What is P2P Lending?

Peer-to-peer, or person-to-person, lending (“P2P lending”) is a type of crowdfunding that involves the facilitation of loan originations outside of the traditional consumer banking system by connecting borrowers directly with lenders, or investors, through an Internet platform. P2P lending’s use of Internet platforms reduces costs by eliminating many operational expenses associated with traditional consumer bank loans, such as the cost of maintaining and staffing physical branches. Some cost savings are passed along to borrowers through lower interest rates than those offered by traditional banks.

Although the majority of P2P lending is for mortgages and credit card refinancing, some P2P lending platforms focus on particular segments of the consumer lending market, including small-business lending (OnDeck, Funding Circle), student loans (SoFi, Kiva), low income entrepreneurs (Kiva), and younger borrowers (Upstart). P2P lending platforms typically issue loans in amounts ranging from $1,000 to $35,000 with fixed interest rates and maturities of three to five years. P2P lending platforms also set minimum FICO credit scores (e.g., 660 and 640). The P2P lending platform that makes the loan then receives origination fees (usually 1% to 2% of the loan balance) and servicing fees (typically 1% of the outstanding loan balance).

How Does P2P Lending Work?

The P2P lending process can vary by platform, but it generally involves the following steps:

• Before a loan is posted on a platform’s website, a prospective borrower submits an application to the platform for consideration;
• The platform obtains a credit report on the applicant and uses this information, along with other data (e.g., loan characteristics), in proprietary models to assign a risk grade to the proposed loan and set an interest rate corresponding to the assigned risk grade;
• If accepted, a loan request is posted on the platform’s website, where investors can review all loans or search for specific loans that meet their desired risk/return characteristics;
• If there are enough investors to fund the loan (a single loan is typically divided into many pieces to allow investors to diversify their portfolio and distribute the default risk among multiple investors), the loan is then originated by a bank (the “originating bank”), the deposits of which are insured by the Federal Deposit Insurance Corporation (FDIC);
• The originating bank then sells the notes associated with the specific loan to the platform, which at the same time, sells the notes to each lender that has agreed to fund the loan in the principal amount of that commitment. The notes issued by the platform are specific to each borrower, and some notes may be registered with the Securities and Exchange Commission (SEC);
• The notes issued by the platform (also referred to as “borrower payment dependent notes”) are guaranteed by the underlying loan, which means that investors are only due payment by the platform if the underlying borrower repays the loan; and
• The platform receives a fee on the loan, as well as origination and servicing fees, before lending the remaining proceeds to the underlying borrower.

Advantages of P2P Lending

P2P lending platforms have grown in popularity, due to advantages offered to both borrowers and investors. The advantages to borrowers include the following:

• Lower interest rates on average than those charged by traditional banks for credit cards or installment loans;
• Ease of use of online platforms;
• Transparency of platforms through uniform and clearly disclosed loan terms; and
• Efficient decision-making through the use of technology to quickly assess and assign risk grades and interest rates to loan applicants.

The advantages to investors include the following:

• High risk-adjusted returns;

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1 Standard program loans are three- to five-year personal loans made to borrowers with a FICO score of 660 or above, and meet other strict credit criteria.
• Access to a high yield investment class (traditionally reserved for institutional investors) in investment increments as low as $25;
• Transparency and autonomy in selecting which loans to invest in (through the ability to examine each loan at a granular level before investing, and monitor loan performance in real time); and
• Ready access to credit profile data for each approved loan.

P2P lending platforms themselves enjoy cost savings through a more efficient use of technology. P2P lending can in fact be viewed as a form of securitization where efficiencies of automation permit P2P lending platforms to divide individual loans (with individual borrowers) into numerous notes issued to numerous investors. Although there are significant cost savings from the resulting elimination of a physical branch network, the more enduring cost savings stem from the fact that P2P loans are not carried on the books of the originating banks or the P2P lending platforms and are not subject to bank capital requirements. For more information regarding regulatory considerations, see “Consumer Credit Regulatory Considerations” below.

Risks Associated with P2P Lending

Although P2P lending provides significant advantages to both investors and borrowers, there are certain considerations that should be taken into account. As a general matter, investors are exposed to more risk than borrowers in P2P lending, as typical borrower protections — including usury laws and regulations against unfair collection practices, misleading advertising, and discriminatory practices — generally still apply to P2P lending platforms. Investors in P2P lending, like investors in other types of lending, are exposed to borrower credit risk, interest rate risk, liquidity risk, and regulatory risk.

Specific risks associated with P2P lending for investors include the following:

• Inefficiencies in the proprietary risk-scoring models of P2P lending platforms;
• Increased potential for fraud due to the anonymity associated with Internet lending;
• Limited operating history of P2P lending platforms;
• Limited diversification of funding sources for P2P lending platforms;
• Dependency of P2P lending platforms on low interest rates to stimulate high transaction volumes;
• P2P lending platforms do not carry any portion of the underlying loans they originate on their balance sheet (in contrast to traditional lending);
• P2P lending platforms are not obligated to make any payments to investors if borrowers do not make payments on the underlying loans; and
• The “regulatory purgatory” in which P2P lending currently operates (which we discuss in more detail below).

Since P2P lending platforms profit the moment the underlying loans are originated and serviced, they do not share the downside of potential borrower defaults with investors. Investors only receive payments from P2P lending platforms if borrowers make payments on the underlying loans. Furthermore, once an underlying loan enters default, any monies recovered from the borrower and paid to the investor are subject to an additional servicing fee by the collection agency to which the P2P lending platform assigns the underlying loan. However, P2P lending platforms have taken some steps to mitigate borrower credit risk, including providing credit scores for each borrower, offering collection services for delinquent loans, and offering diversification through the purchase of fractional loans.

Consumer Credit Regulatory Considerations

P2P lending platforms may be subject to certain consumer banking and related regulations. Consumer credit, whether bank-originated or otherwise, is subject to an extensive web of federal and state laws, and participants in consumer credit markets are subject to the authority of numerous federal and state regulators. This web of federal and state law regulates all aspects of the credit life-cycle, including advertisements and solicitations, underwriting, agreements and disclosures, payment terms, and debt collection practices. Federal and state laws also prohibit credit discrimination and unfair or deceptive acts or practices. Other bodies of law that regulate relationships between financial institutions and consumers — e.g., privacy and data security and anti-money laundering laws — would also apply. Because of this complex web of regulation, and to take advantage of banks’ powers with respect to interest rates, non-bank creditors often partner with banks that have existing compliance infrastructure. However, bank partnerships with non-bank consumer lenders in other contexts (e.g., payday lending) have drawn scrutiny from banking regulators and state Attorneys General with respect to their lending practices and compliance with state usury laws.

Below is a summary of key federal statutes to which banks and non-bank credit providers alike may be subject:

• Truth in Lending Act — Prescribes uniform methods for computing the cost of credit, disclosing credit terms, and resolving
errors on certain types of credit accounts;\textsuperscript{3}

- **Equal Credit Opportunity Act** — Prohibits creditors from discriminating against credit applicants, establishes guidelines for gathering and evaluating credit information, and requires written notification when credit is denied;\textsuperscript{4}
- **Fair Credit Reporting Act** — Requires a permissible purpose to obtain a credit report, requires “furnishers” to report information to credit reporting agencies (i.e., credit bureaus) accurately, requires notice by creditors who take adverse action based on credit reports, and requires creditors to develop and maintain an identity theft prevention program;\textsuperscript{5}
- **Gramm-Leach-Bliley Act** — Restricts disclosure to nonaffiliated third parties of nonpublic personal information about a consumer, and requires financial institutions to notify their consumers about their information-sharing practices and inform consumers of their right to “opt out,” in certain circumstances, if they do not want their information shared with certain nonaffiliated third parties;\textsuperscript{6}
- **Electronic Fund Transfer Act** — Establishes the rights, liabilities, and responsibilities of parties in electronic funds transfers (“EFTs”), and protects consumers when they use EFT systems;\textsuperscript{7}
- **Bank Secrecy Act** — Requires financial institutions to implement anti-money laundering procedures, implement a customer identification program, and screen names against certain government watch lists; and\textsuperscript{8}
- **Fair Debt Collection Practices Act** — Restricts third-party debt collectors\textsuperscript{9} conduct in connection with the collection of consumer debts.\textsuperscript{9}

Where a non-bank platform has partnered with a bank to originate consumer loans, the platform may still be subject to regulatory oversight and examination. For example, in the context of P2P lending platforms, the platform provider may be viewed as a service provider with respect to its origination or servicing activities.\textsuperscript{10} The Consumer Financial Protection Bureau (CFPB) would have unfair, deceptive, or abusive acts or practices (“UDAAP”) enforcement authority over bank originators of P2P loans if the bank has assets of greater than $10 billion, and the same authority with respect to a service provider to such a bank. The CFPB could also adopt UDAAP rules applicable to all banks and platforms involved in P2P lending. In addition, the Federal Trade Commission can investigate and enforce consumer protection statutes as applied to non-bank platforms under its authority under Section 5 of the Federal Trade Commission Act.\textsuperscript{11}

At the state level, non-bank platforms may be subject to lending, servicing, debt collection, and usury laws — which may include licensing, background screening, and capital requirements — and licensees may be subject to examination by the state licensing authority.

### Regulation of Funding Side of P2P Lending

In addition to consumer credit regulations, the funding side of P2P lending platforms is subject to SEC regulation. In November 2008, the SEC issued a “cease and desist” order to P2P lending platform Prosper Marketplace, Inc. (“Prosper”), indicating that notes issued by Prosper were unregistered securities.\textsuperscript{12} In finding that the notes were unregistered securities, the SEC applied the analysis used in *Reves v. Ernst & Young*.\textsuperscript{13} To determine whether a note is a security, the *Reves* analysis begins with the rebuttable presumption that every note is considered a security. When there is a question, a determination needs to be made whether the notes offered bear a “family resemblance” to cases where notes have been deemed not to be securities. The following four-part balancing test must be applied to determine whether this resemblance exists:

- The motivation of the buyer and seller;
- The plan of distribution of the notes;
- The expectations of the investing public;\textsuperscript{14} and
- Whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the Securities Act unnecessary.

\textsuperscript{3} 15 U.S.C. §§ 1601 et seq.; see also 12 C.F.R. Part 1026.
\textsuperscript{4} 15 U.S.C. §§ 1691 et seq.; see also 12 C.F.R. Part 1005.
\textsuperscript{5} 15 U.S.C. §§ 1681 et seq.
\textsuperscript{6} 15 U.S.C. §§ 6801 et seq.; see also 12 C.F.R. Part 1005.
\textsuperscript{7} 15 U.S.C. §§ 1693 et seq.; see also 12 C.F.R. Part 1010.
\textsuperscript{9} 15 U.S.C. §§1692 et seq.
\textsuperscript{10} A platform provider may also be viewed as a “service provider” subject to the CFPB’s jurisdiction if it provides a material service to “covered persons” in connection with the covered persons’ offering or provision of a consumer financial product or service, as those terms are defined in the Dodd-Frank Act of 2010 (the “Dodd-Frank Act”), Pub. Law No. 111-203, 124 Stat. 1955, §§ 1001 et seq.
\textsuperscript{13} Reves v. Ernst & Young, 494 U.S. 56 (1990).
\textsuperscript{14} The *Reves* court indicated that notes could be treated as securities on the basis of public perception, even where the actual economics of the notes would suggest otherwise (for example, when the notes are non-interest bearing).
Although the exact application of these factors is somewhat ambiguous and fact dependent, when applying the test, the Reves court emphasized that the presumption is that notes should be treated as securities.\textsuperscript{15} Applying the Reves analysis to the notes in question, the SEC indicated that the notes are securities because:

- Lenders are motivated by an expected return on their funds;
- Prosper loans are offered to the general public;
- A reasonable investor would likely expect that the loans are an investment; and
- There is no alternate regulatory scheme that reduces the risks to investors presented by the P2P lending platform.

As a result of the SEC action, Prosper registered its notes with the SEC. Lending Club Corporation (“LendingClub”), another P2P lending platform, also has registered its notes with the SEC. The costs and administrative burdens associated with registering notes with the SEC have potentially reduced the number of platforms in the P2P lending space. Furthermore, P2P lending platforms are still subject to blue sky registration requirements because the notes may not be “covered securities” under the National Securities Markets Improvement Act of 1996.\textsuperscript{16}

A report issued in 2011 by the U.S. Government Account Office (GAO) pursuant to requirements under the Dodd-Frank Act acknowledged the confusing overlapping jurisdiction of multiple regulatory agencies, including the SEC, state securities regulators, state banking regulators, the FDIC, and the CFPB, with respect to P2P lending.\textsuperscript{17} The GAO report outlined two approaches to the future regulation of P2P lending on the federal level:

- An \textbf{SEC-centered approach}, whereby potential risks to investors are regulated at the federal level by the SEC. Under this approach, there would be broad exemptions to individual state-level securities regulations for P2P lending platforms that are in compliance with federal regulations. However, borrower protections would remain under the jurisdiction of state regulators.\textsuperscript{18}
- An \textbf{CFPB-centered approach} that would bring together the monitoring of investors and borrowers under the CFPB. Instead of being federally regulated securities, P2P loans and investments in P2P loans would be “consumer financial products” and the CFPB would regulate the relationship between investors and P2P lending platforms.\textsuperscript{19}

Despite the GAO’s thorough analysis, due to the infancy of the industry and expected evolution of P2P lending over time, the GAO did not make any firm recommendations as to which of these regulatory models was best. Subsequently, the SEC remains the primary regulatory agency for the funding side of P2P lending.

\textbf{Title III of the JOBS Act}

When President Obama signed Title III of the Jumpstart Our Business Startups Act (the “JOBS Act”) in April 2012, it was thought that the long-awaited federal crowdfunding exemption of the JOBS Act would offer relief to P2P lending platforms. Title III of the JOBS Act addresses crowdfunding — of which P2P lending may be considered a type — by providing an exemption from registration, provided that:

- The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, is not more than $1 million;
- The aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, does not exceed:
  - The greater of $2,000 or 5\% of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000, or
  - 10\% of the annual income or net worth of the investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000;
- The transaction is conducted through a registered broker or funding portal that complies with the requirements of the exemption; and
- The issuer complies with a number of specific informational and other requirements specified under the exemption.

\textsuperscript{15} The Reves court also indicated that where the notes being offered are interest-bearing, absent a countervailing factor, the notes are considered securities.

\textsuperscript{16} “Covered securities” include: (i) securities listed or authorized for listing on the New York Stock Exchange or NASDAQ; (ii) securities registered under the Investment Company Act of 1940, as amended; (iii) securities offered pursuant to Rule 506 of Regulation D under the Securities Act; and (iv) securities exempt under Section 3(a) of the Securities Act (with certain exceptions).


\textsuperscript{18} See id.

\textsuperscript{19} See Id.
Considerations and the Future of P2P Lending

There are some considerations that should be taken into account when assessing the current state of P2P lending and its future. The long-term viability of the P2P lending model that relies on the efficient use of technology as a cost savings mechanism is unclear. Although there are significant cost savings from the elimination of a physical branch network, the more enduring cost savings stem from the fact that P2P loans are not carried on the books of the originating banks or the P2P lending platforms and are not subject to bank capital requirements. Nevertheless, it remains to be seen whether the cost advantages from P2P lending platforms’ efficiencies will persist if banks adopt a more cost efficient business model that better utilizes technology. P2P lending platforms thus far have been enjoying a “first to market” advantage that may be impacted by new entrants to the P2P lending space. Heightened competition in the short- and long-term could raise the marketing costs of P2P lending platforms and force the platforms to expand further into new market sectors and geographic areas. This would likely cut into the cost savings that P2P lending platforms currently enjoy. Further, as discussed above, the future regulation of the funding side of P2P lending also remains unclear, given that the SEC has yet to adopt final rules to implement the crowdfunding exemption. However, the adoption of such final rules, when it occurs, should help further decrease regulatory costs and spur growth in P2P lending.

Despite these considerations, the growth opportunities for P2P lending are significant. P2P lending represents just a fraction of the outstanding balance of consumer credit in the United States. As a result, P2P lending platforms have expanded their product offerings and expanded into new sectors of consumer lending in order to capture greater market share. P2P lending is also being used to raise capital for a small percentage of real estate companies, with more than $110 million of capital raised between April 2013 and September 2014.21 For example, leading real estate crowdfunding platform Fundrise recently announced that it will begin to offer “guaranteed pre-funding,” which means that sponsors can have a project pre-funded prior to the offering being posted on the crowdfunding platform and receive capital within 10 days.22

Investor interest in P2P lending platforms also appears to be increasing. P2P lending platforms have begun to plan to, or already have, filed for initial public offerings (“IPOs”). For example, both LendingClub and OnDeck completed their IPOs in December 2014,23 which were well received by investors and seen as a validation of the P2P lending model. The success of these recent IPOs suggests that the P2P lending market is healthy and growing.