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Memorandum

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Good Things Come in Small Packages: An Investor's Guide to Buying Peer-to-Peer Loans

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"As this new asset class grows, savvy investors have the opportunity to shape both their own portfolios and the industry itself."

Institutional investors are beginning to see new investment opportunities in consumer and small business loans. These opportunities are driven by innovations in online direct lending, including "peer-to-peer" ("P2P") lending. By developing online platforms and automating borrower on-boarding and loan underwriting procedures, a growing field of direct lenders is generating ever-increasing numbers of small loans for investment. Much media attention has focused on opportunities for individuals to invest in these loans (and to "disintermediate" banks in the process). But online lending is no longer the exclusive province of individual, "retail" lenders. Enterprising fund managers have begun to realize that P2P lending may allow them to build large, diversified portfolios of small consumer and business loans in ways that were cost-prohibitive just a few years ago.[1] In short, online consumer and small business finance is emerging as an appealing asset class for institutional investors.

As this new asset class grows, savvy investors have the opportunity to shape both their own portfolios and the industry itself. Rapid expansion has led to a variety of platforms serving an array of consumer and small business borrowers across geographies and often with a specialty focus. Investors have the opportunity to customize their investment profiles by selecting the most attractively priced loans on each platform and by identifying platforms that generate opportunities meeting their needs. Further, because the regulatory treatment of the industry remains uncertain, and, so far, oversight has been limited, investors (or groups of investors) have the opportunity to participate in the development of "best practices" for the industry.

As they enter the P2P and online direct lending market, investors and their legal counsel should be aware of the channels for investing in loans generated by the platforms and the due diligence concerns this type of investing raises. In this memorandum, we survey growth trends in the P2P and direct lending industry, summarize the primary methods for gaining direct lending exposure and highlight key risks (and mitigation strategies) for those investing through direct lending platforms.

1. For a more extensive overview of P2P and direct lending platforms, please see our legal white paper, "Too Big to Disintermediate? Peer-to-Peer Lending Takes on Traditional Consumer Lending," by Jon Kibbe, available at: http://www.rkollp.com/assets/attachments/20131015%20Too%20Big%20to%20Disintermediate.pdf.

I. A NEW ASSET CLASS

The P2P and online direct lending industry has grown rapidly over recent years and promises to continue to expand.[2] Consumer borrowers have gravitated towards the P2P platforms in search of lower interest rates than those offered by credit cards, and traditional banks' withdrawal from small business lending has left those borrowers seeking new sources of financing. Given platforms' scalability and the lower cost of operations for online lenders compared to these for bricks-and-mortar banks, this shift to online lenders seems likely to pick up pace.

In 2013, LendingClub and Prosper, the two largest U.S. P2P lenders, originated $2.4 billion of loans. While those numbers represent only a tiny fraction of overall consumer lending, they were up 180% over 2012. Given the size of the market, they have the potential to continue growing rapidly.[3] U.S. consumers carry $3.1 trillion in debt, of which $850 billion is revolving debt, largely credit cards. The most common application of P2P consumer loans is to refinance more costly credit card debt, so it seems likely that P2P loans will ultimately replace a much larger portion of the $850 billion of revolving consumer debt.

The small business sector shows similar opportunities for growth as traditional lending sources have become less available. The U.S. ended 2013 with only $650 billion of small business loans outstanding (25% of all business loans), down from a high of $780 billion in 2008 (33% of all business loans). Much of that gap has been filled by merchant cash advances, factoring and non-traditional lenders offering high interest rates. While true P2P-style lending for small businesses is relatively new in the U.S., the entry of LendingClub and numerous smaller platforms into the market should provide ample opportunity for institutional investors to invest in small business loans going forward.

Outside the U.S., P2P and online direct lenders are active in the United Kingdom (with Ratesetter, Zopa and Funding Circle as three of the largest) as well as Germany, France, Italy, Spain, Finland, Poland, the Netherlands, Denmark, Mexico and Argentina. Further, many online lenders focus on specific types of loans, including student loans or green-tech. This diversity of geographies and loan types can allow an investor to gain exposure to the consumer and small business asset classes, while still tailoring its portfolio to meet specific investment objectives.

II. INVESTMENT PATHWAYS

"Shopping online"

Websites like Prosper and LendingClub, which are accessible to both "retail" and institutional investors, as well as several other platforms available only to accredited investors, allow investors to simply log in, peruse loan applications online and commit to fund (or partially fund) loans whose credit profiles and interest rates match their desires. If a loan is funded, the platform will transfer investor funds to the borrower in exchange for the borrower's promise to repay the platform, and the platform will issue a matching back-to-back note to the investor. The back-to-back platform note's principal and interest terms will mirror the borrower loan's terms (less servicing fees and other fees payable to the platform), but payment to the investor by the platform will be explicitly contingent on the borrower making payments on the borrower loan. As we discuss in Part II below, the back-to-back nature of the borrower loan and the back-to-back note means that investors holding back-to-back notes are exposed to platform credit risk in addition to the more obvious risk of the underlying borrower's default.

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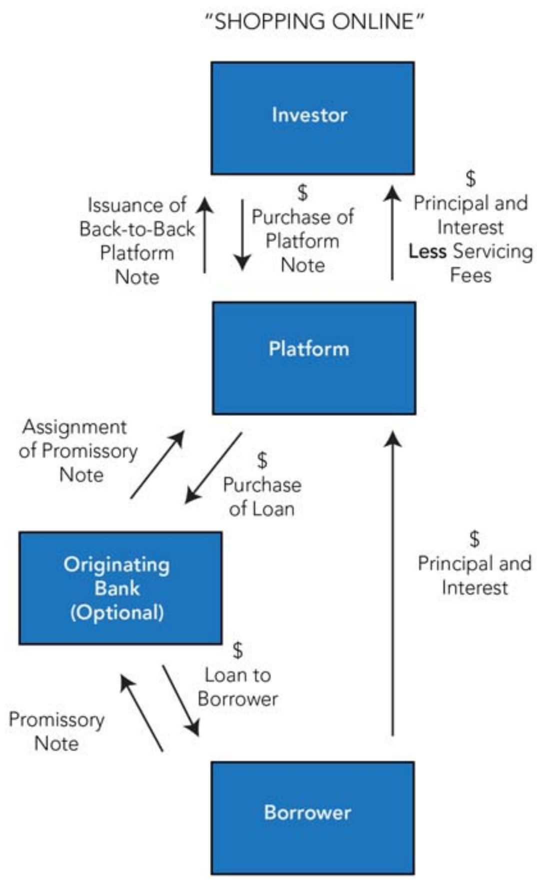
2. The term "peer-to-peer" lending originated in the context of platforms specializing in matching retail investors with consumer lenders. However, as the result of heavy institutional interest in the industry, it has come to refer more to a style of lending than to the participants. The term is often used to refer to lending through online platforms more generally, including lending by institutional investors to consumers or small businesses. For the purposes of this paper we use the terms "P2P", "online lending" and "online direct lending" interchangeably.
3. The UK has shown similar rapid growth, ending 2013 with £843 million cumulative P2P lending (both consumer and small business), a 120% increase from 2012's year-end cumulative figure of £381 million.



Some platforms offer APIs, which allow investors to develop in-house software to communicate directly with the platform's servers in order to download and analyze loan data and commit to fund desirable loans at high speeds.[4] Recently, a combination of fund managers' technological savvy and intense competition for appealing credits has led to many borrower loan applications being analyzed algorithmically as soon as they are posted online and bought up nearly instantly thereafter. The periodic posting of borrower loan requests and ensuing competition to fund the appealing loans has been dubbed "feeding time" on some platforms. This trend means that any investor interested in building a large portfolio of loans from online platforms must either invest in real-time credit analysis systems or be prepared to pick from credits that already have been passed over by other, faster institutions. As a further complication, those investors that do seek to implement high-speed software interfaces must determine whether a given platform employs (or could in the future employ) features designed to limit large-scale investors' access to loans to level the playing field for retail investors who also use the platform. Such investment "speed bumps" may involve minimum posting times before users can purchase loans or caps on the amounts of loans a single user may purchase.

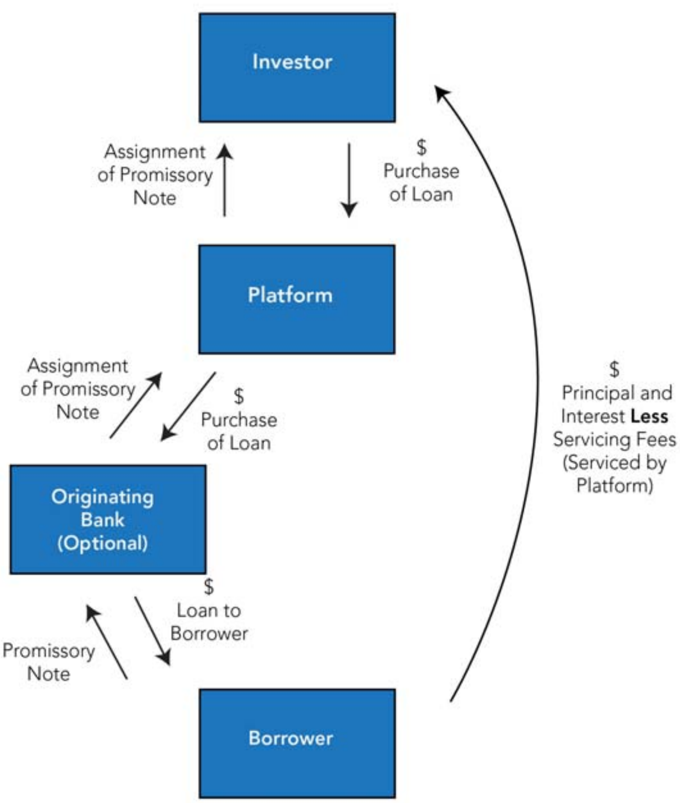
Summary: "Shopping online"	
Pros	• Limited upfront cost for investors who want to browse and handpick investments online. • No obligation to purchase any minimum amount of loans.
Cons	• Intense competition for appealing credits. • Investors seeking large portfolios likely will need to implement appropriate software infrastructure. • Some platforms may limit access for heavy users. • Exposure to platform credit risk (in addition to risk associated with servicing failure).

4. An API, or "application programming interface", is a set of commands that allows a platform's website and other software applications (such as an investor's analysis and trading applications) to communicate with one another without human intervention. Even if platforms do not offer an API, investors can develop software to "scrape" platform websites for large quantities of loan data (though the terms of use of some platforms may prohibit this practice).

Whole Loan Purchases

As an alternative to investing indirectly in Borrower Loans through the purchase of Platform Notes, most P2P platforms provide options for institutional lenders to purchase large numbers of whole loans that have been originated through the platform.

WHOLE LOAN PURCHASES



The economic and contractual terms of these arrangements vary (and may be negotiable), but they generally give an institutional investor the right (and obligation) to purchase a specified volume of loans per month or a portion of all loans meeting criteria established by the platform and investor in advance.

Interests in loans typically are transferred as whole loans to the investor (or sometimes to a trust acting for the benefit of the investor), with the investor (or trustee) becoming the lender of record. Whole loan transfers obviate the need for a back-to-back note issued by the platform and therefore mitigate platform credit risk. Such transfers often also come with stronger platform representations regarding a loan's quality, compared to those received by investors purchasing back-to-back notes. On the other hand, purchasing whole loans may expose investors to lending and regulatory risk, depending on how the program is structured. We discuss those risks and others in Part III.

Summary: Whole Loan Purchases	
Pros	• Ability to purchase loans meeting pre-negotiated criteria. • Ability to deploy large amounts of capital with greater certainty. • Mitigated platform credit risk (though risk of servicing failure remains).
Cons	• Investor's obligation to purchase loans may be difficult to amend after the fact. • Loan criteria must be carefully determined in advance; no ability to "hand pick" appealing loans. • Additional lending regulatory questions.

III. DUE DILIGENCE CONCERNS AND SOLUTIONS

An institution investing in platform loans, whether indirectly through back-to-back notes or directly in whole loans, faces a number of due diligence concerns. Any investor should carefully assess the most critical of these concerns and consider the available methods for resolving or mitigating the related risks before creating an online direct lending portfolio.

Borrower Credit Risk

As with more traditional lending arrangements, the most critical issue for an investor lending through an online platform is evaluating the underlying borrowers' (and affiliated guarantors') ability to repay principal and interest obligations. In the online direct lending context, this not only requires a careful review of borrower information made available on a platform, but also a determination of how the platform obtained that information, whether the platform verifies any information and, if it does, whether the platform guarantees the accuracy of any information. Because much of the direct lending process is automated, without face-to-face interactions with loan applicants, it may be more susceptible to fraud and reporting errors than more traditional bank lending.

Different platforms engage in varying degrees of diligence during the underwriting process. Some, for instance, merely verify a borrower's identity, satisfy "know your customer" regulations and download a third-party credit report, while relying on borrowers to report other information, such as job status, income or home ownership, accurately and honestly. Other platforms may investigate borrower data more aggressively, for example, by verifying reported income or even making site visits for small business owners. In any case, an investor should determine the source of borrower information provided to the platform and the extent to which that information has been confirmed by the platform or by reputable third-party sources.

A platform should also disclose to what extent it will indemnify an investor for information provided by a borrower that is either deliberately false or unintentionally inaccurate. Expressly unverified information is very unlikely to be guaranteed by a platform, but platforms have varying policies regarding reimbursing investors for losses related to intentional fraud perpetrated by borrowers and identity theft. Investors should review platform documents for terms governing the allocation of borrower fraud risk between the platform and investors.

Depending on the platform and loan product, borrowers may be subject to on-going reporting requirements and other covenants. Periodic financial reporting and cross-default provisions can be tremendously useful early warning devices built into loan documents, but if a platform has no practical ability, or contractual obligation to investors, to police borrower compliance with such terms, their value to investors is greatly diminished.

Lastly, investors should consider the practical value of the collateral, if any, that a platform describes as supporting a loan listing. To fully realize the benefits of any pledged collateral after a borrower default, the investor (or the platform on the investor's behalf) must have a perfected and senior security interest over collateral assets that retain their value and can be liquidated efficiently. Searching for preexisting liens and perfecting security interests in certain types of collateral (e.g., real estate, vehicles and borrower cash accounts) prior to the extension of new borrower loans may be too costly and time-consuming for many platforms' business models. In addition, many borrower assets may be subject to preexisting secured financing arrangements (e.g., equipment leases) or restrictions on transfer (e.g., business and intellectual property licenses), further diminishing the usefulness of any security interest backing a loan.

Borrower creditworthiness is clearly a key component of any lending transaction. The issues above should be considered carefully but generally can be resolved through risk-adjusted pricing. However, a platform's failure to provide clear information about those issues should be viewed as a red flag about the platform and its business more generally.

Platform Credit Risk

An investor who purchases back-to-back notes linked to underlying borrower loans should recognize that it effectively faces two layers of counterparty credit exposure—the credit risk of the underlying borrowers and the credit risk of the platform. In a platform bankruptcy, noteholders may be treated as general unsecured creditors of the platform and other creditors of the platform may seek to share in proceeds of the underlying loans. In addition, noteholders may be unable to pursue their claims against the platform due to the "automatic stay" that applies in bankruptcy cases.

In light of the insolvency risk, platforms may build in financial reserves or capital call rights to buffer their notes against platform losses related to borrower fraud, regulatory risk, platform operational error and malfeasance and other potential liabilities.

Platforms may also establish a trust to hold borrower loans and grant an indenture trustee a security interest in underlying loans. Another common (but not universal) approach is for platforms to hold borrower loans in, and issue notes from, a bankruptcy-remote special purpose vehicle. A bankruptcy-remote vehicle, when established and managed properly, may significantly reduce the chance that the entity that holds the loans and issues the notes will become subject to bankruptcy proceedings. These various legal approaches to mitigating platform insolvency risk will generally be available to institutional investors but can be highly technical in nature; interested investors may find it useful to consult counsel as to their scope and likely effectiveness.

In addition, in the direct lending process, the platform provides a critical–and difficult to replace–function as the servicer of the loans. Accordingly, before investing through a platform, investors should evaluate the platform's ability to provide continuous servicing operations. This may mean investigating not only a platform's corporate structure, capitalization and potential exposure to liabilities, but also determining whether a back-up servicer is on retainer and to what extent that back-up servicer is capable of undertaking the variety of servicing, website maintenance and payment processing duties of the platform.

Other Risks and Mitigation Strategies

Outside of borrower and platform credit concerns, an array of additional risks may affect an investor's ability to participate in the online direct lending market. Some of those obvious risks and strategies for mitigation follow:

- Lending laws: Consumer lending and commercial lending are both subject to federal regulation and myriad state-level laws and licensing requirements. As a general matter, investors will want to be confident that a given platform holds necessary licenses or has made arrangements with a third-party bank (which holds the necessary lending licenses) to originate loans in any given state. The use and selection of a third-party bank may also determine whether loan interest rates are subject to caps under the usury laws of a borrower's state. A platform's breach of applicable lending or usury laws may render loans unenforceable in certain circumstances, impairing investment returns. In certain circumstances, investors should consider whether the purchase of whole loans may subject them to state lending regulations and licensing regimes, an area of the law that merits careful monitoring as it develops. Generally investors will be able to limit this risk by ensuring that the platform making the loans has the appropriate licenses and is itself in compliance with relevant laws and regulations.
- Securities laws: If a platform issues back-to-back notes (or other securities backed by underlying borrower loans), it will be subject to the federal and state securities laws, which were not drafted with today's innovative P2P platforms in mind. The analysis of how securities laws apply to these platforms is complex and evolving. Compliance can be burdensome, particularly for smaller platforms,

and the appropriate solution will depend on the specifics of each platform's business model. Investors should be aware that such breaches of securities laws by a platform could result in costly penalties and injunctions against the platform, jeopardizing the platform's ability to generate new loans and service outstanding loans.

- Conflicts of interest: Investors should determine whether affiliates of the platform, or favored third-party investors, have preferential access to loan listings or faster investment execution capabilities. If an investor is a significant purchaser of platform notes or loans, it may wish to negotiate for a "most favored nation" clause in its dealings with the platform.
- Collections upon default: An investor may wish to consider how a platform intends to collect on loans in default, as platform approaches vary. Some may have a sophisticated collections department while others may simply sell defaulted loans at a steep discount to third-party collection agencies. Investors should understand how much discretion a platform has in modifying loans terms in work-out scenarios, exercising remedies or pursuing litigation against borrowers, and consider how these practices will affect expected returns.
- Transfer restrictions: Currently, many direct loan investments remain untradeable due to contractual restrictions and securities law concerns. Where trading is possible, liquidity tends to be thin. However, secondary markets for lender notes are developing in response to investor demand.
- Taxes: Investors will want to consider the tax implications associated with receiving payments on back-to-back notes and/or whole loans, as well as related tax concerns tied to permanent impairments on bad debt and sales of debt instruments.

IV. CONCLUSION

The influx of both platform entrepreneurs and institutional investors into the direct lending space means there is now a variety of investment channels into consumer and small business loans. While investors should carefully evaluate platforms' business models and disclosure documents and understand the risks associated with these investments, they should not let the complexities deter them from participating in a potentially valuable investment opportunity.

QUESTIONS

If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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