THE FRONTIERS OF PEER-TO-PEER LENDING: THINKING ABOUT A NEW REGULATORY APPROACH

WILLIAM S. WARREN[†]

ABSTRACT

The growth of online alternative lending presents several advantages for both those seeking credit and those with excess capital to lend. Over the past decade, several different models of peer-to-peer lending have emerged in the US and U.K. Each of these models has developed in response to the different regulatory system it faces, which has led to the models' different risk and reward profiles. However, the current regulatory framework for regulating peer-to-peer lending, especially in the U.S., leaves much to be desired. The inadequate regulatory regime not only hampers the potential for growth and further innovation in the industry, but also creates risks for consumers, lenders, and, as the sector grows, entire markets. There is no clear or easy answer as to the optimal regulatory regime, but regulators should at least consider the basic functions of peer-to-peer lending and how to address risks with a more comprehensive and sensible model for regulation.

INTRODUCTION

Peer-to-peer lending has existed in many formats and many cultures[1] for some time. Today, potential borrowers can go on websites like Prosper.com or LendingClub.com and input their financial information. Then, these sites filter that information through a proprietary formula for assessing creditworthiness before anonymously advertising the information to potential lenders who wish to fund that consumer's loan.[2] The rise of the internet has created huge potential for the

---

[†] Duke University School of Law, *Juris Doctor* 2016. Special thanks to Professor Steven L. Schwarcz for his guidance and advice. This paper owes a debt to his work on *Regulating Financial Change: A Functional Approach* (August 8, 2014), http://ssrn.com/abstract=2469467.

[1] *See, e.g.*, Eric C. Chaffee & Geoffrey C. Rapp, *Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry*, 69 WASH. & LEE L. REV. 485, 497 (2012) (discussing the existence of informal peer-to-peer lending networks within Chinese, Mexican, and Korean communities in the U.S. and abroad).

[2] *See How It Works*, PROSPER, https://www.prosper.com (last visited Apr. 14, 2015); *How Does an Online Credit Marketplace Work*, LENDING CLUB,

disintermediation of financial services.[3] Just as Web 1.0 websites such as eBay.com allowed the buyers and sellers of goods to connect directly and efficiently over large distances,[4] other technology companies like Paypal made forays into business-lines that were previously the exclusive province of banks and other financial services sector players.[5] Thus, it wasn't long before companies' websites like Prosper.com and LendingClub.com in the US, Zopa.com in the UK, and other Web 2.0 platforms began experimenting with models of lending that would by-pass the traditional bank lending experience. These models would directly connect individuals and small businesses seeking funds with other individuals and businesses (now typically hedge funds) with excess capital to lend.[6]

Since the early 2000s the Peer-to-Peer (P2P) Lending industry has grown into a multi-billion dollar, global industry.[7] P2P lenders have grown both in number and complexity along with the industry. The Prosper/Lending Club model discussed below is no longer the only model of P2P lending.[8] Instead, innovators in this space have developed a variety of models for sourcing capital to fund these loans, while other innovators

---

https://www.lendingclub.com/public/how-peer-lending-works.action (last visited Apr. 14, 2015).

[3] Disintermediation refers to the process of removing the process of or going around the traditional intermediaries in a transaction. In the lending context, banks, credit unions, pay-day lenders served as intermediaries connecting those with capital (often in the form of bank deposits) with borrowers seeking funds.

[4] *See generally Who We Are*, EBAY, http://www.ebayinc.com/who_we_are/one_company (last visited May 26, 2016).

[5] *See id.* Paypal Holdings, Inc. is now a subsidiary of eBay, Inc.

[6] *See* GOV'T ACCOUNTABILITY OFF., PERSON-TO-PERSON LENDING: NEW REGULATORY CHALLENGES COULD EMERGE AS THE INDUSTRY GROWS (2011) [hereinafter GAO, PERSON-TO-PERSON LENDING], http://www.gao.gov/new.items/d11613.pdf; Tracy Alloway, *Peer-to-Peer Lending Comes of Age as Wall Street Muscles In*, FIN. TIMES (Sept. 21, 2014), http://www.ft.com/intl/cms/s/0/d6903c54-4447-11e4-8abd-00144feabdc0.html#axzz49knqQTh6 (last visited May 26, 2016) (discussing the growing role of traditional financial sector players like institutional investors in funding P2P Lending); PEER2PEER FIN. ASSOC., PEER-TO-PEER FINANCE: MARKET DATA 2 (2014) [hereinafter P2PFA, MARKET DATA (2014)], http://p2pfa.info/wp-content/uploads/2014/10/Peer-to-Peer-Lending-DataSheet-Q3-v3.pdf.

[7] *See* P2PFA, MARKET DATA (2014), *supra* note 6, at 2.

[8] *See, e.g.*, Mike Butcher, *Landbay Brings The P2P Finance Model To Buy-To-Let In The UK*, TECH CRUNCH (Apr. 11, 2014), http://techcrunch.com/2014/04/11/landbay-brings-the-p2p-finance-model-to-buy-to-let-in-the-uk/.

have identified niche spaces and markets in which to concentrate their lending activity.[9]

Currently, the SEC is responsible for regulating P2P lenders in the U.S.[10] This means that P2P lenders are in the position of either registering the loans (i.e. notes that correspond to the loans)[11] or finding an exemption to Section 5 of the '33 Act.[12] The consumer-side (i.e. borrower-side) of the transaction is still governed by state usury laws and, now, potentially the federal Consumer Financial Protection Bureau ("CFPB").[13] The U.K., the country where most of the world's other major P2P lenders reside, regulates P2P lending through its Financial Conduct Authority ("FCA").[14] The FCA is in some ways like a hybrid of the CFPB and SEC, as its mandate includes consumer credit protection, broker-dealer oversight, insider-trading and market-abuse prosecutions.[15] P2P Lending in the U.K. is additionally overseen by the Peer2Peer Finance Association, a self-regulatory organization, which promulgates standards and best practices for member-firms operating in the sector.[16] Right now, these two regulatory models serve as the only existing examples of ways to approach P2P lending.

---

[9] *See, e.g.*, Michael J. de la Merced, *After Year of Growth, Prosper Buys a Surgical Procedures Lender*, DEAL BOOK (Jan. 27, 2015), http://dealbook. nytimes.com/2015/01/27/after-year-of-growth-prosper-buys-a-surgical-procedures-lender/ (discussing a P2P lender bought by Prosper that focuses exclusively on providing P2P loans for elective surgical procedures).

[10] Paul Slattery, *Square Pegs in A Round Hole: Sec Regulation of Online Peer-to-Peer Lending and the CFPB Alternative*, 30 YALE J. ON REG. 233, 254–258 (2013).

[11] Prosper and Lending Club, the two largest P2P lenders in the U.S. have decided to register their securities with the SEC. *See id.*

[12] Other P2P Lenders in the U.S. have presumably used § 3(a)(11), *see* Press Release, Jackellyn Trinh, GROUNDFLOOR, *Groundfloor Launches Landmark Securities Offering to Enable Crowdfunding of Real Estate Transactions* (Apr. 29, 2014) (explaining that it previously restricted investors to Georgia residents), or have sold exclusively to accredited investors presumably under a Regulation D offering, *see* PATCH OF LAND, https://patchofland.com (last visited March 3, 2015).

[13] GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 5.

[14] Financial Conduct Authority, Un-official Outline of FCA Regulatory Requirements for Peer-to-Peer Lending Platforms (2014), p2pfa.info/wp-content/uploads/2014/06/FCA-P2P-regulation-vf.docx.

[15] The FCA was created by the Financial Services Act (2012) (U.K), which enumerated the powers of the FCA and its counter-part the Prudential Regulation Authority, which primarily regulates the banking sector. *See* Financial Services Act, 2012, cl. 21 (UK).

[16] *Rules and Membership Criteria of P2PFA*, PEER2PEER FIN. ASSOC., http://p2pfa.info/rules (last visited May 26, 2016).

While the U.K. system lends itself to a more systematic and comprehensive approach to P2P lending, both the U.S. and U.K. regulatory systems seem backward-looking—focusing on the consumer credit abuses of the past—rather than identifying the ways P2P lenders function within the financial system in the present. The purpose of this note is to survey the different models of P2P lending and take a functional approach in identifying the strengths and weaknesses that result from those models. Part I will explore the history and regulation of P2P lending focusing mostly on the U.S., using the U.K. as a point of comparison. Part II will examine examples of different models of P2P lending and the regulatory requirements each model faces. Part III will look at the financial functions of P2P lending on both a microprudential and macroprudential level, noting the effect of different models of P2P lending on these functions. By doing this, the hope is that regulators, innovators, and students of P2P lending can design comprehensive and systematic regulatory solutions that take full advantage of P2P lending's innovative approach to solving problems in the financial sector.[17]

I. REGULATING THE PEER-TO-PEER LENDER: THE HISTORY AND CURRENT STATE OF THINGS

The regulation of P2P lenders in the US involves oversight by various state and federal regulators.[18] Much of the current debate over the regulation of P2P lending in the U.S. has focused on an early draft of Dodd-Frank proposed by the House of Representatives that would have moved responsibility for regulating the industry from the SEC to the newly formed CFPB. While the final version of Dodd Frank did not contain such a provision, it did require the GAO to study the issue and publish a report.[19] Congress has taken no further action on designating an agency to oversee P2P lending.[20] Thus, the discussion below will focus primarily on the role of the SEC and the debate over whether the CFPB is a better candidate for supervising the industry.

The U.K.'s regulation of P2P lenders benefited from a complete overhaul of the U.K.'s regulatory approach to financial services regulation in 2012.[21] Thus, it is worth considering the U.K.'s single agency approach

---

[17] This "functional approach" is borrowed from Steven Schwarcz, *Regulating Financial Change: A Functional Approach*, 100(4) MINN. L.R. 1441 (2015) [hereinafter Schwarcz, *Regulating Financial Change*].
[18] GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 2.
[19] *See* Pub. L. No. 111-203, § 989F, 124 Stat. 1376 (2010).
[20] *See* Andrew Verstein, *The Misregulation of Person-to-Person Lending*, 45 U.C. DAVIS L. REV. 445, 450 (2011).
[21] *See generally* Philip Rawlings, *All Change: The Fall of the FSA and the Further Rise of the Bank of England*, 30 No. 4 BANKING & FIN. SERVS. POL'Y REP. 16

to regulating P2P lending as a point of comparison in considering the merits of such a system.

A. Regulation by the SEC

The federal regulation of P2P lending in the U.S. started in earnest with the SEC's action against Prosper Marketplace ("Prosper") in 2008.[22] Prior to the SEC's action it was unclear whether P2P lenders were issuing securities within the bounds of federal securities laws when connecting lenders and borrowers.[23] The SEC's action forced Prosper to register the notes it issued to those providing the capital to fund its consumer loans,[24] which also resulted in Lending Club suspending operations for several months in order to voluntarily register its notes.[25]

The SEC imposed registration requirements on Prosper and Lending Club largely due to the way the two companies structure their transactions.[26] The companies use their online platforms to identify borrowers and then apply proprietary risk-appraisal methods to determine borrowers' creditworthiness and the appropriate interest rates.[27] The platforms also let lenders make loans anonymously to the borrowers based on these proprietary formulas.[28] At this point, however, the lender does not directly lend their money through the platform to that buyer.[29] Instead, borrowers using Lending Club or Prosper receive loans from WebBank, an FDIC-insured bank based in Utah.[30] The online platforms then purchase the loan and issue a corresponding note for that loan to the lender.[31] The P2P platform is responsible for servicing the loan and passing on proceeds to the lender.[32] The P2P platform makes money in these transactions by

---

(2011) (discussing the restructuring financial services regulation in the U.K. after the 2008 financial crisis).

22 Prosper Marketplace, Securities Act Release No. 8984.

23 Paul Slattery, *supra* note 10, at 252.

24 *See id.*; Prosper Marketplace, Securities Act Release No. 8984.

25 Carl E. Smith, *If It's Not Broken, Don't Fix It: The SEC's Regulation of Peer-to-Peer Lending*, 6 BUS. L. BRIEF (AM. U.) 21, 22–23 (2010).

26 *Id.* at 21–22; *see also* Prosper Marketplace, Securities Act Release No. 8984.

27 *Id.*; GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 11–12. Prosper originally allowed lenders to bid on an interest rate, but switched to designating an interest rate based on a proprietary formula in 2010. *See also* Chaffee & Rapp, *supra* note 1, at 494.

28 *See* Slattery, *supra* note 10, at 236.

29 *See* GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 10–14.

30 *See id.*

31 *Id.*

32 *Id.* at 13.

charging an origination fee for the loan and then a servicing fee on the payments.[33]

In the Prosper enforcement action, the SEC determined that these notes qualified as securities under *SEC v. W.J.Howey Co.* and *Reves v. Ernst & Young*.[34] The *Howey* investment contract was easy for the SEC to meet.[35] Prosper (and Lending Club) serves as a promoter for a common investment scheme and investors rely on the expertise of the P2P platforms to find opportunities and operate.[36] The SEC also successfully argued that the note issued by the P2P platforms did not fall into any of the exemptions found in *Reves*.[37] This meant that each note sold to investors would need to meet Section 5 of the 1933 Act's requirements.[38] Thus, the result of the SEC's actions was a chilling effect on other P2P platforms following the Prosper and Lending Club model.[39]

Other P2P lenders in the U.S. have avoided the registration of their securities by limiting participation on the lender-side to accredited or institutional investors.[40] At least one other P2P lending platform tested its model using a § 3(a)(11) intrastate offering, but, in a relatively short time decided to submit to the expense and heightened regulatory scrutiny that accompanies registration.[41] These approaches allow new entrants into the P2P lending space to experiment with different models and in different markets, but in other ways diminishes some of the overall goals of P2P Lending—namely the disintermediation of financing and connecting borrowers and willing lenders.

---

[33] Verstein, *supra* note 20, at 454.
[34] *See generally* Prosper Marketplace, Securities Act Release No. 8984. For a thorough summary and analysis of the SEC's action, see Chaffee & Rapp, *supra* note 1, at 509–19.
[35] Chaffee & Rapp, *supra* note 1, at 509–19.
[36] *Id.* at 509–14.
[37] *Id.* at 514.
[38] *See* Verstein, *supra* note 20, at 476.
[39] *See id.* at 490. *See, e.g.*, Giles Andrews, *The Tricky World of US Regulation*, ZOPA BLOG (Nov. 28, 2008), http://blog.zopa.com/archives/2008/11/28/the-tricky-world-of-us-regulation.
[40] *Se,e e.g.*, PATCH OF LAND, https://patchofland.com (last visited May 26, 2016). Patch of Land takes advantage of the 506(c) exemption created by the JOBS Act, which allows for the advertisement of Regulation D offerings so long as the issuer using the exemption only sells to accredited investors and has some means of confirming all of the purchasers qualify, in fact, as accredited investors. *See id. See also* Exemption for limited offers and sales without regard to dollar amount of offering, 17 C.F.R. § 230.506(c).
[41] *See, e.g.*, Trinh, *supra* note 12.

B. Dodd Frank and the Consumer Financial Protection Bureau

During the 2008 Financial Crisis, traditional lines of credit became nearly impossible for ordinary individuals and small businesses to access.[42] Nonetheless, P2P lending continued to grow during the crisis.[43] The original House version of the Dodd Frank Act exempted P2P lending from SEC oversight.[44] Instead, the House bill designated the newly created CFPB as the appropriate regulator for the P2P lending industry.[45] Scholars have argued that the new agency, with its focus on protecting consumers, could best consolidate the regulation of P2P lending and help the nascent industry avoid the current regulatory environment that subjects platforms to "at least ten federal statutes and as many agencies."[46] Thus, arguments in favor of the CFBP taking up regulatory responsibility for P2P lending focuses on two points—first, the benefits of a single regulator, and, second, the consumer credit focus of the new agency.[47]

The benefits of a single regulator in the CFPB are obvious. Rather than subjecting existing P2P lenders and new entrants to regulation by various state and federal agencies, P2P lenders could benefit from the certainty that comes with interfacing with a single regulator. Proponents of the CFPB as a single regulator model also note that having a single regulator with a broad mandate overseeing P2P lending means that the regulator can be much more responsive to innovations and new models of P2P lending.[48]

The broad mandate of the CFPB also supports arguments for a single CFPB regulator. The CFPB's mandate contains a "catchall jurisdiction to regulate any entity that the CFPB has 'reasonable cause to determine' poses a risk to consumers in financial transactions."[49] This broad mandate gives the CFPB far more flexibility to tailor regulation to the unique benefits and threats posed by individual P2P lenders and the industry at large.[50] The SEC, on the other hand, traditionally operated on a narrower mandate that focuses on protecting investors through

---

[42] Slattery, *supra* note 10, at 235.
[43] *See id.*
[44] *Id.* at 253–54.
[45] *See id.*
[46] *Id.* at 237.
[47] *See, e.g.*, *id.*; *see also* GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 36–37 (discussing the role and powers of the CFPB generally).
[48] *See* Slattery, *supra* note 10, at 264 (explaining that the CFPB's broad jurisdictional grant "could allow the CFPB to uniformly regulate P2P lending platforms, regardless of their particular business models," thus best positioning the CFPB to serve as a unified regulator for P2P platforms).
[49] *See id.*
[50] *Id.*

disclosure requirements.[51] This narrower focus on investors poses problems with regard to the P2P lending industry and its involvement with both "investors" (i.e. those lending money through the platforms) and the mostly individual and small business consumers that turn to P2P lending platforms.[52]

Arguments in favor of a single regulator in the form of the CFPB have garnered much attention and support.[53] However, rather than include the House proposal in the final version of Dodd-Frank, Congress opted to have the Government Accountability Office (GAO) study the issue further.[54] The study took a comprehensive look at the structure of the industry, the current regulatory environment, the possibility of having the CFPB as a single regulator, and the effects of maintaining the status quo.[55] Still, the GAO's conclusion left much to be desired. The GAO essentially found that either the current system or the CFPB as a single regulator system had merits and recommended a sort of wait-and-see approach.[56] Thus, P2P platforms find themselves in the same place today as they did in 2008—registering with the SEC (or finding an exemption) while struggling to comply with various state and other federal regulations.

C. The U.K.'s Regulation of P2P Lenders: A point of comparison

The U.K.'s regulatory system for financial services looks very different from the U.S. system. For several years beginning in 2000, the U.K. had a single regulator for financial services under the auspices of the Financial Services Administration.[57] After the financial crisis, the deficiencies and inefficiencies of the single regulator system became apparent.[58] The U.K.'s response was to create three different, independent

---

[51] SEC, *What We Do*, https://www.sec.gov/about/whatwedo.shtml (last modified June 10, 2013) (noting "the mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation").
[52] *Cf.* Slattery, *supra* note 10, at 274 (discussing the inflexibility of the SEC and its sole focus on investors).
[53] *See, e.g., id;* Verstein, *supra* note 20; Chaffee & Rapp, *supra* note 1. *But see* Smith, *supra* note 25 (arguing against SEC regulation generally).
[54] *See* GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 2; Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. No. 111-113, § 989F, 124 Stat. 1376 (2010) (to be codified at 12 U.S.C. §5301).
[55] *See* GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 42.
[56] *See id.* at 56–57.
[57] Philip Rawlings, *All Change: The Fall of the FSA and the Further Rise of the Bank of England*, 30 No. 4 BANKING & FIN. SERVICES POL'Y REP. 16, 20 (2011) (discussing the restructuring financial services regulation in the U.K. after the 2008 financial crisis).
[58] *Id.*

regulators under the supervision of the Bank of England and with responsibilities to the Treasury as well.[59]

As of 2014, the Financial Conduct Authority ("FCA") retains responsibility for regulating P2P lending in the U.K.[60] The FCA's broad mandate and coverage of financial services activities and firms may give it the power and flexibility to adapt to a changing industry and promulgate regulations specifically tailored to the industry. FCA's work in the P2P lending sector appears promising thus far.

The FCA's regulations are broader than those in the U.S. While the SEC mandates disclosure and the CFPB maintains consumer protection measures, the FCA's regulation includes mechanisms for disclosure, consumer protection, and, importantly, capital requirements for P2P lenders.[61] The FCA's focus on all the parties involved—investors, borrowers, and the integrity of the financial system—results in a much more comprehensive approach to regulation.[62]

As mentioned before, especially important is the prudential[63] approach to regulation that is part of the FCA's model.[64] P2P lenders are part of the disintermediation of financial services, but in some ways are

---

[59] *See generally* Financial Services Act, 2012, cl. 21 (UK). The regulators responsible for the financial services sector in the U.K. include the Prudential Regulation Authority, the Financial Conduct Authority, and the Financial Policy Committee. *Id.* The Prudential Regulation Authority is primarily responsible for the prudential regulation of the banking sector. *Id.* The Financial Policy Committee is the least powerful of the three and is primarily a macroprudential regulator with limited abilities to promulgate direct regulations. *Id.* The Financial Conduct Authority is tasked with regulating the intersection between consumers and the financial sector. *Id.* It regulates broker-dealer activities, financial fraud, insider trading, and consumer credit in addition to P2P lending. *See id.*

[60] Jonathan Moules, *Government Boost for Peer-to-Peer Lending*, FIN. TIMES (Dec. 7, 2012, 12:17 PM), http://www.ft.com/intl/cms/s/0/1d7a4a16-4061-11e2-8e04-00144feabdc0.html?siteedition=uk#axzz3TdyCwwxR.

[61] FIN. CONDUCT AUTH., THE FCA'S REGULATORY APPROACH TO CROWDFUNDING OVER THE INTERNET, AND THE PROMOTION OF NON-READILY REALISABLE SECURITIES BY OTHER MEDIA (2014), http://www.fca.org.uk/static/documents/policy-statements/ps14-04.pdf.

[62] *See id.*

[63] Here, prudential regulation or regulators most often refers to the types of regulations to which banks or banking entities are subject. These regulations typically focus on capital requirements, loan-to-value ratios, and other best practices rather than solely on disclosure.

[64] *Cf. id.* (discussing the minimum capital standards required by the FCA for online lending platforms).

providing many of the same services as banks.[65] Thus, the FCA implementation of prudential regulations in addition to consumer protection and disclosure makes sense given the nature of P2P lending. Its efforts create a strong point of reference for the U.S. and others. Finally, the FCA also has a role in the U.K.'s macroprudential policy through its chief executive's membership on the board of the Financial Policy Committee, the U.K.'s primary macroprudential regulator.[66]

II. DIFFERENT MODELS OF PEER-TO-PEER LENDING

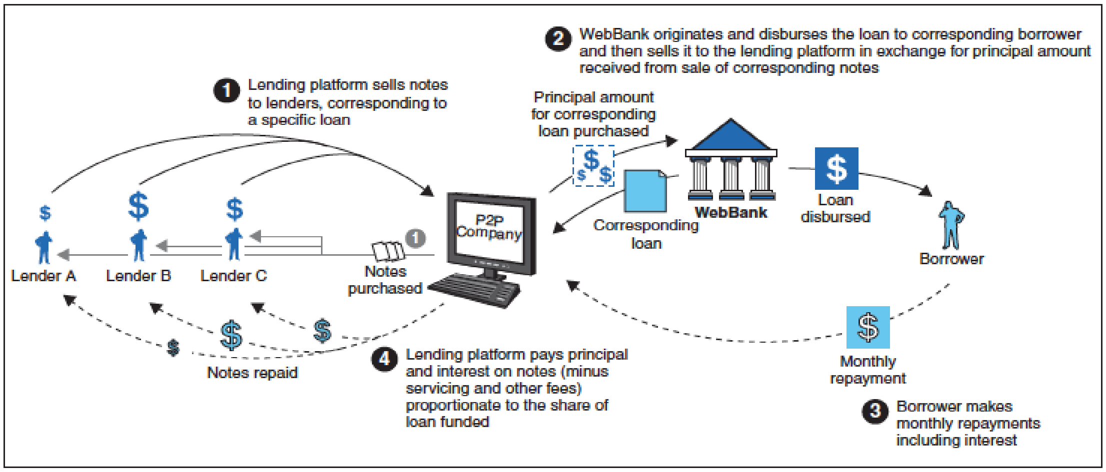
Different models of P2P lending have developed in response to changes in the market and the regulatory environment after 2008. Before examining these P2P lenders by taking a functional approach, it is important to take a look at the different models of P2P lending currently in existence along with some of the unique benefits and risks features of each model.

A. The Loan-to-Note Model: Prosper, Lending Club, and Zopa

This model is the most common and probably the largest by volume of loans.[67] As previously discussed, these platforms rely on a local FDIC-insured bank—WebBank in the case of both Lending Club and Prosper—to extend bank loans to consumers.[68] The loan is purchased by the P2P platform, which then sells a note to the lender based on the lender's selection of either a specific loan or a category of loans.[69] The lender makes money through both an origination fee and a service fee taken out of the interest payments made on the loan.[70]

---

[65] *See* Smith, *supra* note 25, at 21 (discussing how P2P lenders manager loans and provide information about borrowers to lenders); Verstein, *supra* note 20, at 254.
[66] Donald Kohn, Senior Fellow, The Brookings Inst., Address at the Kennedy School of Government: Institutions for Macroprudential Regulation: The UK and the U.S. (Apr. 17, 2014), www.brookings.edu/research/speeches/2014/04/ 17-institutions-macroprudential-regulation-kohn.
[67] *See* Chaffee & Rapp, *supra* note 1, at 493–94.
[68] GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 11–13.
[69] *Id.*
[70] Verstein, *supra* note 20, at 454.



Source: GAO analysis based on information from Prosper and LendingClub; Art Explosion.

Figure 1[71]

The payment on the note by the platform to the lender is contingent upon continued payment by the consumer borrower.[72] While the lenders admit a duty to "use commercially reasonable" efforts to collect on delinquent loans, these efforts are attended by high fees.[73] This feature is important, as it greatly reduces or eliminates most of the default risk for the P2P platform and places the risk on the lender.[74]

The default risk—how frequently consumers defaulted— is the primary risk posed by this model. Early on in the life of Prosper, its default rate on loans made through the platform was high.[75] Lending Club's default rate was lower, but it also restricted its loans to consumers with much higher credit scores.[76] The danger occurs because the P2P platform has little incentive to pursue repayment when borrowers default. Their own liability to the lender is contingent upon the borrower's repayment, and the size of the loans makes it economically inefficient for

---

[71] GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 12 (illustrating the mechanics of P2P lending platforms such as Prosper and Lending Club).
[72] Slattery, *supra* note 10, at 248.
[73] *Id.* at 248–49.
[74] *Id.* What is even more concerning is that Lending Club "reserves the right to issue debt senior to lenders' rights secured by payment on the loans lenders fund." *Id.* at 251.
[75] *See id.* at 248 (discussing how default rates on loans made by Prosper were originally as high as 36%).
[76] *Id.* Prosper also adjusted its eligibility terms to raise the minimum credit score for borrowers eligible to take out a loan using the site. Since then, its default rate has decreased to be more in-line with Lending Club's. *See* Verstein, *supra* note 20, at 453.

the sites to track down every delinquent borrower.[77] Certainly, as major players in the field, there is a reputational incentive to make sure that borrowers are creditworthy, so that the sites can continue to attract lenders. But it is probably only the high costs of SEC registration[78] that prevent less scrupulous platforms from taking advantage of this mismatch of incentives.

B. Pure Crowdfunding and Market Place Model

The high costs and enhanced scrutiny stemming from SEC registration has probably led some sites to take advantage of exemptions by catering to accredited investors.[79] Currently, this model exists primarily for P2RE (Peer to Real Estate) loans,[80] which involves crowdfunding short-term construction, rehabilitation, or other real-estate-focused projects.[81] This model also seems appealing and suited for those who wish to target the small business market.[82]

The entrance of institutional investors such as hedge funds will probably pose the most interesting challenges for this type of lending.[83] The promise of a democratized system of truly peer-to-peer lending is threatened whenever the pool of potential lenders is restricted to those who qualify as accredited investors. But more importantly, the rise of secondary markets and securitization for these types of loans[84] re-introduces some of the same dangers, such a moral hazard or risk transmission, that financial disintermediation promises to address.

C. Shadow Banking Model

Though not properly P2P lenders, online lending platforms that operate in the same market and use the same technologies as P2P platforms merit some consideration. OnDeck is probably the largest of these new

---

[77] Slattery, *supra* note 10, at 248–50.
[78] *Id.* at 256. Prosper spent over $5 million on compliance costs in 2010. *Id.* at 258.
[79] *See, e.g.*, PATCH OF LAND, https://patchofland.com (last visited May 26, 2016); Butcher, *supra* note 8.
[80] Groundfloor is another example of real estate-focused P2P platform that until recently used intrastate offering exemptions in order to crowdfund projects. *See* Trinh, *supra* note 12. Recently, however, they decided to register their securities in order to scale their business and offer loans outside of Georgia. *See id.*
[81] *Id.*
[82] William Alden, *Start-Up Lendoor Aims to Use Crowdfunding for Small-Business Loans*, DEAL BOOK (Oct. 29, 2014), http://dealbook.nytimes.com/2014/10/29/start-up-lendoor-aims-to-use-crowdfunding-for-small-business-loans/.
[83] *See* Alloway, *supra* note 6.
[84] *Id.*

online lending shadow banking firms.[85] OnDeck operates more like a traditional banking or shadow banking entity by lending money backed by its own capital.[86] Like the major true P2P lending platforms, OnDeck uses advanced, proprietary technology to weigh the risks posed by usually small business borrowers.[87] OnDeck also sells many of these loans in secondary markets,[88] which creates the potential for the lax underwriting standards by firms operating in this market.[89]

D. Micro-Finance Model

Micro-finance websites like Kiva operate in much the same way as Lending Club or Prosper.[90] These sites allow individuals who may be committed to a cause, such as funding women in the third world who are starting a business, to provide the capital necessary to fund small-scale economic development.[91] The amounts of these loans are not necessarily smaller than those found on Lending Club or Prosper.[92]

The money is aggregated by the P2P and transferred to the platform's "field partners" who vet and collect repayment from the borrower.[93] The field partners are paid interest by the borrower, but the lender providing the money is not paid any interest.[94]

---

[85] *See* Jeremy Quittner, *How OnDeck's IPO Went Off Without a Hitch*, INC. (Dec. 18, 2014), http://www.inc.com/jeremy-quittner/ondeck-capital-ipo-and-the-jobs-act.html. Shadow banking is a term used to describe intermediaries that participate in the creation and sale of credit, but are not regulated as traditional banks.

[86] *Id.*

[87] *Id.*

[88] *Id.*

[89] However, nothing indicates that OnDeck's lending or underwriting standards are lax or below par in any way. Rather, the *model* examined here comes with many of the same structural dangers one sees in mortgage brokers and other lenders that make money sourcing loans, but don't necessarily keep "skin in the game." The lax (or non-existent) underwriting standards of many mortgage brokers in the years leading up the financial crisis was, of course, dangerous enough to contribute to the worst recession since the Great Depression.

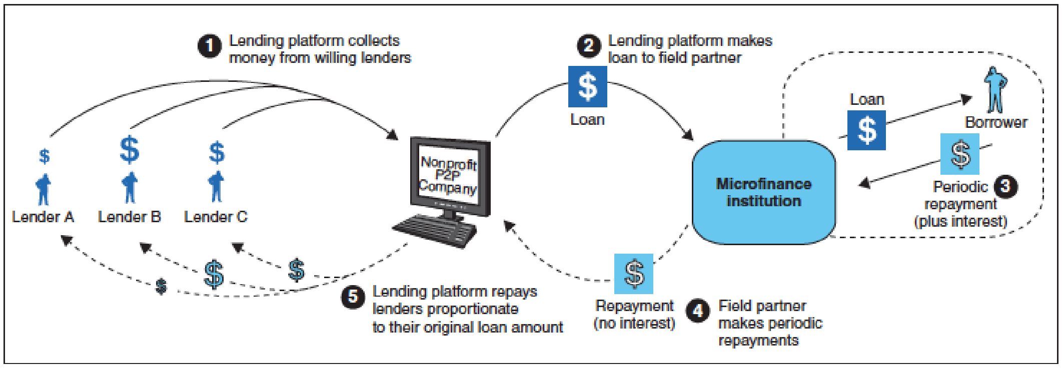
[90] *See generally* Kevin Davis & Anna Gelpern, *Peer-To-Peer Financing for Development: Regulating The Intermediaries*, 42 N.Y.U. J. INT'L L. & POL. 1209 (2010).

[91] Steven L. Schwarcz, *Disintermediating Avarice: A Legal Framework for Commercially Sustainable Microfinance*, 2011 U. ILL. L. REV. 1165, 1167–68 (2011) [hereinafter Schwarcz, *Disintermediating Avarice*].

[92] *Compare* Lisa T. Alexander, *Cyberfinancing for Economic Justice*, 4 WM. & MARY BUS. L. REV. 309, 347 (2013), *with* Verstein, *supra* note 20, at 452.

[93] Davis & Gelpern, *supra* note 90, at 1222–23.

[94] *Id.*



Source: GAO analysis based on information from Kiva; Art Explosion.

Note: The microfinance institutions often disburse loans to borrowers before the loans are funded by lenders.

Figure 2[95]

Using the no-interest system on the lender-side avoids forcing these types of P2P entities from needing to register with the SEC.[96] Because they are charities, they might be subject to other forms of regulation in order to maintain their 501(c)(3) status.[97] The danger in this model is not really to the lender, who is presumably providing capital out of generosity, but to the borrower who still pays high interest rates to the field partners.[98] These interest rates can sometimes even exceed the rates charged by pay-day lenders in the U.S.[99]

E. Regulating the Different Types of P2P Lenders

As discussed, different P2P lenders pose different risks and benefits to lenders and borrowers. An optimal regulatory solution to a highly diverse field should not focus too much on the specific structure of these transactions and platforms, since they are likely to change and evolve. Rather, regulations should focus on the general functions of P2P lending. It is yet unclear what government entity or regulator would be positioned best to lead the charge on regulating P2P platforms.[100] However, the following section will discuss an approach that any or all of

---

95 GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 15 (illustrating how Kiva works).
96 Davis & Gelpern, *supra* note 90, at 1241.
97 *Id.* at 1240–44.
98 Schwarcz, *Disintermediating Avarice*, *supra* note 91, at 1168.
99 *Id.* In his article, Schwarcz makes an interesting argument for switching to a securitization model to attempt to lower the costs for borrowers. *Id.*
100 *See, e.g.*, GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 56–57.

the regulators could take to address the P2P lending sector in all of its various manifestations.

III. TAKING A FUNCTIONAL APPROACH TO THE REGULATION OF PEER-TO-PEER LENDERS

In an article on regulating financial change, Prof. Steven Schwarcz suggests taking a "functional approach" to the regulation of financial services.[101] He, like many others, has noted that too much of the regulation of financial services is backwards-looking.[102] Instead, Schwarcz encourages regulators to look at the core functions of finance in order to understand the basic contours and operations of the system.[103] In this way, regulators can avoid constantly trying to regulate the newest product, transaction, or threat, but can approach regulation in a way that addresses the risks at the very heart of the financial system.[104]

Given the potential blank regulatory slate for an industry like P2P lending,[105] a functional approach provides a strong starting point for framing future discussions about regulation. Though Schwarcz focuses on the microprudential and macroprudential functions and risk separately in his article,[106] it is worth examining these functions together. That way, the macroprudential risks of the P2P industry may be better understood.

A. Functions of Peer-to-Peer Lending

The various functions discussed below are those noted and examined in Schwarcz's article on regulating financial change.[107] Again, they provide a useful framework for understanding P2P lending's place in the financial system and can be used to focus conversations about the risks and benefits of different models of P2P lending.

1. Disaggregation and Efficient Funding

Disaggregation is the spreading of financial participation and risk amongst those in the best position to put capital to its highest and best use.[108] On the other hand, failures in information-access and rationality

---

[101] *See generally* Schwarcz, *Regulating Financial Change*, *supra* note 17.
[102] *See, e.g.*, Barry Eichengreen, *Euro Area Risk (Mis)management*, *in* RECALIBRATING RISK: CRISES, PERCEPTIONS, AND REGULATORY CHANGE (Edward Balleisen et al., eds.) (forthcoming); *see also* Schwarcz, *Regulating Financial Change*, *supra* note 17.
[103] *See* Schwarcz, *Regulating Financial Change*, *supra* note 17, at 5–6.
[104] *Id.*
[105] *Cf.* GAO, PERSON-TO-PERSON LENDING, *supra* note 6, at 56–57 (noting that regulators should continue to look at various regulatory solutions).
[106] *See, e.g.*, Schwarcz, *Regulating Financial Change*, *supra* note 17, at 8.
[107] *See generally id.*
[108] *See id.* at 12.

present two barriers to the efficient functioning of capital markets.[109] P2P lending has the potential to overcome these barriers by increasing disaggregation.[110]

P2P lending platforms' greatest strengths are in this area. Not only do they open up lending and borrowing to greater numbers of people, but they also use technology to address some of the information and rationality failures previously faced.[111] The real value of Prosper and Lending Club along with the other P2P lenders' is their ability to efficiently evaluate the credit worthiness of borrowers and disseminate that information amongst the largest possible pool of potential investors.[112]

Thus, any regulation in this space should focus on making sure the information gathered and disseminated by P2P lending platforms is accomplishing this goal.

2. Risk Management and Behavior Monitoring

A weakness of P2P lending platforms is the incentive mismatch between lenders and the platforms. The platforms take an origination fee and then a relatively small fee for the continued servicing of the loan.[113] This compensation structure may incentivize the P2P platforms to originate loans with little regard for the borrowers' potential to default given the borrower's responsibility for repaying the notes is contingent upon the borrowers' repayment of the loan.[114] The small size of the loans also makes it inefficient for the platform and the lender to pursue delinquent borrowers either on their own or through a third-party debt collection agency.[115]

The SEC's current registration requirement reduces the risk for lenders who use Prosper and Lending Club by theoretically requiring disclosure of these risks to lenders through the Section 5 registration and prospectus process.[116] However, the SEC's registration process is not ideally suited for retail investors seeking to lend extra capital through one of these platforms.[117] Any future regulation should seek to optimize risk

---

[109] *See id.* at 12–13.
[110] *See* Slattery, *supra* note 10, at 235.
[111] *See id.* at 238.
[112] *See, e.g., id.* at 238–39.
[113] *See* Verstein, *supra* note 20, at 454.
[114] *Cf.* Slattery, *supra* note 10, at 248 (noting Prosper's early default rates).
[115] *See supra* text accompanying notes 74–76.
[116] *Cf.* Chaffee & Rapp, *supra* note 1, at 507; Smith, *supra* note 25, at 21 (noting registration requirements around the loans).
[117] The average prospectus can run over a hundred pages and include detailed financial statements, which makes it unlikely that the average investor will closely examine it. *See, e.g.*, Chaffee & Rapp, *supra* note 1, at 507.

management by either adjusting the liability imposed on P2P platforms for defaults or utilizing some other mechanism to correct the mismatch of incentives.[118]

3. Maturity Transformation

Maturity Transformation refers to "the asset-liability mismatch that results from the short-term funding of long-term projects."[119] This is less of a problem with P2P lenders than with traditional banks, since P2P lenders, in theory, rely on customers who are willing to invest in the full-term of the loans advanced to borrowers[120] unlike banks that rely on short-term funding for long-term loans. However, this could be a problem for marketplace lenders that self-fund their loans and then, like banks, rely on the secondary markets or securitization to fund new loans. As consumers become more reliant on access to capital through these online lenders, the failure of a major lender could significantly disrupt the financial system.

4. Interconnectedness and Concentration

Interconnectedness and concentration in the financial markets were among the primary contributors to the 2008 financial crisis.[121] In his article, Schwarcz discusses the importance of limiting the effects of any shocks to the financial system by breaking the transmission of those shocks.[122] Globally, macroprudential regulators and oversight committees have proposed various tools for dealing with the transmission of risk including ring-fencing, contingent capital, and counter-cyclical capital requirements for financial system participants.[123] Unfortunately, many of

---

[118] The risk of poor oversight and corporate controls at P2P lenders is best reflected in the corporate governance controversy that engulfed Lending Club and resulted in the resignation of its founder and CEO. Lending Club was found to have knowingly sold a large investor $22 million-dollars of loans that violated the investor's express instructions. *See* Peter Rudegeair, *Lending Club CEO Fired over Faulty Loans*, WALL STREET JOURNAL (May 9, 2016), http://www.wsj.com/articles/lendingclub-ceo-resigns-over-sales-review-1462795070.

[119] Schwarcz, *Regulating Financial Change*, *supra* note 17, at 34.

[120] *See, e.g.*, PETER MANBECK & SAMUEL HU, CHAPMAN & CUTLER, LLP, THE REGULATION OF PEER-TO-PEER LENDING: A SUMMARY OF THE PRINCIPAL ISSUES 1 (2014).

[121] INT'L MONETARY FUND, BANK FOR INT'L SETTLEMENTS, & FIN. STABILITY BD., GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS AND INSTRUMENTS: INITIAL CONSIDERATIONS (2009), https://www.bis.org/publ/othp07.pdf.

[122] Schwarcz, *Regulating Financial Change*, *supra* note 17, at 45–47.

[123] *See, e.g.*, EUR. SYSTEMIC RISK BD., FLAGSHIP REPORT ON MACRO-PRUDENTIAL POLICY IN THE BANKING SECTOR (2014), https://www.esrb.europa.eu/pub/pdf/other/140303_flagship_report.pdf; FIN. STABILITY BD.,

these tools seem poorly adapted to the P2P lending sector. Thus far, this has not been an issue due to the relatively small size of the P2P lending sector compared to other parts of the financial services sector.[124]

Recent trends in the P2P market show the potential for concentration within smaller market segments.[125] The failure of one or two P2P lending platforms in a niche market has the potential to destroy access to credit within those niche markets and cause a credit crisis—at least within that market—if reliance on those lenders is great enough. The FCA's imposition of capital requirements on P2P lenders may mitigate these risks.[126]

The other issue that may arise as the industry matures is the interconnectedness that arises from a secondary market for P2P loans. The first securitization of P2P loans has already taken place.[127] With securitization, many of the benefits of disaggregation native to the P2P lending model could be lost if platforms and the initial lenders rely on large financial institutions to provide a robust secondary market for these loans.

Any future regulation of P2P lenders should consider the interconnectedness of the industry and the potential for risk to transmit through the system causing mini-credit crises.

CONCLUSION

The advantages of P2P lending are clear, but the regulatory responses to this new industry are inadequate thus far. The U.S.'s fragmentary model of regulation offers the least hope for a comprehensive and well-thought out response to the risks posed by P2P lending. The fragmented model also presents the greatest chance for burdensome and uncoordinated regulation to stifle future innovation in the industry.[128] The U.K. offers a promising example for the U.S. to follow, because a single

MACROPRUDENTIAL POLICY TOOLS AND FRAMEWORKS: PROGRESS REPORT TO G20 (2011), http://www.fsb.org/wp-content/uploads/r_111027b.pdf.

[124] Peer-to-peer platforms facilitated roughly $700 million in loans during 2013, while standard consumer loans accounted for about $60 billion that same year. *See* Yuliya Demyanyk & Daniel Kolliner, *Peer-to-Peer Lending Is Poised to Grow*, FED. RESERVE BANK OF CLEVELAND (Aug. 14, 2014), https://www.clevelandfed.org/newsroom-and-events/publications/economic-trends/2014-economic-trends/et-20140814-peer-to-peer-lending-is-poised-to-grow.aspx.

[125] *See, e.g.*, de la Merced, *supra* note 9.

[126] FIN. CONDUCT AUTH., THE FCA'S REGULATORY APPROACH TO CROWDFUNDING OVER THE INTERNET, AND THE PROMOTION OF NON-READILY REALISABLE SECURITIES BY OTHER MEDIA 6 (2014), http://www.fca.org.uk/static/documents/policy-statements/ps14-04.pdf.

[127] Tracy Alloway, *supra* note 6.

[128] *See generally* Verstein, *supra* note 20.

regulator taking a functional approach to regulation would certainly be the ideal.

Rethinking the balance between the benefits provided by P2P lending and the risks posed by the industry can help regulators arrive at an optimal regulatory structure. Part of rethinking the regulation of P2P lending might begin by looking at other situations where access to credit trumps greater regulation in importance. For instance, bank loans and notes are not subject to SEC regulations even though banks are serving the same function as the lenders on P2P platforms.[129] The bankruptcy code also allows companies to issue securities without complying with SEC regulations presumably because solvency and debtor rehabilitation are valued higher than investor protection in this situation.[130]

The relative youth of the P2P lending industry[131] should inspire governments and regulators to take a proactive approach to designing comprehensive and thoughtful solutions that spur innovation and protect investors, borrowers, and the financial systems that rely on the efficient allocation of capital through these platforms.

---

[129] *See* Reves v. Ernst & Young, 494 U.S. 56, 65 (1990) (quoting Exch. Nat'l Bank of Chi. v. Touche Ross & Co., 544 F.2d. 1126, 1138 (2d Cir. 1976) (noting that "notes delivered in consumer financing" are not securities under the "family resemblance" test).
[130] *See, e.g.*, 11 U.S.C. § 1125 (2012).
[131] Zopa, the oldest P2P lending site, was founded in 2005. *See also* Slattery, *supra* note 10, at 234.