In the Matter of Lending Club Asset Management, LLC (Case Note), Investment Advisers Act Release No. 5054 (September 28, 2018)

Jim Leahy

December 10, 2018

Case Note

LendingClub Operation: LendingClub Asset Management, LLC ("LCA") is a San Francisco based registered investment adviser and a wholly owned subsidiary of LendingClub Corporation ("LendingClub"). LendingClub is an online lending platform that matches individual borrowers seeking consumer credit loans with retail and institutional investors that want to purchase securities backed by these loans. Once all interests in a loan are sold to investors the loan is originated by a third-party bank. LendingClub's revenue derives from origination fees charged to borrowers and servicing fees charges to investors in the loans.

If a borrower expressed a desire to borrow but LendingClub is unable to find an investor then the loan will not be funded and LendingClub will not be entitled to any loan origination or servicing fees. LendingClub's profitability is correlated to loan volume. From 2010 until early 2013, the demand from investors for LendingClub loans outstripped supply. This was not the case starting in 2013 and in subsequent years. For example, in 2015, two institutional investors stopped purchasing 60 month loans from LendingClub which was under intense pressure to close these loans that many consumers wanted. LendingClub needed to find alternative purchasers for this 60 month loan product or the loan requests would expire unfunded and would drive potential borrowers to LendingClub competitors.

With $1.3 billion under management, LCA managed private funds ("LCA Funds") whose investment objective was to purchase a broad mix of loans from the LendingClub platform. From December 2015 to April 2016 LCA managed six private funds including: (i) the Broad Based Consumer Credit (Q) Fund ("BBFQ"); (ii) the Broad Based Consumer Credit Fund ("BBFAI"); (iii) the High Yield Consumer Credit (Q) Fund ("HYF"); and (iv) the Broad Based Consumer Credit II Fund ("BBFII"). LCA charged a management fee for managing the LCA Funds.

LendingClub managed LCA, its subsidiary, pursuant to a three member Investment Policy Committee ("IPC") that included (i) LendingClub's founder, Renaud Laplanche who was also President of LCA, (ii)

Carrie Dolan, CFO of both LendingClub and LCA and (iii) LCA's Secretary who was also general counsel to LendingClub.

LCA's Form ADV Part 2A (the "Brochure") disclosed that potential conflicts of interest might arise from its relationship with LendingClub. The solution to this potential conflict was to establish "policies and procedures regarding the prioritization of individual loan selections" and for allocating such loans on each trading day. The Brochure also indicated that there was "an ethical wall" between LendingClub and LCA. Furthermore, LCA's Code of Ethics required supervised persons to place the interests of the LCA Funds over their own or LCA's interests.

Portfolio Construction: BBFQ's private placement memorandum ("PPM") set forth certain investment portfolio restrictions pertaining to, among other things, the target mix and limits of portfolio loan maturities. BBFQ's investment strategy was to purchase a broad mix of 36 month <u>and</u> 60 months loans. In March 2013, BBFQ's holdings fell short of the minimum amount of 36 month loans and it exceeded the maximum allowed for 60 month loans. This problem increased over time and was further exacerbated by the departure of the two institutional investors in 60 month LendingClub loans mentioned above.

At an IPC meeting in February of 2016 an operations employee reported that LCA was now <u>only</u> purchasing 60 month loans for BBFQ thus further increasing the breach of the concentration limits in the PPM. LCA's Secretary (also general counsel to LendingClub) objected to this practice and said that this practice violated LCA's fiduciary duty to its clients. Nonetheless, President Laplanche did not discontinue the practice of purchasing <u>only</u> 60 month loans (and no 36 month loans as required).

LCA did not identify for BBFQ investors that it had a conflict of interest with LendingClub and that it was purchasing the 60 month loans as a means of supporting LendingClub. To this end, LCA was ignoring both its fiduciary duty to act in the best interest of BBFQ as well as BBFQ's disclosed concentration limits. This practice was contrary to the allocation policy and disclosures about conflicts in the Brochure and BBFQ's PPM. LCA did not amend these disclosures to reveal that it was using BBFQ's assets for the benefit of LendingClub.

Monthly Valuations: LCA marks each LCA Fund's investment portfolio of loans at fair value pursuant to Financial Accounting Standards Board Accounting Standards Codification Topic 820 ("ASC 820"). Fair value is the price that would be received to sell an asset in an orderly transaction between market participants as of a specified measurement date. The fair value hierarchy of assets has three levels that generally are in line with an asset's liquidity: The fair value of Level 1 assets (generally the most liquid category) is based on observable inputs that reflect quoted prices such as for exchange traded assets; Level 2 assets are valued based on observable inputs other than quotes from an exchange such as a broker quotes, indications of value or broker price opinions; and the generally least liquid asset category is Level 3 assets whose value is based on unobservable inputs. LCA's consumer loans are Level 3 assets and are therefore valued using management estimates or pricing models.

LCA published fund returns in monthly reports based on a discounted cash flow model ("DCF Model") that attempted to predict future loan performance discounted to a present value. The LCA finance team would run the DCF Model and then make adjustments to the DCF Model output for changes that were not directly taken into account by the DCF Model such as loss trends. These adjustments were described in LCA's written financial close and reporting procedures and have a direct effect on reported monthly fund performance.

Management adjustments were proposed by the finance team and then reviewed by the CFO and President who may make additional modifications to those proposed. As detailed in LCA's procedures, the adjustments were for the sole purpose of taking into account supportable bases impacting valuation that were not captured by the DCF Model.

In December of 2015, the monthly returns indicated by the DCF Model showed historically low returns as a result of an interest rate hike on the LendingClub platform; the higher interest rate on the loans increased the discount rate used in running the DCF Model and decreased the projected monthly fund returns. In response, LCA imposed an artificial floor on the monthly returns it would disclose to investors. This floor for returns was not disclosed to investors. For example, in January of 2016, BBFAI returns were adjusted from -14 basis points ("bps") to 2 bps; HYF was adjusted from -5 bps to 10 bps.

Another detail about HYF was that the Brochure disclosed that if the President was invested in an LCA Fund then LCA would restrict his participation on the IPC in connection with policy or management decisions concerning that fund. President Laplanche was invested in HYF but LCA did not follow its disclosed policy of restricting him from the management of HYF as was indicated by his setting an artificial floor on monthly returns for that fund.

Another nuance of LCA's valuation policy was that in running its DCF Model, LCA was required to discount projected cash flows based on actual interest rates paid on LendingClub loans. In March of 2016, LendingClub was contemplating lowering interest rates for certain loans but did not actually implement the reduction. Nonetheless, in violation of its valuation policy, LCA used the lower prospective interest rate in running its DCF Model which permitted it to adjust HYF returns from -52 bps to 11 bps.

Compliance Deficiencies: As a result of the shenanigans described above, the SEC cited LCA's failure to implement written policies and procedures reasonably designed to prevent violations of the Advisers Act[1] in important respects: First, LCA failed to implement policies and procedures to prevent the improper use of BBFQ fund assets to purchase expiring loans to benefit LendingCub. Second, LCA failed to implement policies and procedures to prevent the improper valuation of LCA Funds including preventing arbitrary valuations based on improper considerations. Finally, LCA failed to implement written policies and procedures to prevent Laplanche's participation in the management of HYF following his personal investment in the HYF fund as required.

[1] All section references are to the Investment Advisers Act unless otherwise notes.

Violations of Law: LCA and Laplanche willfully violated **Section 206(1)** which prohibits an investment adviser from employing any device, scheme, or artifice to defraud any client or prospect.

LCA, Laplanche and Dolan willfully violated **Section 206(2)** which prohibits advisers from engaging in any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospect.

LCA willfully violated and Laplanche and Dolan caused LCA's violation of **Section 206(4)** and **Rule 206(4)-7** by failing to implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder.

LCA, Laplanche and Dolan willfully violated **Section 206(4)** and **Rule 206(4)-8** thereunder by making an untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospect.

LCA and Laplanche willfully violated **Section 207** which makes it unlawful for any person to willfully make any untrue statement of a material fact in any registration, application or report filed with the SEC or willfully to omit to state in any such application or report any material fact which is required to be stated therein.

LCA willfully violated and Laplanche caused such violation of **Section 204(a)** which requires registered investment advisers to amend Form ADV promptly when any information in the brochure becomes materially inaccurate.

Remedial Efforts/Undertakings: It is interesting to note that LendingClub's board of directors initiated a review in May of 2016 and self-reported the problems it identified to the SEC. In June of 2016 LCA established a new governing board a majority of which are independent members to supervise LCA's exercise of its fiduciary duties to its clients. Also in June of 2016, LCA notified its investors of the improper management adjustments to monthly returns and valuation and returned approximately $1 million to investors who were adversely impacted by the improper adjustments. LCA also outsourced its monthly valuation process to an independent third party.

LCA, Laplanche and Dolan were required to pay civil money penalties of $4,000,000, $200,000 and $65,000 respectively. Laplanche was barred from the industry and Laplanche and Dolan were censured.

If you have any questions about this article please contact:

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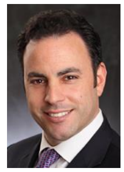

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