

The Regulation of Marketplace Lending

A Digest of the
Principal Issues

Appendix A

Securities Laws, Bankruptcy
Considerations, Tax Considerations,
Blockchain, and Crowdfunding Rules
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Appendix A

Securities Laws, Bankruptcy Considerations, Tax Considerations, Blockchain, and Crowdfunding Rules

NOVEMBER 2025 UPDATE TO *THE REGULATION OF MARKETPLACE LENDING*

Elsewhere on our website, we are pleased to offer once again our update of the principal regulatory and securities issues applicable to marketplace lending and related legal issues. Coming out of the 2024 election cycle, the regulatory landscape is seeing an “about face.” While the Biden years brought robust enforcement primarily by the Consumer Financial Protection Bureau (“CFPB”), from the early days of the second Trump administration, curtailing if not dismantling the CFPB seems to be on the horizon. That publication discussed these events.

As in past updates, we have no shortage of topics to discuss, given both significant legislation and regulatory initiatives that reflect the industry’s growing importance in the financial markets. Most notably, true lender litigation continues. Buy Now Pay Later, Earned Wage Access, and other similar innovative products have come on the scene, navigating into regulatory headwinds, and new regulations and a proliferation of state laws continue to impact the industry, including attempts to “opt out” of federal preemption and impose state limitations on programs of banks supported by fintechs. We discuss these and other important developments that have occurred since the November 2024 publication in the “Recent Developments in Marketplace Lending Regulation” section. The remainder of that publication then describes in greater detail the status of marketplace lending under existing consumer protection and other applicable laws. We have changed the name of this publication from a “summary” of the principal issues to a “digest” of those issues since we discuss an overview of issues as well as their historical development and current status.

Since marketplace lending was born out of innovation, we have added a new section dealing with recent innovations related to digital assets including cryptocurrency as part of our “Recent Developments in Marketplace Lending Regulation” section. In addition to summarizing current events in this area, we also attempt to provide insight on how these new arenas impact the now more conventional marketplace lending space.

APPENDIX A – HISTORICAL REVIEW OF THE ORIGINS OF THE MARKETPLACE LENDING INDUSTRY AND SECURITIES LAW AND RELATED ASPECTS

Given that the securities law implications on marketplace lending have diminished, the largely historical references to seminal programs have been placed in this appendix for reference.

The marketplace lending industry originally attracted widespread public attention through the pass-through notes programs operated by LendingClub Corporation and Prosper Marketplace. These so-called peer-to-peer (or “P2P”) programs enable retail investors to purchase nonrecourse notes representing fractional interests in specific underlying consumer loans. It was once widely expected that P2P programs would become common. In fact, however, most marketplace lenders do not operate such programs on either a public or private basis, in part because of the availability of funding from other sources, but also in part because of the costs and difficulties of securities law compliance. As marketplace lenders who operate P2P programs therefore face some compliance issues that may not apply to those who don’t, herein we refer to lenders who operate such programs as “Operators.” The development of these programs and the laws applicable to those P2P note programs are discussed in this appendix.

Securities Laws

A. Securities and Exchange Commission (SEC)

As of late, the SEC has not had a significant impact on marketplace lending although it oversees the P2P note programs of some industry players. However, in April 2019, the SEC fined an online lender \$3 million for allegedly overstating returns for more than 30,000 investors.¹ The overstatement was alleged to have resulted from omission of debts that were unlikely to be repaid. The disclosed returns excluded the impact of the worst performing loans.² The SEC claimed some returns were double their true value. The SEC stated that it is committed to holding fintech companies to the same standards applicable to other participants in the securities markets.

In March 2021, the SEC adopted its final rule “Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets,” which implements several amendments to the crowdfunding regulations.³ The amendments included raising the offering limit from \$1.07 million to \$5 million, as well as amending the investment limits to remove them entirely for accredited investors and to permit non-accredited investors to invest the greater of their annual income or net worth. These changes suggest a desire by the SEC to make crowdfunding offerings more available and on simpler terms than had been the case under the preexisting regulatory scheme.

B. Background

Two of the largest consumer marketplace lenders—LendingClub Corporation (“*LendingClub*”)⁴ and Prosper Marketplace, Inc. (“*Prosper*”)—have been the market leaders in using the Internet to sell pass-through notes representing fractional interests in individual loans to retail investors (so called “*peer-to-peer*,” or “*P2P*,” programs). These programs have made new investment opportunities available to the public by enabling

1 *In re Prosper Funding LLC*, Adm. Proc. No. 3-19148 (Sec. Exch. Comm’n Apr. 2019).

2 The company engaged in debt sales where third-party debt buyers purchased defaulted loans and the company’s system then stopped including those loans in calculating investors’ returns. Investors continued to buy securities based on the inaccurate return figures, allowing the company to profit from additional transaction fees related to the loans, according to the SEC. The company did not admit or deny the SEC’s findings but has implemented increased supervision, periodic reviews and testing.

3 86 Fed. Reg. 3496 (Jan. 14, 2021).

4 LendingClub is now a bank holding company and loans are made by LendingClub Bank, N.A.

investors to purchase indirect interests in specific consumer loans. Although most marketplace lenders now fund themselves principally from other sources, P2P note programs continue to fund a significant amount of loan originations. Certainly, these programs have attracted and continue to attract a great deal of media attention and public interest. The remainder of this subsection therefore describes the structure of consumer-oriented P2P platforms, as a prelude to the discussion that follows of related securities law issues, but readers are cautioned that most lenders do not operate such platforms and that, of those who do, most exclude retail investors from the notes offering in order to simplify securities law compliance.⁵

The goal of any P2P platform operator (hereinafter, an “*Operator*”) is to create a user-friendly Internet-based platform that permits an efficient matching of investors having capital to deploy with consumers seeking credit.⁶ To that end, the Operator will establish and manage a website that permits investors to register as prospective lenders and individuals to register as prospective borrowers. Each registered borrower that satisfies certain criteria fixed by the Operator may from time to time request the Operator to post loan requests on the website for viewing by prospective lenders.⁷ Each borrower must disclose or make available to the Operator, and through the Operator to prospective lenders, certain financial and other information including, among other items, the borrower’s credit score (as determined by a credit reporting agency), self-reported income range, debt-to-income ratio, employment status, homeownership status, number of existing credit lines, intended use of funds, and number and/or amount of recent payment defaults and delinquencies. Borrowers may not, however, disclose their identities to prospective lenders or post information that would permit their identities to be determined. The identities of lenders similarly are not disclosed to borrowers. The Operator will use the information reported by each borrower to assign a proprietary credit rating to the requested loan and to fix the interest rate for the loan. The Operator will include in the website posting for each loan request the relevant borrower-reported information, the Operator’s proprietary credit rating of the borrower, and the yield to lenders (*i.e.*, the fixed interest rate on the loan net of the Operator’s servicing fees). Prospective lenders may view the posted information for each loan request and determine whether they wish to fund the loan or any portion of it. No borrower may request a loan in excess of a specified maximum (*e.g.*, \$35,000) or have outstanding multiple loans that, in the aggregate, exceed the maximum. A lender who chooses to invest in a loan may offer to fund any portion of the loan that equals or exceeds a specified minimum (*e.g.*, \$25). In order to minimize credit risk through diversification, it is in fact typical for lenders (other than certain institutional investors) to fund only a small portion of each loan in which they invest and to acquire over time investment portfolios comprised of partial interests in many different loans.⁸

5 Most marketplace lenders are not currently offering to sell pass-through notes to retail investors but are funding themselves principally through lines of credit, whole-loan sales to institutional investors, securitizations, and/or other arrangements that do not entail an Internet-based securities offering. Much of the discussion that follows pertaining to securities laws will therefore not be relevant to most marketplace lenders. At the same time, even marketplace lenders who do not issue pass-through notes may finance themselves through other types of transactions—such as securitizations—that will be subject to certain of the securities laws discussed below.

6 The remainder of this section summarizes the structures employed by LendingClub and Prosper. The discussion is not, however, intended to provide a complete description of the LendingClub and Prosper structures or to identify all of the differences that may exist between them. It also does not describe all of the lending businesses in which LendingClub and/or Prosper is currently engaged.

7 The Operator may, for example, choose to arrange loans only for borrowers having credit scores that exceed a specified minimum and/or debt-to-income ratios that are lower than a specified maximum.

8 Marketplace lenders have increasingly come to rely upon institutional rather than retail investors to finance their lending operations and most lenders (excluding LendingClub and Prosper) do not solicit retail funding. These institutional investors may include investment funds organized to acquire P2P loans. It is not efficient for institutional investors to purchase fractional interests in individual consumer loans, and in response most lenders have established “whole-loan” programs through which institutional investors may acquire the entire beneficial interest in individual loans. In certain programs the institutional investor will be able to select the specific loans it purchases; in others the marketplace lender will allocate whole loans to participating institutional investors with reference to category-wide loan eligibility approved by the investor. These programs have greatly facilitated the growth of the industry by accommodating institutional demand, but they also may reduce the opportunities for small investors to purchase interests in certain loans. Increased reliance on whole-loan programs and the securitization market is, to some extent, inconsistent with the argument that has often been made that P2P lending can level the playing field between institutional and individual investors and provide the latter with attractive investment opportunities previously denied to them.

A loan will fund if before the funding deadline stated in the loan request lenders subscribe for the full amount of the loan or, if the borrower has indicated that he or she will accept less than full funding, lenders subscribe for not less than the minimum amount of funding set forth in the loan request. The funding deadline for each loan request will be fixed according to the rules of the platform (*e.g.*, 14 days after the request is posted) rather than by the borrower. The platform similarly will prohibit loans from funding at any level less than a specified percentage (*e.g.*, 70%) of the requested principal amount. Each loan will have a fixed term (typically, two, three, or five years) and will amortize through equal monthly payments to its maturity date.

The Operator will maintain with a bank (the "*Deposit Bank*") a segregated deposit account on behalf of the lenders (the "*Funding Account*"). Each lender must have deposited in the Funding Account, at the time it offers to fund any loan, an amount that is both sufficient to provide that funding and is not committed to the funding of any other loan. The lender will be required to maintain this amount on deposit in the Funding Account until either the relevant loan is funded or the related loan request is withdrawn (*e.g.*, because lenders did not commit to fund the loan at a level equal to or exceeding the minimum funding amount). The principal amount of each funded loan (hereinafter, a "*Borrower Loan*") will be advanced by a bank (the "*Funding Bank*") not affiliated with the Operator. The Funding Bank and the Deposit Bank may be different institutions. The Funding Bank will deduct an origination fee from the funds it provides to the borrower and will pay a portion of that fee to the Operator as its transaction fee. The amount deducted may vary with the credit rating assigned to the Borrower Loan by the Operator. Shortly after the funding of the Borrower Loan by the Funding Bank, the Operator will (i) purchase the Borrower Loan from the Funding Bank at par using funds of the applicable lenders on deposit in the Funding Account, and (ii) issue to each such lender at par a note of the Operator (or an affiliate of the Operator) (a "*Platform Note*") representing the right to receive the lender's proportionate share of all principal and interest payments received by the Operator from the borrower on the applicable Borrower Loan (net of the Operator's servicing fees). The Platform Notes will be nonrecourse obligations of the Operator (except to the extent that the Operator actually receives payments from the borrower on the applicable Borrower Loan). Accordingly, lenders assume all of the credit risk on the applicable Borrower Loan and will not be entitled to recover any deficiency of principal or interest from the Operator if the borrower defaults. The Operator will service the Borrower Loans on behalf of the lenders and may refer any delinquent loan to a collection agency. The relatively low principal amounts of the Borrower Loans, however, generally will make it impracticable for the Operator to commence legal proceedings against defaulting borrowers. The Operator will maintain a segregated deposit account (the "*Collections Account*") at the Deposit Bank into which it will deposit all payments it receives on the Borrower Loans. The Operator will deduct its servicing fee from each Borrower Loan payment it receives before forwarding the net amount to the applicable lenders as payments on their Platform Notes.⁹

As might be expected in connection with an Internet-based lending system, both the notes evidencing the Borrower Loans and the Platform Notes are executed electronically, and physical Borrower Loan notes and Platform Notes are not delivered. The Platform Notes are not listed on any securities exchange but may be transferable through an electronic trading system operated by a broker-dealer not affiliated with the Operator. The Operator provides no assurances as to the liquidity or value of the Platform Notes. Notwithstanding the associated credit and liquidity risk, potential investors may find P2P lending attractive, as the available performance data indicate that a well-diversified portfolio of Platform Notes can produce

9 The servicing fee deducted from each Borrower Loan payment is typically in the area of 1% of the payment amount.

attractive risk-adjusted rates of return. At the same time, Operators who fund themselves through Platform Notes will face the challenge of securities law compliance.¹⁰ The P2P platforms are subject on a continuing basis to a number of separate federal and state securities laws. As discussed below, these laws are complex and compliance entails substantial costs.

C. *Securities Act*

The Securities Act of 1933 (the "*Securities Act*") requires any issuer engaged in a public offering of its securities to register the securities with the SEC unless an exemption from registration applies. The registration exemptions in the Securities Act are rather narrow in scope and none of them will be available for a public offering of Platform Notes.¹¹ An Operator therefore must register its Platform Notes with the SEC before commencing public sales of its securities.¹²

The SEC registration process is not simple. The Securities Act requires each issuer engaged in an offering of registered securities (or the dealer or underwriter selling the securities) to deliver to the investors a prospectus that sets forth specified information concerning the issuer and the securities. Among other matters, the prospectus will need to include a detailed description of the Operator and the Platform Notes, an analysis by the Operator's management of the Operator's financial condition and its recent results of operations, specified financial information, a discussion of the applicable risk factors, certain information concerning the issuer's directors and executive officers, and descriptions of the Operator's material contacts, any material transactions between the issuer and its directors, officers, and/or affiliates, any material legal proceedings affecting the Operator, and the plan for distributing the securities. The SEC developed its disclosure guidelines long before Internet-based lending became a possibility and accordingly certain of them are not an exact fit for P2P companies. Although each of LendingClub and Prosper has successfully registered its Platform Notes with the SEC, and although LendingClub's and Prosper's prospectuses may provide some guidance regarding the disclosure formats and level of disclosure that the SEC will approve, prospective Operators should allow at least several months (and probably more) to complete the SEC registration process and should expect to incur substantial related expenses. The timeline for obtaining

10 Although certain categories of "notes" are not treated as "securities" under the Securities Act, the SEC determined in an enforcement proceeding in 2008 that Platform Notes don't fall within those categories but instead create an "investment contract" and are subject to regulation as "securities." Among other factors that it deemed relevant to this determination, the SEC noted that P2P lenders and borrowers would not connect but for the Internet platform; that the lenders would rely entirely upon the Operator to service the loans and manage all aspects of the repayment process; that a "reasonable investor" would likely believe that Platform Notes are "investments"; and that lenders would not be protected under any alternative regulatory scheme if the Platform Notes were deemed not to be "securities." The SEC ruling leaves no doubt that the Securities Act will apply to Platform Note offerings.

11 As used in this book, the term "Platform Notes" includes loan pass-through obligations issued by any Operator and is not limited to obligations issued by LendingClub or Prosper.

12 Operators that do not issue Platform Notes but rather simply sell whole loans (or participations in such loans) are advised to consider whether such loans (or participations therein) are in fact "securities" under the Securities Act. Among the factors relevant to this determination are whether the loan purchaser is a regulated lender or an investor not principally engaged in lending as a business, the plan of distribution of the loans (*i.e.*, whether the loans will be marketed to many unrelated investors in small denominations in a manner more typical for securities distributions than for lending arrangements), the reasonable expectations of the investors, and whether the program will be subject to an alternative regulatory scheme (such as banking and consumer lending laws) that could make the application of the securities laws unnecessary for the protection of investors. The analysis of whether a marketplace loan (or certain commitments by the Operator to investors) is a "security" can also be affected by the composition of the investor base for the loans. See footnote 629 below.

approval will largely be driven by the number and significance of the comments submitted by the SEC staff on the applicant's filings—a variable that the applicant can affect but not control through careful preparation of its documents.

At the same time, newly formed Operators are likely to qualify for certain advantages that the Jumpstart Our Business Startups Act (the "*JOBS Act*") provides to "emerging growth companies." Among other matters, an emerging growth company is permitted to (i) reduce the scale of certain financial disclosures that would otherwise be required in its prospectus, (ii) not provide an auditor attestation of its internal controls over financial reporting procedures (as would otherwise be required by the Sarbanes-Oxley Act), and (iii) choose to implement new or revised accounting procedures (when promulgated by FASB) under the extended transition period available to nonpublic companies. An emerging growth company (unlike other issuers) also is permitted to submit its initial registration statement to the SEC on a confidential basis so that the issuer can consider and address initial SEC staff comments before any filings become public. An issuer's status as an emerging growth company does not continue indefinitely but will terminate on specified dates. As initially constructed, issuers that had total annual gross revenues of less than \$1 billion during their most recently completed fiscal year and that, as of December 8, 2011, had not sold any of their equity securities under a Securities Act registration statement qualified as an "emerging growth company" under the JOBS Act. Pursuant to the statutory definition, the SEC is required every five years to index to inflation the annual gross revenue amount used to determine emerging growth company status to reflect the change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics. In September 2022, the SEC adopted amendments to Securities Act Rule 405 and Exchange Act Rule 12b-2 to reflect the most recent updates to the emerging growth company definition with an inflation-adjusted annual gross revenue threshold from \$1,070,000,000 to \$1,235,000,000.

An Operator that registers its securities will need to rely on Securities Act Rule 415. This rule permits issuers to file "shelf" registration statements under which they register a specified amount of a generic category of securities (*e.g.*, "notes" or "debt securities") but don't specify the maturity dates, interest rates, or other negotiated financial terms that will apply to individual securities. When the issuer (or its underwriter) reaches agreement with an investor for an issuance of specific securities, the issuer will take the requisite amount of securities off the "shelf" by delivering to the investor and filing with the SEC a prospectus supplement that specifies the amount of securities sold and the applicable negotiated terms. The alternative approach—under which the issuer files a separate registration statement for each security that it sells—would not work for Operators because of the sheer volume of securities they will sell. Stated differently, if Rule 415 were not available, each Platform Note—because its underlying borrower, maturity date, and interest rate won't in combination match those of any other Platform Note—would constitute a distinct series of securities and would have to be separately registered. The cost of filing multiple registration statements would be prohibitive. Rule 415 therefore makes registered offerings of Platform Notes possible but, at the same time, the Rule was not specifically designed to accommodate P2P lending. In particular, Operators remain subject to the requirement to file with the SEC separate preliminary or final prospectus supplements for each security offered or sold under the shelf registration. Unlike corporate issuers that utilize Rule 415, and that ordinarily will sell debt securities off their shelf registrations only on an occasional basis, Operators will expect to offer and sell multiple series of Platform Notes to multiple investors every day. An Operator therefore will be required to prepare and file with the SEC each year numerous prospectus supplements or

“listing reports,” which briefly summarize the terms of each Borrower Loan underlying a Platform Note. An Operator can significantly reduce the burden of this filing requirement by automating the preparation and filing of the supplements. The filing nonetheless seems to impose an unnecessary expense on Operators (except, of course, to the extent that it enables them to remain in technical compliance with the Securities Act) since P2P investors almost universally will rely upon the platform website and not on SEC filings to access the terms of their Platform Notes.¹³

Planning Tip: The SEC registration process is complex, time-consuming and expensive. Operators who choose to register their Platform Notes for sale to the general public must be prepared to devote substantial resources to the effort.

Regulation AB under the Securities Act sets forth the disclosure requirements that apply to registered offerings of asset-backed securities and to certain periodic reports that the issuers of registered asset-backed securities must file. Operators have not structured their disclosures to Platform Note investors to satisfy Regulation AB requirements and in view of the effort and expense involved may prefer not to do so. Although Platform Notes could, in one sense, be characterized as “asset-backed” obligations since each Platform Note is backed by the cash flow from a specific Borrower Loan, the SEC has not treated Platform Notes as “asset-backed securities” for purposes of Regulation AB, nor should it have done so. Regulation AB defines an “asset-backed security” as a security that is “primarily serviced by the cash flows of a discrete *pool* of receivables or other financial assets” (emphasis supplied). As each Platform Note is backed by only a single Borrower Loan and not by a “pool” of financial assets, Platform Notes are not covered by the Regulation AB definition.¹⁴ In addition, Regulation AB limits the concept of “asset-backed security” to securities of an issuer that limits its activities to “passively owning or holding the pool of assets, issuing the asset-backed securities ... and other activities reasonably incidental thereto.” An Operator, however, will not limit its activities to “passively owning or holding” the Borrower Loans and issuing the related Platform Notes but will instead be actively engaged in structuring, promoting, and operating its proprietary Internet-based lending system. The Operator, in other words, should be considered an operating company that is fundamentally different from the securitization trusts and other special purpose issuers that historically have been subject to Regulation AB. However, the fact that Platform Notes are not “asset-backed

13 The SEC is not unaware of the need for securities regulation to evolve in tandem with changes in financial technology. In October 2018 the SEC announced the launch of its “Strategic Hub for Innovation and Financial Technology” (“*FinHub*”). Among other goals, the SEC intends FinHub to provide a forum through which industry and the public can directly engage with the SEC on innovative ideas and technological developments. See <https://www.sec.gov/finhub>.

14 It is true that Regulation AB can apply to certain issuers that hold only a single cash-generating asset. For example, single-property commercial mortgage-backed securities (“*CMBS*”) may be viewed as asset-backed securities even though the securities are backed by a single asset (a mortgage loan on the underlying real estate). Such CMBS are not backed by a “pool” of separate mortgage loans but still will have two features that are commonly associated with asset-backed securities: (i) the CMBS will create credit tranches (*i.e.*, the securities will be issued in multiple senior and subordinate classes), and (ii) the CMBS issuer will make payments on each class of its securities from the cash flow paid by a number of different underlying obligors (*e.g.*, the lessees holding separate leaseholds at the mortgaged property). Neither of these features applies to Platform Notes. In other cases, the issuer will hold no material assets other than a single security representing an indirect interest in a pool of financial assets (*e.g.*, the issuer in a credit card securitization may invest in an underlying credit card master trust that holds the credit card receivables). It’s reasonable to conclude that such issuers are issuing “asset-backed securities” since they are indirectly investing in a broad group of self-liquidating financial assets and will use the cash flow generated by those assets to make the payments on their securities. This is not the case for Platform Notes since each Platform Note is backed by only one Borrower Loan.

securities” under Regulation AB does not necessarily mean that they are not “asset-backed securities” under certain other federal securities laws. See “Risk Retention Requirements” below.

Another issue that prospective Operators should consider is the potential for liability to investors for inaccurate disclosures. The Securities Act provides investors with recourse against issuers who sell securities through offering materials that contain an untrue statement of a material fact or omit to state a material fact (the standard of liability can vary in certain respects between registered and unregistered offerings). All issuers therefore face potential liabilities to investors if their offering materials are inaccurate. Most issuers, however, are in a position to verify the accuracy of the information they disclose to investors since the information concerns or derives from the issuer itself. In contrast, Operators may also have liability for inaccurate information submitted to them by prospective borrowers and disclosed to prospective lenders through the platform website. Operators may verify some of the information submitted to them by prospective borrowers but almost certainly will not have the time or resources to verify all such information. The information so disclosed will be considered part of the Operator’s prospectus for Securities Act purposes, and some of the information (*e.g.*, the borrower’s self-reported income range or intended use of proceeds) may be deemed material by investors who fund the related loans. Accordingly, investors who lose money on their Platform Notes and can identify borrower misstatements in the related loan postings possibly could bring claims against the Operator under the federal securities laws. However, it is far from certain that any such claims would succeed. The Operator will have disclosed in its prospectus that not all borrower-reported information is verified by the Operator and that investors must assume the risk that such information is inaccurate. A court might well decide that the Operator satisfied its Securities Act disclosure obligations by disclosing this risk. In addition, as most Platform Notes have relatively low principal amounts it generally will be impractical—unless there are grounds for class certification—for investors to initiate legal proceedings against an Operator. The scope of Operator liability for inaccurate borrower information nonetheless has not yet been considered by any court. Prospective Operators should be aware that, in a worst-case scenario, they could face liability under the federal securities laws for inaccurate borrower information (including intentional borrower misstatements).

As discussed above, registration of Platform Notes with the SEC is an expensive and time-consuming process. An Operator therefore might choose not to register its securities but to offer them in a private placement exempt from registration pursuant to Section 4(a)(2) of the Securities Act. The SEC has adopted Rule 506 of Regulation D under the Securities Act to provide a “safe harbor” that issuers may follow to ensure that their offerings will be exempted by Section 4(a)(2). Under the original version of Rule 506, it would have been difficult for an Operator to conduct a valid private placement because the exemption was not available to issuers that offered their securities through “general advertising” or “general solicitation.” A securities offering made over the Internet—even if sales of the securities were limited to the institutions and high net worth/income individuals that qualify as “accredited investors” under Regulation D—might be deemed by the SEC to involve “general advertising” or “general solicitation” and thus would not qualify for the exemption. In the JOBS Act, however, Congress directed the SEC to revise Regulation D so that the issuers of offerings made pursuant to Rule 506 of Regulation D are not prohibited from using general advertising or general solicitation if the securities are sold only to “accredited investors.” The SEC approved implementing rules that became effective in September 2013. Under these rules, Operators are able to sell Platform Notes over the Internet to “accredited investors” without incurring the substantial time, expense,

and paperwork that would be required to register the securities with the SEC. The following section provides details on Rule 506 offering procedures.

D. The Private Placement Rules

The freedom that Operators enjoy under amended Rule 506 to engage in general solicitations of accredited investors without registering their Platform Notes with the SEC has made the path of many startup companies much easier. Most marketplace lenders who issue Platform Notes, including various companies engaged in consumer, small business, and real estate lending, in fact accept investments only from accredited investors. A prospective Operator must nonetheless consider whether restricting the sale of its Platform Notes to accredited investors will unduly limit its investor base. In relevant part, the term “accredited investor” includes most institutional investors and individuals who (i) individually, or with their spouse, have a net worth exceeding \$1 million exclusive of the value of the person’s primary residence (and subject to certain adjustments for “underwater” mortgages), or (ii) individually had an income in excess of \$200,000 in each of the two preceding years, or had a joint income with spouse in excess of \$300,000 in each of those years, and have a reasonable expectation of reaching the same income level in the current year.¹⁵ An Operator that intends to sell Platform Notes to individuals may not use Rule 506 unless it excludes nonaccredited investors.¹⁶ Operators whose business plans require a broader investor base should continue to register their Platform Notes with the SEC or, possibly, consider using Regulation A+ (discussed below). The strong interest of institutional investors in marketplace loans as an asset class, however, may well reduce the pressure for prospective Operators to register their notes for public sale.

The Rule 506 amendments that made general solicitation possible also added two important conditions to the Rule 506 exemption. First, the Operator is required to take “reasonable steps to verify” that each purchaser of the Platform Notes is, in fact, an accredited investor. Congress and the SEC have imposed the verification requirement to reduce the risk that general solicitation by Rule 506 issuers will result in sales of securities to nonaccredited investors. This concern applies with particular force when sales are made to natural persons. The SEC has not required that issuers employ any specific procedures to confirm that their investors are accredited but, to facilitate compliance, it has listed in the Rule certain nonexclusive procedures that it will deem sufficient to verify a natural person’s status. If, for example, the Operator proposes to sell

15 On August 26, 2020, the SEC adopted amendments to the definition of accredited investor (SEC Release Nos. 33-10824; 34-89669; File No. S7-25-19). The amendments to the accredited investor definition added new categories of natural persons based on professional knowledge, experience, or certifications and added new categories of entities, including a “catch-all” category for any entity owning in excess of \$5 million in investments. In particular, the amendments to the accredited investor definition: (1) added to the definition new categories that permit natural persons to qualify as accredited investors based on certain professional certifications and designations, such as a Series 7, 65 or 82 license, or other credentials issued by an accredited educational institution; (2) with respect to investments in a private fund, added a new category based on the person’s status as a “knowledgeable employee” of the fund; (3) added limited liability companies that meet certain conditions, registered investment advisers, exempt reporting advisers and rural business investment companies to the current list of entities that may qualify as accredited investors; (4) added a new category for any entity, including Indian tribes, that owns “investments,” as defined in Rule 2a51-1(b) under the Investment Company Act, in excess of \$5 million and that was not formed for the specific purpose of investing in the securities offered; (5) added “family offices” with at least \$5 million in assets under management and their “family clients,” as each term is defined under the Investment Advisers Act; and (6) added the term “spousal equivalent” to the accredited investor definition, so that spousal equivalents may pool their finances for the purpose of qualifying as accredited investors.

16 An issuer technically may sell its securities to not more than 35 nonaccredited investors and continue to rely upon Rule 506. If, however, the issuer makes any such sales the offering will become subject to certain disclosure requirements. Accordingly, as a practical matter Rule 506 issuers almost always sell the securities only to accredited investors.

Notes to a natural person who represents that he or she satisfies the income test, the Operator could verify the prospective purchaser's status by (i) reviewing copies of any Internal Revenue Service form that documents such person's income for the two most recent years (*e.g.*, Form W-2 or 1040), and (ii) obtaining a written representation from such person that he or she has a reasonable expectation of having an income during the current year that is sufficient to satisfy the test. Alternatively, if the prospective purchaser represents that he or she satisfies the net worth test, the Operator could (among other possible approaches) verify the purchaser's status as an accredited investor by reviewing copies of personal brokerage or bank account statements (to confirm assets) and a consumer report from at least one nationwide consumer reporting agency (to confirm liabilities). It will be important for the Operator (or any third party that it engages for the purpose) to perform the verification review diligently as the Operator must have a "reasonable belief" that each of its investors is accredited to qualify for the exemption.¹⁷ It's also important to remember that each investor must be accredited whenever he or she purchases a Note (and not only on the date of the investor's first purchase). The Operator therefore must take care to obtain and review updated financial information for each of the investors on a periodic basis. Finally, the Operator will need to consider whether any verification procedures that require natural persons to deliver personal financial information to the Operator will impair the marketability of the Platform Notes.

Second, Rule 506 contains disqualification provisions that make the exemption unavailable if the issuer or any of various persons associated with it or the offering (including, among others, its directors, executive officers, other officers participating in the offering, 20% equity holders, and any placement agent) has been convicted of specified felonies or misdemeanors or is subject to specified court or regulatory orders (collectively, "*Disqualifying Events*"). The list of Disqualifying Events includes a broad range of criminal, regulatory, and administrative proceedings. As examples, an Operator will be unable to rely upon Rule 506 if it, or any of its relevant associated persons, has within the past ten years (or five years, in the case of the Operator itself) been convicted of any felony or misdemeanor in connection with the purchase or sale of any security; is subject to any court order or judgment entered within the past five years that enjoins the Operator or such person from engaging in any practice arising out of the business of an underwriter, broker, dealer, or investment adviser; or is subject to a final order of any state securities, banking, or insurance commission that bars such person from engaging in the business of securities, banking, or insurance. It should not be difficult for an Operator to monitor its own status under the disqualification provisions but, if it engages any placement agent to assist it in the sale of the Platform Notes or of other securities offered under Rule 506, it must also confirm (and monitor on an ongoing basis) that the placement agent and its associated persons are not subject to any Disqualifying Event.

Takeaway: Operators who don't need unrestricted access to a retail investor base will often find it quicker and cheaper to sell their Platform Notes only to "accredited investors" in a private placement exempt from SEC registration.

17 Private placements that use general solicitation will be made pursuant to Rule 506(c) of Regulation D. Alternatively, it remains possible for issuers to undertake Regulation D private placements without using general solicitation pursuant to Rule 506(b). In such event, the issuer still must have a "reasonable belief" that each accredited investor is, in fact, accredited, but in the absence of general solicitation the issuer is not required to take additional actions to verify the investor's status as described herein. An Operator that offers its Platform Notes over the Internet to accredited investors with whom it does not have a preexisting relationship would likely be deemed to be engaged in "general solicitation" and therefore subject to the verification requirement.

A final point to consider in relation to Rule 506 offerings is the potential application of broker-dealer registration requirements. Any company that makes direct offers of securities through an Internet platform (rather than through a broker-dealer registered with the SEC and in the applicable states) potentially is subject to registration as a broker-dealer at both the federal and state levels. To address this issue Congress included in the JOBS Act (codified as Section 4(b) of the Securities Act) an exemption from broker-dealer registration for persons who maintain a platform or mechanism (which may include a website) to offer securities if (i) the securities are offered only under Rule 506, and (ii) certain other conditions are satisfied. Among such other conditions, neither that person nor any person associated with it may receive any compensation in connection with the sale of the securities. The SEC interprets the term “compensation” broadly and the Section 4(b) exemption narrowly. The SEC would likely view the origination fees payable to the Operator in connection with new Borrower Loans as “compensation” for these purposes. The SEC has in fact stated that “the prohibition on compensation makes it unlikely that a person outside the venture capital area would be able to rely upon the [Section 4(b)] exemption.” Other elements of Section 4(b) also indicate that the exemption is meant for platforms through which third-party issuers undertake Rule 506 offerings rather than for issuers engaged in offering their own securities. Accordingly, although at first glance Section 4(b) appears to be helpful to Operators that undertake Rule 506 offerings, such Operators will in fact need to look elsewhere for exemptions from broker-dealer registration. See “Securities Exchange Act” below.

E. Regulation A+

The SEC some years ago adopted Regulation A under the Securities Act to provide an exemption from registration for certain relatively small offerings. Regulation A permitted an issuer to offer its securities publicly but imposed a number of conditions that are not applicable to Rule 506 private placements, including specified disclosure and presale filing requirements. In addition, an issuer could not use Regulation A to sell more than \$5 million of securities in any 12-month period. These provisions made Regulation A less flexible than Rule 506, and issuers did not often use it. Having concluded that Regulation A was too narrow and that it could promote capital formation by allowing small issuers a broader exemption from Securities Act registration, Congress directed the SEC in the JOBS Act to adopt regulations that would permit certain issuers to publicly offer and sell up to \$50 million of their securities in any 12-month period. On March 25, 2015, the SEC responded to this mandate by heavily amending Regulation A. The revised version of Regulation A (so-called “*Regulation A+*”) is proving useful to many privately held operating companies that are seeking to raise equity capital from both accredited and nonaccredited investors. Unfortunately, Regulation A+ includes a number of restrictions and requirements that will likely make it unsuitable for most public offerings of Platform Notes.

Regulation A+ is divided into two tiers: Tier 1, for securities offerings of up to \$20 million, and Tier 2, for offerings of up to \$50 million.¹⁸ Both Tier 1 and Tier 2 issuers will be required to make certain specified disclosures to investors, file an offering statement with the SEC, and obtain SEC clearance before commencing sales. Each issuer must also provide investors with certain financial statements including, in the case of Tier 2 issuers, audited statements. The disclosure requirements are broader for Tier 2 issuers

¹⁸ Regulation A+ cannot be used to offer “asset-backed securities” as defined in Regulation AB under the Securities Act. As previously discussed, Platform Notes should not constitute “asset-backed securities” for this purpose. See “Securities Act” above.

than for Tier 1 issuers and in many respects, resemble those that would apply in a registered public offering by the same company. In addition, Tier 2 issuers will be subject to ongoing reporting requirements pursuant to which they must file annual, semiannual, and current event reports with the SEC similar to (though less comprehensive than) the periodic reports that registered issuers must file under the Securities Exchange Act of 1934 (the “*Exchange Act*”). See “Securities Exchange Act” below. The issuer also would be required to file a pricing supplement with the SEC in connection with the sale of each Platform Note similar to the prospectus supplements that are filed for individual sales of registered Platform Notes. Tier 1 issuers will be required to register their securities under the Blue Sky laws of the states in which they are sold (or qualify for an exemption from such registration), whereas Tier 2 securities will be exempt from state registration requirements.¹⁹ Regulation A+ will not be available if the issuer or certain other transaction participants are subject to a Disqualifying Event (as described under “The Private Placement Rules” above). In addition, Tier 2 issuers may not sell their securities to any purchaser (other than accredited investors) in an amount exceeding 10% of the greater of the purchaser’s (i) annual income or net worth (in the case of natural persons), or (ii) annual revenue or net assets at fiscal year-end (in the case of non-natural persons).

Securities issued under Regulation A+ will not constitute “restricted securities” under the federal securities laws. Holders of the securities (other than issuer affiliates) therefore may resell them free from any Securities Act restrictions as to the amount or timing of sales. In contrast, securities sold under Rule 506 do constitute “restricted securities” and are subject to resale restrictions. See “Secondary Trading” below.

The principal difficulty posed by Regulation A+ for offerings of Platform Notes remains the cap on the permitted offering amount. The respective Tier 1 and Tier 2 caps refer to the amount of securities sold by the issuer in reliance upon the exemption in any 12-month period. The increase in the offering cap relative to prior Regulation A will permit many privately held operating companies to raise substantial amounts of capital, but an Operator engaged in a continuous offering of Platform Notes is unlikely to achieve long-term success if it cannot sell more than \$20 million principal amount of Platform Notes (in the case of a Tier 1 offering) or \$50 million (in the case of Tier 2) in any 12 months.²⁰ An Operator could consider selling Platform Notes under Regulation A+ as it ramps up operations and then registering its Platform Notes

19 The Securities Act authorizes the SEC to define classes of “qualified purchasers” to whom securities may be sold without Blue Sky registration. Pursuant to this authority, the SEC has exempted all Tier 2 securities from Blue Sky registration by adopting a rule that defines “qualified purchaser” to include all purchasers of Tier 2 securities. The states of Massachusetts and Montana sued the SEC in federal court to invalidate this rule. These states contended that Congress intended the SEC to restrict its definition of “qualified purchaser” to narrowly defined classes of sophisticated and/or wealthy individuals who could reasonably be presumed to have the capacity to protect their own interests, and that the SEC exceeded its authority in granting a blanket exemption for all sales to Tier 2 purchasers. In June 2016, the U.S. Court of Appeals for the District of Columbia ruled in favor of the SEC and upheld the rule. *Linden v. SEC*, 825 F.3d 646 (D.C. Cir. 2016).

20 A study of the Regulation A+ offerings that have been undertaken through December 2016 found that over 85% of Regulation A+ issuers have used the Regulation to sell equity rather than debt securities. A. Knyazeva, “Regulation A+: What Do We Know So Far,” available at https://www.sec.gov/dera/staff-papers/white-papers/Knyazeva_RegulationA-.pdf. This finding is consistent with our expectation that Regulation A+ will likely be more useful to marketplace lenders seeking to raise limited amounts of equity capital than to those hoping to issue Platform Notes to retail investors. In March 2021, the SEC adopted amendments to the exemptive framework under the Securities Act of 1933 that increases the offering limits for Regulation A and revises certain individual investment limits based on the Commission’s experience with the rules, marketplace practices, capital raising trends, and comments received (86 Fed. Reg. 3496 (1/14/2021)) (the “*Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*”). The amendments also provide for expanded rules governing offering communications between investors and issuers, including permitting certain “demo day” activity without running afoul of the prohibition on general solicitation.

under the Securities Act (at which point the Operator could sell Platform Notes to the public in amounts not exceeding the amount registered with the SEC). However, since we expect that most new Operators will choose not to register their Platform Notes with the SEC because of the costs involved, and since an Operator can sell unlimited amounts of its Platform Notes to accredited investors under Rule 506 without becoming subject to the filing, disclosure, and reporting requirements that apply under Regulation A+ (which are particularly burdensome in Tier 2 offerings), it seems that Operators will have an incentive to use Regulation A+ rather than Rule 506 only if they can accept the offering cap and want to (i) sell a limited amount of Platform Notes to nonaccredited investors, and/or (ii) exempt their Platform Notes from Securities Act resale restrictions.²¹

Takeaway: Regulation A+ may sometimes be helpful to Operators seeking to raise limited amounts of capital (particularly equity capital), but is unlikely to provide an attractive framework on which to base a Platform Notes program.

F. Blue Sky Laws

In addition to registering its securities under the Securities Act, an issuer must register its securities in every state in which the securities are offered for sale to the public unless an exemption from registration applies. Platform Notes generally will not qualify for any exemption from registration under the state securities laws (the so-called “*Blue Sky*” laws) other than an exemption available in every state for the sale of securities to specified classes of institutional investors (the categories of exempt institutions vary between the states but typically include banks, insurance companies, investment companies, pension funds, and similar institutions). Accordingly, any Operator that intends to engage in a broad public offering of Platform Notes must register its securities in multiple states and pay the associated filing fees.

In many states, the state securities commission has authority to apply “merit” regulation and to deny registration to any securities it deems unsuitable for sale. A limited number of states—often citing the novel nature of Platform Notes and/or the Operator’s failure to provide lenders with fully verified borrower information—have in fact refused to permit the sale of Platform Notes to retail investors. Alternatively, a state may agree to register the Platform Notes but only subject to suitability criteria that will limit the scope of the offering therein. A state could, for example, limit sales of Platform Notes to investors whose annual income and/or net worth exceeds specified amounts or limit the dollar amount of Platform Notes that any single retail investor may purchase. The Operator must observe these restrictions in the applicable state even though the SEC has not imposed any equivalent restrictions at the federal level. In addition, prospective Operators should note that the Blue Sky laws contain provisions that may impose civil liability

²¹ An Operator might be able to undertake simultaneous Rule 506(c) and Regulation A+ offerings pursuant to which it could sell unlimited amounts of Platform Notes to accredited investors and not more than \$50 million of Platform Notes in any 12 months to nonaccredited investors. The Operator would remain subject to the Regulation’s ongoing filing and reporting requirements. An important question is whether the SEC would “integrate” the Regulation A+ and Rule 506(c) offerings (*i.e.*, treat the two offerings as a single combined offering for Securities Act purposes). Although Regulation A+ contains a safe harbor from integration of Regulation A+ offerings with other offerings of securities that are registered or fall within certain exemptions from registration if certain safeguards are observed, the Operator and its counsel would need to consider carefully if they can avail themselves of the safe harbor because integration, if applied, could result in the loss of both the Regulation A+ and the Rule 506(c) exemptions.

on the Operator for (i) disclosure violations (in much the same manner as previously discussed in relation to the Securities Act), or (ii) any failure to maintain required registrations in effect. In particular, the Blue Sky laws generally permit investors to rescind their investments and recover the full purchase price from the issuer (plus interest) if the issuer sold them unregistered, nonexempt securities. In view of the fact that most Blue Sky registrations must be renewed annually, it will be very important for Operators to monitor their Blue Sky filings and timely renew each registration before it expires.

Take Care: When structuring a securities offering, issuers sometimes focus on the Securities Act and the SEC and pay insufficient attention to the Blue Sky laws. This can be a very costly mistake given the civil, administrative and criminal penalties that can result from Blue Sky violations.

The Securities Act does preempt the right of the states to require the registration of certain categories of securities offerings. In particular, the states are not permitted to require the registration under the Blue Sky laws of any securities that are offered in a private placement pursuant to Rule 506 of Regulation D (although the states may require the issuer to submit certain notice filings and pay associated filing fees). Accordingly, an Operator that offers Platform Notes solely to accredited investors in a Rule 506 private placement (as described above) will be entitled to offer the securities in all of the states, and the states may not impose suitability criteria or otherwise restrict the categories of eligible investors. As previously mentioned, the Securities Act also preempts Blue Sky registration requirements in relation to securities sold under Tier 2 of Regulation A+.

The Securities Act also prohibits the states from requiring the registration of any securities listed on the New York Stock Exchange or the Nasdaq National Market System ("*Listed Securities*") or of any securities of a listed issuer that are senior or equal in rank to the Listed Securities. Some commentators have stated that an Operator that lists its common stock will thereby be exempted from Blue Sky restrictions because its Platform Notes will be "senior" securities. However, that statement might not be correct. The Blue Sky laws historically have included exemptions for the securities of listed companies because such companies (i) must satisfy stock exchange listing standards (which can, to some degree, be used as a proxy to identify "quality" companies), and (ii) are subject to ongoing regulation under both stock exchange and SEC rules.²² The exemption nonetheless does not extend to any subordinate securities of a listed issuer (*i.e.*, securities of the issuer that would be subordinate to its listed common stock in the event of an issuer insolvency) as these securities, by definition, entail a higher degree of risk than the Listed Securities. It follows that the Platform Notes of a listed Operator will be exempt from Blue Sky registration requirements only if, in the event of the Operator's insolvency, the Operator's assets would be applied to pay the Platform Notes before any distributions are made to the common stockholders (or, at a minimum, if the assets would be distributed between the noteholders and the stockholders on a *pari passu* and *pro rata* basis). Platform Notes generally do not satisfy that requirement since they are not full-recourse obligations. Specifically, the noteholders would have at most a claim, in any insolvency proceeding, only to the proceeds of the specific Borrower Loans allocated to their notes and could not make a claim against other Operator assets that might remain available for distribution to the common stockholders. Some states therefore may

²² The Blue Sky laws in most states for many years included exemptions for listed securities. In 1996 Congress effectively codified these exemptions, on a nationwide basis, by amending the Securities Act to preempt the application of state securities registration requirements to all listed securities and all securities of the same issuer of equal or senior rank.

take the view that Platform Notes are not “senior-to-list” or “equal-to-list” securities and that Blue Sky filings must continue to be made notwithstanding the Operator’s status as a public company.²³

LendingClub completed its initial public offering in December 2014 and listed its common stock on the New York Stock Exchange. LendingClub to date has chosen not to claim Blue Sky preemption for its Platform Notes but has continued to register them under state securities laws. In view of the significant civil and even criminal liabilities that could result from a failed claim of preemption, this appears to be a prudent decision.

G. Secondary Trading

Our discussion of securities law issues has to this point focused on the federal and state securities registration requirements that apply when Operators sell their Platform Notes to investors. A complete analysis of the registration requirements, however, must also consider their application to secondary market transactions. Investors in Platform Notes are not necessarily free under the securities laws to resell their notes whenever or wherever they choose. The scope of the applicable resale restrictions will depend significantly upon the manner in which the Operator originally placed the Platform Notes.

If the Operator sold the Platform Notes in a registered public offering, holders of the notes will be permitted to resell them without restriction under the Securities Act. The registration statement filed by the Operator with the SEC, as a practical matter, covers both the initial placement of the notes and subsequent resales, and no further filings with the SEC by either the Operator or the selling holders will be required. The Blue Sky laws, however, may nonetheless impose significant restrictions on resales. An important point—and one that is sometimes overlooked—is that the Blue Sky laws apply not only to an issuer’s sale of its securities but also to all secondary market sales. A holder of Platform Notes that have been registered under the Securities Act therefore will be entitled to resell the notes in those states in which they have been registered but may *not* resell them in the remaining states except pursuant to an exemption from registration. The Blue Sky laws do in fact contain various exemptions for “nonissuer” transactions that may be available to Platform Note investors. It therefore will often be possible for holders of outstanding securities to resell into a state securities that have not been registered in that state. Any such holder—and any securities broker acting for the holder—still should confirm the availability of a registration exemption in the applicable state before making such sale.²⁴

23 It would not be possible for an Operator to obtain Blue Sky exemptions for the Platform Notes by listing the notes on the New York Stock Exchange since, among other issues, the principal amount of each note will be far too small to satisfy the listing criteria. Also, as discussed under “Bankruptcy Considerations” below, an Operator may elect to isolate its noteholders from Operator insolvency risk by issuing the Platform Notes through a wholly-owned subsidiary. Under this structure, the issuers of the Listed Securities (*i.e.*, the Operator) and of the Platform Notes (*i.e.*, the subsidiary) will be different companies and Blue Sky preemption definitely will not apply.

24 The Securities Act preempts the application of Blue Sky securities registration requirements to certain nonissuer transactions in the securities of “reporting companies” (*i.e.*, issuers who file periodic reports under the Exchange Act). As discussed in “Securities Exchange Act” below, any Operator engaged in a continuous offering of registered Platform Notes will be subject to these reporting requirements. When preemption applies, investors will be permitted to resell their Platform Notes in all states without regard to the terms of the individual state securities laws. Although federal preemption therefore appears to exempt secondary trading in SEC-registered Platform Notes from all Blue Sky registration requirements, preemption in fact applies only if the seller is not acting as an “underwriter” of the securities. The Securities Act defines “underwriter” broadly and the term could extend to any holder who resells its Platform Notes prior to the expiration of certain waiting periods calculated from the notes’ original issuance dates. Federal preemption therefore will sometimes be helpful in creating Blue Sky exemptions for resales of SEC-registered Platform Notes but does not provide a basis for unrestricted trading in all such Platform Notes without regard to the circumstances of the resale.

If the Operator sold the Platform Notes under Regulation A+, holders of the securities (other than the issuer affiliates) may freely resell them without restriction under the Securities Act. In this respect, Regulation A+ securities have the same Securities Act status as registered securities. In addition, the Securities Act and Regulation A+ preempt the application of Blue Sky registration requirements to all securities sales made under Tier 2 of Regulation A+ (but not Tier 1). The preemption of Blue Sky requirements extends, however, only to the initial placement of the Tier 2 securities and not to any resales; any such resales therefore must comply with applicable Blue Sky laws.

If the Operator sold the Platform Notes in a Rule 506 private placement, the Platform Notes will constitute “restricted securities” for purposes of the Securities Act. A holder of restricted Platform Notes may not resell them unless the holder (i) registers the notes under the Securities Act, or (ii) sells them in an exempt transaction. The first of these options is not practical because of the expense that registration would entail. In contrast, several exemptions from registration are available for resales but each such exemption is subject to significant restrictions. The SEC has imposed these restrictions to help implement one of the Securities Act’s fundamental policies: that issuers must register their securities with the SEC (or satisfy Regulation A+) before offering them publicly. Stated differently, if the SEC permitted holders of Rule 506 securities to resell them without restriction, secondary market transactions could result in the securities being distributed broadly to the public in much the same manner as if the issuer had originally registered them for public sale.

Worth Remembering: The fact that an Operator has lawfully sold its Platform Notes to an investor does not necessarily mean that the investor can freely resell the Platform Notes to others. In all resales, the Platform Notes must either be registered or resold under an available exemption from registration.

There are three principal exemptions that may be available for resales of privately placed Platform Notes: Rules 144 and 144A under the Securities Act and Section 4(a)(7) of the Securities Act.

Rule 144. Rule 144 permits a holder of unregistered securities (other than an affiliate of the issuer) to resell the securities without registration under the Securities Act if the holder has held the securities for at least (i) six months, if the issuer is a reporting company under the Exchange Act, or (ii) one year, if the issuer is not a reporting company. There is no limit on the amount of securities that may be sold in reliance upon the exemption or the types of persons to whom the sales may be made.²⁵ Rule 144 therefore provides a very useful and straightforward exemption for holders of restricted Platform Notes who have satisfied the applicable holding period (which generally will be one year since Operators who have not registered their Platform Notes under the Securities Act are unlikely to be reporting companies under the Exchange Act). The very fact that the holding period applies, however, will prevent broker-dealers from using the Rule to develop a broad trading market for unregistered Platform Notes.

Rule 144A. Rule 144A exempts from registration any sale of securities made by a nonissuer to a “qualified institutional buyer” (“QIB”) if certain conditions are satisfied. Among other matters, each holder and

²⁵ The discussion of Rule 144 in this paragraph is limited to transactions by non-affiliates of the issuer. Rule 144 imposes a number of additional important restrictions, including limits on the volume of securities that may be sold, on transactions by affiliates.

prospective purchaser of the securities must have the right to obtain upon request certain basic information concerning the issuer and specified issuer financial statements. Rule 144A imposes no holding period and, like Rule 144, does not limit the amount of securities that the investor may sell. However, no sales to individual investors may be made under Rule 144A and, with limited exceptions, an institution must hold at least \$100 million in securities investments to qualify as a QIB. Rule 144A is designed to facilitate secondary trading of unregistered securities between large institutional investors and therefore also is unsuited to the development of a broad trading market for privately placed Platform Notes.

Section 4(a)(7). Section 4(a)(7) of the Securities Act permits the holders of privately placed securities, including securities originally sold under Rule 506, to resell the securities to accredited investors subject to certain conditions. Among other requirements, the seller cannot use the exemption if it is subject to certain disqualifying events (including those discussed above in relation to Rule 506) and may not offer the securities through general solicitation or general advertising. The seller must make available to the purchaser substantially the same issuer information and financial statements as would be required under Rule 144A. Although Section 4(a)(7) does not impose any holding period, the securities being sold must be part of a class of securities that has been authorized and outstanding for at least 90 days. As discussed below, Section 4(a)(7) could enable accredited investors to trade unregistered Platform Notes that have been outstanding for the requisite period.

Any secondary market seller must also consider Blue Sky compliance. As previously discussed, the Securities Act preempts state securities registration requirements in all Rule 506 offerings. The preemption, however, applies only to the issuer's initial sale of the securities and not to any resales made by the purchasers. Accordingly, each holder of Rule 506 securities will need to identify and comply with an available Blue Sky exemption—or identify a basis for federal preemption other than Rule 506—in connection with any resale it makes. Along these lines, Section 4(a)(7) resale transactions qualify for federal preemption in the same manner as Rule 506 offerings. It follows that both an issuer's initial sale of Platform Notes under Rule 506 and any resales of the notes made by the purchasers to other accredited investors will be exempt from Blue Sky registration (subject to the issuer's duty to submit state notice filings (in the case of the initial placement) and the seller's compliance with the specific terms of Section 4(a)(7) (in the case of resales)). Any resales of notes made by investors to QIBs under Rule 144A also generally will be exempt from state registration under exemptions the Blue Sky laws provide for sales to institutional purchasers. In contrast, Rule 144 transactions don't qualify for federal preemption and, depending upon the states involved, such transactions may not be exempt from state registration when the purchaser is not an exempt institution.

It's quite clear that Platform Notes will be more attractive as an investment if they are freely tradable. As discussed above, the Securities Act will not restrict trading in Platform Notes originally issued in a registered public offering or under Regulation A+. In addition, Securities Act registration will not be required for any resales of privately placed Platform Notes made to accredited investors under Section 4(a)(7). An Operator might therefore choose to facilitate secondary trading by establishing an electronic marketplace on which outstanding Platform Notes may be resold. The marketplace could be made available to all investors if the Platform Notes were originally sold in a registered offering or pursuant to Regulation A+ (subject to compliance with applicable Blue Sky laws in connection with each such resale) and to any accredited investor if the Platform Notes were sold in a Rule 506 private placement (subject to a determination that the seller's action in listing its securities for sale on an electronic marketplace does not constitute "general solicitation"

or “general advertising”). Any such marketplace must be operated by a registered broker-dealer and will likely have to be registered with the SEC under the Exchange Act as an “alternative trading system.” In this regard, LendingClub has arranged for a registered broker-dealer, FOLIO^{fn}, to operate an alternative trading system on which its outstanding Platform Notes may be traded.²⁶

Some market participants also have expressed interest in developing an electronic platform for the trading of consumer loans originated by Internet-based consumer lenders. If the loans (in contrast to Platform Notes) are not “securities,” they could be actively traded by investors without being registered under federal or state securities laws (or complying with Regulation A+ disclosure and reporting requirements) and without being subject to the restrictions that would otherwise apply under nonissuer resale exemptions such as Rules 144 and 144A. The Supreme Court has stated that notes evidencing consumer loans ordinarily will not constitute “securities” under the Securities Act. In addition, banks and other institutional investors routinely trade very substantial volumes of commercial loans (or participations therein) between themselves without deeming the loans or participations to be “securities.” These facts could provide some basis for arguing that the securities laws should not restrict trading in consumer loans originated by Internet-based lenders. Unfortunately, both the SEC and state securities regulators are very unlikely to accept that argument, at least in relation to any trading platform that permits participation by nonaccredited investors. Case law has made it quite clear that instruments that are not “securities” when originated—such as notes evidencing consumer loans—can become “securities” (or can be deemed to entail the offering of an associated “investment contract”) because of the manner in which they are marketed or the types of investors to which they are sold. Both the factors the courts have deemed relevant in those cases and the SEC’s analysis in the enforcement proceeding in which it held that Platform Notes are “securities” would strongly support a decision by the regulators to treat consumer loans as “securities” to the extent they are made available for trading by the general public on an electronic platform.²⁷

26 Prosper previously sponsored a similar FOLIO^{fn} trading system for its Platform Notes but terminated it in October 2016 due to low trading volumes.

27 The SEC’s readiness to treat certain marketplace loan sales as securities offerings is evident in comments made by the SEC staff in 2016 when it approved the registration of two closed-end investment companies organized to invest in marketplace loans. See “Closed-End Investment Companies” below. In the course of the registration process, each Fund was advised by the SEC staff that “it is the view of the SEC that the purchase of whole loans through alternative lending platforms involves the purchase of ‘securities’ under the Securities Act of 1933 ... issued by the originating platforms.” These statements by the SEC staff are not necessarily inconsistent with the general view that unsecured consumer loans, taken by themselves, are not “securities” because (i) the definition of “security” in the Securities Act also includes any “investment contract,” and (ii) it is possible for an investment that is not a “security” to be coupled with an “investment contract” and sold as a single financial product. In other words, the SEC could deem marketplace lenders who sell loans to retail investors also to be offering an associated “investment contract” consisting of the investment-related services that the lender provides to loan purchasers. In this connection, it is significant that the SEC staff stated that it viewed the issuer of the marketplace loan “security” as the originating lender (and not as the borrower under the loan). The relevant lender-provided services may consist of (i) loan servicing, (ii) the platform’s assignment of credit ratings to the loans, (iii) representations by the platform that each borrower satisfies specified criteria, (iv) the platform’s undertaking to handle all related cash flows (including the application of purchase prices paid by the investors), (v) undertakings to maintain a secondary market or trading platform for the loans, (vi) any general solicitation of borrowers and/or investors by the platform to assemble the mass of participants needed to make the investment scheme possible, and/or (vii) other similar activities. The manner in which the program is marketed to investors (*e.g.*, if it is presented as an alternative to lower-yielding debt investments such as CDs) also can be relevant. It follows that a marketplace lender that sells whole loans to retail investors could reduce the risk that it will be deemed to be offering “securities” by limiting the number of investment-related services it provides to investors. For example, the platform could require each investor to engage its own servicer. However, certain of the foregoing services are integral to any marketplace lending program and could not easily be withdrawn. It further could be difficult in connection with a retail offering to reduce the services provided to a level at which the SEC (and state regulators) would concur

H. Securities Exchange Act

Any issuer that sells securities under a registration statement declared effective under the Securities Act automatically becomes subject to certain ongoing reporting requirements pursuant to Section 15(d) of the Exchange Act. Any Operator that sells registered Platform Notes therefore will be required to file various reports with the SEC, including Annual Reports on Form 10-K and Quarterly Reports on Form 10-Q. These reports must contain such information concerning the Operator (including financial statements) as the SEC shall specify by rule. The preparation of these reports—particularly the Form 10-K—will require significant effort.

The Exchange Act also requires “brokers” and “dealers” to register with the SEC. The term “broker” means “any person engaged in the business of effecting transactions in securities for the account of others.” The term “dealer” means “any person engaged in the business of buying and selling securities for such person’s own account.” An issuer selling its own securities is not required, solely by reason of such sales, to register as either a broker or a dealer. The exemption does not necessarily extend, however, to employees of the issuer who represent the issuer in effecting the securities sales, particularly if the employees receive transaction-based compensation. An Operator that sells its Platform Notes directly to investors (rather than through a registered broker-dealer) therefore should observe the terms of a safe harbor that the SEC has adopted under the Exchange Act to provide an exemption from “broker” registration for issuer employees and, in particular, should not pay its own employees compensation that is directly tied to the number or principal amount of Platform Notes that are sold.

The need for broker registration must also be carefully considered if the Operator does not itself issue the Platform Notes but instead (i) organizes an affiliate to issue the Platform Notes (an option that the Operator could consider to address certain issues discussed under “Bankruptcy Considerations” below) and, as the affiliate’s manager, supervises or otherwise participates in its sale of the Platform Notes, or (ii) organizes an investment fund to invest in Borrower Loans and, as the fund’s general partner or managing member, places interests in the fund with unaffiliated investors. In these situations, the Operator potentially could be viewed as a “broker” that is placing securities on behalf of an issuer other than itself. At the same time, any person or company is much less likely to be deemed a “broker” if it does not receive transaction-based compensation. An Operator therefore will greatly strengthen its argument that SEC registration is not required for either it or its employees if, to the extent that the Operator has organized an affiliated issuer or investment fund, it does not take transaction-based fees from such issuer or fund and does not pay transaction-based compensation to its own employees.

Finally, each Operator should also consider the potential application of state broker-dealer registration requirements. In contrast to Blue Sky securities registration requirements, state laws requiring the

that no investment contract exists. It would be reasonable for the SEC to be concerned that individual marketplace loans can be risky and should not be marketed to unsophisticated individual investors without securities law compliance. The SEC therefore is likely to take an expansive view of its jurisdiction in connection with any such offerings. All this being said, an important factor in determining whether “securities” have been offered in connection with a loan sale remains the relative degree of sophistication, bargaining power and financial capacity of the investor, and, unless the SEC clearly states to the contrary, market participants will probably continue to take the position that institutional whole-loan sale programs do not entail a securities offering (although loan sellers may, as a precautionary measure, nonetheless require each purchaser to represent that it is an accredited investor and/or a QIB for Securities Act purposes).

registration of broker-dealers and/or sales personnel are not preempted by federal law in offerings by listed companies or in any Regulation A+ or Rule 506 offerings.²⁸ A breach of the requirements will expose the Operator to civil and/or criminal penalties and may entitle each purchaser of Platform Notes in the relevant state to rescind its investment. Most states exempt issuers from registration as broker-dealers, but a small number do not.

I. Investment Company Act

The Investment Company Act of 1940 (the “*Investment Company Act*”) requires “investment companies” to register with the SEC before selling any of their securities to the public.²⁹ The Act defines an “investment company” (in relevant part) as any person engaged in the business of investing in or holding “securities” and that (subject to certain adjustments) owns “securities” having a value exceeding 40% of the value of its total assets. Although the Borrower Loans funded through an Internet-based platform will not constitute “securities” for purposes of certain of the federal securities laws, the Investment Company Act definition of “securities” is very broad and will include the loans. The value of the Borrower Loans held by an Operator typically will greatly exceed 40% of the value of its total assets. Accordingly, absent an exemption, the Operator could be subject to registration as an investment company. As a practical matter, however, Operators cannot register as investment companies—even if they were otherwise prepared to do so—because the Investment Company Act imposes certain restrictions on registered investment companies (including restrictions on affiliated party transactions and permitted levels of aggregate indebtedness) that would make it impossible for the Operator to conduct its business. An exemption from registration therefore is needed.³⁰

Key Consideration: An Operator should not sell any Platform Notes unless it has identified an exemption from Investment Company Act registration and it strictly complies with the terms of the exemption.

Operators may in fact qualify for several different exemptions. Section 3(b)(1) of the Investment Company Act, for example, exempts from registration as an “investment company” any issuer primarily engaged in a business or businesses other than that of investing in, holding, or trading securities. An Operator could reasonably take the position that its primary business (even if the Borrower Loans are “securities”) is not investing in or holding loans but is, instead, the operation of an Internet-based financing platform intended to match borrowers needing credit with third-party lenders. In this regard, it is significant that the Operator, unlike a traditional investment company, does not purchase assets with a view to earning investment returns

28 In June 2013 the Ohio Division of Securities initiated against an online platform that was facilitating small business lending enforcement proceedings for multiple alleged violations of the Ohio Securities Act, including the platform’s failure to register itself as a dealer under the Ohio Securities Act.

29 The registration requirement applies to the investment company itself, rather than to its securities, and the investment company remains obligated also to register the securities under the Securities Act. In practice, the investment company will be able to file a single registration statement with the SEC that covers both investment company and securities registration.

30 An Operator that offers or sells Notes in violation of the Investment Company Act will face very serious consequences. In addition to the risks of SEC enforcement proceedings and/or civil claims by investors, Section 47 of the Investment Company Act provides that any contract executed by an unregistered, non-exempt investment company “is unenforceable by either party ... unless a court finds that under the circumstances enforcement would produce a more equitable result than non-enforcement.” In other words, all of the Operator’s contracts and Notes would potentially be void.

in the form of interest payments or capital gains but instead is compensated for its services through the onetime origination fees paid by borrowers and the servicing fees paid by lenders. Certain Operators might also claim exemption under Section 3(c)(4) of the Investment Company Act, which exempts from registration any person “substantially all of whose business is confined to making small loans.” The SEC deems the term “small loans” to include only consumer loans made to individuals for consumption (and not business) purposes. The availability of Section 3(c)(4) to consumer-oriented platforms that utilize Funding Banks is, however, not entirely clear because such platforms technically do not “make” loans to consumers but instead purchase bank loans that indirectly are funded by the third-party lenders.

A separate exemption may be available for commercial lenders under Section 3(c)(5) of the Investment Company Act. Specifically, Section 3(c)(5) exempts companies primarily engaged in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, loans, accounts receivables, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Although Section 3(c)(5) is broad in scope, it is important to note that it does not extend to all commercial loans and that, in particular, unrestricted working capital loans will not qualify under Section 3(c)(5)(B) because such loans are not made to fund the purchase of “specified” merchandise, insurance, or service. Any small business lender that relies upon Section 3(c)(5)(B) therefore will need to impose certain restrictions on its borrowers’ use of the loan proceeds to ensure that the platform is engaged “primarily” in making eligible loans. In addition, any such lender should require each of its borrowers to provide specific information on the merchandise, service or insurance which the borrower will purchase with the loan proceeds as general representations from the borrower that it will apply the proceeds to an eligible use may not be sufficient under SEC staff interpretations of Section 3(c)(5)(B).³¹

A further exemption may be available to Operators that issue their securities in a private placement pursuant to Rule 506 of Regulation D (as discussed above). Section 3(c)(7) of the Investment Company Act exempts from registration any issuer whose securities are held only by “qualified purchasers” and that does not make a public offering of its securities. As previously discussed, private placements made pursuant to Rule 506(c) of Regulation D are not deemed “public offerings” for Securities Act purposes. The SEC has stated that it similarly will not deem Rule 506(c) offerings to constitute “public offerings” under Section 3(c)(7). Accordingly, Operators who sell Platform Notes only to investors who are both “accredited investors” and “qualified purchasers” should be able to claim the Section 3(c)(7) exemption. As a practical matter, however, Section 3(c)(7) will be useful only to Operators who intend to solicit only large institutional investors and high net worth individuals. In particular, individuals generally will qualify as “qualified purchasers” only if they beneficially own at least \$5 million in “investments” (as defined by the SEC).

31 The Investment Company Act does not specify the percentage of a lender’s loan portfolio that must consist of eligible loans in order for the lender to satisfy the “primarily engaged” standard. In the case of lenders making commercial loans other than real estate loans (Sections 3(c)(5)(A) and (B)), some SEC no-action letters suggest that a lender can qualify for the exemption if at least 55% of its assets consist of eligible loans. These letters do not provide a definitive interpretation of the statute, however, and to help ensure compliance most platforms will choose to operate under a higher minimum. In the case of real estate lenders (Section 3(c)(5)(C)), the SEC has stated that the lender must invest at least 55% of its assets in mortgages and other liens on and interests in real estate and an additional 25% in real estate-related assets.

Another private placement exemption under the Investment Company Act, Section 3(c)(1), may be useful to Operators who organize investment funds to invest in Borrower Loans (as discussed below). Specifically, Section 3(c)(1) provides an exemption for issuers not engaged in a public offering of securities and that have fewer than 100 security holders (subject to certain exceptions not relevant here). An investment fund that invests in Borrower Loans may qualify for this exemption if it appropriately limits the number of its investors. The Operator itself, however, will not be able to use Section 3(c)(1) to issue Platform Notes because it will expect, at any one time, to have substantially more than 100 holders of its Platform Notes.

The SEC to date has not required Operators to register as investment companies. A prospective Operator nonetheless should carefully consider the Investment Company Act implications of any changes it proposes to make, relative to established programs, in the securities that it offers, the manner in which it offers the securities, or the classes of assets that it finances.³²

J. Investment Advisers Act

The Investment Advisers Act of 1940 (the “*Advisers Act*”) requires “investment advisers” to register with the SEC unless an exemption applies. The Advisers Act defines an “investment adviser” as any person who for compensation engages in the business of advising others as to the value of securities, or as to the advisability of investing in, purchasing, or selling securities, or who issues reports or analyses concerning securities as part of a regular business.³³ Registered investment advisers are subject to a detailed regulatory regime that governs, among other matters, fiduciary duties owed to clients, required disclosures to clients, procedures for handling client assets, recordkeeping and reporting requirements, and the content of investment adviser advertisements. Although the related initial and ongoing compliance expenses would not be insignificant, and material changes to its business practices could be required, an Operator required to register as an investment adviser likely could comply with most of the applicable regulations. At the same time, investment advisers, as fiduciaries to their clients, are required at all times to act in the client’s best interests, subject to any advisory contract that the client agrees to after full and fair disclosure. As discussed below, an Operator that manages an investment fund formed to invest in Borrower Loans will be deemed an investment adviser and, as such, will need to manage and adequately disclose the conflicts that may exist between its fiduciary duty to the fund and its duties to other purchasers of Platform Notes.

As previously mentioned, a number of consumer and small business marketplace lenders assign proprietary credit ratings to borrowers of loans they originate. These ratings may reflect the lender’s internal assessment of a borrower’s relative creditworthiness and the probability that the borrower may default on a loan. As an example, a lender might assign each borrower a credit rating of “A,” “B,” “C” or “D,” with A-rated borrowers deemed to have the lowest relative probability of default and D-rated borrowers the highest. The ratings do not constitute a statement by the lender of the actual probability that any borrower will default or of the expected loss on any loan given default. The lenders disclose these ratings to investors who may consider them in choosing which loans to purchase. The lenders also may use the ratings in

³² The fact that Operators engaged in issuing Platform Notes may be exempt from investment company registration has no bearing on the Investment Company Act status of funds that are organized expressly to enable retail investors to invest in pools of marketplace loans. Any such fund almost certainly will be an investment company and, if its shares are publicly offered, it will need to register with the SEC. See “Closed-End Investment Companies” below.

³³ 15 U.S.C. § 80b-2(a)(11).

connection with automated investment programs pursuant to which participating investors may direct the lender to allocate their available investment funds (or specified percentages of their available funds) to purchase loans to borrowers having specific credit ratings or loans to borrowers that fall within a specified range of credit ratings.

It could be argued that in posting these ratings the Operator is acting as an investment adviser under the Advisers Act and therefore required to register with the SEC. Registration is generally required if an Operator is considered to be (i) in the business (ii) of providing advice, or issuing reports or analyses, regarding securities (iii) for compensation. In the past, the SEC staff has raised whether an Operator should register as an investment adviser due to its construction of model portfolios that correspond to certain risk levels and estimated returns of loans,³⁴ and the SEC could raise similar concerns with respect to an Operator's proprietary ratings.

While the analysis inevitably depends on the facts and circumstances of each Operator, ratings that reflect the Operator's view of a borrower's creditworthiness may resemble ratings issued by traditional credit rating agencies, which the SEC staff suggests should not be interpreted as investment advice or viewed as a recommendation to buy or sell any securities.³⁵ Moreover, ratings are generally impersonal in nature, meaning they do not purport to meet the objectives or needs of specific lenders. Therefore, assuming lenders are already given adequate disclosure of an Operator's business and any applicable conflicts of interest, requiring an Operator to register as an investment adviser with the SEC would seem to offer limited benefits to lenders who use ratings as a tool to invest in loans. Since there is no existing authority from the SEC on the issue, an Operator should take care when using ratings in its business, including making clear disclosures to lenders that the ratings do not constitute investment advice and should not be viewed by lenders as a recommendation to purchase any Borrower Loans.

The investment adviser analysis is different, however, for Operators (or their affiliates) who manage investment funds. As discussed under "Bankruptcy Considerations" below, an Operator may choose to organize an investment fund that will use investor capital to invest in Borrower Loans generated by the platform. As investment manager, the Operator (or, if applicable, an affiliate thereof formed to be the general partner/manager of the fund) will determine the specific Borrower Loans the fund will purchase and will receive related management and/or performance fees. The status of consumer loans as "securities" under the Advisers Act is not entirely clear, but an Operator should assume that the Advisers Act applies given that the investors' interests in the fund are likely securities. It follows that, in receiving any compensation, including reimbursement of expenses, for managing the fund's investments, the Operator will be acting as an "investment adviser."

No Free Rides: The fact that an Operator and any fund it manages are exempt from Investment Company Act registration does not mean that the Operator is exempt from

34 See Letter from Prosper Marketplace, Inc. to the Division of Corporation Finance, at *6 (Nov. 24, 2009), <https://www.sec.gov/Archives/edgar/data/1416265/000141626509000266/filename1.htm>.

35 See SEC Updated Investor Bulletin: The ABCs of Credit Ratings (Oct. 12, 2017), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_creditratings.

investment adviser registration. The Operator's status under the Advisers Act and the investment adviser provisions of any applicable Blue Sky laws must still be considered.

It is important to note that not all Operators who act as investment advisers will be required, or are indeed eligible, to register with the SEC. The Advisers Act establishes a bifurcated regulatory scheme under which larger investment advisers register with the SEC and smaller advisers (unless an exemption applies) register with the states in which they provide advice. In general, an investment adviser may not register with the SEC unless it has at least \$100 million of assets under management. An Operator that manages investment fund(s) and/or managed accounts that invest in Borrower Loans but does not satisfy the \$100 million threshold should consider the possible application of state registration requirements. If the Operator is not required to register with its state securities regulator, for example, if a state law exemption applies, then the Operator may be required to register with the SEC as an exempt reporting adviser. An Operator generally will be permitted to treat each of its managed funds as a single client and will not be deemed, for purposes of most state requirements, to be providing advice in each state in which fund investors are located. It should also be noted that the Operator will be deemed a "private fund adviser" for purposes of the Advisers Act if it only manages funds that rely upon Section 3(c)(1) or 3(c)(7) of the Investment Company Act (*i.e.*, the Operator does not accept any separately managed accounts). Investment advisers who only advise such private funds are exempt from registering with the SEC if they have less than \$150 million in assets under management (including any uncalled commitments and leverage).

As previously noted, investment advisers must act as fiduciaries to their clients. An Operator that manages an investment fund therefore must endeavor in selecting the fund's investments to act solely in the fund's best interests. To the extent, however, that the investment fund and self-directed investors who purchase Platform Notes directly through the platform are competing to fund a limited supply of desirable loans, the Operator will face a clear conflict of interest between its duty to select for the fund the best possible investments (determined in view of the fund's stated investment strategy) and its obligation to treat the direct investors fairly. As the Operator will enjoy certain advantages over the direct investors in any such competition (it will, for example, have more information than the direct investors concerning the borrowers, the loans, and the total amount of lender funds available for investment and generally will be more financially sophisticated), this conflict will not be easily resolved if the Operator is allowed complete discretion to select specific loans for the fund. It therefore likely will be necessary to employ a random loan allocation procedure and/or require the investment fund to purchase loans only under a predefined investment strategy that restricts both the amount of fund capital that may be employed at any one time and the total amount that may be invested in specific ratings categories of loans. The goal will be to develop parameters that will permit the fund to attract investors but will also provide direct investors with continued access to the most attractive loans. The investment fund must of course fully disclose these parameters in its offering materials along with any conflicts of interest.

K. Risk Retention Requirements

Much of the blame for the "Great Recession" has been placed on the "originate-to-distribute" model of asset securitization. Certainly, it's reasonable to believe that asset originators who transfer all of the credit risk on the securitized assets may have incentives that won't necessarily advance investor protection. Accordingly, the Dodd-Frank Act required the SEC, the Board of Governors of the Federal Reserve System

(the “*Federal Reserve Board*”), the Federal Deposit Insurance Corporation (the “*FDIC*”), the Federal Housing Finance Agency (“*FHFA*”), and the Office of the Comptroller of the Currency (the “*OCC*”) and, together with the SEC, the FDIC, the Federal Reserve Board, and FHFA, the “*Agencies*”) jointly to prescribe regulations that (i) require a securitizer to retain not less than 5% of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party, and (ii) prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that it is required to retain.³⁶ The risk retention requirement is intended to create economic incentives for securitizers to structure transactions carefully and to monitor the quality of the securitized assets. The ultimate goal is to help align the interests of securitizers with those of investors.

Final regulations implementing the risk retention requirement became effective in December 2016 (the “*Retention Rules*”).³⁷ The requirements apply to both public and private offerings of asset-backed securities and securitizers therefore cannot avoid the requirements by selling their securities only in private placements exempt from Securities Act registration. Marketplace lenders need to consider two questions under the Retention Rules. First, does the risk retention requirement apply to Platform Notes? And second, in securitizations of marketplace loans (to which the Retention Rules unquestionably apply), who will be deemed the “sponsor” required to retain the credit risk?³⁸

As to the first of these questions, technical arguments can be made that Platform Notes constitute “asset-backed securities” to which the retention requirement applies.³⁹ If that were the case, the Funding Bank would likely be deemed the party required to retain the risk.⁴⁰ At the same time, technical arguments also

36 The Dodd-Frank Act required the Agencies to exempt securitizations of certain assets (most significantly, “qualified residential mortgages”) from the risk retention requirement. Marketplace loans will not qualify for any of these exemptions.

37 The Retention Rules became effective in December 2015 for residential mortgage securitizations that are not otherwise exempted.

38 Although numerous securitizations of marketplace loans have been completed, to date there have been no securitizations of Platform Notes. Securitizing Platform Notes (as opposed to marketplace loans) offers no advantages to either the sponsor or investors and would create additional expense and complexity.

39 As previously discussed, Platform Notes do not constitute “asset-backed securities” for purposes of Regulation AB under the Securities Act because (i) each Platform Note is backed by a single Borrower Loan and does not represent an investment in a “pool” of assets, and (ii) the Operator is not a “passive” issuer as contemplated by Regulation AB. The risk retention requirements therefore would not apply to Platform Notes if Congress had incorporated the Regulation AB definition of “asset-backed security” in the Dodd-Frank Act. In fact, however, the Dodd-Frank Act amended the Exchange Act to include a new (and broader) definition of “asset-backed security” that will govern the retention requirements. Under this definition, an “asset-backed security” will include any “fixed-income ... security collateralized by any type of self-liquidating asset (including a loan ... or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset.” It follows that a Platform Note will constitute an “asset-backed security” for purposes of the risk retention requirements if (i) it is “collateralized” by a loan, and (ii) the holder’s right to receive payments depends primarily on the cash flow from such loan. Platform Notes appear to satisfy both clauses of this test. In regard to the first clause, the Retention Rules state that an asset “collateralizes” a security (whether or not the issuer grants the investors a security interest over the asset) if the asset provides the cash flow that the issuer will use to make payments on the securities. The Borrower Loans do of course provide the cash flow that the Operator will use to make payments on the Platform Notes. In regard to the second clause, payments on the Platform Notes will depend not only “primarily” but in fact solely on such Borrower Loan cash flow. In contrast to Regulation AB, the Exchange Act definition does not require the “asset-backed security” to be backed by the cash flow from a “pool” of financial assets.

40 If Platform Notes are “asset-backed securities” subject to risk retention, the Funding Bank arguably is the “sponsor” subject to the retention requirement since it transfers assets (*i.e.*, the Borrower Loans) to the issuing entity. If this is the case, the Funding Bank would be required to retain credit risk and would not be permitted to transfer 100% of the credit risk on any Borrower Loan to the Operator. Regulators might also be inclined to deem the Operator to be a “sponsor” (whether in addition to, or in place of, the Funding Bank) since the Operator manages the overall program and helps to select the “securitized” assets by determining

can be made that the Retention Rules do not extend to Platform Notes.⁴¹ It is unnecessary for us to debate the relative merits of these opposing arguments as the Agencies (although they have made no formal pronouncement) have not applied risk retention to Platform Notes nor have they indicated any intention to do so. In this regard, the industry may consider itself fortunate since, if risk retention did apply, the economic and regulatory capital costs that Funding Banks incur in funding Borrower Loans would increase significantly.

The second question noted above—identifying the party subject to the retention requirement in actual marketplace loan securitizations—sometimes has an easy answer. The Retention Rules apply the risk retention requirement to “sponsors” and define “sponsor,” in relevant part, as “a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, ... to the issuing entity.” If a balance sheet lender securitizes loans that it originated and holds on its balance sheet, the lender unquestionably will be the “sponsor” since it is both “organizing” and “initiating” the securitization and selling assets to the securitization issuer. At the same time, in many marketplace loan securitizations the loan seller is not the originator but rather a commercial bank, investment fund, or other loan aggregator (each, an “*Aggregator*”) which has acquired a pool of loans that it intends to refinance. In this latter situation, should the sponsor be deemed the Funding Bank, the marketplace lender, or the Aggregator? Each of these entities has been the loan seller in one of the series of transactions through which the securitized loans are transferred to the securitization issuer. The Funding Bank and the marketplace lender both know that the loans they are originating and/or selling may subsequently be securitized, and the marketplace lender has very likely agreed to provide specified assistance to the Aggregator in connection with future securitizations.⁴² It therefore could be argued that each of the Funding Bank, the marketplace lender, and the Aggregator is a “sponsor” for purposes of the Retention Rules.⁴³ However, the Aggregator will make no commitment to the Funding Bank or the marketplace lender to

the loan underwriting criteria in conjunction with the Funding Bank. However, a court decision strongly suggests that the regulators do not have authority under the Retention Rules to treat the Operator as a “sponsor” in this situation because the Operator, assuming that it does not acquire the Borrower Loans from the Funding Bank and then transfer them to a special-purpose company that issues the Platform Notes, has not transferred any Borrower Loans to the issuing entity (*i.e.*, to itself). *See* footnote 655 below.

- 41 Under the Retention Rules the retention requirement applies only if assets are transferred to an “issuing entity” and the asset-backed securities are issued in a “securitization transaction” (which similarly requires that the asset-backed securities be issued by an “issuing entity”). Although the Operator (or an Affiliated Issuer or a Trust, as further discussed under “Bankruptcy Considerations” below) unquestionably is the issuer of the Platform Notes, it may not be an “issuing entity.” The Retention Rules define “issuing entity” as the entity that (i) owns or holds the *pool* of assets to be securitized, and (ii) issues the asset-backed securities in its name (emphasis supplied). Each Platform Note is backed not by a *pool* of underlying assets but by a single Borrower Loan. It therefore may be reasonable to conclude that, although Platform Notes are “asset-backed securities” for purposes of the Retention Rules, they are not issued by an “issuing entity” in a “securitization transaction” and therefore are not subject to risk retention requirements. Although in certain circumstances the SEC has deemed pass-through securities backed by a single asset to constitute “asset-backed securities” within the meaning of Regulation AB (notwithstanding the pooling requirement in Regulation AB), there are reasons to differentiate those securities from Platform Notes and to view them as not controlling. *See* footnote 616 above.
- 42 Among other matters, the marketplace lender may agree to review and/or provide indemnities in regard to certain disclosures in the securitization offering memorandum and to allow the securitization issuer to exercise any rights that the Aggregator has to require the marketplace lender to repurchase loans that failed to satisfy specified eligibility criteria and/or to pay indemnities in respect of such loans. *See* “Securitization” below.
- 43 It is possible under the Retention Rules for a securitization to have multiple sponsors. In this situation, it is sufficient that at least one of the sponsors retains 5% credit risk. The remaining sponsors are not required to retain credit risk (though they may do so voluntarily) but are obligated to ensure that at least one of their members is satisfying the retention requirement.

securitize the purchased loans but instead will have complete discretion to retain, securitize, or resell them (outside of a securitization). It follows that the Funding Bank and the marketplace lender cannot require the Aggregator to securitize the purchased loans and do not control the timing, amount, structure, or collateral selection in any securitizations which it does undertake. Under these circumstances there is a strong argument that only the Aggregator should be viewed as the “sponsor” of any securitizations of the purchased loans.⁴⁴

Don’t Forget: In every securitization of marketplace loans (including private placements) there must be at least one “sponsor” who retains not less than 5% of the credit risk on the securitized loans.

A sponsor may satisfy its retention obligation by holding an “eligible horizontal residual interest,” an “eligible vertical interest,” or a combination of eligible horizontal and vertical interests, or by posting cash collateral in an “eligible horizontal cash reserve account.”⁴⁵ In all cases, however, the interest retained by the sponsor must represent not less than 5% of the credit risk on the securitized assets. The sponsor may hold the retained interest directly or through a “majority-owned affiliate.” The latter term includes any entity that owns a majority of the sponsor’s equity, in which the sponsor holds a majority of the equity, or which is under common majority control with the sponsor. The option to hold the risk position through a majority-owned affiliate enables sponsors to reduce the economic cost of risk retention by arranging for third parties to provide part of funding for the risk position. Although the third-party investor will require appropriate compensation for the risk it assumes, marketplace lenders who choose to securitize their loans but face capital constraints in funding their risk positions may be able to increase their securitization volumes by holding the positions through majority-owned affiliates organized with outside investors. Alternatively, or in addition, the Retention Rules also permit a securitization sponsor to finance its retained interest and to pledge it as collateral under a loan, repurchase, or other financing agreement so long as the lender has full recourse against the sponsor.⁴⁶

L. Securitization

The volume of marketplace loan securitizations continues to grow rapidly. Securitization entails the creation of asset-backed securities (“ABS”) that represent the right to receive the cash flow from a pool of segregated financial assets. The goal in the securitization is to create ABS whose credit risk derives solely from the credit quality and payment characteristics of the asset pool and is not tied to the credit standing of the asset

44 The Agencies have indicated that an entity will not be a “sponsor” for purposes of the Retention Rules unless it has “actively participated” in the “underwriting and selection of the securitized assets.” See Credit Risk Retention, 79 Fed. Reg. 77609 (Dec. 24, 2014). The marketplace lender and the Funding Bank should not be deemed “sponsors” under this test so long as they are not actively involved in selecting the assets the Aggregator chooses to securitize.

45 An “eligible horizontal residual interest” refers to a subordinate class of securities in the securitization structure to which losses will be allocated before any losses are allocated to other ABS interests. An “eligible horizontal cash reserve account” refers to a cash account funded by the sponsor in the required amount to provide credit support for the ABS interests issued in the securitization. An “eligible vertical interest” refers to the purchase by the sponsor of an equal proportionate interest (but not less than 5%) of all classes of ABS interests issued in the securitization.

46 The European Union (“EU”) also imposes certain risk retention requirements in securitizations. Sponsors who wish to market their ABS to European investors will need to comply with the applicable EU regulations. A discussion of the EU risk retention regulations is outside the scope of this book.

originator. Asset classes that have long been securitized include trade receivables, commercial and residential mortgages, credit card receivables, student loans, and auto loans and leases. Although the first marketplace loan securitizations were completed little more than five years ago, marketplace loans have already become an important part of the securitization market and will likely someday represent a significant portion of overall consumer ABS. Securitization has already become an important funding source for certain lenders, and expanded access to the ABS markets will be important to the industry's growth.

Look to the Future: Marketplace loan securitizations are getting high credit ratings and gaining broader investor acceptance. Continued rapid growth is likely.

The first step in the securitization process is to establish a special purpose issuer. A “special purpose” issuer is an entity (an “*SPE*”) formed specifically for the purpose of issuing ABS. The SPE will not engage in any business other than issuing ABS to finance its purchase of the financial assets to be securitized. Its organizational documents and contracts will contain operating restrictions and covenants intended to make it very unlikely that it will ever become subject to bankruptcy proceedings. The SPE may be organized as a limited liability company, as a statutory trust, or, particularly if it is organized in an offshore tax haven jurisdiction, as a corporation. In all cases, however, the SPE must be completely isolated from the potential insolvency of any associated companies including, in particular, the originator and/or seller of the securitized financial assets (who is sometimes referred to as the “sponsor” of the securitization). If the securitization is structured properly, the credit risk on the securitized assets is segregated from the sponsor's own credit risk. Securitizations thus allow investors to evaluate the credit risk associated with the underlying financial assets independently of the sponsor's overall business.

The sponsor's sale of financial assets to an SPE doesn't eliminate the need for someone to continue to service the assets. Accordingly, in most marketplace loan securitizations the SPE will appoint the marketplace lender as the loan servicer and the lender will continue to collect payments on the loans, pursue delinquent borrowers, and otherwise interact with borrowers in much the same manner as if the securitization had not occurred. Appointing the marketplace lender as the servicer, however, could leave investors exposed to lender credit risk since the lender's ability to perform its duties as servicer will, to a large extent, depend upon its continuing solvency. A properly structured securitization therefore will include robust backup servicing arrangements under which a preapproved backup servicer will assume the servicing function should the lender become insolvent or otherwise unable to service the marketplace loans. The market will ultimately dictate the backup servicing requirements for marketplace loan securitizations but “hot” backup servicing arrangements—in which the backup servicer stands ready to assume the servicing duties on short notice—will often be required, especially with respect to securitizations of loans originated by a marketplace lender with a short operating history.

Another key concept in securitizations is credit enhancement, which can be achieved through a number of means. Most typically, the SPE will issue multiple classes of ABS with different levels of seniority. The more senior classes will be entitled to receive payment before the subordinate classes if the cash flow generated by the underlying assets is not sufficient to allow the SPE to make payments on all of the classes of ABS. Naturally, the senior classes of ABS will carry higher credit ratings whereas the subordinated classes will carry higher interest rates. The SPE also typically will purchase the financial assets from the sponsor at a discount to their face amounts. As a result, the aggregate principal amount of financial assets owned by the SPE will exceed the aggregate principal amount of the debt securities issued by it and such excess (“*overcollateralization*”) helps to protect the security holders against the consequences of defaults on the

collateral.⁴⁷ In any securitization of marketplace loans, careful thought will need to be given to the amount of credit enhancement to be provided for the senior classes of ABS through overcollateralization and/or the sale of subordinated or equity tranches. A sponsor may also provide credit enhancement by funding a reserve account upon which the SPE will draw to make payments due on the senior securities if the transaction cash flow would otherwise result in a shortfall.⁴⁸ Credit enhancement can also be provided by monoline insurers or other financial institutions that “wrap” the securities and effectively guarantee scheduled payments of principal and interest on the most senior class of ABS and/or by requiring the SPE to pay down the senior securities at an accelerated rate if specified financial triggers are tripped. As performance data for marketplace loan securitizations is still not available for a complete credit cycle, investors in marketplace loan ABS may require the structures to include higher credit enhancement levels than might be expected for similar asset classes; however, these differentials recently have been decreasing as investors gain more confidence in the product.⁴⁹

Rating agencies were originally somewhat reluctant to rate marketplace loan securitizations because of the limited performance history available for marketplace loans (including default, prepayment, and recovery characteristics). The agencies were particularly concerned (and to some extent remain concerned) that Operators cannot supply performance information covering a complete credit cycle. The decision by Moody’s in early 2015 to grant the first investment-grade rating to marketplace loan ABS therefore represented something of a milestone, and investment-grade ratings have subsequently become common.⁵⁰ Although the Dodd-Frank Act required federal regulators in many instances to replace references to securities ratings in federal banking and securities regulations with alternative metrics, many institutional investors by law or policy continue to be limited in their ability to purchase unrated debt securities. In consequence, the availability of investment grade ratings has played an important role in broadening the investor base for marketplace loan securitizations.

Of course, the rating agencies consider many factors beyond performance history when rating marketplace loan securitizations. Among other factors, the agencies will consider (i) default correlation among borrowers, (ii) the operational history of marketplace lenders, (iii) whether lenders are able to detect fraud among potential borrowers, (iv) the lack of secondary liquidity in marketplace loans, (v) the unique aspects of servicing consumer loans originated through an Internet platform and the adequacy of the backup servicing arrangements, (vi) the number and depth of the credit tranches contemplated by the proposed structure, (vii) whether the lender has the financial capacity to repurchase ineligible loans from the SPE if so required

47 Any losses resulting from defaults on the collateral will be allocated in the first instance to the holders of the equity (or “residual”) in the SPE and thereafter to the several classes of notes issued in the securitization in reverse order of seniority.

48 The reserve account will be funded by the sponsor at a specified level on the transaction closing date. Thereafter, the SPE will apply available funds from its cash flow on each scheduled distribution date to maintain the reserve account balance at a predetermined level after giving effect to any drawings made on the account. The sponsor is not permitted after the closing date to make discretionary contributions to the reserve account to support the senior securities, as any such contributions could undermine the SPE’s status as a bankruptcy-remote entity.

49 The risks inherent in securitizing a relatively new asset class were demonstrated in 2016 and 2017 when certain marketplace loan securitizations hit early amortization triggers because of poor loan performance.

50 In January 2015 Moody’s Investors Service assigned a Baa3 (sf) rating to the Class A Notes of Consumer Credit Origination Loan Trust 2015-1. The Class A Notes were collateralized by a portfolio of consumer loans originated by Prosper. There is strong market interest in the ratings analysis of marketplace loan securitizations, and a number of rating agencies have published related research reports or policy statements.

(and whether repurchase obligations are triggered by a breach of any of numerous eligibility criteria or only in limited circumstances such as verifiable identity theft), (viii) the possibility that some borrowers may place a lower priority on repaying marketplace loans than other personal obligations (*e.g.*, residential mortgages or auto loans), and (ix) regulatory issues affecting the industry. At least in the short term, certain of these considerations could lower the ratings of marketplace loan ABS below the ratings that might otherwise be assigned to securitizations of traditional consumer loans of an equivalent credit quality (as measured by borrower credit scores).

Most securitizations of traditional asset classes are sponsored by the loan originator or one of its affiliates. In this regard, a number of marketplace lenders regularly securitize loans which they hold on balance sheet and, and as discussed below, certain lenders are now sponsoring securitizations that permit multiple institutional investors to pool and securitize loans which they have purchased from the lender. At the same time, many marketplace loan securitizations have been sponsored by banks, investment funds, or other institutional investors (each, an "*Aggregator*") who have acquired a substantial amount of loans from a particular marketplace lender with whom they are not affiliated. In these transactions, the lack of affiliation between the Aggregator and the lender can complicate the documentation. To take one example, much of the disclosure in the ABS offering materials will focus on risk factors specific to the originating marketplace lender as well as the lender's underwriting policies, servicing practices, regulatory status, and loan performance information. Unless otherwise agreed in the loan purchase agreement pursuant to which the Aggregator has purchased loans from the marketplace lender (the "*Loan Purchase Agreement*"), the Aggregator, because it is not a lender affiliate, cannot require the lender either to provide information needed to prepare the offering materials or to certify that the relevant portions of the offering materials (once prepared by the Aggregator) are accurate. The underwriters or placement agents for the ABS will nonetheless want the Aggregator's counsel and their own counsel to provide unqualified "negative assurance" letters as to the accuracy of the offering materials. Similarly, the Aggregator will want the SPE to have the benefit of any undertakings made by the marketplace lender to the Aggregator to repurchase ineligible loans (*i.e.*, loans the lender sold to the Aggregator in breach of the eligibility criteria stated in the Loan Purchase Agreement) or to pay related indemnities. Again, however, because the Aggregator is not an affiliate of the marketplace lender it cannot—except by contract—compel the lender to consent to any such assignment of the Aggregator's rights. Aggregators therefore will want the marketplace lender to provide certain undertakings intended to facilitate future securitizations. Among other matters, the marketplace lender may agree in the Loan Purchase Agreement (or in a related "multi-party" agreement) to provide certain lender-related information for use in the securitization offering memorandum (including loan performance information); to indemnify the SPE and the underwriters against material inaccuracies in that disclosure; to arrange for its counsel to provide a "negative assurance" letter in relation to such disclosures (other than any financial disclosures); to authorize the SPE to rely upon its representations in the Loan Purchase Agreement; to repurchase ineligible loans from the SPE as if the SPE were the Aggregator; and, if the securities will be rated, to assist the Aggregator in responding to pertinent questions raised by the rating agencies. Marketplace lenders generally have been willing to provide some or all of these types of undertakings as they recognize that Aggregators can (and very often will) reinvest the securitization proceeds in new marketplace loans. The exact terms negotiated between marketplace lenders and Aggregators can nonetheless vary substantially from one transaction to the next. Of particular importance, the scope of the marketplace lender's obligation to repurchase ineligible loans (or to pay related

indemnities) has not been uniform across transactions. The lack of uniform terms can reduce secondary market demand for marketplace loan ABS and thereby impair the industry's overall access to the securitization markets.⁵¹

Looking forward, Aggregator-sponsored securitizations are becoming relatively less common because of an important innovation in marketplace loan securitizations that made its debut in 2017. Specifically, several of the largest consumer marketplace lenders now operate securitization platforms that enable institutional investors to sell loans purchased by them from the lender to an SPE organized and managed by the lender. The ABS issued by the SPE typically will be collateralized by loans that the SPE has purchased both from the lender and from a number of institutional investors not affiliated with the lender. These multiseller structures provide significant benefits to both the participating loan investors and the sponsoring lenders. The investors, for their part, save the expense and administrative burden of sponsoring a securitization that is limited to loans they themselves own⁵² and, since they are not the securitization sponsor, they are not subject to credit risk retention obligations under the Retention Rules.⁵³ The lenders also can use the structures as a convenient means to securitize loans they hold on-balance sheet. Of perhaps equal or greater importance, platform-sponsored securitizations—by providing institutional investors with a convenient means to resell purchased loans—can increase both investor interest in marketplace loan investing and the total volume of marketplace loan securitizations. Lenders further can use the structures to influence (if not control) the timing and amounts of the securitizations of their loans and to help ensure that key terms of the securitizations (*e.g.*, transaction structure, collateral composition, credit enhancement levels and ratings) are consistent from one transaction to the next. Greater consistency between transactions makes it easier for ABS investors to analyze individual ABS tranches and may result in greater investor demand. In view of these advantages, it is not surprising that lender-sponsored multiseller securitizations have accounted for a substantial portion of all marketplace loan ABS issued in the past three years and additional lenders will likely sponsor such platforms as their loan volumes increase.

51 As discussed below, to date all marketplace loan ABS has been sold in private placements exempt from registration under the Securities Act. An active secondary market for the ABS that includes retail investors is therefore not possible. The ABS do remain eligible for resale to QIBs under Rule 144A. However, QIBs may have less interest in purchasing marketplace loan ABS in the secondary market if they believe that more effort is required to analyze the terms of individual marketplace loan securitizations than is needed for other ABS classes.

52 Each participating investor will, however, likely be required to reimburse the sponsoring lender for the investor's pro rata share of the transaction expenses and may be required to pay program fees to the lender as a condition to being allowed to participate in the securitizations.

53 Although it could be argued that the participating investors (because they are selling assets into the securitization) are acting as "sponsors" of the securitization under the Retention Rules and are therefore subject to the risk retention requirement, in most cases the sponsoring lender will agree to be treated as the "sponsor" under the Retention Rules and to retain credit risk accordingly. The retention of credit risk by the lender will satisfy any obligation that the investors may have to retain credit risk. A recent decision of the U.S. Court of Appeals for the District of Columbia Circuit does, however, strongly suggest that the lender must itself sell loans into the securitization to constitute a "sponsor" under the Retention Rules and that the Retention Rules will not be satisfied if the lender has organized and manages the ABS issuer and accepts credit risk at the level required by the rules but does not itself transfer any assets into the securitization. See *The Loan Syndications and Trading Ass'n v. Sec. and Exch. Comm'n and Bd. of Governors of the Fed. Reserve Sys.*, 882 F.3d 220 (D.C. Cir. 2018) (holding that open market CLO managers who do not themselves transfer assets into the CLO issuers they manage are not "sponsors" subject to the Retention Rules). There have also been recent securitizations involving multiple sellers in which one of the sellers (other than the marketplace lender) agreed to act as the securitization sponsor and to retain credit risk. These include certain transactions in which the sponsor also acted as the lead ABS underwriter and did not sell any loans to the SPE other than loans it acquired on the securitization closing date from other investors for the express purpose of securitizing them.

Certain marketplace lenders have also established ongoing programs to issue asset-backed series certificates (*"ABS Certificates"*) collateralized by specific pools of consumer loans. These programs also can provide marketplace lenders and institutional loan investors with enhanced liquidity. At the same time, there are several important distinctions between these programs and other marketplace loan securitizations. The most important of these is perhaps frequency of issuance—whereas an SPE organized to issue marketplace loan ABS typically issues securities only on a single closing date, in an ABS Certificates program the issuer will purchase loans from its sponsor, and will issue a separate series of securities collateralized by the loans then being purchased (the *"Relevant Loans"*), on each of multiple closing dates. Each series of ABS Certificates entitles the holder to receive (through the issuer) the cash flow on the Relevant Loans (net of servicing fees and other expenses) but the holder will have no rights in the loans allocated by the issuer to any of its other ABS Certificates series.⁵⁴ Second, in contrast to traditional securitizations, the ABS Certificates programs have no credit tranching or embedded credit support (such as overcollateralization, reserve funds or excess spread) and are not rated. Each ABS Certificate simply passes through to the certificate holder the economic performance of the Relevant Loans.⁵⁵ And finally, an ABS Certificates issuer typically will purchase loans only from a single marketplace lender or Aggregator (rather than from multiple potential sellers as in the multiseller securitizations discussed immediately above). An ABS Certificates program can provide a convenient means for a marketplace lender or Aggregator to effect periodic sales of loans that it has funded or acquired and reduces execution costs because all such sales will be made under a common template. Of course, since the programs have no credit enhancement, a structural solution may not be readily available if poor loan performance depresses investor demand for the ABS Certificates of any particular program.

Any marketplace lender or Aggregator who sponsors a securitization will be subject to the federal risk retention rules previously discussed. The sponsor therefore will be required to retain at least 5% of the credit risk on each of the securitized loans. See *"Risk Retention Requirements"* above. The sponsor also must comply with a number of other SEC rules governing ABS offerings. Among other matters, the sponsor will be required to file periodic reports with the SEC disclosing the amounts of any demands that it receives from investors (or from an indenture trustee on behalf of investors) to repurchase ineligible loans and of any such repurchases that it makes. Any marketplace lender or Aggregator who sponsors a securitization should take care to review and understand the applicable requirements.

M. Closed-End Investment Companies

In 2016 the SEC approved the registration of the first marketplace lending funds to be registered with the SEC as investment companies under the Investment Company Act. These two investment companies—the

54 The ABS Certificates issuer typically will be organized as a Delaware series trust. The Delaware Statutory Trust Act permits these trusts to issue beneficial interests in separate series, to allocate specific trust assets to specific series, and to provide that the debts and obligations of any series shall be enforceable only against the assets of that series and not against the assets of the trust generally or of any other series.

55 As pass-through securities the ABS Certificates bear a strong resemblance to Platform Notes. They differ from Platform Notes, however, insofar as they (i) represent the economic interest in a pool of whole loans, rather than a fractional interest in a single loan, (ii) are sold only to institutional investors in private placements rather than to the general public in registered public offerings, (iii) require the sponsors to comply with the Retention Rules, and (iv) would generally be characterized as equity interests in the underlying debt comprising the loan pool, rather than as directly constituting debt themselves, for U.S. federal income tax purposes. See *"Tax Considerations—Tax Treatment of Platform Notes"* below.

RiverNorth Specialty Finance Corporation (formerly, the RiverNorth Marketplace Lending Corporation)⁵⁶ and the Stone Ridge Alternative Lending Risk Premium Fund,⁵⁷ together with subsequent launches of investment companies investing in marketplace loans⁵⁸ (each, a “Fund,” and together, the “Funds”)—operate as closed-end investment companies, or “closed-end funds,” one of three basic types of investment companies.⁵⁹

Interval Closed-End Fund Structure. The Funds currently operate as an “interval closed-end fund.” Interval funds are classified as closed-end funds but they are very different from “traditional” closed-end funds in that their shares typically do not trade on an exchange in the secondary market. Instead, their shares are subject to periodic repurchase offers by the Fund.⁶⁰ As an interval fund, the Funds will make periodic repurchase offers to their shareholders, generally every three, six, or twelve months, as disclosed in the Fund’s prospectus. When the Funds make a repurchase offer to their shareholders, they will specify a date by which shareholders must accept the repurchase offer. The price that shareholders will receive on a repurchase will be based on the per-share net asset value determined as of a specified (and disclosed) date. In addition, the Funds continuously offer their shares at a price based on the Fund’s net asset value.

Platform Concentration Issues. Registered investment companies are required to meet a diversification test in order to qualify as a regulated investment company (“RIC”) under the Internal Revenue Code of 1986, as amended (the “Code”). An investment company is required to be treated as a RIC under the Code in order to avoid entity-level income taxes. If an investment company is not eligible to be treated as a RIC due to its failure to meet the RIC diversification test, it would be obligated to pay applicable federal and state corporate income taxes on its taxable income. At the close of each quarter of the taxable year, (a) at least 50% of the value of a RIC’s total assets must be represented by (i) cash, cash equivalents, U.S. government securities, or securities of other RICs and (ii) other securities whose value with respect to any one issuer is not greater than 5% of the value of the total assets and does not represent more than 10% of the outstanding voting securities of any one issuer and (b) not more than 25% of the value of the RIC’s total assets may consist of (i) the securities of any one issuer (other than U.S. government securities or RICs) or of any two or more issuers controlled by the RIC and that are engaged in the same or similar trades or businesses or a related business, or (ii) the securities of one or more qualified publicly traded partnerships.⁶¹

56 See RiverNorth Specialty Finance Corporation (SEC File Nos. 333-204866; 811-23067).

57 See Stone Ridge Trust V (SEC File Nos. 333-208513; 811-23120).

58 See, e.g., AlphaCentric Prime Meridian Income Fund (SEC File Nos. 333-21603; 811-01397).

59 The SEC prohibits the two other basic types of investment companies, open-end mutual funds and unit investment trusts, from investing more than 15% of their portfolio in “illiquid assets” in order to ensure that they can generate enough cash to meet redemption requests. An illiquid asset is one that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund. Revisions of Guideline to Form N-1A, 57 Fed. Reg. 9828, 9829 (Mar. 20, 1992). As there is currently no developed secondary market for marketplace loans or Platform Notes, these assets would be considered illiquid assets under the Investment Company Act and thus a fund investing substantially in such instruments could not be a mutual fund or UIT. However, because closed-end funds are not required to make redemptions, they are not subject to the Investment Company Act liquidity requirements.

60 Rule 23c-3 of the Investment Company Act provides that a closed-end fund can adopt a policy of repurchasing between 5% and 25% of its outstanding common stock at periodic intervals pursuant to repurchase offers made to all shareholders. The RiverNorth Specialty Finance Corporation, which remains an interval closed-end fund, began trading on the New York Stock Exchange (NYSE) effective June 12, 2019, under the ticker symbol “RSF.”

61 I.R.C. § 851(b)(3).

As a result of the above requirements, there is a concern that an investment company's investment in marketplace loans concentrated in a particular platform would violate the RIC test.⁶² For general U.S. federal income tax purposes, the person who is obligated under a debt is viewed as the issuer of the debt. As such, for purposes of the RIC diversification test, the individual borrowers of the marketplace loans purchased by the Fund should be considered to be the "issuer," not the platform through which such whole loans were originated. In regard to the marketplace loans purchases, the Funds become the owner of the marketplace loans for U.S. tax purposes, bearing the risk of loss and the potential for profit on the purchase. A Fund's risk exposure on the marketplace loans is dependent upon the willingness and ability of the individual borrowers to pay—if one of the individual borrowers were not to pay, the platform seller would not be obligated to make the Fund whole. The platform seller, although retained as servicer, no longer bears the risk of loss on marketplace loans sold. This contrasts with Platform Notes, in which the applicable platform should be considered the issuer, as the Fund's risk exposure is also dependent upon the platform's ability to make the pass-through payments.

Separately, an investment company will need to limit the portion of its investments which it allocates to the marketplace loans from any single platform in order to avoid the potential for the SEC to require a platform to co-register as an issuer on the investment company's registration statement during the continuous offering of the securities. As set forth in the registration statements for the Funds and as further discussed herein, the SEC currently takes the position that marketplace loans facilitated by a platform involve an associated investment contract, or "security" under the Securities Act, issued by the platform in connection with the prepurchase activity by the platform, as well as the servicing and other arrangements.⁶³ Pursuant to Rule 140 under the Securities Act, a co-issuer is generally considered to exist with respect to "[a] person, the *chief* part of whose business consists of the purchase of the *securities* of one issuer ...". The SEC has interpreted the term "chief" as used in Rule 140 to mean an investment of greater than 45% of a person's assets in an issuer.⁶⁴ Because the marketplace loans are treated as securities issued by a platform with respect to determining the co-issuer status of such platform, the Funds may be required to agree in its registration statement that it will not invest greater than 45% of its managed assets in the securities of, or marketplace loans originated by, any single platform.

Investment Company Act Custody Requirements. Section 17(f) of the Investment Company Act requires that an investment company's "securities and similar investments" be placed and maintained in the custody of a bank, a member firm of a national securities exchange, or the investment company itself, subject to certain conditions or in accordance with the rules and regulations or orders as the SEC may prescribe. With respect to an investment company's custody of traditional loans, the SEC has conditioned compliance with Section 17(f) on whether (i) the fund's custodian would hold relevant documentation evidencing the fund's ownership in the loan; (ii) the documentation would permit the custodian to enforce all the fund's ownership

62 In determining the issuer of a security for the purposes of the RIC qualification rules, the IRS will normally follow the guidance of the SEC on the issue. Rev. Rul. 77-342, 1977-2 C.B. 238. However, the IRS has also stated that the "issuer" of a security for the purposes of the RIC diversification rules is the entity whose economic fortunes ultimately determine the performance of the security—in short, the issuer is the person in whom the RIC invests. GCM 37233 (Aug. 25, 1977), underlying Rev. Rul. 83-69, 1983-1 CB 126. In other words, although the SEC guidance is normally determinative, the IRS has reserved the right to make an independent determination.

63 See footnote 629 above for a more detailed discussion of the "investment contract" issue in the context of marketplace loan sales.

64 See, e.g., FBC Conduit Trust I, SEC No-Action Letter (Oct. 6, 1987).

rights in a court of law; and (iii) the administrative agents, in transmitting interest and principal payments to the fund, do not hold assets of the fund, but act as paying agents.⁶⁵

As described in the Funds' registration statements, each borrower under a marketplace loan electronically signs the loan documents, binding the borrower to the terms of the loan, including provisions authorizing the lender to transfer the loan to another party. In general, each Fund will direct its custodian to open an account with each platform selected by the Fund. The account will be opened in the name of the custodian as custodian for the Fund. When a Fund directs the purchase of a loan, the Fund custodian receives electronically from the platform the loan documents and evidence of the Fund's purchase and ownership of the loan, thereby obtaining custody of the documentation that creates and represents the Fund's rights in the loan. In addition to the promissory note, such documentation generally includes (depending on the platform) the borrower agreement, authorization to obtain a credit report for loan listing, truth in lending disclosure, terms of use and consent to electronic transactions and disclosures, credit profile authorization, bank account verification, and debit authorization (or equivalents thereof). The Fund's custodian then wires funds to the platform in payment for the loans. The custodian maintains on its books a custodial account for the Fund through which the custodian holds in custody the platform account, the loan/loan documents, and, if applicable, any cash in the platform account including the interest and principal payments received on the loan. As transferee of the platform's contractual rights in the loan, the Fund obtains all of the platform's rights in the loan and is able to enforce those contractual rights against the platform and the borrower, as applicable.

Valuation Considerations. Investment companies are required to adopt and implement policies and procedures designed to prevent violation of the federal securities laws, including investment portfolio valuation requirements under the Investment Company Act.⁶⁶ An investment company's board must approve procedures pursuant to which the investment company will value its investments. If market quotations are not readily available (including in cases where available market quotations are deemed to be unreliable or infrequent), the Fund's investments will be valued as determined in good faith pursuant to policies and procedures approved by its board of directors ("*fair value pricing*"). As there is no developed secondary market for marketplace loans and Platform Notes, these instruments will necessarily be required to be fair valued.

Each Fund generally relies on prices provided by a third-party pricing service for its marketplace loans, which will be based upon the specific factors relating to such instruments as described below and subject to review by its board of directors or its designee. The criteria that will be used to value marketplace loans include the transaction data on initial purchases of loans from platforms and other relevant market data regarding

65 The SEC issued a no-action letter to a Merrill Lynch fund that invested in loans. Merrill Lynch Prime Fund, SEC No Action Letter (Nov. 4, 1992).

66 Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) (adopting rule 38a-1). Investment companies are required to adopt policies and procedures that require monitoring for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments. Funds may be required to fair value portfolio securities if an event affecting the value of the security occurs after the market closes but before the fund prices its shares.

loan productions and purchases generally for the current valuation period including, but not limited to, FICO scores, borrower employment status, borrower delinquency history, credit inquiries, debt-to-income ratio, loan size, and loan age. Due to concerns with respect to the valuation of marketplace loans, the SEC required each of the Funds to represent in its registration statement that the Fund will invest solely in loans originated by platforms that will provide the Fund with a written commitment to deliver or cause to be delivered individual loan-level data on an ongoing basis throughout the life of each individual loan that is updated periodically as often as the Fund's net asset value is calculated to reflect new information regarding the borrower or loan.

Bankruptcy Considerations

A. Addressing Insolvency Risk

As Platform Notes are pass-through obligations of the Operators, and not direct obligations of the borrowers under the related Borrower Loans, holders of Platform Notes are exposed to the Operator's credit risk. An Operator that becomes subject to bankruptcy proceedings may be unable to make full and timely payments on its Platform Notes even if the borrowers under the related Borrower Loans timely make all payments due from them. A number of different aspects of the bankruptcy proceedings could result in investor losses. First, other creditors of the Operator may seek access in the bankruptcy proceeding to payments made on the Borrower Loans. Second, a bankrupt Operator may no longer have the financial capacity to continue to service the Borrower Loans and/or may reject its servicing agreement as an executory contract. Third, the investors will be subject to the Bankruptcy Code's "automatic stay" and therefore will be prohibited from taking legal action against the Operator to enforce their rights to payment. Fourth, the Bankruptcy Court may not recognize investor claims for interest that accrued on the Platform Notes after the bankruptcy proceedings commenced. An Operator could endeavor to mitigate some of these risks by granting the indenture trustee a security interest over the Borrower Loans, the Collections Account, and the proceeds thereof. It may also enter into a "backup" servicing agreement with an unaffiliated company pursuant to which the backup servicer agrees to service the Borrower Loans if the Operator can no longer do so. Any such measures, however, will provide the holders with less than complete protection. The holders of secured Platform Notes, for example, will remain subject to the automatic stay. It's also not certain that the Bankruptcy Court would require that the proceeds of each Borrower Loan pledged as collateral be applied to the payment only of the related Platform Notes. If, instead, the Bankruptcy Court (which has broad discretionary powers under the Bankruptcy Code) permitted the proceeds of the Borrower Loans to be applied on a *pari passu* basis to pay all amounts due on the Platform Notes, holders of Platform Notes could incur losses by reason of defaults on Borrower Loans other than the specific loans that they had elected to fund. Similarly, a backup servicer—particularly if it has not been appointed under a "live" backup servicing arrangement—may be unable immediately to service the loans if the Operator stops servicing them. Any lag that occurs between the termination (or withdrawal) of the Operator as servicer and the backup servicer's assumption of full servicing duties could significantly reduce loan collections and cause related losses on the Platform Notes.

Caution: Platform Note investors are not necessarily isolated from Operator insolvency risk. The degree of the risk is significantly affected by the platform structure and can be reduced by organizing a bankruptcy-remote issuer.

The risks to the Platform Note holders will be particularly acute if, as may be the case, the Operator does not pledge the Borrower Loans to secure the Platform Notes and is permitted by its governing documents to incur other indebtedness that is not subordinated to the Platform Notes and/or is permitted to pledge the Borrower Loans to secure indebtedness other than the Platform Notes. In this situation, the holders may see some or all of the collections on the Borrower Loans paid to other creditors of the Operator if the Operator becomes bankrupt. The risk to investors also is heightened if the Operator is thinly capitalized and/or has exposure to significant potential liabilities (*e.g.*, pending litigation claims). It seems likely that many retail investors in Platform Notes—notwithstanding any related prospectus disclosures—will not fully appreciate the scope of the Operator credit risk that they have assumed. Institutional investors, however, are well aware of these risks and have insisted that Operators address them as a condition to committing significant capital to Platform Notes. In response to this pressure, Operators have implemented two different operating structures that are intended to isolate investors from Operator credit risk.

The first of these structures provides for the Operator to form a wholly-owned subsidiary (the “*Affiliated Issuer*”) that will assume the rights and obligations of the Operator under its agreements with the Funding Bank, the indenture trustee, other service providers, and the borrowers and lenders. The Affiliated Issuer will purchase the Borrower Loans from the Funding Bank and issue the Platform Notes in its own name. The Affiliated Issuer also will license or purchase the Operator’s proprietary technology and become the website operator. Simultaneously, the Affiliated Issuer will appoint the Operator to provide back-office services, to perform (or supervise the performance of) all of the Affiliated Issuer’s obligations to third parties, to service all of the Borrower Loans, and to manage both platform operations (including the issuance of Platform Notes) and the website as its agent. The Affiliated Issuer will pay the Operator a servicing fee tied to the amounts of origination and servicing fees it receives from borrowers and investors. The Affiliated Issuer will have no employees and the Operator will perform its servicing duties through its own employees. The Operator will remain the sole lessee under all office and equipment leases. The Affiliated Issuer will not incur any indebtedness other than the Platform Notes and will not accept liability for any claims made against the Operator including, if applicable, any preexisting litigation claims. The Affiliated Issuer’s governing documents will prohibit it from engaging in any business other than the issuance of Platform Notes and related activities and otherwise will impose limitations on its activities intended to reduce the likelihood that it will become subject to voluntary or involuntary bankruptcy proceedings. The structure therefore (i) makes the Operator solely responsible for the platform’s operating expenses (other than the servicing fees payable to the Operator itself), (ii) isolates the Affiliated Issuer from the Operator’s preexisting or future liabilities, and (iii) provides for the issuance of the Platform Notes through a special purpose, bankruptcy-remote entity (*i.e.*, the Affiliated Issuer) that will have no significant liabilities other than the Platform Notes.

The issuance of Platform Notes through an Affiliated Issuer will not benefit investors, however, if the Operator becomes bankrupt and the Bankruptcy Court uses its equitable powers to order “substantive consolidation” of the Affiliated Issuer and the Operator. Substantive consolidation is a judicially developed

doctrine that, if applied, disregards the separate legal existence of a bankruptcy debtor and one or more of its affiliates, resulting in a combination of assets and liabilities and the elimination of intercompany claims between the entities being consolidated. Creditors of each entity become creditors of the combined entity. Although the court decisions that have ordered substantive consolidation have not always used the same analysis, in general a Bankruptcy Court could decide to consolidate two entities if (i) creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, or (ii) their financial affairs are so entangled that consolidation will benefit all of their creditors. The Bankruptcy Court may also consider whether the benefits of substantive consolidation would outweigh the harm it would impose on any particular creditors. In the context of P2P lending, substantive consolidation of an Affiliated Issuer with a bankrupt Operator could make the Affiliated Issuer's assets (*i.e.*, the Borrower Loans) available for the payment of the Operator's liabilities (although, as discussed above, the risk that creditors other than investors would have access to payments on the Borrower Loans may be mitigated if the Affiliated Issuer grants a security interest in the Borrower Loans and the Collections Account). Any such result would make the Affiliated Issuer structure pointless since holders of the Platform Notes would remain exposed to the Operator's credit risk.

An Operator that forms an Affiliated Issuer therefore must structure its program carefully to reduce the risk of substantive consolidation. The fact that the Affiliated Issuer will engage the Operator to manage the website and oversee the performance of the Affiliated Issuer's contractual duties does not by itself mean that substantive consolidation would (or should) be ordered if the Operator were to become bankrupt. It is instead common in securitization transactions for the transaction sponsor and the special purpose issuer that it forms and services to address substantive consolidation risk by making certain "separateness covenants" intended to ensure that the parties will maintain separate legal identities and to make clear to investors that neither party is liable for the other's debts. Although P2P lending does not involve traditional asset securitization, Operators and any Affiliated Issuers should follow the same approach. To that end, among other covenants the Affiliated Issuer should undertake to (i) conduct its business only in its own name, (ii) strictly comply with all organizational formalities required to maintain its separate existence, (iii) maintain its own separate books, records, and bank accounts, (iv) prepare its own financial statements and tax returns, (v) pay its liabilities only out of its own funds, (vi) maintain adequate capital in light of its contemplated business purpose, transactions, and liabilities, (vii) not hold out its credit or assets as being available to satisfy the obligations of others, and (viii) maintain an arm's-length relationship with the Operator and its other affiliates. Without limitation to the foregoing, the Affiliated Issuer should operate the P2P website in its own name (rather than that of its parent) and should execute in its own name all contracts with borrowers and lenders. If these and similar steps are taken (and the parties in fact observe their respective undertakings), there should be little risk that a Bankruptcy Court overseeing Operator bankruptcy proceedings would substantively consolidate the Operator and the Affiliated Issuer.⁶⁷

67 It should be noted, however, that if the Affiliated Issuer structure is used, because of the nature and extent of the Operator's continuing involvement in managing the website, evaluating proposed loan postings, assigning proprietary credit ratings, participating in the loan origination process with the Funding Bank, and servicing the Borrower Loans, the SEC may deem the Operator to be offering "management rights" or an "investment contract" that constitutes a security that must be separately registered under the Securities Act. *See* footnote 629 above. Because such an approach results in prospective lenders being offered two separate securities by distinct but affiliated issuers in order to make an investment in Platform Notes, and therefore may arguably be confusing to investors as to whether they are looking to the Operator or the Affiliated Issuer, or both, as the party responsible to them for specific aspects of their investment, the substantive consolidation analysis becomes more complex.

The second approach that Operators have utilized to address Operator credit risk also entails the formation of a special purpose entity to issue pass-through securities but differs from the first approach insofar as the Operator itself continues to issue Platform Notes. Specifically, under the second approach the Operator forms (i) an investment fund that offers partnership interests or similar securities to institutional and/or high net worth investors on a private placement basis (the "*Fund*"), (ii) a subsidiary that acts as the Fund's general partner and investment manager (the "*Manager*"), and (iii) a statutory trust or similar special purpose company that purchases Borrower Loans (or portions thereof) from the Operator (the "*Trust*"). The Fund will use its members' capital contributions to purchase certificates ("*Certificates*") from the Trust and the Trust in turn will use the Certificates' purchase price to purchase the Borrower Loans from the Operator. Each Certificate will represent the right to receive all principal and interest payments (net of servicing fees) made on the related Borrower Loan. The Trust will appoint the Operator to service all Borrower Loans that it purchases. Although all Borrower Loans will continue to be funded through the website and initially will be purchased by the Operator from the Funding Bank, this structure largely eliminates Operator credit risk for the Fund investors by enabling them indirectly to invest in pass-through securities issued by an SPE (*i.e.*, the Trust) rather than in Platform Notes issued by the Operator.

The establishment of Funds rather than an Affiliated Issuer may offer the Operator greater flexibility in tailoring investment opportunities to specific investor interests. Stated differently, the Operator may be able to broaden its appeal to different institutional investors by forming multiple Funds that differ from one another in investment periods, management fees, minimum commitments, and/or investment strategies. An Operator that uses an Affiliated Issuer will not have such opportunities. At the same time, the use of Funds can have some disadvantages. As an initial matter, unless the Fund registers its interests under the Securities Act (and incurs the substantial related expenses) or is willing to observe the Regulation A+ offering cap, it will be permitted to offer its interests only to institutional and/or high net worth investors. The Operator accordingly will want to continue to sell Platform Notes through its website. The purchasers of the Platform Notes, however, will continue to have exposure to Operator credit risk. The Fund structure therefore can result in retail investors who purchase Platform Notes having greater exposure to such credit risk than institutional investors who acquire Fund interests. In addition, the Manager (i) may need to register as an investment adviser, and (ii) will need to develop an investment strategy that fairly allocates the Borrower Loans available for investment (or portions thereof) between the Fund and direct purchasers of Platform Notes. See "Investment Advisers Act" above. Finally, although Fund investors may find it convenient to invest in Borrower Loans through the Fund (and thereby rely upon the Manager rather than their own efforts to identify specific Borrower Loans for investment), the management fees they pay to the Fund may exceed the servicing fees that Platform Note purchasers pay to the Operator.

As a final point, it should perhaps be noted that neither of the two structures fully eliminates the servicing risks associated with an Operator bankruptcy. In particular, a bankrupt Operator may be entitled to reject its servicing agreement as an executory contract and/or may need to obtain bankruptcy court approval to transfer its servicing duties to a backup servicer. Any such rejection or delay would not by itself expose

Under these circumstances, in addition to strict adherence to the "separateness covenants," the manner in which the respective roles and obligations of the Operator and the Affiliated Issuer are presented in the disclosure in the offering materials, as well as the context in which each appears on the website, becomes critical if potential confusion as to which entity is responsible for what (which could provide an argument in favor of substantive consolidation) is to be avoided.

investors to claims by the Operator's creditors but could result in collections on the Borrower Loans being delayed or reduced. The funds available for distribution to investors similarly would be reduced if the backup servicer charges higher servicing fees than the Operator had charged.

B. Security Interests in Electronic Collateral

As described above, careful structuring can significantly reduce the risk that the Platform Notes issuer will become subject to bankruptcy proceedings. It's nonetheless impossible to be certain that such proceedings won't occur or that outside creditors won't assert claims against the issuer's assets. An Operator therefore may choose to offer the noteholders additional protection by issuing its Platform Notes under an indenture and granting the indenture trustee a security interest over the underlying Borrower Loans and any bank account (other than the Collections Account) that it maintains to receive payments made on the related Borrower Loans (a "*Receipts Account*").⁶⁸ If the Operator subsequently does become insolvent, the security interest should provide the indenture trustee with a first priority claim on the Borrower Loans, any funds held in the Receipts Account, and any proceeds thereof. The security interest thus helps to ensure that any collections received on the Borrower Loans (including the proceeds of any dispositions) will be applied in the insolvency proceeding to the payment of the Platform Notes in priority over any claims that other Operator creditors might assert. An SPE that issues ABS in a securitization similarly will pledge its pool of Borrower Loans and the related Receipts Account to an indenture trustee for the benefit of the ABS investors. Outside of the context of securities issuances, any bank or other commercial lender that extends credit to an institutional investor for the purchase of Borrower Loans will try to reduce its potential exposure to a borrower default by requiring the borrower to grant a security interest over the purchased loans and any related Receipts Account.

The UCC has been enacted in every state (subject to certain variations between the states), and therefore consistent legal principles apply to transactions covered by the UCC regardless of jurisdiction. Article 9 of the UCC governs security interests granted on most types of personal property collateral, including assets like the Borrower Loans and deposit or securities accounts such as Receipts Accounts.⁶⁹ Article 9 also treats

68 As previously discussed, the Operator (if acting as loan servicer) typically will maintain a Collections Account into which all Borrowers are directed to make payments on their Borrower Loans. If the Operator is itself the issuer of secured Platform Notes, it will also maintain a Receipts Account with the indenture trustee and promptly transfer from the Collections Account to the Receipts Account any payments it receives on the underlying Borrower Loans (net of servicing fees and expenses). If the Operator is issuing the Platform Notes through an Affiliated Issuer, it similarly will be required, in its capacity as servicer, promptly to transfer from the Collections Account to the Receipts Account maintained by the Affiliated Issuer any payments it receives on the Borrower Loans owned by the Affiliated Issuer. If the Operator is servicing Borrower Loans that have been sold to an SPE in connection with a securitization or collateralized loan facility, it will be required promptly to transfer from the Collections Account to a Receipts Account maintained by the SPE any payments which the Operator receives on Borrower Loans owned by the SPE. The Operator typically will not grant a security interest over the Collections Account for the benefit of Platform Noteholders, ABS investors or warehouse lenders because the Collections Account will hold payments received on all of the Borrower Loans and not only on those owned by the Affiliated Issuer or SPE. Investors and lenders must instead accept the risk associated with the temporary commingling in the Collections Account of payments due to them with other Operator funds. This risk is addressed by requiring the Operator to transfer any relevant collections from the Collections Account to the applicable Receipts Account promptly after its receipt thereof (typically within several business days) and by structuring the transaction to minimize substantive consolidation risk. See "Addressing Insolvency Risk" above.

69 The Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (Concluded 5 July 2006) became effective in the United States on April 1, 2017 (the "*Hague Securities Convention*"), and supplants the ordinary UCC choice-of-law rules as applied to collateral held in securities accounts. A detailed analysis of the Hague Securities Convention is

the interest of a buyer of most types of accounts, chattel paper, payment intangibles and promissory notes as a security interest.⁷⁰ Therefore, to the extent Borrower Loans fall within one of those four categories of collateral, Article 9 will apply to sales of those loans. Borrower Loans are not “promissory notes” because they are originated and documented in electronic form and are not evidenced by tangible written “instruments.”⁷¹ Similarly, Borrower Loans are likely not “accounts” because they do not evidence a payment obligation for property sold or services rendered and therefore may not meet the requirements of that definition.⁷² In relevant part, “chattel paper” is defined as a “record or records that evidence both a monetary obligation and a security interest in specific goods.” Consumer Borrower Loans are not “chattel paper” because the borrower’s payment obligations are not secured. Other types of Internet-originated loans, such as a commercial loan that is secured by specific equipment or goods, may constitute electronic chattel paper.⁷³ The term “payment intangible” is defined as a payment obligation where the “account debtor’s principal obligation is a monetary obligation” and such obligation is not one of the other collateral types defined in Article 9. Because Borrower Loans are either payment intangibles or, in certain instances, electronic chattel paper, Article 9 applies to sales of Borrower Loans.

The requirements for an enforceable security interest under Article 9 are: value, collateral rights, and an “authenticated” security agreement that includes a collateral description.⁷⁴ A loan to a Borrower or a payment of the purchase price to the seller of Borrower Loans constitutes value under the UCC. Depending on the structure of a transaction, satisfaction of the other two requirements may not be quite as straightforward. Often, the securitization of marketplace loans involves an SPE that is a statutory trust under Delaware law. Because the Delaware Statutory Trust Act⁷⁵ permits a trustee to hold “legal title to the property of the statutory trust”⁷⁶ a secured party must determine if the trust or the trustee (or a combination of the two) has rights in the collateral. If the trustee holds legal title to any portion of the trust estate, then

beyond the scope of this book. Lenders should consult legal counsel to determine the effect of the Hague Securities Convention on any transaction involving collateral held in a securities account.

70 See UCC §§ 1-201(b)(35) and 9-109(a)(3).

71 See UCC § 9-102(a)(65) (“a promissory note means an instrument”) and UCC § 9-102(47) (defining an “instrument” as “a ‘negotiable instrument’ or any other writing that evidences a right to payment of a monetary obligation”). See also, UCC § 1-201 (“writing” and “written” requires a “tangible form”), and UCC §§ 3-104(e), and 3-103(a)(12) (note that is a negotiable instrument is required to be in writing).

72 See UCC § 9-102(a)(2) (defining accounts primarily as “payment obligations” for “property that has been sold” or for “services rendered”).

73 Electronic chattel paper is defined as “chattel paper evidenced by a record or records consisting of information stored in an electronic medium.”

74 UCC § 9-203(b). Article 9 permits parties to document security agreements either electronically or in tangible form. See, e.g., UCC § 9-203(b)(3) (permitting security agreements to be “stored in an electronic or other medium and that is retrievable in perceivable form”). In addition, a signature that meets the requirements of an “electronic signature” under the E-Sign Act or UETA will satisfy the requirements of “authentication” under Article 9. Compare, UCC § 9-102(a)(7)(B) (defining authenticate to include “with present intent to adopt or accept a record, to attach to or logically associate with the record an electronic sound, symbol or process”) to 15 U.S.C. § 7006(5) of the E-Sign Act (defining an electronic signature to mean “an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record”) and UETA § 2(8) (defining an electronic signature to mean “an electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record.”). The term “authenticate” also includes manual “wet-ink” signatures under Article 9. See, UCC § 9-102(a)(7)(A).

75 Delaware Statutory Trust Act, DEL. CODE ANN. tit. 12, § 3801 *et seq.*

76 Delaware Statutory Trust Act, DEL. CODE ANN. tit. 12, § 3805(f).

both the trust and the trustee should be grantors under the security agreement. Although the Borrower Loans and related loan documents will be signed electronically in accordance with the E-Sign Act and UETA,⁷⁷ Platform Note indentures and ABS securitization documents are not typically prepared and executed with the E-Sign Act or UETA in mind. Therefore, a security agreement must be manually signed or electronically authenticated in accordance with the UCC.⁷⁸ The requirement that a security agreement adequately describe the collateral is easy to satisfy when the secured party takes a blanket lien on all of the debtor's assets.⁷⁹ Collateral descriptions are more challenging when the security interest arises out of a sale of Borrower Loans, however, because the sold loans must be specifically identified each time a sale occurs.

Creation of a valid security interest is only half of the story. A security interest must be perfected under Article 9 before it will be enforceable against third parties.⁸⁰ Filing a financing statement disclosing the security interest with the Secretary of State (or other appropriate authority) of the state in which the debtor is located⁸¹ is necessary to perfect a security interest in most types of collateral.⁸² If more than one financing statement is filed in relation to the same collateral, the financing statement with the earliest filing date will have priority.⁸³ A security interest in collateral consisting of electronic chattel paper or a securities account may be perfected by filing or by "control,"⁸⁴ but a security interest in a deposit account may only be perfected by "control."⁸⁵ A security interest perfected by "control" will generally have priority over a security interest perfected by filing—even if the perfection by filing occurred first.⁸⁶ A security interest in tangible collateral may also be perfected by possession.⁸⁷ However, that method of perfection is not available with respect to Borrower Loans and related loan records that are documented entirely in electronic, or intangible, form.

77 See footnote 510 above.

78 UCC § 9-102(a)(7).

79 See, UCC § 9-108(b)(3) (permitting the use of Article 9 defined terms to describe the collateral).

80 UCC §§ 9-308 and 9-317. A security interest created upon the sale of payment intangibles and promissory notes is automatically perfected when the sale occurs. UCC § 9-309(3) and (4). Nevertheless, purchasers should file financing statements to ensure that third parties are aware of the purchaser's rights in the assets that have been sold.

81 This is usually the jurisdiction in which the debtor is organized, but different rules apply for certain foreign entities and for entities organized under federal law. See, UCC § 9-307.

82 See, UCC §§ 9-310 and 9-312.

83 Under the UCC, a purchase of payment intangibles technically is perfected when the security interest "attaches" (*e.g.*, when a loan purchaser has paid the purchase price to the seller under a written agreement). However, given the large number of Borrower Loans that are typically transferred to institutional investors in whole-loan purchase programs or to ABS issuers in securitizations, and the multiple electronic copies of the promissory notes and other loan documents that typically will exist, the purchaser should file a financing statement rather than rely solely upon automatic perfection. Doing so helps to ensure that the purchaser will retain a perfected security interest even if the characterization of the transaction as a "sale" is later disputed.

84 UCC § 9-314.

85 UCC § 9-312(b)(1).

86 See, UCC § 9-322(f)(1). See also, UCC §§ 9-327, 9-328, 9-329, 9-330, and 9-331.

87 UCC § 9-313.

Worth Remembering: A security interest in electronic notes evidencing Borrower Loans *cannot* be perfected by possession because electronic notes are not in tangible form. Similarly, a security interest in electronic notes *cannot* be perfected by “control” unless such electronic notes constitute “electronic chattel paper.” A financing statement should be filed to perfect a security interest in electronic notes evidencing Borrower Loans and related electronic loan records.

The definition of “control” depends on the type of collateral. A secured party has “control” of electronic chattel paper if, among other requirements, there exists “a single authoritative copy” of the paper which is “unique, identifiable and [with limited exceptions] unalterable” and such authoritative copy is “communicated to and maintained by the secured party or its designated custodian.” Although the UCC does not indicate how the parties are to create a “single authoritative copy,” creditors who are secured by electronic chattel paper often arrange for an e-service provider to act as custodian of the electronic records. The custodian will hold each electronic record in a dedicated electronic “vault” (with the copies so held being deemed to constitute the authoritative copies), will “tag” each authoritative copy with an electronic identifier that permits it to be distinguished from all other electronic copies of the same record, and will otherwise employ procedures intended to provide the creditor with requisite degree of “control.”⁸⁸ To obtain “control” over a securities account or deposit account, the secured party must enter into a control agreement with the debtor and securities intermediary or depository bank, as applicable, whereby the securities intermediary or depository bank, as applicable, agrees to comply with instructions from the secured party without the need for consent or approval from the debtor.⁸⁹

Takeaway: Warehouse lenders and whole loan purchasers should carefully review the security arrangements in their transaction documents to ensure that their interests are fully protected.

C. *Transferable Records*

Article 3 of the UCC⁹⁰ governs promissory notes that qualify as “negotiable instruments” by meeting the following requirements: (1) the note contains an unconditional written promise to pay a fixed amount of

88 The creditor also should file a financing statement so that it will retain a perfected security interest even if the custodial arrangements are later determined not to have established “control.” A creditor secured by electronic notes other than electronic chattel paper also could decide to implement custodial arrangements of this type but, as discussed, doing so will likely not be sufficient under Article 9 to perfect the creditor’s security interest.

89 See, § 9-104 (Control of Deposit Account) and §§ 8-106 (Control) and 9-106 (Control of Investment Property). As is the case with electronic chattel paper, the secured party should also file a financing statement with respect to its security interest in any securities account. It is not necessary to file a financing statement with respect to a deposit account, because a financing statement is ineffective to perfect a security interest in a deposit account.

90 UCC § 3-102(a). Every state other than New York has adopted the 1990 version of Article 3 of the UCC. See, Legislative Fact Sheet—UCC Article 3, Negotiable Instruments (1990):

[http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=UCC%20Article%203,%20Negotiable%20Instruments%20\(1990\)](http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=UCC%20Article%203,%20Negotiable%20Instruments%20(1990)) (viewed 3.19.2018).

New York follows the version of Article 3 of the UCC that was adopted in 1962. Eleven states have adopted the 2002 amendments to the 1990 version of Article 3 of the UCC. See, Legislative Fact Sheet—UCC Article 3, Negotiable Instruments and Article 4, Bank Deposits (2002):

money (with or without interest); (2) the note is payable “to bearer” or “to order” on demand or at a definite time; and (3) the note does not (subject to certain limited exceptions) include any other undertaking or covenant in addition to the payment of money.⁹¹ The purpose of Article 3 is to facilitate the transfer of negotiable instruments by granting special rights to good faith purchasers of such instruments.⁹² More specifically, a holder in due course⁹³ obtains a negotiable instrument free from the claims of others, including prior perfected security interests.⁹⁴ Furthermore, Article 3 limits the payment defenses that an obligor may raise against a holder in due course.⁹⁵ Unlike Article 9, Article 3 does not contemplate or permit the use of electronic documents or electronic signatures. Therefore, electronic notes are not negotiable instruments under Article 3 even if all of the other requirements of negotiability are satisfied.

To facilitate electronic commerce and create legal parity for electronic transactions, both the E-Sign Act and UETA include the concept of “transferable records” which are intended to be electronic equivalents of tangible negotiable instruments.⁹⁶ Neither statute attempts to insert the concept of a transferable record into the UCC or otherwise override Article 3. Instead, the E-Sign Act and UETA import from the UCC those concepts that are necessary to create a legal framework for transferable records that is the equivalent to the existing legal framework for tangible negotiable documents.⁹⁷ UETA defines a “transferable record” as “an electronic record that: (1) would be a note under [Article 3 of the UCC] ... if the electronic record were in writing; and (2) the issuer of the electronic record expressly has agreed is a transferable record.”⁹⁸ The E-Sign Act adds a further requirement that a transferable record must relate “to a loan secured by real property.”⁹⁹ A transferable record can only be created at the time of issuance because the issuer of an

[http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=UCC%20Article%203,%20Negotiable%20Instruments%20and%20Article%204,%20Bank%20Deposits%20\(2002\)](http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=UCC%20Article%203,%20Negotiable%20Instruments%20and%20Article%204,%20Bank%20Deposits%20(2002)).

References in this book to Article 3 of the UCC are to the 1990 version of Article 3.

91 UCC § 3-104(a) and (e).

92 Hart, Frederick M.; Gerding, Erik F.; and Willier, William F., *Negotiable Instruments under the Uniform Commercial Code* (Matthew Bender, 2d ed.) (hereinafter “*Negotiable Instruments under the UCC*”) at § 1B.02.

93 Article 3 of the UCC refers to a good faith purchaser as a “holder in due course.” See § 3-302 for the requirements of a holder in due course.

94 UCC § 3-306. See also, UCC § 9-331(a) (Article 9 does “not limit the rights of a holder in due course ... [t]hese holders or purchasers take priority over an earlier security interest, even if perfected”).

95 UCC § 3-305.

96 Documents governed by Article 7 of the UCC are also included in the definition of “transferable record” under UETA, but are not included under the E-Sign Act. Because documents governed by Article 7 are not relevant to this book, they are not discussed here. New York’s ESRA does not specifically include the concept of a “transferable record.” Rather, § 307 of New York’s ESRA states: “This article shall not apply ... To any negotiable instruments and other instruments of title wherein possession of the instrument is deemed to confer title, unless an electronic version of such record is created, stored or transferred pursuant to this article in a manner that allows for the existence of only one unique, identifiable and unalterable version which cannot be copied except in a form that is readily identifiable as a copy.”

97 The “provisions of UETA are broader in scope [than the E-Sign Act], applying to all documents which would, if on paper, be ... a promissory note under UCC Article 3.” *Why Enact UETA? The Role of UETA After THE E-SIGN ACT*, Patricia Brumfield Fry, Uniform Law Commission. The practical effect of these differences is that all transferable records under the E-Sign Act are transferable records under UETA. The converse, however, is not true.

98 UETA § 16(a). Transferable records are a specific subset of “electronic records” under UETA. If a record does not meet the requirements of an “electronic record,” it cannot be a “transferable record.” See, Subsection G, “Electronic Commerce Laws,” of Section IV, “Consumer Protection Laws,” above, for a further discussion of the requirements of electronic records.

99 See, 15 U.S.C. § 7021(a).

electronic record must expressly agree that such record be treated as a transferable record in order to qualify as such.¹⁰⁰ In other words, a document that is issued as a tangible negotiable instrument *cannot* later be converted to an intangible transferable record (for example, by storing an electronic copy of the tangible negotiable instrument and destroying the paper original.)¹⁰¹

Another element of creating an electronic equivalent to tangible negotiable instruments is to establish an equivalent method of transferring such records. UETA does this by “borrowing” the concept of “control” of electronic chattel paper from the UCC¹⁰² which is discussed in the prior section of this book. Under UETA, a person has control of a transferable record if a system employed for evidencing the transfer of interests in the transferable record reliably establishes that person as the person to which the transferable record was issued or transferred.¹⁰³ Because “control” requires an uninterrupted and verifiable “chain of title,” the original holder to whom the transferable record is issued must have control of the transferable record from the outset to be able to transfer control to an assignee. A person having “control” of a transferable record has the same rights and defenses as a holder of a tangible negotiable instrument under the UCC, including, if the applicable statutory requirements under the UCC are satisfied, the rights and defenses of a holder in due course.¹⁰⁴ It is important to remember that “control” of a transferable record under UETA and the E-Sign Act does *not* perfect a security interest in such transferable record under Article 9.

Worth Remembering: Neither UETA nor the E-Sign Act amend or modify the UCC. Control of a transferable record under UETA and the E-Sign Act does *not* perfect an Article 9 security interest in such transferable record. A secured party must still comply with Article 9 to perfect its security interest.

Whether or not a marketplace lender should use transferable records is a business decision based on weighing the benefits and costs of creating transferable records. The benefit of using transferable records is that a holder of a transferable record with “control” may qualify as a holder in due course under the UCC.¹⁰⁵ The primary costs of using transferable records is the need to retain a third-party custodian to provide an electronic “vault” for establishing and maintaining control of the transferable records. If a marketplace lender is already using a third-party custodian to hold other electronic records, then the use

100 See, e.g., UETA § 16 Official Comment 2. Because New York’s ESRA does not include a requirement that the issuer of an electronic record expressly agree that such record is a transferable record, it may be possible for a tangible negotiable instrument to be converted to an electronic negotiable instrument under New York’s ESRA.

101 In fact, the intentional destruction of a negotiable instrument by the holder thereof may discharge the underlying obligation. UCC § 3-604.

102 See, e.g., UETA § 16 Official Comment 3. Notably, the definition of “control” in the E-Sign Act is essentially identical to the corresponding definition in UETA. See, 15 U.S.C. § 7021(b) and (c). Although New York has not adopted UETA’s definition of “transferable record,” it recognizes the existence of an electronic equivalent of negotiable documents and uses similar language for the concept of “control” without defining it as such. See, ESRA § 307.

103 UETA § 16(b). See “Bankruptcy Considerations—Security Interests in Electronic Collateral” in the Appendix for a further discussion of the requirements of “control.”

104 UETA § 16(d) through (f) and the 15 U.S.C. § 7021(d) through (f). New York’s ESRA does not lay out the rules governing the manner and effect of enforcing electronic negotiable records in the detail specified in UETA § 16(d) through (f).

105 At the same time, potential lenders against marketplace loans as collateral may prefer that the loans not be transferable records to eliminate the risk that a third party not associated with the financing will assert that it has acquired “control” of the loans from the borrower (or its assignee) and therefore has rights in the loans senior to those of the lenders.

of transferable records will cause significant additional expense. Another downside to using a transferable record is the requirements that the electronic note be payable “to bearer” or “to order.” Restrictions on assignment in the electronic note will adversely affect negotiability. Finally, the prohibition on including undertakings or covenants of the borrower in addition to the obligation to repay the loan, may not be acceptable to certain marketplace lenders. If a marketplace lender wishes to use transferable records, then the form of electronic note should be drafted to conform with the express requirements of UETA and, if applicable, the E-Sign Act. Conversely, if a marketplace lender does not want to use transferable records, then the form electronic note should not include the issuer’s agreement to treat the electronic note as a transferable record.¹⁰⁶ The classification of an electronic note must be made at the time it is issued, and once made that classification cannot be changed.

Tax Considerations

A. Tax Treatment of Platform Notes

The appropriate treatment of Platform Notes for U.S. federal income tax purposes is uncertain and the related rules are complex. Among other possibilities, the Platform Notes could be characterized for tax purposes as debt instruments of the Operator (the “*Debt Approach*”) or as loan participations, or even as an equity interest in the Operator. The tax consequences to both the Operator and investors can vary substantially depending upon the characterization chosen. In the absence of guidance from the Internal Revenue Service (which has not yet been publicly provided), it’s not possible to be certain which characterization is “correct.” Both LendingClub and Prosper, however, have opted for the Debt Approach, and this choice does appear to be among those best suited to the economic substance of Platform Notes. The remainder of this section therefore focuses on the consequences of the Debt Approach. Prospective Operators are nonetheless reminded that they must carefully review with their counsel the tax treatment of any Platform Notes that they issue.

Under the Debt Approach, the Operator generally will recognize as income all interest that accrues on the Borrower Loans and will take a corresponding deduction for all interest amounts payable on the Platform Notes. Accordingly, the Operator will recognize as taxable income only those amounts (such as its servicing fee) that will not be paid through to the investors. The Debt Approach also requires that the Operator and the investors treat the Platform Notes as debt instruments issued with original issue discount, or “OID.”¹⁰⁷ In subjecting the Platform Notes to reporting under the OID rules, investors effectively are required to report income for federal income tax purposes with respect to Platform Notes on an accrual rather than a cash

106 For added certainty, the electronic note should include an express statement that it is neither a negotiable note under Article 3 of the UCC nor a transferable record under UETA or the E-Sign Act (if applicable). *See*, UCC § 3-104(d) (a note that bears a conspicuous statement when it first comes into possession of a holder that such note not negotiable or is not an instrument governed by Article 3 of the UCC is not a negotiable instrument).

107 Platform Notes treated as debt instruments, and treated as issued by the Operators, would be subject to the OID rules to the extent that interest on those notes is not regarded as “unconditionally payable”—an eminently reasonable assumption given that interest is payable only to the extent received on an underlying Borrower Loan. It is possible, however, that interest on Platform Notes technically may be regarded as “unconditionally payable” based on the interest on the underlying Borrower Loans so qualifying and the economic linkage between Platform Notes and Borrower Loans—in which case, Platform Notes would not be subject to the OID rules. Most Operators do, nonetheless, apply OID reporting in their Platform Note programs, and do so notwithstanding the additional complexity, perhaps because—for the reasons expressed in the text immediately following this footnote—the Internal Revenue Service seems unlikely to question that treatment.

method of accounting. Accrual accounting does, in general, more clearly reflect the investor's economic income—but it also requires the investor to forego the otherwise potentially tax-advantageous income deferral that cash method accounting might allow.¹⁰⁸

While the application of the OID rules to the Platform Notes is complex, the rules generally will require each investor to include in income for each taxable year an amount equal to the accrued, constant yield earned with respect to its Platform Note, determined on the basis of the Platform Note's projected payments (net of Operator servicing fees but without regard to any potential default on the underlying Borrower Loan) and the Platform Note's issue price (generally, its principal amount). This treatment will cause all stated interest on the Platform Note to be reported as OID, which (like interest) would constitute ordinary income; payments of interest and principal on the Platform Note would be treated first as a payment of accrued OID, and then as a payment of principal. A variety of special rules address and modify this baseline treatment in the event of payment delays on the underlying Borrower Loan (generally requiring a continuing accrual of Platform Note OID, notwithstanding late payment or nonpayment of the related underlying cash), Platform Note prepayment (or extension), Platform Note worthlessness, and Platform Note sale.

Don't Get Caught Short: Platform Note investors who hold their notes in taxable accounts should remember that, under prevailing practice, they will be required to recognize income on an accrual basis for federal income tax purposes and accordingly, during any given reporting period could be required to recognize taxable income in excess of their related cash receipts.

Operators will be required under the Debt Approach to provide each investor with an annual tax information statement, generally on Form 1099-OID (or other applicable form) reporting the aggregate amount of OID accrued on the investor's Platform Notes. The Operator also must file a copy of each such statement with the Internal Revenue Service. As investors typically will purchase multiple Platform Notes representing partial interests in a substantial number of different Borrower Loans, an Operator must implement procedures to aggregate the OID accrual information for each investor across multiple investments and to prepare and timely file the related reports. An Operator that fails to do so could be subject to financial penalties imposed by the Internal Revenue Service for deficient information reporting.

The fact (as discussed above) that the Debt Approach is not the only possible tax characterization of the Platform Notes does leave the investors at some risk of economic disruption if the Internal Revenue Service later requires a different characterization. Any such change in tax characterization could significantly affect the amount, timing, and character of the income, gain, or loss that an investor will recognize for tax purposes from an investment in Platform Notes. Equity for tax treatment of the Platform Notes—*i.e.*, treatment as Operator stock—in particular could be adverse as the Operator could no longer claim interest or OID deductions for payments or accruals made on the Platform Notes, and non-U.S. holders of the Platform Notes could become subject to 30% withholding tax (*i.e.*, the Operator would be required to withhold 30% of each interest or OID payment due to the non-U.S. holder, remitting the same to the Internal Revenue

¹⁰⁸ Illustrative discussions of these modifications and other related Platform Note tax consequences (*e.g.*, market discount and premium) may be found in the tax discussions set forth in the disclosure documents for Prosper and LendingClub.

Service in satisfaction of the holder's presumed U.S. tax liability in respect of such payments). In general, tax withholding on payments to non-U.S. holders would not be required if (as contemplated by the Debt Approach) income on the Platform Notes is properly treated as interest or OID. In order to limit the risk to investors that would result from equity recharacterization, an Operator might choose to offer its Platform Notes only to U.S. persons.¹⁰⁹

B. Direct Investments in Marketplace Loans by Non-U.S. Persons

As previously discussed, most marketplace lenders do not issue Platform Notes but instead fund themselves through other means. In many cases, these other means include securitizations and sales of whole loans to institutional investors. A full discussion of the tax issues facing securitization and/or whole-loan investors is beyond the scope of this book. We would, however, like to highlight one issue that can strongly discourage foreign investors from purchasing whole loans and certain ABS tranches: U.S. withholding tax. Specifically, absent an exemption, non-U.S. investors generally will be subject to 30% U.S. withholding tax on *gross* payments of interest (and OID) made on any direct investments they make in marketplace loans. For these purposes, "direct" investments include both whole loans directly purchased by the foreign investor and equity tranches in marketplace loan securitizations or other funding vehicles. The potential for U.S. withholding tax can create a particular problem for startup marketplace lenders who intend to borrow their initial lending capital from foreign investors (as can often happen when the sponsors of the lender are themselves foreign). Fortunately, certain structures can be employed that may provide an exemption from the withholding requirement. First, it is becoming increasingly common for marketplace loans to be documented with terms intended to satisfy the "registered form" provisions of the Internal Revenue Code.¹¹⁰ The goal is to qualify any whole-loan purchasers for a withholding exemption generally available to non-U.S. purchasers of bonds and similar debt securities (the so-called "portfolio interest" exemption).¹¹¹ Securitization and funding structures also are often designed indirectly to achieve the same result with respect to loans that are not in registered form, by first repackaging the loans in pass-through trusts that issue certificates of beneficial interest which are themselves in registered form.¹¹² Second, some foreign investors who purchase newly originated marketplace loans may be subject to U.S. *net* income taxation if by reason of those investment activities (together with any other similar activities) the investor is deemed to be engaged in a trade or business of making loans in the United States. To help reduce that risk, some marketplace loan purchase facilities provide for the originator or a third party to "season" or warehouse the loans by retaining them for a specified period of time (often at least 30 days, but ranging as widely as from 5 to 90 days) before they are sold to the investor. The extended retention period bolsters the argument that the investor is purchasing the loans in a secondary market investment transaction (rather than as part of a

109 Prosper, for example, generally does not permit non-U.S. residents to register as investors on its platform, while LendingClub restricts non-U.S. based persons from registering as investors and does not facilitate investment in Platform Notes outside the U.S. Further, neither Operator provides assurances or comfort in its tax disclosure regarding the tax consequences of an investment in Platform Notes to non-U.S. investors, perhaps shifting (or, at least, allowing for shifting by allowing for withholding) the withholding risk introduced by any such investors.

110 Generally, these provisions condition transfers of ownership interests in the loan upon the recording of that transfer in a registry of ownership.

111 The portfolio interest exemption is not available to certain affiliates of the loan seller and/or securitization sponsor.

112 This technique was originally authorized by U.S. Treasury Regulations in order to facilitate non-U.S. investment in pools of mortgage loans, since such loans were also traditionally not documented in registered form.

business of originating loans) and therefore is exempt from U.S. net income tax under a safe harbor provided for “securities trading.”¹¹³ Importantly, satisfactory resolution of both issues—*i.e.*, the adequacy of registered form provisions and the avoidance of material trade or business risk—will matter not only to foreign investors but also (and perhaps even more so) to marketplace lenders who, in serving as paying agents to pay through to investors amounts received by them (as servicers) on the purchased loans, may be liable for any tax owing by the investors but not properly withheld and remitted to the U.S. Treasury by such lenders.

Blockchain

“Revolutionary!” “A Game-Changer!” “The Hottest Topic in Financial Services!” Such were the calls of proponents, media commentators and public company 10-Ks in 2017. The frenzy around blockchain technology has subsided in the subsequent year; however, the move toward actually building projects on blockchain has inched forward. In the lending world, the focus has been on finding ways to use this new technology to reduce processing costs and improve information security in documenting, executing and settling commercial and financial transactions. In addition, 2020 has seen the emergence of decentralized finance (or “*DeFi*”) protocols that create online markets for collateralized borrowing in digital assets, creating yield for liquidity providers.

In evaluating the claims made for blockchain, however, it is important to remember in the first instance that blockchain is not itself a financial product but refers instead to a new form of the computer science technology used to develop and maintain databases. Instead of traditional structures that used a single, trusted server to maintain a database, blockchain technology allows for a shared record, or “distributed ledger,” that is accessible to all transaction participants and capable of near-instantaneous updating but which is (at least in certain cases) designed to prevent unauthorized transactions or after-the-fact changes to the record.

Advocates and analysts of blockchain-based solutions are still trying to identify where these data structures improve on existing, centralized systems, and are assessing where value accrues in so-called DeFi ecosystems. Blockchains can be applied in a variety of methods, and the applications (and blockchain networks, themselves) can be designed to fit the needs of the network participants. This means that market participants can select a network or platform with features involving decentralization, or with semi-centralization that relies on blockchains only in part.

Blockchain networks can be open and transparent, or can be made accessible only to a controlled set of users who have limited data access. Any changes in the ledger can be made only through the consensus of the participants.¹¹⁴ Any information that is added to the ledger is recorded in a distinct electronic “block” and each block is irrevocably tied (or “chained”) to all blocks previously created for the transaction. The

113 The securities trading safe harbor also requires that the purchaser purchase the loans at their market value on the purchase date. The required delay in the purchase date, together with the fact that the purchaser eventually may purchase the loans for less than par, very often makes it difficult for originators to offer these “season and sell” structures to interested non-U.S. investors.

114 Consensus for each data point proposed for the ledger is achieved through computations automatically performed by the computers having access to the database and does not require any hands-on intervention by the transaction participants’ employees (which would rather defeat the purpose of blockchain).

electronic records thus created are accessible to all transaction participants and, since each record has been created through consensus, the blockchain ledger at any point in time will constitute an authoritative statement of the transaction terms and status. In this regard, since each ledger is, in effect, created by the parties themselves according to the rules established for the network, blockchain can eliminate the need for the parties to affect their transactions through “trusted intermediaries” of the types that have traditionally been employed in similar transactions (*e.g.*, registrars or escrow agents) and can thereby reduce both transaction costs and processing times.

Although Bitcoin is the first and most well-known blockchain network, newer blockchains are battling for open-source supremacy, particularly in the world of smart contract computing on which enterprise use cases are theorized. Like the networks and platforms that utilize them, these smart contracts are designed to be somewhat decentralized, in that they operate automatically. But they are also architected or encoded by individuals, an important reminder that design choices and platform control impact the application and adoption of blockchain technologies.¹¹⁵

Blockchain technology has application in many contexts and the financial services industry and cryptocurrency and token issuers have not been and will not be the only users.¹¹⁶ The potential for blockchain to improve the efficiency of payment, clearance and settlement procedures is nonetheless of particular interest to financial institutions and commercial and investment banks have been among the leaders in blockchain implementation. Marketplace lenders also are well positioned to utilize blockchain, in part because their business models focus on technological innovation, but also, in part, because they have relatively little capital committed to legacy recordkeeping or transaction processing systems that blockchain could supplant.

A marketplace lender interested in its blockchain options must first decide whether it will use the technology to create a settlement system or a communications channel. In a settlement system, the underlying assets (*i.e.*, the marketplace loans) are “tokenized” using smart contracts and the rights that attach to the tokens can be transferred and settled on the blockchain with near instant settlement. If the related regulatory issues

115 Smart contracts are, generally speaking, computer programs that are designed to be posted to a blockchain network, such as Ethereum, with a designed set of rules that operate strictly in accordance with the code. These programs can be complex, with participant voting rights, algorithmic decision-making, and references to on-chain events, or they can be simple “if this than that” scenarios that rely on a specific data point or particular actions that trigger a defined result. In many ways, smart contracts can reflect the commercial agreement, only documented electronically to provide for self-execution when applicable conditions precedent have been satisfied. As an example, a smart contract could provide for the automatic transfer of funds or delivery of goods to a contract participant when the conditions to such transfer or delivery have been satisfied as recorded in the related blockchain ledger. Smart contracts can interpret data from the resident blockchain, in messages or voting from contract participants, or from designated data streams known as “oracles.”

While most blockchain networks permit some forms of smart contract, development of standards on the Ethereum network has permitted large scale experimentation. At the same time, smart contracts are both living systems and static code; once published to Ethereum, a smart contract may not be easily amended, if at all, presenting significant issues relating to risk assessment and potential developer and administrator liability for both public and private systems. On private or administered networks, smart contract errors may be remedied based on agreed-upon rules, but errors relating to Ethereum contracts have resulted in catastrophic losses and controversy.

116 As examples of the use of blockchain outside of the financial industry, manufacturers can use blockchain to track the movement of assets through their supply chains and shipping companies can use it to track the status and location of shipping containers. A discussion of such uses of blockchain is beyond the scope of this book.

could be solved, the tokenization process could greatly facilitate the development of an active secondary trading market for marketplace loans.¹¹⁷

In a communications channel, the blockchain is used as an interactive system that automates reconciliation, but does not consolidate all records and settlement within the blockchain. Under these circumstances, the assets are recorded and settlement takes place on traditional database stacks and the blockchain merely serves as a means of facilitating instructions and record transmission.

As one would expect, blockchain raises many novel legal questions, depending upon the specific uses to which the technology is put. The most fundamental question a marketplace lender will confront when approaching a potential blockchain-focused project or proposal is who “owns” the blockchain and what are the network characteristics. In this, a participant must consider who is selecting the type of blockchain (open or private¹¹⁸), who is providing administrative controls and maintenance, and who is granting permission for access.

Parties joining onto blockchain-based projects must also negotiate the terms of such access, particularly when the platform or network will be shared among multiple business participants. Although blockchain based projects are at least partially decentralized, the smart contract does not typically replace the legal constructs among counterparties. While many of the issues that relate to these platforms will be similar to other fintech ventures, marketplace lenders and banks will be concerned with issues including whether or not a blockchain will be considered the definitive record of transactions recorded upon it, what administrative rights are held with respect to the blockchain, and how data is shared, monitored and owned on the blockchain. Recent developments in consumer data privacy also raise issues of the storage of financial and personally identifiable information on a relatively immutable and somewhat transparent data set. Blockchain technology may also raise unique questions of interpretation in regard to on-network governance and dispute resolution. To the extent that the programs are also built on open, distributed networks, allocation of liability for errors in code or in execution, as well as counterparty identification and anti-money laundering requirements will be heavily negotiated.

Lenders joining settlement-based platforms and networks will also need to address the legal status of “tokens” used to transmit and settle information. In particular, the tokenization of information, rights and value can create issues under both securities laws and money service business laws. The facts and circumstances around a platform or networks architecture will largely determine this analysis, both for the

117 It would be necessary to consider whether any tokens representing financial interests in marketplace loans constitute “securities” subject to regulation under federal and state securities laws. Any such tokens offered to retail investors would likely be treated as securities (which in turn would likely make the offering impractical because of securities law registration requirements).

118 An open blockchain network, such as Bitcoin or Ethereum, features relative transparency of the data and transactions that appear on the network. This means that smart contract code, transaction volume, and transaction memo field contents are posted to the distributed ledger storing all network data. This data may be encrypted, at least in part, or may be shielded by technology such as zero knowledge proofs that has been pioneered in the digital asset world; however, one of the fundamental questions regarding enterprise use of blockchain technology is the largely immutable publication of data to a public ledger.

Private blockchains, often built on top of Ethereum or Hyperledger code, can be designed to restrict both read and write access, meaning that some of the transparency and data retention issues can be mitigated; however, as parties move to private blockchains, they sometimes determine that the potential benefits of blockchain technology are removed, and that traditional data-structures with distributed systems can satisfy these results. In these cases, the specific uses and the potential benefits of smart contract implementations and immediate settlement and reconciliations systems drive considerations.

tokens themselves and the rights or value tokenized therein. A growing body of guidance and, in some instances, case law is developing with respect to federal and state securities and money service laws.

In addition to these issues, there are jurisdictional questions. Several states have promoted pro-blockchain and pro-digital asset legislation over the past two years. As the extreme example, Wyoming has aggressively pushed blockchain-friendly legislation to address issues relating to state money transmission licensing, securities law, the enforceability of electronic signatures and smart contracts, and the application of the UCC to various forms of digital assets. However, these states are the outlier, and issues exist on both the federal and state level in the United States' fragmented system of regulation. In addition, many platforms and most blockchain networks have global audiences and participants, opening up additional questions in this ever expanding landscape.

Finally, blockchain-based platforms have increasingly incorporated the use of digital assets, including stablecoins intended to represent fiat currencies.¹¹⁹ Digital assets are often used as collateral for loans in such platforms, and information regarding real world collateral may be tokenized for easy movement. This activity is occurring on centralized lending platforms and through smart contract-based DeFi systems. In centralized lending platforms, the activity is more plainly similar to traditional lending services to which the principles discussed in this book may be applied; however, in DeFi protocols the issues become more complex—although participants are cautioned against assuming the notion that technology choices would obviate existing lending, consumer protection, Bank Secrecy Act, securities laws or commodities laws.

In a DeFi protocol, a developer establishes a series of smart contracts and decentralized applications ("*DApps*") that create an ecosystem for defined activities that exist wholly or largely on the blockchain network. These systems are generally intended to be accessible to any party with access to the blockchain network, although some require the acquisition of a particular token or, more rarely, the white-listing of access. These DeFi systems include projects that seek to remove intermediaries from digital asset trading platforms (decentralized exchanges or "*DEXs*"), to provide investment exposure to baskets of digital assets (basket or set tokens) and to generate yield based on over-collateralized loans (DeFi lending or "*yield farming*"). A general premise often advanced for DeFi projects is that, following publication of the smart contracts and DApps, the developers of the project cede control to the network users, meaning that no administrator, issuer or sponsor controls the system and has operational or regulatory responsibility for its activity. The accuracy and practicality of this premise is largely untested, both on a factual and legal basis. This presents a significant issue for both retail users and potential market entrants seeking to assess DeFi opportunities.

Keep in Mind: The open access of most popular blockchain networks presents an issue for any party seeking to access a public blockchain for even the most simple of purposes. In

119 A stablecoin is intended to be a digital asset that retains a relatively consistent value based on (i) the right of users to create and redeem the digital asset for an underlying asset (which may be a single asset or basket of assets) or (ii) an algorithmic or smart contract based system that incentivizes the stabilization of assets through supply control and collateralization. Although the first widely used dollar-based stablecoin Tether continues to dominate market share, the proposal of the Libra stablecoin associated with Facebook brought intense regulatory scrutiny to this type of token. Regulatory issues relating to stablecoins are complex and legislators and regulators have brought significant focus on how stablecoin issuers may be impacted by Bank Secrecy Act, securities laws, and consumer protection rules, among other areas.

most blockchain activity, standard transactions are bilateral in nature, simplifying the “know your counterparty” equation and risks. With DeFi, a prospective participant cannot easily ascertain the identity of the counterparties that also access the DeFi application. As government agencies—including the Office of Foreign Asset Control—have begun to focus more on digital asset networks, financial institutions and all other users exploring DeFi must consider anti-money laundering, countering the financing of terrorism and sanctions compliance risks.

It may be years before firm guidance exists regarding the use of digital assets in lending or confirmation that blockchain and smart contract technology can be used to adequately describe assets intended as collateral for purposes of the UCC. Even more complex issues are raised by the emergence of DeFi protocols that seek to entirely remove intermediaries and sponsors that fill regulated roles in commercial activity. It follows that for the foreseeable future, certain aspects of blockchain systems will likely remain subject to some (or a great) degree of legal uncertainty.

Crowdfunding Rules

The term “crowdfunding” is often used broadly to include any Internet platform that matches multiple investors with natural persons and/or companies seeking debt or equity financing. In this sense, peer-to-peer platforms engage in crowdfunding. So also do sites that permit interested persons to contribute funds to a company or project without any expectation of earning a financial return.¹²⁰ There is yet another category of crowdfunding, however, that after a long incubation period finally became a reality in 2016: small business equity or debt securities offerings. Specifically, Congress in 2012 concluded that the federal securities laws unduly impeded small business capital formation and, accordingly, in the JOBS Act directed the SEC to provide an exemption from securities registration to small businesses that engage in crowdfunding in compliance with specified criteria. After considerable delay—resulting partly from the need to consider the views of multiple constituencies but also from significant concerns within the SEC that the exemption could be abused—the SEC in November 2015 adopted final rules (the “Rules”) to implement the crowdfunding exemption. The Rules became effective in May 2016. The remainder of this section summarizes the key provisions of the Rules.

Worth Remembering: The SEC crowdfunding rules relate to a specific Securities Act exemption and include restrictions which make them unlikely to be useful to marketplace lenders.

Section 4(a)(6) of the Securities Act (as added by the JOBS Act) exempts from Securities Act registration any sale of equity or debt securities made by a company in compliance with the Rules. The company therefore will not be required to register its securities with the SEC or sell them in a Regulation D private placement

¹²⁰ These latter sites include such well-known venues as Kickstarter. The companies or projects that obtain funding through these sites may provide their backers with nonfinancial “perks” (e.g., samples of the company’s products), but they don’t transfer ownership interests to the backers and don’t undertake to repay the backers’ contribution with interest. As the sites don’t entitle the backers to any financial return on the contributed funds, they are not deemed to offer “securities” and therefore are not subject to securities or broker-dealer registration requirements under the federal securities laws.

but may instead sell them through a crowdfunding platform to any investor regardless of the investor's annual income or net worth. It merits noting, though, that Section 4(a)(6) and the Rules can be used to provide financing only to companies and not to individuals. The Rules therefore cannot be used to provide credit directly to consumers. The Rules also cannot be used by certain other categories of companies, including any company that files periodic reports with the SEC under the Exchange Act (thus excluding any public company and many large private companies); any investment company, hedge fund, or similar vehicle; or any foreign company. Those companies that are eligible to use the Rules must observe a number of important conditions, including the following:

- The aggregate amount of securities sold by the issuer in reliance upon the Section 4(a)(6) crowdfunding exemption may not exceed \$1.07 million in any 12-month period. Securities sold by the issuer in offerings registered with the SEC or pursuant to other exemptions will not count against the \$1.07 million limit. An issuer therefore could undertake simultaneous Regulation D and Section 4(a)(6) offerings and could, in theory, sell unlimited amounts of the securities to accredited investors under Regulation D and not more than \$1.07 million of securities to other investors under Section 4(a)(6). Since, however, issuers may not advertise crowdfunding securities (except to the limited extent discussed below), issuers and crowdfunding platforms must take certain precautions if the issuer will undertake concurrent Rule 506(c) and Section 4(a)(6) offerings, as any general solicitation the issuer uses in the Regulation D offering could otherwise be deemed an unlawful advertisement for the crowdfunded securities.
- Investors are strictly limited in the amount of securities they may purchase under Section 4(a)(6) in any 12-month period. Investors having an annual income and/or a net worth of less than \$107,000 may purchase not more than the greater of \$2,200 or 5% of the lesser of the investor's annual income or net worth, and investors having both an annual income and a net worth of \$107,000 or more may purchase not more than the lesser of \$107,000 or 10% of the lesser of the investor's annual income or net worth. Note that these caps are applied against the aggregate amount of securities the investor purchases from any issuer through any crowdfunding platform and therefore any purchase of crowdfunding securities by an investor will reduce the amount of other crowdfunding securities that the investor may purchase during the following 12 months.
- Neither the issuer nor certain associated persons may be subject to specified criminal convictions or other disqualifying events. The relevant events are substantially similar to those that apply under Rule 506. See "The Private Placement Rules" above.
- The issuer must conduct its offering through a single intermediary that is registered with the SEC as either a broker-dealer or a "funding portal." The funding portal concept is new to the securities laws. It permits crowdfunding intermediaries—who otherwise would likely be subject to mandatory registration as broker-dealers—to register with the SEC under a simpler process and to avoid most of the ongoing compliance costs associated with broker-dealer registration. However, the Rules impose significant restrictions on funding portal operations. Among other matters, the funding portal may not offer investment advice or recommendations; solicit purchases, sales, or offers to buy the securities displayed on its platform; pay transaction-based compensation to its employees or agents; or hold, manage, or possess investor funds or securities. The funding portal also may not (absent suspicion of fraud) deny access to its website to an issuer based on the portal's evaluation of the merits of the offering. The portal may, however, apply objective criteria to screen issuers (for example, the portal could choose to list only issuers

that are involved in a particular industry, are located in a particular geographic region, or are offering common stock or another particular kind of security). The funding portal must maintain communication channels by which investors can communicate with one another and issuer representatives regarding each offering on the platform. The portal also must become a member of the Financial Industry Regulatory Authority (“FINRA”), provide investors with certain educational materials, and comply with certain FINRA rules and applicable privacy laws, anti-money laundering laws, and recordkeeping requirements.

- The issuer must make specified disclosures. Among other items, the issuer must provide the intermediary and investors with descriptions of its business, ownership, capital structure, and financial condition; the names and backgrounds of its officers and directors; statements of its anticipated business plan and of any material risk factors; the target offering amount and the intended use of proceeds; and the offering price or method for determining the price. Any issuer offering more than \$535,000 of securities must provide audited financial statements (subject to an exception for certain first-time issuers).¹²¹ If the offering amount exceeds \$107,000 but not \$535,000, the issuer must provide audited financial statements (if such statements are available) or statements reviewed by an independent public accountant (if they are not). If the offering amount is \$107,000 or less, the issuer must provide audited or reviewed financial statements or, if such statements are not available, must disclose its total income, taxable income, and total tax for its most recently completed fiscal year and must provide its financial statements, in each case certified by its principal executive officer. The issuer must file the disclosure information with the SEC before commencing the offering and must make certain other filings during the course of the offering.
- The issuer may not advertise its offering except for notices that direct investors to the intermediary’s platform and contain only limited categories of information as specified in the Rules. The issuer nonetheless may communicate with investors regarding the offering through the communication channels maintained by the intermediary as described above.
- If the issuer succeeds in selling its securities it must thereafter file annual reports with the SEC containing information specified in the Rules until such time as (i) the issuer becomes a reporting company required to submit periodic reports under the Exchange Act, (ii) the issuer or another party repurchases all of the crowdfunded securities (including the full payment of any debt securities and the complete redemption of any redeemable securities), (iii) the issuer has filed at least one annual report and has fewer than 300 holders of record, (iv) the issuer has filed at least three annual reports and its total assets do not exceed \$10 million, or (v) the issuer liquidates or dissolves its business.

Any securities sold by an issuer pursuant to Section 4(a)(6) will also be exempt from registration under state securities (Blue Sky) laws.

Many commentators have praised the crowdfunding exemption as an important step toward the “democratization” of finance since it can, in theory, permit small investors to make early-stage investments in promising companies that previously would have been funded only by venture capitalists and other

¹²¹ First-time issuers may provide financial statements reviewed (rather than audited) by an independent public accountant if the offering amount exceeds \$535,000 but not \$1.07 million. In determining the financial disclosure requirements, the offering amount will be deemed to include the current offering and any other offering made by the issuer under Section 4(a)(6) of the Securities Act in the preceding 12-month period.

accredited investors.¹²² At the same time, there is certainly reason to question whether crowdfunding will meet the expectations of its strongest proponents. The percentage of startup enterprises that become successful public companies or otherwise achieve a profitable exit is quite small. Although the Rules provide an exemption from Securities Act registration, they impose significant compliance costs that don't apply in Regulation D offerings (particularly in respect of the need for ongoing SEC filings and, depending on the offering size, independent accountant reviews or audits).¹²³ The offering expenses incurred by an issuer will therefore often be greater under crowdfunding than under Regulation D and this, in turn, suggests that crowdfunding may be of particular interest to smaller, and frequently more risky, companies that are unable to obtain financing from traditional venture capital providers.

In March 2021, the SEC adopted its final rule "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets," which implements several amendments to the crowdfunding regulations.¹²⁴ The amendments included raising the offering limit from \$1.07 million to \$5 million, as well as amending the investment limits to remove them entirely for accredited investors and to permit non-accredited investors to invest the greater of their annual income or net worth. These changes suggest a desire by the SEC to make crowdfunding offerings more available and on simpler terms than had been the case under the preexisting regulatory scheme. It will be interesting to see whether Section 4(a)(6) crowdfunding, over the longer term, provides a net benefit to small investors.

122 The number of offerings conducted and the amount of funds raised under the Rules both increased significantly in 2018 (680 offerings in 2018 versus 474 in 2017 and total proceeds of \$109.2 million versus \$71.2 million). *"Regulation Crowdfunding performed solidly in 2018. Here's the data,"* Sherwood Neiss, Crowdfund Capital Advisors (Jan. 30, 2019). A number of aspects of the Rules—including the disclosure and reporting requirements, the caps on the offering and investment amounts and the exclusion of investment funds under the issuer eligibility criteria—nonetheless create obstacles or expense for potential issuers that may constrain future market growth.

123 Broker-dealers and funding portals are permitted under the Rules to provide issuers with assistance in the preparation of disclosure materials. An intermediary may be able to help issuers reduce their offering costs by developing automated procedures for the preparation of initial drafts of the disclosure materials and related filings.

124 86 Fed. Reg. 3496 (Dec. 14, 2021).

More Information

We are available at any time to answer questions, discuss scenarios, and provide guidance. Please do not hesitate to reach out to book author Marc Franson, a member of our marketplace lending team, or any other Chapman attorney with whom you regularly work.

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About Chapman

Chapman and Cutler LLP has represented nearly every type of financial services entity, from hedge funds to specialty lenders, to some of the world's largest financial institutions. Our lawyers are actively involved in providing legal advice to and about marketplace lending programs.

We Know Lenders. For decades, we have represented lenders in capital structures ranging from the straightforward to the complex. For us, representing lenders isn't just another service area—rather, representing lenders is at the heart of what we do every day. Our experience has helped us gain a thorough understanding of our clients' processes, products, and systems, as well as their market challenges and legal needs.

Commitment to Value. We understand the evolving needs of financial services clients and skillfully combine legal acumen with business and market insight. Our commitment to value goes beyond closing a deal or resolving a matter—we share our market knowledge to help clients advance their own business goals.

Depth of Knowledge. We have extensive experience representing Internet-based platforms engaged in consumer, student, and small business lending and providing other financial products. We have the experience needed to help our clients comply with the novel legal and regulatory issues presented by these programs and to assist with expanding funding sources.

Comprehensive Counsel. With our singular focus on finance, Chapman has developed a deep bench of attorneys with the experience and skills necessary to tackle virtually any issue our clients may face. From beginning to end, Chapman provides a tailored, dynamic team of attorneys prepared to respond to any legal matter that may arise.

Securitization Experience. Chapman has been at the forefront of the efforts to develop securitization structures for marketplace lending platforms. Our broad experience in asset-backed transactions enables us to provide effective advice to our clients in connection with this developing sector of securitizations. We represent sponsors, agent banks, and investors in securitizations of consumer Internet loans as well as lenders and institutional investors in connection with securitization warehouse facilities.

Marketplace Lending Services

We handle funding arrangements for originators and purchasers of marketplace loans and also assist with development of programmatic whole-loan sale, servicing, and custodial agreements; due diligence and compliance reviews for investors; and assessment of federal and state regulatory requirements, including securities law compliance; lender, broker, and debt collector licensing requirements; usury and fee limitations; and disclosure, reporting, and fair lending regulations.

Startup Advice. We advise startup online lenders (in both consumer and commercial loan segments) in connection with the negotiation of program/marketing, servicing, and loan sale agreements with originating bank partners.

Issuance Program and Regulatory Advice. We advise online lenders interested in establishing notes issuance programs and we counsel all participants on compliance with applicable federal and state laws, rules, regulations, and requirements.

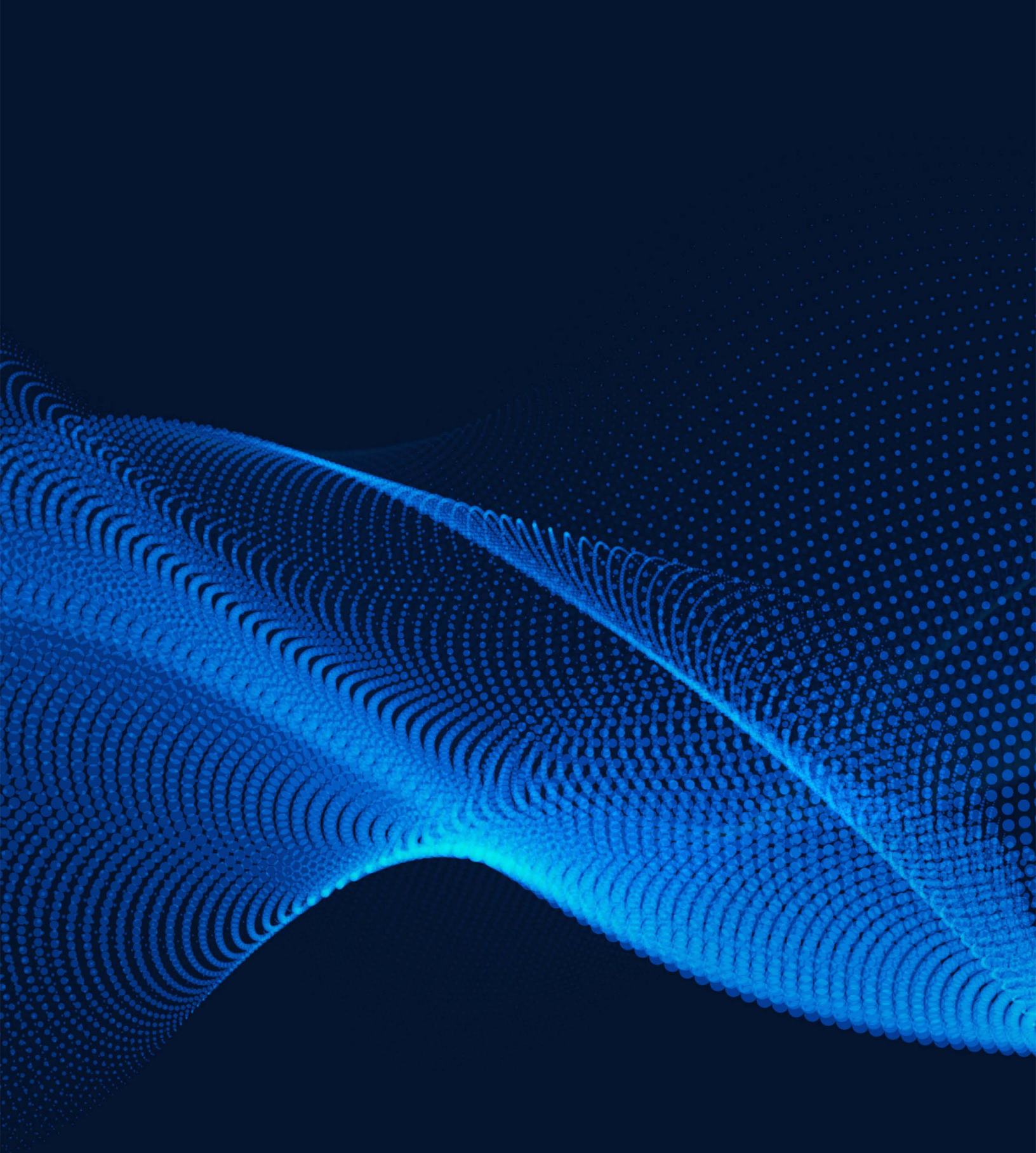
Regulated Investment Companies and Private Funds. We represent regulated investment companies and private funds in connection with investments in marketplace lending products. We were the first to structure a closed-end fund filed with the SEC specializing in marketplace lending investments.

Consumer Loans. We represent various online lenders and loan investors in connection with loan sale and servicing agreements and participation agreements.

Small Business Loans. We represent online small business lenders in structured loan facilities and in the establishment of Internet-based notes issuance programs directed to individual and institutional accredited investors.

Student Loans. We were among the first to structure capital markets-based financing solutions for marketplace education finance platform sponsors and we have recently been involved as either bank/issuer counsel or counsel to lenders and note purchasers for three newly formed marketplace student loan originators.

Securitization. We represent issuers, platforms, and lenders/investors on a variety of warehouse and term securitizations of consumer loans, student loans, small business loans, and other asset classes.



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