted from SEC regulation and placed under the Consumer Financial Protection Bureau ("CFPB").
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Introduction

December 2007 through June 2009 marked the most significant recession
in U.S. markets since the Great Depression. The “Great Recession” severely
disrupted nearly all facets of the U.S. economy, and consumer credit markets
were no exception. Credit card borrowing fell precipitously; mortgages and

1. See Announcement, NATIONAL BUREAU OF ECONOMIC RESEARCH BUSINESS CYCLE
   DATING COMMITTEE, (Sept. 20, 2010), http://www.nber.org/cycles/sept2010.pdf (setting the dates of the
   recession between December 2007 and June 2009); Chris Isidore, The Great Recession, CNNMONEY
   (noting the general consensus that the recent recession is the worst since the Great Depression).
3. Id.
home equity lines of credit dried up as home values declined, and consumers and small businesses faced reduced access to credit from banks and credit unions.

While traditional sources of consumer credit began a shaky rebound in late 2010, online peer-to-peer lending, also called person-to-person or P2P lending, grew throughout the recession. P2P lending platforms, which connect individuals looking to borrow with individuals looking to lend, have generated over a billion dollars in loans since 2006. P2P lending continues to grow 100% year over year, while other consumer credit sources remain conservative.

In one sense, P2P lending is as old as borrowing from friends and family. However, much as eBay radically transformed the garage sale, P2P lending platforms drove a metamorphosis in community lending. By providing searchable electronic marketplaces, standardized loan contracts, borrower creditworthiness data, and loan servicing, P2P lending platforms generate an impressive volume of small loans between anonymous individuals.

For borrowers, P2P lending platforms offer debt consolidation, increased access to liquidity, and significantly less racial and sexual discrimination than traditional lenders. For lenders, they offer accessible portfolio diversification and socially conscious investing. For both groups, P2P lending platforms generally offer more attractive interest rates than retail banks.

The Great Recession, however, changed more than markets. Financial regulation shifted dramatically between 2008 and the present, and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") is


5. Id.


8. Id.

9. Id. (noting 100% year-over-year growth for the two largest U.S. P2P lending platforms); see also Updated: State of Selected P2P Lending Companies, P2P-BANKING (March 15, 2012, 9:53 AM), http://www.wiseclerk.com/group-news/countries/germany-updated-state-of-selected-p2p-lending-companies/ (charting monthly loan originations for P2P lending platforms around the world); Lange, supra note 6 (describing tepid growth in consumer credit markets).


the chief example. The House version of the bill exempted most P2P lending activity from Securities and Exchange Commission ("SEC") regulation, placing it instead under the newly minted Consumer Financial Protection Bureau ("CFPB"), an approach this Note advocates.

The SEC sparked this congressional wrangling by opting to regulate P2P lending. In 2008, one of the two largest platforms, Lending Club, entered a quiet period pending voluntary registration as a seller of securities. The other, Prosper Marketplace ("Prosper"), eventually received a cease-and-desist order from the SEC. The order found that Prosper marketed securities without a valid registration statement, a violation of the Securities Act of 1933. When Prosper and Lending Club emerged from SEC registration, they found the P2P lending market largely cleansed of competitors.

This Note focuses on the "heartland" of P2P lending in the United States: platforms that offer competitive interest rates in an anonymous online marketplace. It argues three things with regard to that market. First, the P2P lending industry offers significant benefits to consumers through rapidly evolving web-based platforms. Consequently, regulation of P2P lending should facilitate its growth while responding to emergent consumer protection issues. Second, SEC regulation of P2P lending cripples the industry and harms its customers. Most P2P lending activity should be exempt from the SEC's jurisdiction as it was under the House version of Dodd-Frank. Finally, the CFPB best suits the regulatory challenges of P2P lending. Dodd-Frank equipped the CFPB to both harmonize existing consumer financial laws with P2P lending and craft new regulations to protect consumers from new threats.

This Note also argues that the P2P lending example illustrates the CFPB's potential to help financial firms rather than harm them. The fledgling CFPB is embattled. Conservative commentary on the agency ranges from partisan—criticizing selection of a ""Consumer-Protection" Czar" when "economic wounds inflicted by other unaccountable government entities are still

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16. Id.
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fresh” to apocalyptic—accusing the CFPB’s “bureau mandarins” of “hunting for scalps” in advance of the presidential election.

As P2P lending illustrates, however, the CFPB can actually help financial firms. At least ten federal statutes and as many agencies govern a tiny, unsecured P2P loan.21 Consumer financial regulation is profoundly balkanized, which increases compliance costs and barriers to innovation. The CFPB can simplify this quagmire. Congress gave the agency sole rulemaking authority—consolidated from myriad regulators—under key federal consumer financial protection laws.22 The CFPB can tailor these laws to particular transactions23 and, if necessary, exempt markets or firms from its regulations.24 Moreover, the CFPB’s broad jurisdiction under Dodd-Frank allows it to harmonize regulation across disparate financial service providers. The agency is no doubt empowered to protect consumers in financial transactions, but it is equally empowered to rationalize regulatory burdens on financial firms. In sum, industry advocates might be better served to help define the agency’s future rather than decry its existence.

I. The Online P2P Lending Industry

From its inception, online P2P lending spawned diverse business models.25 Since 2001, at least fourteen platforms have operated in the United States26 and many more operate abroad.27 This Note focuses on U.S. P2P lending platforms that offer competitive interest rates in anonymous marketplaces of borrowers and lenders. This particular market creates distinct risks, benefits, and regulatory issues.

22. Dodd-Frank, § 1002(12).
23. Id. at § 1061(b)(1)(A).
24. Id. at § 1022(b)(3).
25. CAL. S. COMM. ON BANKING, FINANCE & INSURANCE, PERSON-TO-PERSON LENDING BACKGROUNDER 2 (2009) [hereinafter "CALIFORNIA SENATE BACKGROUNDER"].
A. U.S. P2P Lending on the Interest-Bearing, Anonymous Marketplace Model

Today, Prosper and Lending Club dominate the U.S. noncharitable P2P lending market.  

Prosper launched in 2006, while Lending Club launched in 2007. Initially, Prosper experienced rapid growth, but it misjudged the threat posed by the SEC. In October 2008, while traditional consumer credit markets collapsed, Lending Club emerged from voluntary SEC registration just as Prosper received an SEC cease-and-desist order that shut its doors for 9 months. From that point forward, Lending Club steadily gained market share, and it has now originated $943 million in loans to Prosper’s $408 million. 

In format, the two platforms differ little. Both provide an anonymous online marketplace for individual—i.e., not securitized—loans to consumers. Borrowers post narratives and consent to credit checks. Lenders browse borrowers’ applications and fund loans at platform-determined interest rates. Both platforms contract with an FDIC-insured bank to execute loans, and both issue notes to lenders dependent on borrower payment streams. Obviously, this is more complex than a typical neighbor-to-neighbor loan, and the exact mechanics of P2P lending determine the regulatory issues. This Section explores Prosper’s model in detail before addressing Lending Club’s relevant differences in Lending Club’s model.

1. The Prosper Marketplace Model

A P2P lending transaction that goes well consists of four steps: the process for borrowers, the process for lenders, the execution and servicing of the loan, and the potential resale of the loan. Borrowers do sometimes default; P2P lending platforms can collapse; and fraud does happen. These mishaps create key issues in P2P lending regulation, discussed infra Section I.C.

a. The Process for Borrowers

After registering with Prosper, a prospective borrower submits a loan application. Prosper appends the borrower’s credit score, credit history, other

28. Verstein, supra note 18, at 452.
31. GAO REPORT, supra note 26, at 7.
32. Id. at 7-8.
34. See Lending Club Statistics, LENDING CLUB, supra note 10.
income data, and proprietary “Prosper Rating.” The borrower adds a narrative to explain the loan’s purpose, as well as any sympathetic circumstances or negative credit history. Prosper assigns an interest rate to each loan application based on credit scores and other factors.

Borrowers may also join Prosper affinity groups. These groups are based on commonalities of geography, profession, and other characteristics. Group leaders manage the groups, particularly the application processes. Applicants may need to verify, for example, that they attended a particular university. Previously, group leaders could charge fees on loans granted to group members, but this drove the leaders to hawk low-quality loans. Group leaders now work for free. Group membership has a statistically significant impact on whether a borrower’s loan is funded. Group membership also affects the interest rate Prosper sets for the loan.

b. The Process for Lenders

Lenders provide a bank account, social security number, and other information. They agree to a credit check, a tax withholding statement, and terms and conditions. They gain access to anonymized borrower financial data, and lenders may bid on any loan that is not yet fully funded. Bidding on a loan commits lenders to purchase a “borrower payment dependent note” if the loan receives full funding.

Today, lenders may use a search tool, dubbed Quick Invest, to search for loans with particular characteristics. They may then bid on all search results at once or on individual loans. Previously, Prosper offered a tool called

36. PROSPER MARKETPLACE, INC., PROSPECTUS FOR REGISTRATION STATEMENT NO. 333-14701 (May 17, 2011) at 1 [hereinafter PROSPER PROSPECTUS May 2011].
37. Id.
38. Id.
42. Id.
43. Michal Herzenstein et al., The Democratization of Personal Consumer Loans? Determinants of Success in Online Peer-to-Peer Loan Auctions (Boston U. Sch. of Mgmt., Research Paper No. 200914, 2008).
44. PROSPER PROSPECTUS May 2011, supra note 36, at 15.
45. Id. at 9.
46. Id.
47. The bidding period for a loan is 14 days from when it is posted, unless it receives full funding earlier. Id. at 69.
48. Id. at 2.
Portfolio Plan that automatically bid on loans meeting lenders' search criteria. However, Prosper replaced Portfolio Plan with Quick Invest, fearing that Portfolio Plan could be construed as a separate, unregistered security.

c. Executing and Servicing the Loan

Prosper loans are fixed-rate, unsecured, fully amortizing loans. They have one-, three-, and five-year terms and range from $2,000 to $25,000. WebBank—an FDIC-insured, Utah-chartered, industrial bank—executes the loans. It then sells and assigns the loans to Prosper, without recourse, in exchange for the lenders' principal. Because WebBank is FDIC-insured, it exports Utah's usury laws wherever it issues loans, permitting Prosper to offer uniform terms across states.

Prosper transfers borrower payments to the corresponding lenders. Borrowers pay a variable closing fee ranging from 0.5% to 4.95% of the loan value based on their credit rating and loan amount. Borrowers also pay a "Failed Payment Fee" of $15 when, for example, a check bounces. Lenders pay a 1% annual servicing fee, which accrues on the amortized daily principal balance.

d. The Secondary Market

To make lenders' notes more liquid, Prosper created a note resale market, serviced by Foliofn Investments. As an SEC-registered broker-dealer, Foliofn can deal in existing securities. Lenders offer notes for sale at a minimum price, and buyers bid on the note in an auction. Upon the sale of a note, Foliofn charges a fee of 1% of the purchase price. The note buyer receives all legal rights of the original lender, and Prosper still services the loan.

50. CALIFORNIA SENATE BACKGROUNDER, supra note 25, at 6.
51. PROSPER PROSPECTUS May 2011, supra note 36, at 43.
54. Legal Compliance, PROSPER, supra note 52.
55. GAO REPORT, supra note 26, at 36 n.65.
57. Id.
58. Id.
59. PROSPER PROSPECTUS May 2011, supra note 36, at 77.
61. PROSPER PROSPECTUS May 2011, supra note 36, at 77.
62. Id. at 78.
63. Id. at 77.
64. Legal Compliance, PROSPER, supra note 52.
2. The Lending Club Model

Lending Club also charges various fees and uses WebBank to issue its loans. Its loans are fixed-rate, unsecured, fully amortizing loans with similar terms and limitations. Foliofn also manages Lending Club’s resale market. For the purposes of this Note, there are only two relevant distinctions between Prosper and Lending Club.

First, Lending Club historically imposed stricter underwriting standards on borrowers. It has consistently accepted fewer than 10% of its borrower applicants, while Prosper initially accepted most applicants and relied on lenders to make prudent investments. Lending Club claims to have “positioned [itself] in the lending market as a platform for higher quality borrowers.” In reality, however, Prosper eventually tightened its underwriting standards to be “essentially as selective” as Lending Club.

Second, Lending Club embraces regulatory complexity and the attendant costs in seeking a competitive advantage. Lending Club voluntarily registered as a seller of securities to help “define the [P2P lending] space.” While Prosper eliminated Portfolio Plan to avoid registering it as a security, Lending Club offers three levels of preselected investment plans. It also offers a “PRIME Account” with increased access to its investor services teams, and it has registered a subsidiary as an investment advisor so it can offer managed investment accounts. Finally, unlike Prosper, Lending Club now offers self-directed IRA accounts in a partnership with a bank.

B. The Benefits of P2P Lending for Consumers

P2P lending platforms now substitute for two traditional financial activities: borrowing and investing. They accomplished this by making P2P

67. Verstein, supra note 18, at 453.
68. LENDING CLUB, PROSPECTUS FOR REGISTRATION STATEMENT NO. 333-151827 (June 6, 2011) at 34 [hereinafter LENDING CLUB PROSPECTUS June 2011].
69. Verstein, supra note 18, at 453.
70. Eisenbeis, supra note 14.
73. GAO REPORT, supra note 26, at 54-55.
loans economically viable on a national scale and by making P2P loans attractive relative to traditional financial services.

P2P lending platforms made person-to-person loans economically viable on a national scale by reducing the search costs and other transaction costs inherent in traditional person-to-person loans. P2P lending platforms reduce search costs by creating instantaneously searchable databases of borrowers. This gives lenders access to an exponentially larger market of potential borrowers than would otherwise be available, which encourages entry into the P2P lending market.

P2P lending platforms also reduce other transaction costs. First, they make it cheaper to evaluate counterparty risk. Borrowers need not worry about familial strife or loan-shark collection tactics, and lenders get verified creditworthiness data. Second, the platforms provide a standard contract, making negotiations unnecessary. Finally, the platforms enforce that contract, obviating the need for individual collections activity. Compared to the corresponding costs for traditional person-to-person loans, the fees platforms charge to find, analyze, execute, and enforce P2P loans are trivial, and the platforms have made a thriving national market in P2P loans possible.

P2P lending platforms also make P2P loans attractive relative to traditional financial products, primarily by offering better interest rates. P2P lending platforms offer better rates because they replace retail banks with leaner, more efficient intermediaries. The platforms dispense with the need for physical locations, in-person loan processing, and vast underwriting staffs. Of course, lean intermediaries may become so lean that the risks they pose outweigh the benefits they offer. That concern is addressed infra Section I.C, but the remainder of this Section describes empirical benefits of P2P lending.

75. Search costs, a subset of transaction costs, describe the disutility of looking for a product, service, or transaction partner. Economically rational individuals search for better products, services, or partners only until the marginal cost of searching exceeds the expected marginal benefit of finding something better. High search costs discourage transactions and drive consumers to known products, services, and partners. Gerald E. Smith et al., Diagnosing the Search Cost Effect: Waiting Time and the Moderating Impact of Prior Category Knowledge, 20 J. Econ. Psychol. 285, 286 (1999).

76. Transaction costs describe the disutility of engaging in an economic exchange. In addition to search costs, they include the costs of bargaining for and enforcing an agreement. A rational consumer will incur transaction costs only until the marginal cost of transacting exceeds the expected marginal benefit of searching, bargaining, policing, or otherwise investing in the transaction. Jürg Niehans, Transaction Costs, in THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 677-80 (1987).

77. Lending Club discusses many of these factors in its prospectus. LENDING CLUB PROSPECTUS June 2011, supra note 68, at 31. It explains that its business model is to operate at a low cost to offer borrowers and lenders better rates than traditional financial institutions. Id. at 29.
1. Better Rates for All

P2P lending promises more attractive interest rates for both borrowers and lenders, and this promise is often fulfilled. For borrowers, P2P rates average between 11.4% and 20.6% on three-year loans, which compares favorably to unsecured bank debt and credit card debt, as well as payday loans. Many borrowers use their loans to consolidate debt, which suggests they prefer P2P lending platform rates to institutional lenders' rates.

For lenders, P2P lending rates are also attractive. As of March 2011, Prosper reported average net annualized returns of 11%, while Lending Club reported net annualized returns over 9%. Contemporaneous yields on savings accounts, money market accounts, and three-year certificates of deposit were below 2.2%. A Lending Club investment from June 2007 to November 2008 would have outperformed the S&P 500, the Nasdaq Composite Index, one-year certificates of deposit, and six-month treasury bills. Admittedly, market indices fared poorly between June 2007 and November 2008, but the fact remains that P2P lending offers returns that compete with common consumer investments.

2. Additional Benefits of P2P Lending for Consumers

P2P lending offers benefits to borrowers beyond attractive interest rates. Recently, 25% of Prosper borrowers and 57% of Lending Club borrowers have used their loans to consolidate debt. In contrast to credit cards, P2P loans offer fixed rates and predictable payment schedules. In contrast to payday lenders, P2P loans create credit history, enhancing access to traditional credit sources. In sum, P2P lending allows borrowers to swap in a more attractive creditor at a better rate.

79. Brill, Peer-to-Peer Lending, supra note 11.
80. While 20.6% is not terribly appealing, this figure includes all of Prosper's loans back to its inception, well before it tightened its underwriting standards and lowered its rates. GAO REPORT, supra note 26, at 9.
81. Id.; Brill, Peer-to-Peer Lending, supra note 11.
82. California Hearings, supra note 17 (statement of Chris Larsen, Prosper CEO & Founder).
83. GAO REPORT, supra note 26, at 10.
84. Id. at 9.
85. Id.
86. Id. at 2.
87. GAO REPORT, supra note 26, at 10.
88. See California Senate Back grounder, supra note 25.
89. See California Hearings, supra note 17 (statement of Chris Larsen, Prosper CEO and Founder).
P2P lending platforms also offer liquidity in weak consumer credit markets. As the recession illustrated, P2P lending performance does not closely track the performance of institutional lenders. As a result, P2P lending provided credit “in a financial marketplace that [had] been largely frozen for [ ] two-and-a-half years.”90 When home equity loans and lines of credit fell along with home values,91 P2P loans stepped into the breach.92

P2P lending platforms also facilitate socially motivated lending, which helps borrowers with compelling personal circumstances.93 Lenders report, for example, gaining emotional utility from lending to small businesses.94 Moreover, affinity groups encourage lending based on attributes ignored by institutional lenders. Prosper hosts groups for veterans,95 environmental projects, and graduates of educational institutions,96 among others. Prosper offers better rates to members of high-performing groups,97 and group membership increases the likelihood that an applicant’s loan will be funded.98 The full potential of this socially motivated P2P lending remains to be explored.99

Finally, P2P lenders are less discriminatory than traditional financial institutions.100 Race and gender, in particular, play a reduced role on P2P lending platforms,101 though they still play a role.102 In fact, the platforms offer a “particularly congenial venue for certain consumer groups such as women, single and divorced individuals, and those with children to obtain unsecured loans at more attractive interest rates than they might be able to obtain through more conventional sources.”103 In sum, P2P lending is a compelling alternative to banks, pawn shops, and payday lenders for underbanked borrowers.

90. Id. (statement of Sen. Ronald Calderon, Chairman).
91. CALIFORNIA SENATE BACKGROUNDER, supra note 17, at 1.
92. Kim, supra note 78.
93. See, e.g., Chu, supra note 78; Amy Feldman, How I Became a Little-Guy Lender, Bloomberg Businessweek (April 23, 2008, 6:16 PM), http://www.businessweek.com/magazine/content/08_18/b4082000029137.htm.
94. Feldman, supra note 93.
96. David Bogoslaw, Peer-to-Peer Lending: Problems and Promise, BUSINESS WEEK (Apr. 6, 2009 12:01 AM), http://www.businessweek.com/print/investor/content/apr2009/pi2009043_811816.htm.
97. PROSPER PROSPECTUS May 2011, supra note 36, at 15.
98. Herzenstein et al., supra note 43.
100. Herzenstein et al., supra note 43, at 31.
101. Id.
102. Devin G. Pope & Justin R. Sydnor, What’s in a Picture? Evidence of Discrimination from Prosper.com, 46 J. HUM. RES. 53 (2011) (noting a tendency for borrowers to avoid similarly situated black borrowers but also noting that black borrowers still tend to have an increased default rate).
P2P lending also offers benefits to lenders beyond attractive interest rates. First, P2P loans create diversification opportunities because they do not closely track returns on traditional investments. Second, unlike mutual fund investors, P2P lenders can select loans and loan increments at a granular level. If they desire, they can spread risk in increments of as little as $25. Finally, lenders may derive emotional utility from lending based on borrowers' social characteristics.

C. The Risks of P2P Lending for Consumers

P2P lending platforms also present risks to consumers. Some risks would be inherent in any analogous transactions with traditional intermediaries. However, other risks are unique to P2P lending platforms. These risks form the core challenge for efforts to regulate P2P lending.

1. The Risks of P2P Lending Platforms for Borrowers

While certain risks mirror those in traditional borrowing, protections against them on P2P lending platforms may not. All borrowers risk misleading loan terms, discriminatory or predatory credit determinations, and abusive collection practices. P2P lending platforms have shown no greater proclivity for these practices than traditional lenders. However, as Part IV explains in detail, federal statutes designed to mitigate these risks may not translate well to the P2P lending context.

P2P lending platforms also pose unique concerns for borrowers. For example, they create well-documented privacy risks. P2P platforms collect and store substantial personal identification and credit data. If a P2P platform sold this data, were hacked, or fell victim to an unscrupulous employee, tremendous damage could be done. Of course, P2P lending platforms attempt to mitigate these risks.

The broader concern is information borrowers voluntarily reveal in their loan applications. Prosper and Lending Club forbid posting personally identifying information, but borrowers may still reveal enough to permit

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104. CALIFORNIA SENATE BACKGROUNDER, supra note 25, at 1.
105. Id.
106. Feldman, supra note 93.
107. GAO REPORT, supra note 26, at 18.
108. Id. at 39.
109. Id. at 31.
110. PROSPER PROSPECTUS May 2011, supra note 36, at 9; LENDING CLUB PROSPECTUS June 2011, supra note 68, at 7-8.
111. PROSPER PROSPECTUS May 2011, supra note 36, at 12; LENDING CLUB PROSPECTUS June 2011, supra note 68, at 15.
112. PROSPER PROSPECTUS May 2011, supra note 36, at 97.
113. GAO REPORT, supra note 26, at 66 n.3.
lenders to deduce their identities. Publishing all loan applications in the SEC’s EDGAR database extends the pool of potential snoops to all Internet users. The GAO reviewed 247 loan listings and found that 47 revealed information that could be used to identify a borrower. However, the GAO noted that “substantial effort might be needed” to do so.

Finally, unscrupulous characters need not rely solely on loan postings for information. Affinity group leaders have successfully asked for “pay stubs, confirmation-of-employment letters, credit reports, bank statements, bankruptcy proceedings, etc.” Lender discussion forums can serve useful functions, but they can also help pair a borrower’s identity with their credit information. Connecting borrowers’ credit history with their names could be merely invasive, but it may also lead to harassment or facilitate identity theft.

2. The Risks of P2P Lending Platforms for Lenders

P2P lenders face more risks than P2P borrowers because of mismatched incentives between the P2P lending platforms and their lenders. P2P lending platforms earn revenue from origination and servicing fees. P2P lenders earn money when borrowers pay back enough of their loans to generate a return; otherwise, they lose money. Ignoring the potential for lost customers and litigation, P2P lending platforms can increase earnings by originating more loans of any quality at any rate, which is not true for P2P lenders.

This incentive mismatch arises because P2P lending platforms are lean intermediaries. Traditional lenders, such as retail banks, mediate credit risk. If they lend out deposits and the borrower fails to pay, they still owe depositors money. P2P lending platforms, however, do not mediate credit risk. They only pay out on “borrower payment dependent notes” if the borrower pays. Hence, the platforms that advertise and enforce the loans have little direct stake in loan repayment.

114. Id. at 31.
115. Id.
116. Id. at 65.
117. Id.
120. See id. at 469-71.
122. Verstein, supra note 18, at 454.
123. They also pay lenders if they sell defaulting loans in a debt sale, but this happens very rarely. This incentive mismatch admittedly bears a resemblance to the impact that securitization and resale of payment streams from mortgages had on mortgage originators leading up to the Great Recession. Jeffrey N. Gordon & Christopher Muller, Confronting Financial Crisis, 28 YALE J. ON REG. 151, 173 (2011). However, thus far, P2P lending platforms offer only unsecured loans, so P2P lenders do not rely on the fiction of an underlying asset that cannot help but perpetually increase in value.
The risks of lost lender confidence and litigation, however, mitigate this incentive mismatch. First, lender confidence drives P2P platforms’ revenues. Lending Club leapfrogged Prosper in loan origination, in part, because it became the “platform for higher quality borrowers,” and Prosper subsequently ratcheted up underwriting standards. Platforms thus depress or misrepresent loan quality at the peril of their loan volume. Second, courts, regulators, and Congress have been the big roadblocks to P2P lending platform viability, and the industry works hard at government relations. Playing fast and loose with consumers would jeopardize these efforts.

However, where the incentives remain mismatched, lenders are at risk. First, lenders risk that P2P lending platforms will massage advertised returns to increase loan origination and fees. Platforms compute lender returns however they wish. Prosper’s advertised net annualized returns only include loans originated since July 2009, when it completed registration and upped underwriting standards. As of March 2011, including older loans would drag returns down to negative 3%. Conversely, Lending Club’s figures incorporate all of its loans. However, they include even loans with only one billing cycle, whereas Prosper segregates loans for 11 months before incorporating them into return data. As loans rarely default early in their terms and Lending Club increases loan origination every month, Lending Club may significantly overstate lenders’ actual returns. Additionally, both platforms pay referral fees to blogs, which encourage these sites to finesse their analysis of lender returns. Finally, neither Prosper nor Lending Club factors the risk of platform default into projected lender returns.

To be fair, P2P lending platforms work hard to be transparent. Prosper and Lending Club encourage users to download all of their data, and an avid community of P2P lenders crunch the numbers continually. The platforms

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125. Verstein, supra note 18, at 453.
127. Of course, they must disclose their methodology in SEC filings and in fine print on their websites.
128. GAO REPORT, supra note 26, at 9 n.22.
129. Id.
130. Id.
131. Id.
132. Verstein, supra note 18, at 472.
133. Id. at 473.
134. Id. at 496.
also provide analytical tools on their websites. If credit card issuers made it that easy to double-check their data, they might also face questions about advertised rates. However, unless P2P lenders are willing and able to analyze the data themselves, they rely on P2P platforms’ rather unconstrained representations.

Second, P2P lenders run the risk of borrower fraud. P2P platforms vet borrower applications only to the extent possible with a credit report. For example, Prosper does not typically validate borrowers’ stories, occupation, stated income, or plans for the loan, and even borrowers’ debt-to-income ratio is partially self-reported. To deter fraud, Prosper and Lending Club verify income and employment data for roughly 40% and 60% of their loans, respectively. Upon verification, around 53% of Prosper and 35% of Lending Club applicants fail to provide a satisfactory response.

When borrowers do lie, Prosper and Lending Club disclaim responsibility for the content of loan listings. These disclaimers even extend to information ostensibly verified by the platforms. This places a “heavy burden” on lenders to recognize fraud or suffer the consequences. Both platforms make an exception for identity theft and will repurchase uncollectable loans. However, both reserve the right to determine if identity theft has occurred at their sole discretion.

Third, P2P lenders rely on the platforms to collect on delinquent loans. Borrowers do default, and in the early days of Prosper, default rates were as high as 36%. More recently, the GAO found that about 55% of Prosper loans and about 70% of Lending Club loans go to credit grades that have default rates of 1.2% and 2% after between nine and fifteen months of payments. Prosper and Lending Club take similar approaches upon borrower delinquency. After fifteen days, both assess a fee of $15 or 5% of the unpaid installment amount,

138. CALIFORNIA SENATE BACKGROUND, supra note 25, at 7.
139. Id.
140. Id.
141. PROSPER PROSPECTUS May 2011, supra note 36, at 12.
142. Id. at 12.
144. Terms of Use, LENDING CLUB, supra note 143; Terms of Use, PROSPER, supra note 143.
146. Verstein, supra note 18, at 470-71.
147. Id. at 471.
149. GAO REPORT, supra note 26, at 21.
whichever is greater, on the borrower.\textsuperscript{150} This fee goes entirely to the lenders.\textsuperscript{151} However, that concludes the good news for lenders.

Both Prosper and Lending Club admit a nebulous obligation to use "commercially reasonable efforts" to collect on delinquent loans.\textsuperscript{152} Both reserve rights to pursue collection in house or through an agency.\textsuperscript{153} Prosper advertises a 17\% fee for its collection agency,\textsuperscript{154} and Lending Club advertises between 30\% and 35\% fees.\textsuperscript{155} These fees come out of lenders' recoveries. Moreover, both platforms define referral to a collection agency after 31 days delinquency as commercially reasonable.\textsuperscript{156}

Both platforms may also modify the loan, initiate legal proceedings, sell the loan to a debt purchaser, or charge the loan off.\textsuperscript{157} If they do sell the debt, lenders receive the entire sale price.\textsuperscript{158} What constitutes commercially reasonable efforts where the P2P lending platforms collect in-house, sell, charge off, or modify loans is undefined.

In short, the platforms have the sole discretion to collect on delinquent loans, and their reward is a small percentage of what they recover.\textsuperscript{159} Lenders, who stand to lose the lion's share of the unpaid amount, have no recourse.\textsuperscript{160} Moreover, neither Lending Club nor Prosper returns to lenders payments made after the final maturity date of the loan.\textsuperscript{161} Lending Club's three-year and five-year loans both have five-year final maturity dates.\textsuperscript{162} Prosper's final maturity date is one year after the initial maturity date on the loan.\textsuperscript{163} In other words, if they delay, the platforms increase their return on collections to 100\%. As Lending Club notes, "a conflict of interest could exist as any delay in receiving

\textsuperscript{151} Legal Compliance, supra note 52; Rates & Fees, supra note 150.
\textsuperscript{152} LENDING CLUB PROSPECTUS June 2011, supra note 68, at 57; PROSPER PROSPECTUS May 2011, supra note 36, at 87.
\textsuperscript{153} LENDING CLUB PROSPECTUS June 2011, supra note 68, at 57; PROSPER PROSPECTUS May 2011, supra note 36, at 87.
\textsuperscript{155} Rates & Fees, supra note 150.
\textsuperscript{156} LENDING CLUB PROSPECTUS June 2011, supra note 68, at 17; PROSPER PROSPECTUS May 2011, supra note 36, at 81.
\textsuperscript{157} CALIFORNIA SENATE BACKGROUNDER, supra note 25, at 4.
\textsuperscript{160} Id. at 38.
\textsuperscript{161} LENDING CLUB PROSPECTUS June 2011, supra note 68; PROSPER PROSPECTUS May 2011, supra note 36, at 4.
\textsuperscript{162} LENDING CLUB PROSPECTUS June 2011, supra note 68.
\textsuperscript{163} PROSPER PROSPECTUS May 2011, supra note 36, at 4.
borrower funds would result in additional money being kept by Lending Club.\textsuperscript{164}

The ultimate test of platforms' collection efforts is actual lender recovery. Lending Club, with its relatively static model, provides the most insight. Since it began, the average recovery rate for Lending Club lenders is 53\% on loans between 31 and 120 days delinquent and 4\% on loans over 120 days delinquent.\textsuperscript{165} Debt sales are not an appealing alternative. Prosper's last debt sale occurred in December 2007, when it sold 701 loans for between 3.5 and 12.5 cents on the dollar.\textsuperscript{166} In short, after 31 days of delinquency, expected recovery begins in the 50\% range and falls rapidly.

Finally, P2P lenders run the risk of platform default or bankruptcy. Neither Prosper nor Lending Club faces imminent peril, but their performance is not reassuring. Both have seen net operating losses throughout their existences.\textsuperscript{167} Both rely heavily on venture funding.

In the event of P2P lending platform insolvency, lenders face three risks. First, upon P2P platform dissolution, lenders could be left without anyone to service the loans,\textsuperscript{169} though both Prosper and Lending Club have arranged for third party servicing upon their default.\textsuperscript{170}

Second, platform insolvency may expose lenders' rights to loan payments to the claims of other platform creditors. Both Lending Club and Prosper use Wells Fargo to maintain lenders' accounts.\textsuperscript{171} Prosper originally gave noteholders indirect security interests in the right to borrower payments.\textsuperscript{172} It then gave Wells Fargo—as trustee for lenders' accounts—a security interest that could be exercised for the benefit of lenders.\textsuperscript{173} As discussed in Part II

\textsuperscript{164.} LENDING CLUB PROSPECTUS June 2011, supra note 68, at 15.
\textsuperscript{165.} Lending Club Statistics, LENDING CLUB, supra note 10.
\textsuperscript{167.} LENDING CLUB PROSPECTUS June 2011, supra note 68, at 23; PROSPER QUARTERLY REPORT (Nov. 12, 2010), http://www.sec.gov/Archives/edgar/data/1416265/000141626510000490/p10q9d30d2010.htm ("Prosper has incurred net losses and negative cash flows from operations since inception, and has an accumulated deficit of approximately $48.1 million as of September 30, 2010."). At the time of writing, Lending Club had announced its first quarter of positive cash flow. Lending Club Exceeds $1B in Personal Loans, WALL ST. J., Nov. 5, 2012, http://online.wsj.com/article/PR-CO-20121105-905889.htm.
\textsuperscript{168.} California Hearings, supra note 17 (statement of Chris Larsen, Prosper CEO & Founder).
\textsuperscript{169.} Updated: State of Selected P2P Lending Companies, supra note 9.
\textsuperscript{170.} CALIFORNIA SENATE BACKGROUNDER, supra note 25, at 24. Both platforms note that transfer of loan-servicing to third parties might create delay or additional fees that would reduce the amount lenders recover. LENDING CLUB PROSPECTUS June 2011, supra note 68, at 22; PROSPER PROSPECTUS May 2011, supra note 36, at 35.
\textsuperscript{171.} LENDING CLUB PROSPECTUS June 2011, supra note 68, at 31; PROSPER PROSPECTUS May 2011, supra note 36, at 2.
\textsuperscript{172.} Verstein, supra note 18, at 491.
\textsuperscript{173.} Id.
infra, the SEC disallowed both of these approaches, and Prosper has weakened lender protections.

Lending Club lenders face even greater risks.\textsuperscript{174} Lending Club expressly reserves the right to issue debt senior to lenders’ rights secured by payments on the loans lenders fund.\textsuperscript{175} Remarkably, “in the event of default, Lending Club grants its creditors [other than lenders] an irrevocable attorney-in-fact to sign the collateral over to themselves, to terminate adverse claims and security interests, and otherwise sign Lending Club’s name for matters involving the collateral.”\textsuperscript{176} In other words, lenders become creditors to both borrowers and Lending Club.\textsuperscript{177} They will not be repaid in full upon either borrowers’ or Lending Club’s default.\textsuperscript{178} Lenders clearly do not appreciate this risk. They accept interest rates that effectively ignore that they have become a creditor to a web startup.\textsuperscript{179}

Finally, P2P lenders also face the slight risk that their funds in Wells Fargo accounts will be at risk upon platform bankruptcy.\textsuperscript{180} However, unless a bankruptcy court found that the platform beneficially owns these accounts, neither the platform nor its non-lender creditors would be able to reach them.\textsuperscript{181} In short, the risk exists and could increase with an alternative P2P lending platform model, but it is currently remote.

II. Current Regulation of P2P Lending

When P2P lending emerged, it had no clear home in the financial regulatory system. Part IV discusses the problems P2P lending platforms cause for federal consumer financial law. More fundamentally, however, jurisdiction over P2P lending was unclear. Platforms claimed to be a banking alternative exempt from securities laws.\textsuperscript{182} The SEC disagreed. Andrew Verstein provides an excellent critique of the SEC’s decision to intervene.\textsuperscript{183} However, given that the agency’s intervention would receive deference from courts, SEC regulation will likely persist absent congressional action.

\begin{itemize}
\item 174. \textit{id.} at 495.
\item 175. \textit{id.}
\item 176. \textit{id.}
\item 177. \textit{id.} at 496.
\item 178. \textit{id.}
\item 179. \textit{id.}
\item 180. PROSPER PROSPECTUS May 2011, supra note 36, at 1.
\item 181. \textit{id.}
\item 183. Verstein, supra note 18, at 517-18.
\end{itemize}
A. The Intervention of the SEC

Prosper and Lending Club travelled different paths to SEC registration. Lending Club, backed by venture capitalists, reached out to the SEC in 2008 with a team of lawyers.184 In the words of Lending Club’s CEO, “We wanted to help define the space, to participate in the dialogue about how our industry would work, and how it would be regulated.”185 In October 2008, it emerged with an approved registration statement.186 Prosper contacted the SEC about launching its note resale market in 2007.187 The SEC instead issued a cease and desist order in November 2008.188 Prosper reemerged with an approved registration statement in July 2009.189

B. The SEC’s Jurisdictional Argument

Neither the SEC’s discussions with Lending Club nor its general perspective on P2P lending have been memorialized.190 Prosper’s cease-and-desist letter “provides only limited insight into the SEC’s motives.”191 Given the similarities between Prosper, Lending Club, and now-defunct P2P platforms, it is “safe to assume” that the reasoning in Prosper’s order would apply with equal force to future platforms.192

The SEC instituted proceedings against Prosper under the Securities Act of 1933, which gives the SEC the authority to issue a cease and desist order upon violation of the Act.193 Prosper argued, to no avail, that its notes were not securities. Section 2(1) of the Securities Act of 1933 defines securities, and the definition includes an incredibly broad list of products.194 The SEC relied on two categories: investment contracts and notes.

The SEC determined that Prosper’s notes constituted “investment contract[s].” In SEC v. W.J. Howey Co., the Supreme Court defined an investment contract as “an investment of money in a common enterprise with profits to come solely from the efforts of others.”195 The SEC cited a variety of facts. First, lenders rely on Prosper to find, evaluate, aggregate, and service

184. Id.
186. Id.
187. Id.
188. Prosper Cease and Desist Order, supra note 15.
190. Verstein, supra note 18, at 521.
191. Id.
192. Smith, supra note 65, at 22.
195. 328 U.S. §§ 293, 301 (1946).
loans. Second, lenders and Prosper engage in a common enterprise because Prosper actively encourages lending and relies on subsequent fees to make a profit.

The SEC also found that Prosper’s notes are “notes” under the Securities Act. In Reves v. Ernst & Young, the Supreme Court held that notes are presumed securities unless exempted.\(^{196}\) It crafted a list of exempted notes,\(^{197}\) and it included anything bearing a “strong family resemblance” to explicitly exempted notes. The family resemblance test is based on: (1) the motivations of the buyer and seller, (2) the plan of distribution, (3) the reasonable expectations of the investing public, and (4) the existence of an alternative regulatory regime.\(^{198}\) The SEC concluded that Prosper notes are bought and sold with an eye toward profit, are broadly offered to the public, are marketed as an investment, and are not subject to “appropriate regulatory safeguards.”\(^{199}\) The SEC ordered Prosper to cease and desist from all violations of Sections 5(a) and 5(c) of the Act.\(^{200}\)

The SEC’s reasoning would seemingly embrace most possible P2P lending platforms. Prosper, along with other industry players, formed the Coalition for New Credit Models to lobby Congress.\(^{201}\) This coalition gained traction and nearly succeeded in exempting P2P lending from the Securities Act in Dodd-Frank.\(^{202}\)

C. Dodd-Frank and P2P Lending

Dodd-Frank addressed “person-to-person lending” by name,\(^{203}\) in addition to presumably subjecting it to CFPB jurisdiction. Representative Jackie Speier introduced an amendment to Dodd-Frank in the House.\(^{204}\) The amendment added P2P lending platforms to the list of exempted entities in Section 3(a) of the Securities Act.\(^{205}\) It exempted any consumer loan or any note “representing a whole or fractional interest in any such loan” funded or sold through a person-to-person lending platform.\(^{206}\) Consumer loans were defined as loans

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\(^{197}\) Id. at 65.  
\(^{198}\) Id. at 66-67.  
\(^{199}\) Prosper Cease and Desist Order, supra note 15, at 5.  
\(^{200}\) Id. at 6.  
\(^{201}\) Bruene, supra note 126.  
\(^{203}\) Dodd-Frank, § 989F.  
\(^{205}\) The section is comprised of a variety of exemptions to the Securities Act of 1933, 15 U.S.C. 77c(a), and Rep. Speier’s amendment would have simply added one for P2P lending platforms.  
\(^{206}\) Dodd-Frank, Pub. L. No. 111-203, § 4315(a) (as numbered and passed by House).
"made to a natural person, the proceeds of which are intended primarily for personal, family, educational, household, or business use." It also defined person-to-person lending platforms:

The term "person-to-person lending platform" means an Internet website, the primary purpose of which is to provide a transaction platform for the funding or sale of individual consumer loans, or the sale of notes representing whole or fractional interests in individual consumer loans, by matching natural persons who wish to obtain such loans with persons who wish to fund them, or by matching persons who wish to sell such loans or notes with persons who wish to purchase them.

The proposal took pains to exclude from exemption any platform that sold multiple loans in a single transaction. It also gave rulemaking and enforcement authority over P2P lending to the CFPB.

The Speier amendment passed in the House, but it floundered in the Senate conference without recorded debate. As a result, the final bill presumed continued SEC oversight. Dodd-Frank did commission a GAO report on P2P lending platforms. It also recognized two options for P2P lending: "maintaining the status quo or consolidating borrower and lender protections under a single federal regulator." Ultimately, however, the GAO report adopts a wait-and-see approach and offers no definite conclusions.

III. The Problems with SEC Regulation

SEC regulation devastated the P2P lending industry. It has pushed most players out of the market, and it ended market entry. In the words of Prosper's founder, "[w]hile the banking regulators have embraced and supported the industry, the securities regulators have nearly crippled it. And frankly, there should be ten companies up here today. Unfortunately, we're the only two companies [Prosper and Lending Club] that had the capital and the resources to survive the securities regulatory process."

In short, SEC regulation of P2P lending platforms effectively forces them to undergo an Initial Public Offer ("IPO") before opening for business. It imposes chronic regulatory costs on an industry focused on simplicity, and it

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207. Id.
208. Id.
209. Id.
210. Id. § 4313(b).
211. Id. § 989F(a)(1).
212. GAO REPORT, supra note 26, at cover page.
213. Id. at 1.
214. Id. at 53.
215. Smith, supra note 65, at 23.
216. California Hearings, supra note 17 (statement of Chris Larsen, Prosper CEO & Founder).
erected insurmountable barriers to market entry. Moreover, SEC regulation offers little protection for P2P consumers and, in fact, harms them.

A. Requirements of SEC Regulation

The Securities Act of 1933 makes it unlawful to sell securities without an approved registration statement and prospectus. Ongoing sales of securities require continually updated filings. SEC regulation emphasizes early, accurate, and up-to-date disclosure of the financial health of the entity selling securities.

The Securities Act demands 32 pieces of information in a registration statement. SEC rules require more. Collecting this information requires extensive research and expensive experts. Issuers must exhaustively describe and model almost every aspect of their business. When selling securities, registrants must also regularly update their prospectus, which requires most of the information required for registration.

If a filing misstates or omits a material fact, the seller of the securities faces legal liability. Any person who has acquired the security after the statement or omission may sue and potentially collect attorney’s fees. Personal liability extends to any signatory of the SEC filing, all company directors, all professionals who prepared the filing, and any underwriter of the securities.

B. The Impact of SEC Regulation on P2P Lending

The cost, complexity, and time involved in first-time SEC registration will not surprise anyone familiar with IPOs. Prosper and Lending Club, as web startups, were effectively forced to pay the costs of an IPO without any of the attendant capitalization benefits. The revenue from the sale of their notes goes
to borrowers, not the platforms. Moreover, they must now make continual disclosures to the SEC.

The IPO process is technical and expensive, and Prosper and Lending Club survived only with substantial venture capital funding. In 2008, the median offering size for an IPO was $120.5 million, and the median annual revenue of IPO companies was $87 million. The majority of IPO companies were profitable, and the vast majority of them were able to afford the services of a “Big 4” accounting firm. The median legal costs for an IPO were $1.2 million; the median accounting costs were $0.8 million; and the median total costs were $2.7 million.

The median time from filing to approval was 117 days. This does not reflect time spent preparing filings. The average time from initial equity investing by a venture capital or private equity firm to IPO was 7.2 years in 2007 and 8.3 years in 2008. This excludes the time before equity investing, when a company typically launches and attempts to prove the viability of its business model. Of course, a typical company operates and generates revenue as it passes these milestones, while a P2P lending platform must remain dormant during this time.

1. Barriers to P2P Lending Market Entry

Unlike Prosper and Lending Club, future P2P lending startups will not operate unregistered in a period of regulatory uncertainty. They will not demonstrate the viability of their platform and develop a user base before registration, which will make securing venture capital or private equity backing difficult. Moreover, unlike a typical IPO, there is no capital payout after a P2P lending platform registers. Venture capital and private equity firms rely in part on IPOs to generate liquidity for investors and to realize the value of their successful investments. P2P lending startups now represent all the downside and none of the upside of an IPO.

Even if a P2P lending startup somehow secures financing, registration will still pose obstacles. Registration statements require accounting for the last three

232. Id.
233. Id.
234. Id.
235. Id. at 4.
236. GAO REPORT, supra note 26, at 49 (noting industry observer concern about the plausibility of market entry).
237. Verstein, supra note 18, at 510 (noting that new platforms must remain “inert”).
238. WILMERHALE, supra note 231, at 5.
years of the company’s business. To the extent that a company has not been in business for three years, accounting must be made “for such time as the issuer has been in actual business, year by year.”240 By definition, unless a P2P lending startup has been violating securities laws, it has never been “in actual business.”

SEC intervention drove a variety of participants out of the market. As mentioned previously, Zopa left the U.S. market.241 Loanio, once a key competitor of Prosper and Lending Club, ceased operation after filing its registration statement in 2009.242 In short, only two platforms have survived SEC registration, and they did so under circumstances that no longer prevail.

2. Ongoing Costs for Existing P2P Lending Platforms

SEC disclosures impose significant costs on P2P lending platforms, costs usually faced by firms with tens of millions in revenue.243 Platforms must file supplements or an entirely new prospectus each time they change loan terms.244 In addition, they must report copious details of every loan listed or funded.245 Prosper, for its part, now makes more securities filings than nearly any other registered company,246 despite the fact that it is yet to turn a profit.

The ongoing compliance costs further inhibit innovation because they discourage existing market players from experimenting. Were Prosper or Lending Club to offer new products, fresh disclosures would be required, and just like initial registration, these filings would not correspond to fresh capital. Prosper once planned to offer an “open market loan” program. The program would have allowed sympathetic financial institutions, such as credit unions in underserved communities, to bring their loans to Prosper for lenders to bid on.247 After the SEC concluded that the credit unions would be co-issuers of asset-backed securities and have to register before listing their loans, Prosper abandoned the program.248 Given that SEC regulation now protects them from new competitors, Prosper and Lending Club have little incentive to incur the costs of innovation.

240. Id.
241. See sources cited supra note 27.
244. PROSPER PROSPECTUS May 2011, supra note 36, at ii.
245. PROSPER PROSPECTUS May 2011, supra note 36, at i.
247. See Smith, supra note 65, at 24; see also Verstein, supra note 18, at 511 (noting that “the SEC hampers the almost continual adjustment and experimentation that is vital to new businesses such as P2P platforms”).
248. Verstein, supra note 18, at 508-09.
249. Id.
The costs of SEC compliance for Prosper and Lending Club have been enormous relative to their revenues. As of 2010, Prosper spent over $5 million in direct SEC compliance costs.\(^\text{250}\) Lending Club spent roughly $3 million.\(^\text{251}\) The platforms have not published estimates of the losses during their quiet periods, though Lending Club was shut down for six months and Prosper was shut down for nine months.\(^\text{252}\) Both companies attribute their survival to millions of dollars in venture capital support.\(^\text{253}\) Both have large debt loads and have consistently posted losses.\(^\text{254}\) Each company’s prospectus devotes substantial language to the chronic burden of SEC compliance.\(^\text{255}\) Each highlights sizable expenditures for director insurance, accounting services, and legal services.\(^\text{256}\)

C. Ill Fit of SEC Regulation and the Need for Exemption

The ill fit of securities regulation for P2P lending goes beyond regulatory costs. It harms consumers. First, SEC intervention increased privacy risks to borrowers. All listings and sales of securities must be published in the SEC’s online EDGAR system.\(^\text{257}\) For P2P lending platforms, this means reporting all information connected with loan applications, including borrower narratives and credit data.\(^\text{258}\) Lending Club objected to publishing this information, and it received a terse rebuke from the SEC.\(^\text{259}\) The SEC’s basic perspective is as follows: if a platform gives lenders any shred of information, it must matter to lenders; if it matters to lenders, it must be material to their lending decision; and if it is material to the lending decision, it must be posted on the EDGAR system.\(^\text{260}\) Under this logic, the SEC now maintains a massive collection of


\(^{251}\) California Hearings, supra note 17, at 18 (statement of John Donovan, Lending Club COO).

\(^{252}\) Smith, supra note 65, at 23.

\(^{253}\) California Hearings, supra note 17, at 17 (statement of Chris Larsen, Prosper CEO & Founder).

\(^{254}\) LENDING CLUB PROSPECTUS June 2011, supra note 68, at 21; PROSPER PROSPECTUS May 2011, supra note 36, at 32.

\(^{255}\) LENDING CLUB PROSPECTUS June 2011, supra note 68, at 28; PROSPER PROSPECTUS May 2011, supra note 36, at 41.

\(^{256}\) LENDING CLUB PROSPECTUS June 2011, supra note 68, at 28; PROSPER PROSPECTUS May 2011, supra note 36, at 41.

\(^{257}\) See California Hearings, supra note 17, at 14 (statement of Chris Larsen, Prosper CEO & Founder).

\(^{258}\) Id.


\(^{260}\) See id.
borrower narratives about ailing parents, kitchen remodeling, and the like, which it shares—along with credit data—with the Internet.

Second, SEC intervention radically increased lenders’ risks in P2P platform insolvency. Prosper and Lending Club originally assigned the notes representing borrowers’ loans to lenders.²⁶¹ Lenders had direct rights to borrower payments and were not exposed to credit risk from P2P platforms themselves.²⁶² Unfortunately, platforms must use shelf registration under Securities Act Rule 415 to make SEC registration viable.²⁶³ Shelf registration permits issuers to register series of securities in advance of sales and take them “off the shelf” as needed.²⁶⁴ Platforms register large groups of notes at one time, which makes registering a $1,000 loan economically tenable.²⁶⁵ Under Rule 415, the platforms must be the sole issuer of the notes,²⁶⁶ which spawned the borrower dependent note model.²⁶⁷ Further, when Prosper attempted to give the indenture trustee—Wells Fargo—a security interest in loan payments to indirectly protect lenders, the SEC balked.²⁶⁸ Even an indirect security interest could not be squared with the sole issuer requirement,²⁶⁹ and Prosper gave up all efforts to grant lenders a security interest in borrower payments.²⁷⁰ As mentioned previously, Lending Club now goes a step further and grants outside creditors senior secured interests in the loan payment streams.

Beyond direct harm to consumers, SEC regulation simply makes little sense in the P2P lending context. First, as Lending Club and Prosper issue the borrower payment dependent notes, they are liable for material misstatements in connection with the sale of those securities. In theory, if a borrower lies and the loan is funded, the platforms commit securities fraud. Prosper believes it has adequately disclaimed liability for inaccurate borrower postings,²⁷¹ but it notes that a court or the SEC might see things differently, giving a lender the right to rescind the loan and sue Prosper.²⁷²

Second, securities regulation does nothing to improve transparency for P2P lenders.²⁷³ There are no formatting or clarity requirements for advertised rates. Firms need only disclose their computational methods in filings,²⁷⁴ which common law fraud likely already compels. Industry observers expressed

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²⁶¹ See Verstein, supra note 18, at 489.
²⁶² See id.
²⁶³ See id.
²⁶⁴ See id.
²⁶⁵ See id. at 489-90.
²⁶⁶ See, e.g., id. at 491.
²⁶⁷ Id.
²⁶⁸ Id. at 492.
²⁶⁹ Id.
²⁷⁰ Id. at 493.
²⁷¹ See PROSPER PROSPECTUS May 2011, supra note 36, at 69.
²⁷² Id.
²⁷³ See Verstein, supra note 18, at 504.
²⁷⁴ See id. at 503.

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concern to the GAO that the SEC’s disclosure-based approach leaves lenders unable to compare rates across P2P platforms.\(^{275}\) The SEC countered, in essence, that crafting a rule affecting only two registered companies was not worth the time.\(^{276}\)

Finally, SEC filings are not useful to lenders. SEC staff and industry leaders agreed that lenders are unlikely to consult filings.\(^{277}\) The filings are enormously dense and detailed, and the same information is available in real-time on the P2P lending sites.\(^{278}\) Of course, lenders could use filings in litigation to demonstrate that platforms omitted material information when selling notes.\(^{279}\) However, private enforcement is a difficult model for P2P lending regulation because lenders are unlikely to file federal securities claims over loans with a maximum value of $25,000.\(^{280}\) In sum, SEC regulation of P2P lending platforms hurts consumers and harms the industry with little countervailing benefit, and P2P lending should be exempted from SEC regulation.

**D. Crafting an Exemption from SEC Jurisdiction**

The Speier amendment provides a template for exempting P2P lending from federal securities law. It exempted consumer loans, as well as notes representing a whole or fractional interest in those loans, that originate on P2P lending platforms.\(^{281}\) This permits the borrower payment dependent note model, but it would also permit a platform to give lenders direct security interests in notes. The Speier amendment also limited its exemption to loans to natural persons primarily for family or household use.\(^{282}\) This prevents platforms from becoming a haven for complicated personal or corporate transactions beyond the reach of securities law. The Speier amendment also only exempts the sale and resale of individual notes.\(^{283}\) This permits P2P platforms to operate simple note resale markets without SEC registration, but it preserves SEC regulation of securitized groups of loans.

The Speier amendment protects the core of online P2P lending without writing a blank deregulatory check. WebBank and its relationships with platforms would remain FDIC regulated. Lending Club would still need to be SEC registered to offer prepackaged groups of loans. Its subsidiary would still need to be a registered investment advisor to manage lenders’ accounts for fees.

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275. See GAO REPORT, supra note 26, at 47.
276. Id.
277. Id. at 49.
278. Id. at 26.
279. Id.
280. See Verstein, supra note 18, at 504-06.
281. Dodd-Frank, § 4315(a).
282. Id.
283. Id.
Lending Club would still need to partner with a regulated entity to offer IRAs. However, a simple upstart P2P lending platform would not need to register with the SEC before it originated its first loan.

Admittedly, the Speier amendment does not exempt P2P lending from state securities regulation, which might mitigate its benefits. However, an exemption from state securities regulation for web startups is not implausible. The recently passed Jumpstart Our Business Startup Act ("JOBS Act"), which pertains to online crowdfunding of new businesses in exchange for equity, included an exemption from state securities regulation as passed in the House.

Moreover, exemption from state securities regulation is not essential. Prosper and Lending Club successfully employed a piecemeal approach to state-level securities registration, slowly bringing their services to successive markets. While state-level regulation may thwart instantaneous entry into the nationwide P2P lending market, P2P lending startups could launch in individual states, build a customer base, and only accrue additional regulatory burdens as they collect revenues. The only truly essential exemption for P2P lending platforms is an exemption from federal securities regulation.

IV. The Consumer Financial Protection Bureau’s Role

The CFPB, minted by Dodd-Frank, has significant powers that it should use to protect both P2P lending platforms and their customers. Dodd-Frank transferred rulemaking and enforcement authority under the "enumerated consumer laws" to the CFPB. These laws include, among others, the Truth in Lending Act, Equal Credit Opportunity Act, and Fair Debt Collection Practices Act. The CFPB should rationalize the application and enforcement of these statutes in the P2P lending context. Moreover, the CFPB may, with some caveats, regulate unfair, deceptive, or abusive practices in any industry that provides consumer financial products. It should use this power to create tailored regulations of P2P lending platforms that address the unique risks they pose to consumers. This two-pronged approach need not be restricted to P2P lending. The CFPB can employ similar strategies to rationalize regulation of both traditional and innovative financial service providers while offering consumers additional protection.

284. GAO REPORT, supra note 26, at 54.
286. Like the Speier amendment, this exemption did not survive the Senate.
287. See, e.g., Legal Compliance, PROSPER, supra note 52.
288. Dodd-Frank, §§ 1001-1100H.
289. Id. § 1002(12).
290. Id. § 1031.
A. The CFPB’s Broad Powers

The CFPB possesses three broad powers relevant to the P2P lending context. First, Dodd-Frank summarily transferred substantive rulemaking authority under the federal consumer financial protection laws to the CFPB. Where the CFPB and another agency apparently possess rulemaking authority under a consumer financial law, the CFPB has exclusive rulemaking power. The CFPB must consult with prudential regulators like the FDIC when issuing its rules, but it is free to ignore their objections. Moreover, the CFPB may exempt entities from its rules, taking into account the entity’s total assets, its volume of transactions, and the extent to which consumers have alternative protections.

Second, Dodd-Frank also summarily transferred enforcement authority under the consumer financial protections laws to the CFPB. This authority was previously vested in a remarkable range of agencies from the FDIC to the Department of Transportation. While Dodd-Frank retains elements of this approach, it generally gives the CFPB enforcement powers under federal consumer protection statutes. The key wrinkle is that the CFPB’s enforcement authority differs with regard to nondepository, very large depository, and other depository institutions.

With regard to nondepository institutions in consumer financial transactions, Dodd-Frank grants the CFPB exclusive enforcement authority. An entity may be defined as a “nondepository institution” in a financial transaction via three paths. First, Dodd-Frank explicitly includes payday lenders, consumer education lenders, and any entity that brokers, services, or originates consumer loans secured by real property. Second, nondepository institutions include any entity that “is a larger participant of a market for other consumer financial products or services, as defined by rule...” The CFPB has begun to issue rules defining “larger participant” in a piecemeal fashion. Finally, nondepository institutions include any person that the CFPB has “reasonable cause to determine... is engaging, or has engaged, in conduct that

292. Id. § 1024(d).
293. Id. § 1022(b)(2)(B)-&C).
294. Id. § 1022(b)(3)(A)-(B).
295. Id. § 1021(b)(4).
296. See, e.g., 15 U.S.C. § 1607(c) (prior to currently uncodified amendments by Dodd-Frank).
297. Dodd-Frank, § 1021(b)(4).
298. Id. § 1024(c)(1).
299. Id. § 1024(a)(1).
300. Id. § 1024(a)(1)(B).
301. See, e.g., Defining Larger Participants of the Consumer Reporting Market, 12 C.F.R. § 1090 (2012).
poses risks to consumers with regard to financial transactions.\textsuperscript{302} Moreover, service providers to any of these nondepository institutions are also subject to CFPB jurisdiction.\textsuperscript{303}

With regard to depository institutions, CFPB enforcement authority is more complicated. It depends on whether or not the institution is “very large.” Dodd-Frank defines “very large” banks, savings associations, and credit unions as both insured depository institutions and credit unions that have total assets greater than $10 billion.\textsuperscript{304} For those entities, the CFPB has primary enforcement authority,\textsuperscript{305} including over their service providers.\textsuperscript{306} For depository institutions that are not “very large,” however, the relevant prudential regulator—e.g., the FDIC or National Credit Union Administration—has exclusive enforcement authority.\textsuperscript{307} Moreover, only service providers to “a substantial number” of small depository institutions are automatically subject to CFPB enforcement authority.\textsuperscript{308}

Third, the CFPB also has broad authority to regulate participants in consumer financial transactions beyond existing consumer financial protection statutes. These transactions include, among other things, “extending credit and servicing loans.”\textsuperscript{309} Potentially regulated entities include “any person that engages in offering or providing a consumer financial product or service” or any affiliate of such a person.\textsuperscript{310} Affiliates include “service providers” that “provide[] a material service to a covered person in connection with the offering or provision by such covered person of a consumer financial product or service.”\textsuperscript{311} In sum, the CFPB possesses broad discretion over which financial entities it will regulate and how it will regulate them.

\textbf{B. The CFPB’s Jurisdiction Over P2P Lending Platforms}

The best approach would be for Congress to grant exclusive jurisdiction over P2P lending to the CFPB, but the CFPB already has a number of jurisdictional hooks for existing platforms. Significantly, those jurisdictional hooks would permit it to regulate many potential P2P lending platform models, allowing it to bring present and future platforms under one regulatory roof.

\begin{itemize}
\item[302.] \textit{Id.} \$ 1024(a)(1)(C).
\item[303.] \textit{Id.} \$ 1024(e).
\item[304.] \textit{Id.} \$ 1025(a).
\item[305.] Dodd-Frank, \$ 1025(c)(1). Other agencies may recommend an enforcement action to the CFPB, \textit{id.} \$ 1025(c)(2), and may pursue it themselves if the CFPB does not act within 120 days, \textit{id.} \$ 1025(c)(3).
\item[306.] \textit{Id.} \$ 1025(d).
\item[307.] \textit{Id.} \$ 1026(d)(1).
\item[308.] \textit{Id.} \$ 1026(e).
\item[309.] \textit{Id.} \$ 1002(15)(A)(i).
\item[310.] \textit{Id.} \$ 1002(6)(A)-(B).
\item[311.] \textit{Id.} \$ 1002(26)(A).
\end{itemize}
Some opportunities for regulatory arbitrage would remain, but the CFPB could eliminate them by coordinating with other agencies.

First, a P2P lending platform could come under the CFPB’s jurisdiction over nondepository institutions that issue education loans, payday loans, or loans secured by real property. If the platform issued the loans itself, it would explicitly fall under the CFPB’s jurisdiction. If the platform instead relied on another nondepository entity to issue the loan, the platform would likely qualify as service provider to that entity and still fall under the CFPB’s jurisdiction. If the platform relied on a depository institution that was not “very large” to execute the loans, however, complications could arise. The CFPB would need to coordinate with the institution’s prudential regulator to ensure uniform application and enforcement of regulations.

Second, P2P lending platforms could fall under the CFPB’s jurisdiction as nondepository “larger participant[s]” in a financial services market. The CFPB’s early articulations of the term “larger participant” have set a threshold based on an entity’s total revenues from a given market. If a P2P platform generated sufficient revenue to be a larger participant in or provided services to a larger participant in a relevant market, it would be subject to CFPB jurisdiction. However, use of this jurisdictional grant could create loopholes that allowed smaller P2P lending platforms or platforms that do not partner with very large depository institutions to operate under different rules.

Finally, the CFPB has catchall jurisdiction to regulate any entity that the CFPB has “reasonable cause to determine” poses a risk to consumers in financial transactions. This jurisdictional grant could allow the CFPB to uniformly regulate P2P lending platforms, regardless of their particular business models. Though the CFPB would not be able to exert jurisdiction over some depository institutions partnered with P2P lending platforms, the CFPB could exert jurisdiction over the platforms themselves. It could also coordinate with the depository institutions’ prudential regulators to ensure uniform application and enforcement of regulations.

312. Id. § 1024(a)(1).
313. Id. § 1024(e).
314. Id. § 1024(a)(1)(B).
316. Dodd-Frank, § 1024(e).
317. Id. § 1024(a)(1)(C).
318. Id. § 1024(e).
C. Reconciling Federal Consumer Financial Law with P2P Lending

The CFPB's broad jurisdiction, coupled with its rulemaking and enforcement authority, equip it to rationalize application of consumer financial protection laws to P2P lending. Nearly all of these laws were drafted before P2P lending platforms existed. As a result, applying them to the platforms often proves tricky. Indeed, both Prosper and Lending Club admit, regarding a host of federal consumer financial protection laws: "We may not always have been, and may not always be, in compliance with these laws." Prosper further explains: "The novelty of our platform means compliance with various aspects of such laws is untested." The CFPB can and should resolve these uncertainties to facilitate innovation, market entry, and compliance, particularly with regard to the Truth in Lending Act, Equal Credit Opportunity Act, and Fair Debt Collection Practices Act.

1. The Truth in Lending Act

The Truth in Lending Act ("TILA") aims to increase the "informed use of credit" and to "protect the consumer against inaccurate and unfair credit billing and credit card practices." Dodd-Frank grants TILA rulemaking authority to the CFPB, as well as most TILA enforcement authority. The FTC does retain coordinated enforcement powers, and prudential regulators retain exclusive enforcement jurisdiction for smaller depository institutions.

In substance, TILA creates obligations for creditors in consumer transactions. Regulation Z further defines these obligations. Under TILA, a "creditor" is an entity that both "regularly extends . . . consumer credit" and "is the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness . . . ." Under Regulation Z, an entity "regularly extends" credit if it did so more than 25 times in the preceding year.

319. This Note does not address tax treatment of P2P lending platforms. For now, it appears that both Prosper and Lending Club intend to treat their notes as their own indebtedness under original issue discount rules, but both note that the "matter is not free from doubt." LENDING CLUB PROSPECTUS June 2011, supra note 68, at 4; PROSPER PROSPECTUS May 2011, supra note 36, at 6.


322. Truth in Lending, § 1601(a).

323. Truth in Lending, § 1100A.

324. Truth in Lending, § 1602(f).

325. Truth in Lending, § 1602(f).

TILA defines "consumer" only by implication in its definition of "consumer credit transaction." "Consumer" limits the statute's application to transactions in which "the party to whom credit is offered or extended is a natural person, and the money, property, or services which are the subject of the transaction are primarily for personal, family, or household purposes." This language unquestionably applies to Prosper and Lending Club loans and would apply to loans from similar potential platforms.

TILA imposes a number of regulatory duties on covered creditors, including duties to: disclose any finance charge, report interest rates as annual percentage rates, identify the creditor, list the amount financed, enumerate the payment schedule, describe late fees, and suggest that the consumer consult a tax adviser. The disclosures must be made "before consummation of the transaction." The CFPB will publish sample disclosure forms as safe harbors. To the extent that the disclosures "complicate, hinder, or make more expensive the credit process for the class of transactions," the CFPB may exempt the class.

TILA's definition of a creditor applies awkwardly to P2P lending. Under TILA, a "creditor" is any person who regularly extends credit and to whom debt is initially payable. In the case of Prosper and Lending Club, the loan is initially payable to WebBank, which makes WebBank the TILA creditor. As WebBank is a depository institution with under $10 billion in assets, the FDIC enforces TILA against it.

This creates uncertainty unless the CFPB and FDIC craft uniform policy. WebBank claims that Prosper and Lending Club are responsible for making TILA disclosures on its behalf. WebBank also makes its own TILA

330. Truth in Lending, § 1602(h).
331. Id. § 1605(a).
332. Id. § 1606(a).
333. Id. § 1638(a).
334. Id.
335. Id.
336. Id.
337. Id.
338. 12 C.F.R. § 226.17(b) (2012).
340. Id. § 1605(f).
341. Id. § 1602(f).
344. Truth in Lending, § 1607.
345. GAO REPORT, supra note 26, at 32.

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disclosures at the time it executes loans. However, if a P2P lending platform failed to make disclosures and the borrower balked at the omission, the legal rights and responsibilities between the platform, bank, and lenders would be unclear.

Moreover, if both a platform and a depository institution fail to make TILA disclosures and a loan issues, the various parties’ legal rights are anything but clear. Borrowers could sue the depository institution for failing to make mandated disclosures about the loan; lenders could sue the platform because the platform’s omission rendered the loan uncollectable; and the platform, the depository institution, or both could pursue contractual claims against each other. If borrowers can claim to be third-party beneficiaries of the platform’s contractual obligation to provide necessary disclosures or if lenders can claim to be third-party beneficiaries of the depository institution’s contractual obligation to properly execute the loan, the web becomes even more tangled.

Innovative P2P lending platform models could also create complications under TILA. First, if a platform executes the loan itself, as Prosper and Lending Club once did, the P2P lending platform will be the TILA creditor and outside FDIC jurisdiction. Unless the CFPB takes on enforcement of TILA in the P2P lending context, this creates a forum-shopping opportunity for P2P lending platforms. Second, it is possible to imagine a P2P lending platform that did not extend credit to borrowers but instead simply matched borrowers and lenders, provided form contracts, and collected registration or servicing fees. In that case, the P2P lender may directly extend credit to the P2P borrower, and unless the individual lender did so 25 or more times in the preceding year, no party to the transaction would be a TILA creditor. The P2P platform would thus be free to promote loans unencumbered by TILA’s constraints.

The CFPB can rationalize the application of TILA to P2P lending. In coordination with the FDIC, it can clarify how TILA will be enforced where a P2P lending platform or depository institution (or both) fail to make TILA disclosures. In connection with its broader powers to combat unfair or deceptive practices by financial service providers, it could create clear legal rights for lenders whose loans become uncollectable because of TILA violations. Finally, it can use TILA rulemaking or its independent regulatory authority to ensure that P2P lending platforms cannot evade consumer protection regulation entirely by tinkering with their business models.

353. GAO REPORT, supra note 26, at 43
349. Dodd-Frank, § 1031(a)-(b).
2. The Equal Credit Opportunity Act

The Equal Credit Opportunity Act ("ECOA") makes it "unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction" on the basis of race, gender, national origin, public assistance income, the exercise of ECOA rights, and other factors. Rulemaking and enforcement authority for ECOA is allocated just as it is for TILA.

ECOA imposes obligations on all "creditors" with respect to "applicants." ECOA defines a creditor as any person "who regularly extends, renews, or continues credit; any person who regularly arranges for the extension, renewal, or continuation of credit; or any assignee of an original creditor who participates in the decision to extend, renew, or continue credit." The term "applicant" refers to "any person who applies to a creditor directly for an extension, renewal, or continuation of credit."

ECOA requires creditors to disclose certain information to applicants. A creditor must notify the applicant of any action on the application. If the creditor takes an "adverse action" on the application—including a refusal to grant credit—the creditor must provide written justification. The statement must give specific reasons for the adverse action. Under ECOA Regulation B, indications that the action was made "on the creditor's internal standards or policies or that the applicant ... failed to achieve a qualifying score on the creditor's credit scoring system are insufficient." Where the application for credit is channeled through a third party, "the notification and statement of reasons required by this subsection may be made directly by such creditor, or indirectly through the third party, provided in either case that the identity of the creditor is disclosed." ECOA creates a private right of action for any applicant discriminated against for membership in a protected class.

ECOA defines creditors more expansively than TILA. Under ECOA, creditors include assignees that "participate[] in the decision to extend, renew, or continue credit" and entities that refer consumers to creditors.
Lending Club, and WebBank, as well as most imaginable P2P platforms, are ECOA creditors. As ECOA assigns enforcement authority in the same fashion as TILA, CFPB and FDIC cooperation is similarly essential to ensure that P2P lending platforms and their partner depository institutions can achieve ECOA compliance under the same standards.

More significantly, ECOA creditors’ obligation to furnish reasons for adverse lending decisions becomes confused in the P2P lending context. Prosper, Lending Club, and WebBank obviously “regularly arrange[] for the extension . . . of credit” or “regularly extend[] . . . credit,” but all three abdicate the decision to fund a loan to disparate consumers who are not ECOA creditors. This has significant implications for ECOA compliance. Either the P2P platform or its partner depository institution must provide spurned borrowers reasons for an “adverse action”—i.e., the failure of a loan to fund. Moreover, communicating “P2P lending platform members decided not to fund you” almost certainly does not comply with ECOA.364 In fact, it is not clear that any entity could provide specific reasons for adverse credit decisions on P2P lending platforms. The platforms aggregate the decisions of many different lenders to fund or not fund a loan. Prosper lenders must represent that they have “not made a decision in connection with any loan requests on our platform on any prohibited basis set forth in the Equal Credit Opportunity Act and Regulation B.”365 However, extracting a promise from lenders not to discriminate does not amount to providing detailed reasons for a loan’s failure to fund.

Finally, ECOA creates a private right of action against ECOA creditors. Barring rules from the CFPB, Prosper, Lending Club, or WebBank could find itself in court explaining the decisions of the many lenders that passed on a loan.366 Though research on P2P lending platforms suggests that African Americans are less discriminated against than in traditional lending markets, African Americans are still significantly less likely to receive funding than other racial groups.367 How WebBank or a P2P lending platform would defend an ECOA claim is unclear.

The CFPB should rationalize application of ECOA to the P2P lending market. At a minimum, it should coordinate with the FDIC to ensure uniform enforcement for small banks and partner platforms. More importantly, ECOA aims to protect individuals who have historically been discriminated against in consumer credit markets,368 and there is evidence that P2P lending platforms are more congenial to these borrowers than institutional lenders.369 However,

365. PROSPER PROSPECTUS May 2011, supra note 36, at 85.
the nature of P2P lending makes it impossible to distill hundreds of P2P lenders' decisions into a statement of why a loan failed to fund. Hence, the CFPB should explore how Regulation B might be amended to permit P2P lending platforms to comply with ECOA while still offering safeguards against discrimination.

3. The Fair Debt Collection Practices Act

The Fair Debt Collection Practices Act ("FDCPA")\(^370\) aims to "eliminate abusive debt collection practices by debt collectors."\(^371\) Previously, the FDCPA differed from other federal consumer protection laws because it did not permit substantive rulemaking. Specifically, relevant agencies could not "promulgate trade regulation rules or other regulations with respect to the collection of debts by debt collectors as defined in this title."\(^372\) Dodd-Frank amends the FDCPA to permit the CFPB to "prescribe rules with respect to the collection of debts by debt collectors" but only as debt collectors are defined by the FDCPA.\(^373\) It also transfers FDCPA enforcement authority to the CFPB.\(^374\)

The FDCPA regulates the interactions between "natural person[s] obligated or allegedly obligated to pay any debt"\(^375\)—and "debt collectors." Debt collectors are defined as any entity "who uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the collection of any debts, or who regularly collects or attempts to collect, directly or indirectly, debts owed or due or asserted to be owed or due another."\(^376\) Creditors are defined as any entity "who offers or extends credit creating a debt or to whom a debt is owed," but creditors have few obligations.\(^377\) For example, officers and employees of creditors who attempt to collect on debt are exempted from the FDCPA's restrictions.\(^378\)

In the course of interacting with consumers, debt collectors assume certain obligations. They must not actively inform third parties that they are collecting a consumer's debt, harass consumers, or generally engage in other unsavory practices.\(^379\) They must also investigate timely assertions by consumers that the debt is invalid and cease collecting while they investigate.\(^380\)

\(^371\) Id. § 1692.
\(^372\) Id. § 1692(d).
\(^373\) Dodd-Frank, § 1089.
\(^374\) Id.
\(^375\) 15 U.S.C. § 1692a(3).
\(^376\) Id. § 1692a(6).
\(^377\) Id. § 1692a(4).
\(^378\) Id. § 1692a(6)(A).
\(^379\) Id. § 1692b-f.
\(^380\) Id. § 1692g-h.
In some sense, the model in which platforms contract with depository institutions to execute loans, purchase the loans with P2P lenders’ funds, and then issue a borrower payment dependent note defeats the intent of the FDCPA. When Prosper and Lending Club pursue collection efforts in house, they function much like traditional debt collectors. They contact borrowers and attempt to collect on debts. If they are successful, they remit the payments to a third party—the P2P lenders. They are incentivized by commissions on the debt they collect, along with a desire to retain the customers for whom they collect debt. However, because P2P lending platforms employ the borrower payment dependent note model, they are technically the ones “to whom a debt is owed,” and the officers and employees of the platform are likely exempt from the FDCPA’s borrower protections.

In practice, Prosper and Lending Club simply contact borrowers to see if they can resolve the issue without referring it to professional debt collectors, but that is not the only possible model. There may be significant incentives for startup P2P lending platforms to engage in questionable collection practices. Lending Club gained market share in part by screening for high quality borrowers who were more likely to pay off their obligations. A P2P lending platform startup could accomplish a similar result with highly effective in-house debt collection, and if it used the borrower payment dependent note model, it would be exempt from FDCPA restrictions.

The CFPB’s rulemaking authority under the FDCPA is limited. It can prescribe rules regarding the collection of debts by debt collectors, but it cannot expand the definition of debt collectors in the statute. That definition clearly excludes any P2P lending platform that adopts the prevailing business model. However, under its broad authority to prevent unfair, deceptive, and abusive acts by financial service providers, the CFPB could craft standards that would provide the same or similar protections to P2P platform borrowers as those offered by the FDCPA.

D. CFPB Regulation of P2P Lending Beyond Consumer Financial Law

Congress equipped the CFPB to regulate the evolving P2P lending industry beyond existing consumer protection statutes. First, unlike the SEC,
primary purpose is to protect consumers. The CFPB has relevant operating units. It has a research unit focused on “market areas of alternative consumer financial products or services with high growth rates” and “access to fair and affordable credit for traditionally underserved communities.”

Third, Dodd-Frank gives the CFPB the necessary regulatory authority to address a fluid industry. It has highly flexible powers to issue rules preventing financial service providers from “committing or engaging in an unfair, deceptive, or abusive act.” Finally, under its enforcement powers, it can monitor service providers, issue subpoenas, adjudicate some violations, and litigate others.

In short, the CFPB can be an alert, potent, and responsive regulator for P2P lending platforms and consumers. It can repair disconnects in the regulation of P2P lending, and it can ferret out and remedy problems as they emerge. Prosper and Lending Club have been fairly scrupulous in their interactions with consumers, but P2P lending constantly changes. If the industry is exempted from federal securities regulation, these challenges will increase tenfold. Had the SEC not quashed P2P lending market entry and forced the convergence of Prosper’s and Lending Club’s models, P2P lending platforms would today be far more numerous and diverse. However, even today, P2P lending presents regulatory concerns that the CFPB could consider addressing.

First, the CFPB could set standards for P2P lending platforms’ advertised rates of return. There is no single right way to calculate expected returns based on prior loan performance. Some variation in rate reporting makes sense. However, the CFPB need not impose strict formulas on P2P lending platforms to protect lenders. The CFPB could craft standards that delineate what constitutes legitimate variation in analysis and what constitutes an unfair or deceptive practice.

Second, the CFPB could impose a minimum standard of care on P2P lending platforms for the information in loan applications. Borrowers will lie, and P2P lending platforms cannot plausibly verify all self-reported information in borrower narratives. However, there is little reason to allow P2P lending platforms to disclaim responsibility for all information on their sites, including information they claim to validate with credit reports. Moreover, all P2P lending platforms should be required to accept an obligation to repurchase loans that are uncollectable due to identity theft, as Prosper and Lending Club do. Platforms hide the identities of borrowers from lenders, and lenders must
Square Pegs

depend on platforms to ensure, at a minimum, that the posted credit data corresponds to the individual receiving the loan.

Third, the CFPB could adopt rules to protect lenders in the event of P2P platform dissolution. The CFPB could require P2P lending platforms to make arrangements with third parties to service loans upon their insolvency, as Prosper and Lending Club have, or it could mandate conspicuous warnings where platforms make no such arrangements. It could also require that P2P platforms grant some form of security interest to lenders in the underlying loans, prohibit platforms from granting senior security interests to other creditors, or simply require aggressive disclosures that lenders effectively become creditors of web startups absent such protections.

Finally, the CFPB can monitor P2P lending platforms and address additional problems as they mature. The CFPB’s complaints unit allows consumers to submit concerns about financial service providers online, and the CFPB anticipates collecting submissions regarding P2P lending platforms. If a P2P lending platform began to sell nonpublic borrower information to third parties, for example, the CFPB would likely be among the first to hear about it. If necessary, it could then address the complaints with either rulemaking or existing statutes that govern the use of financial data.

V. Conclusion

The experiences of P2P lending platforms lay bare a few realities of financial regulation in the United States. First, balkanized regulation imposes an enormous burden on financial firms. It creates significant compliance costs; it forces them to operate under regulatory uncertainty; and it exposes them to the risk that competitors will gain an advantage through forum-shopping and regulatory arbitrage. Moreover, these burdens weigh heaviest on innovative financial firms in novel spaces, which are precisely the firms that fill the gaps left by traditional financial institutions. No one wants to start a business only to write a prospectus that lists four federal statutes followed by "we may not always have been, and may not always be, in compliance with these laws."

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397. CALIFORNIA SENATE BACKGROUNDER, supra note 25, at 24. Both platforms note that transfer of loan-servicing to the third parties might create delay or additional fees that would reduce the amount lenders recover. LENDING CLUB PROSPECTUS June 2011, supra note 68, at 24; PROSPER PROSPECTUS May 2011, supra note 36, at 35.


399. GAO REPORT, supra note 26, at 37.

400. For example, CFPB, FDIC, and Federal Reserve staff indicated to the GAO that the Gramm-Leach-Bliley Financial Modernization Act, Pub.L. 106-102, 113 Stat. 1338 (1999), which restricts the sharing of nonpublic personal information by financial institutions, might be used to address some potential P2P borrower privacy issues. GAO REPORT, supra note 26, at 67.

401. LENDING CLUB, PROSPECTUS FOR REGISTRATION STATEMENT No. 333-151827, at 28 (July 31, 2012).
Second, with regard to financial innovation, federal securities regulation has all the finesse and flexibility of a jackhammer. It is geared toward the needs of investors in complex financial instruments and major corporations, and the SEC correctly sees those investors' needs as its central purpose. When it comes to innovations like P2P lending and crowdfunding, however, rote application of extant securities law simply fails, and the SEC admits that tailoring securities law to web startups is not on its agenda.402

Two solutions to this problem have gained congressional traction. Under one approach, taken by the JOBS Act with regard to crowdfunding, Congress forces the SEC to issue congenial regulations for innovative businesses.403 The SEC then delays through repeated deadlines, and the Chairwoman is summoned before Congress to be accused of “abdicating [her] responsibility to follow the law” by a Member of the House.404 Under another approach, taken by the Speier amendment, Congress leaves the SEC to fulfill its primary purpose, exempts the innovative industry from securities regulation, and searches for or creates another competent regulator. Neither approach is perfect, but both offer advantages over regulation-driven path dependency in financial services.

Finally, failure to clarify and rationalize financial regulation hurts consumers. It imposes unnecessary and significant compliance costs on financial firms that ultimately pass through to lenders, borrowers, and investors. It also creates barriers to entry and innovation. Consumers cannot benefit from enhanced competition if regulations make it implausible to launch a new firm. They also cannot benefit from innovation without market entrants or at least the threat of market entrants.

The Consumer Financial Protection Bureau has the potential to address these issues. Public debates about the CFPB rapidly devolve into the divide between those who think it will “battle exploitive and deceptive financial practices” as part of a “Wall Street overhaul”405 and those who think its director is a “radical” “anti-business zealot,” certain to continue the CFPB’s “wasteful practices . . . as it assumes unprecedented authority over the activities of the private sector.”406 Both sides fail, or perhaps just refuse, to recognize the CFPB’s potential for financial firms.

402. GAO REPORT, supra note 26, at 47.
First, the CFPB can simplify the quagmire of consumer financial protection law. The CFPB combines rulemaking and enforcement authority under consumer financial protection statutes across many different types of financial institutions. It can clarify laws, grant exemptions, and create safe harbors as easily as it can impose new regulation, which means it can substantially reduce uncertainty and compliance costs for financial firms. Moreover, its breadth of jurisdiction allows it to protect financial firms from competitors that engage in forum-shopping or regulatory arbitrage.

Second, the CFPB can promote innovation by both established players and new firms. Fostering new sources of credit is part of its mandate.407 Firms offering new financial products or services now face significantly less risk of being caught between two regulators. The CFPB’s large and flexible jurisdictional grants allow it to adapt its authority for firms with no clear home in the existing regulatory framework. In short, the CFPB can create space for new industries, like P2P lending, that are faltering under regulations designed for fundamentally different institutions.

Admittedly, the CFPB will fulfill its potential to help financial firms only if the agency recognizes and explores it. It may now be difficult to imagine the CFPB outside the context of the Great Recession, President Obama’s ideological leanings, and Elizabeth Warren’s avowedly populist campaign for the Senate.408 Those things, however, are not in Dodd-Frank. The Bureau was created to wield consolidated authority over federal consumer financial protection for both consumers and the financial firms that serve them. That capacity can and probably will affect financial institutions differently depending on market circumstances and political conditions. Firms that come to recognize the CFPB’s potential and work with it, however, stand an excellent chance of reducing their regulatory burdens and bringing innovative products to market.
