Crowdfunding and Peer-to-Peer Lending: Legal Framework and Risks

Peer-to-Peer Lending Meetup New York

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December 18, 2013
Agenda

- Crowdfunding - SEC Rules are Out- now what?
- Peer-to-Peer Lending
- Your Questions Answered
Crowdfunding After the SEC Rules Proposal
JOBS Act Overview

“To increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.”

- **Crowdfunding – online fundraising…but there’s a catch**
- Regulation A+ - from $5mm to $50 mm
- Private Placement Reforms
  - General Solicitation relaxed – effective Sept. 23
  - Enhanced verification of Accredited Investors if Soliciting
- “Go Public” Shareholder Thresholds Increased
- IPO On-Ramp and Emerging Growth Companies
- Relaxation on Research Restrictions
- Decimalization – move to $.09 tick increments?
- Prospective Issuer Outreach
- **Signed into law April 5, 2012**
Crowdfunding background

• Comprises Title III of the JOBS Act
• Originated from two perceived needs:
  – that smaller retail investors did not have access to early stage investment opportunities
  – that start-up companies did not have adequate access to available capital, particularly online capital raising
• Adds exemption from SEC registration for crowdfunding transactions in the form of new Section 4(6) of the Securities Act

• Capital
• Raising
• Online
• While
• Deterring
• Fraud and
• Unethical
• Non-
• Disclosure
**Backdrop: Current Crowdfunding Landscape – Five* Varieties**

<table>
<thead>
<tr>
<th>Type</th>
<th>Rewards/Donation-Based</th>
<th>Equity to Accredited Investors</th>
<th>Equity to the Public</th>
<th>Peer-to-Peer Lending</th>
<th>*Advertised Private Placements/Title II</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Examples</strong></td>
<td>Kickstarter, Indiegogo, Rockethub, Youcaring</td>
<td>FundersClub, AngelList, Ourcrowd</td>
<td>???</td>
<td>Lending Club, Prosper, Zopa (UK)</td>
<td>Private Placements using advertising and general solicitation</td>
</tr>
<tr>
<td><strong>Securities Reg Status</strong></td>
<td>Not sales of “securities”</td>
<td>Sales of securities to accredited investors</td>
<td>Sales of securities to the general public</td>
<td>Registered borrower-payment dependent notes</td>
<td>Exempt private placements under Rule 506(c)</td>
</tr>
<tr>
<td><strong>Regulation</strong></td>
<td>State-level antifraud only; not SEC-regulated</td>
<td>SEC-regulated, no-action letters protect website solicitations from being public offerings</td>
<td>Extensive SEC regulation; currently illegal until SEC rules are finalized</td>
<td>SEC-registered securities, not really crowdfunding; banking regulations, not legal in several states to borrow or invest</td>
<td>Extensive SEC regulation and proposed regulation; enhanced investor verification</td>
</tr>
<tr>
<td><strong>Bad Actor Disqualification</strong></td>
<td>Not applicable</td>
<td>Applies for all issuers and for the crowdfunding sites themselves</td>
<td>Not applicable under JOBS Act, but SEC has said it will apply</td>
<td>Not applicable</td>
<td>Yes</td>
</tr>
</tbody>
</table>

*Advertised Private Placements/Title II
Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act

On April 5, 2012, the Jumpstart Our Business Startups (JOBS) Act was signed into law. The Act requires the Commission to adopt rules to implement a new exemption that will allow crowdfunding. Until then, we are reminding issuers that any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws.

- Deadline for SEC rulemaking was due December 31, 2012
<table>
<thead>
<tr>
<th>Feature</th>
<th>Public Crowdfunding</th>
<th>Regulation A+</th>
<th>Regulation D Rule 506 (4(a)(2))</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum Total Raised</td>
<td>$1 million per 12 month period</td>
<td>$50 million per 12 month period</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Number of Investors</td>
<td>Unlimited but subject to maximum total raised</td>
<td>Unrestricted</td>
<td>Unlimited accredited investors; up to 35 non-accredited investors unless soliciting</td>
</tr>
<tr>
<td>Investment Per Investor</td>
<td>Restricted by income/net worth</td>
<td>Unrestricted</td>
<td>Unrestricted</td>
</tr>
<tr>
<td>Investor Disclosure</td>
<td>Required, must be filed with SEC</td>
<td>Required, must be filed with SEC</td>
<td>Not required if all accredited investors; Form D filing proposed</td>
</tr>
<tr>
<td>Intermediary Required</td>
<td>Yes – broker/dealer or funding portal</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Subject to ongoing SEC reporting following raise</td>
<td>Yes, at least annually, possibly more frequently</td>
<td>Yes; at least audited financials filed annually</td>
<td>No</td>
</tr>
</tbody>
</table>
### Public Crowdfunding vs. Other Exemptions (cont.)

<table>
<thead>
<tr>
<th>Feature</th>
<th>Crowdfunding</th>
<th>Regulation A+</th>
<th>Regulation D Rule 506 (4(a)(2))</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disclosure Liability</td>
<td>Yes, full disclosure liability with a knowledge exception</td>
<td>Yes, full disclosure liability with a knowledge exception</td>
<td>Only anti-fraud liability</td>
</tr>
<tr>
<td>Shares restricted</td>
<td>Yes, for one year</td>
<td>No</td>
<td>Yes, for public companies most can sell under Rule 144 after six months</td>
</tr>
<tr>
<td>State Filing</td>
<td>Possibly, depends on future rules by state</td>
<td>No, if securities sold are listed on a national securities exchange or if sold only to “qualified investors”</td>
<td>Usually no if only offering to accredited investors</td>
</tr>
<tr>
<td>Advertising and general solicitation</td>
<td>Not allowed</td>
<td>Allowed</td>
<td>Allowed if sales are made only to accredited investors and issuer takes reasonable steps to verify accredited status</td>
</tr>
<tr>
<td>Can public cos., foreign issuers, investment companies and exempt inv. companies issue</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>


Peer-to-Peer Lending
Peer-to-Peer Lending

- What is Peer-to-Peer Lending?
- Is it legal?
- What are the risks for borrowers, lenders?
- What is the legal status of the loans?
- Can the loans be resold?
- Is this a form of crowdfunding?
- Why aren’t big banks intervening?
- Institutional vs. Retail Investors
Investors earn better returns, borrowers pay lower rates.

**Invest & Earn Solid Returns**
Thousands of investors each month join Lending Club for solid returns.

- Low volatility
- Monthly cash flow
- Solid returns

Projected Returns by Grade A–C of 5.11% to 9.29%*

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Fast and free to check your rate.

- How much do you need?
- What is it for?
- How is your credit?

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**LATEST STATS:** Lending Club investors have earned $255,090,092 in interest since inception. | see more »

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**Forbes**
America's Most Promising Companies — 2011 & 2012

...earned its place on an income investor’s menu.

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**Featured Borrower**
Alex, Mountain View, CA
Debt Consolidation
$11,100 at 15.99% APR

"Getting engaged forced me to make some important financial decisions, so I consolidated several sources of debt with a single loan from Lending Club.”

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Select the Purpose of Your Loan
Select Your Credit Quality

Check Your Rate

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IN THE NEWS

Pepper Hamilton LLP
Attorneys at Law
In Philadelphia, it’s worth 50 bucks…
What’s Going On Here?

Laptop Lending | How peer-to-peer loans work

BORROWER
1. A would-be borrower applies online for an unsecured loan of up to $35,000.

PEER-TO-Peer PLATFORM
2. The peer-to-peer platform vets the potential borrower by checking on his or her credit history, outstanding debt, employment and bank account.
3. The approved customer is quoted an interest rate based on credit risk...
   ...and the loan request is posted online by the lending platform.

INVESTORS
4. Investors can review vitals for a would-be borrower: income, credit history, size of desired loan, personal statement about reason for loan, but not borrower’s name.
5. The investors can fund pieces of the loan, generally in increments of $25.

6. The loan is issued by a bank, in an arrangement with the lending platform, and the slices sold to investors are technically securities issued by the platform.
7. The lending platform charges the borrower an origination fee, calibrated according to credit risk...
   ...and collects a servicing fee from the lenders.
8. Loan payments from the borrower are distributed in slices to investors.

Source: Peer-to-peer lenders
Reporting by Ianthe Jeanne Dugan, graphic by Joe Shoulak/The Wall Street Journal
Top Legal issues in Peer-to-Peer

• Neither LendingClub nor Prosper are banks
  – Peer-to-peer lending sites facilitate loans to consumers from WebBank, a Utah-chartered state industrial bank
  – WebBank allows interest rate to be “portable”
  – WebBank sets credit terms, extends credit and holds loan for 1 day
  – Both LC and Prosper have been in business over 5 years
    • Battles have been waged in each state to arrive at this point
  – Platforms retain servicing rights and service loan
  – $$ is not FDIC or SIPC insured

• Bank regulatory “lite” applies – Platforms must comply with consumer finance credit, privacy and auto-deduction laws, but……
  – Exempt from 23A and 23B affiliate rules*
  – Exempt from regulatory capital rules*
  – Exempt from too big to fail, living wills, Volcker
  – Will big banks start to care at some point, and then what happens?

• Borrower may not pay and Lender cannot sue Borrower
  – Lender has limited ability compared to traditional lending
  – Limited recourse to enforce loan
  – Collection fees will exceed recovery
States Cannot Agree on Legality

Green - Permitted
Red - Not Permitted
State Consequences

• Big states currently out: Texas, Ohio, Pennsylvania, New Jersey, Massachusetts

• Subject to:
  – historic positions
  – political shifts
  – bureaucratic malaise
  – idiosyncratic state banking laws

• Since platforms are not national banks, not subject to federal preemption

• New states may allow or current states may disallow

• Risk of being lumped in with payday lenders
Securities Law Issues

• Securities regulation: Platforms issue borrower payment dependent notes through daily SEC-registered offerings
  – SEC registered offering preempts state blue sky laws

• Reminder: SEC registered offerings are not subject to the private placement or Title III crowdfunding rules
  – Peer-to-peer is a form of crowdsourcing but not crowdfunding

• Not Private Placements

• Not traded on an exchange
  – Limited liquidity – “lend and hold” model
  – Limited valuation authority

• Base shelf must be refreshed every 3 years, SEC registration fees paid

• Issuer bankruptcy risk (platforms), not borrowers
  – Reliant on issuer for current public information
Example: SEC Prospectus Filed 3-4 Times Per Day
Platforms spending big $$$ to maintain and increase borrower pool
  – How long can upward trends last
  – Will big banks start to care, and if so, what happens then?

Business loan platforms based on cash flow multiples
  – But, hard to standardize and value

More Focus on:
  – repeat borrowers
  – whole loans
  – institutional investors using big data
  – packaging agreements (“institution will take $x per year or pro rata amount of program”)

Secondary market allowing liquidity and valuation marks
Questions & Answers
Speaker Biographies
Corporate and Securities practice group, based in New York

Hands-on transaction execution and market expertise across product categories, including equity capital markets, debt capital markets, leveraged finance and private equity

Former in-house counsel at Barclays and Citigroup investment banks

Specialist in IPOs, the JOBS Act and SEC compliance, as well as early-stage fundraising, high yield debt and swaps/derivatives

Media Appearances: Fox Business Television, Bloomberg, NPR, CCTV America


Seasoned 16 year securities expert and frequent speaker: PLI, NYC Bar faculty member; Speaker at national securities and crowdfunding conferences

J.D. Northwestern University School of Law

- Northwestern Journal of International Law & Business

B.A. with Honors and Distinction, University of California, Berkeley
Partner in Financial Services Practice Group
Concentrates his practice in securities law, particularly in representing investment management companies and other clients on matters arising under the Investment Company Act of 1940 and the related Investment Advisers Act of 1940, and broker dealers and commodity futures traders and pool operators
Represents many hedge funds and other alternative investment funds in fund formation, investment and compliance matters, including compliance audits and preparation work
Writes and speaks frequently on issues involving investment management, health care and other matters and is the author of four books on hedge funds

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