INTRODUCTION

What would you say if you could borrow between $1,000 and $25,000, at rates lower than your bank or credit card company would be willing to offer? Even if you had no home equity on which to draw? What if your lender didn't treat you like a faceless applicant; what if the lender cared about your story -- who you were, why you needed the money, and how you'd use it? What if the loan terms were easy to understand, there was no cost to apply, there were no hidden fees, and there was no prepayment penalty?

What if you could use some of your savings to help borrowers whose stories you found compelling, and receive a healthy rate of return on your money? What if the rate of return you could get on that investment far exceeded what you could earn from a money market account, certificate or deposit, or government bond? What if you wanted to diversify your portfolio beyond safe investments like bonds and CDs, but just couldn't bring yourself to invest any more money in the stock market, until the U.S. economy stabilizes?

The scenarios above are not hypothetical. They are all present-day reality, and are repeated several thousand times a day, across the world, by the users of Internet-facilitated, person-to-person (P2P) lending sites.

On October 14, 2009, the Senate Banking, Finance & Insurance Committee will examine P2P lending for the first time – what it is, how it works, how long it's been around, what it's used for, how it has evolved over time, and how some of its key architects envision it evolving in the future. Industry chief executives, P2P site users, state regulators, and consumer advocates will address the committee about the state of the P2P industry today, and about their visions for the P2P industry of the future.

LARGE, AND GROWING: THE SIZE OF THE P2P INDUSTRY

Online P2P lending is currently a $150 to $200 million industry, and is growing rapidly. Its growth is not hard to understand. Some borrowers used to rely on home equity lines of credit as a source of ready cash, but can no longer access their equity as housing prices have fallen. Others are looking to consolidate their outstanding debt, in the face of rising credit card rates. Still others have been frozen out of the small business loan market by banks' hesitancy to lend. Others have experienced an increased need for student loans, as the cost of a college education has soared, and government-sponsored student loans have become harder to obtain. All of these borrowers are potential users of P2P lending sites.

On the flip side, investors have become weary of low interest rates on so-called safe investments like CDs and government bonds, and wary of a stock market that plunged over 50% percent from its high of 14,164 in October 2007 to its low of 7062 on February 27, 2009. While traditional investments still hold significant allure for many investors, an increasing number are considering P2P lending as a way to diversity their portfolios, and realize higher rates of return than those they could obtain elsewhere.

WHAT IS P2P LENDING, EXACTLY?

Any discussion of "P2P lending" must first acknowledge the significant amount of variation that exists within the P2P lending space. There is no single P2P model; there are, instead, many different models, each of which shares some similarities with other models and introduces various differences, compared to the other models. The business has been in existence for too short a period to draw any conclusions about the "best" model or models. Some models that seemed workable have failed (at least temporarily); other models that are currently workable have evolved significantly since their inception, and are likely to continue evolving in the mid- to longer-term. For all of these reasons, this paper represents a snapshot of a rapidly evolving industry, whose participants, business models, and target markets will change over time.

Given the variability among P2P lending models, the P2P industry can be categorized in several different ways. Some have chosen to focus on the level of intermediation involved (i.e., the extent to which borrowers and lenders interact directly to set their loan terms, versus the extent to which the P2P lender acts as an intermediary to determine which borrowers get funded, at what rates, and through which investors); others have focused on how investors' money is handled once lent (whether it is pooled or lent directly); others have focused on the sites' missions (i.e., whether they are primarily focused on economic or social gains). Several other ways of categorizing the sites are also possible.

For purposes of this background paper, staff has chosen to distinguish existing P2P lenders on the basis of their primary missions, and has identified three different groups: 1) those primarily focused on achieving a monetary return for investors, 2) those primarily focused on formalizing loans between people or groups of people that already know each other, and 3) those primarily focused on furthering social goals, such as a worldwide reduction in poverty. These distinctions, however, are artificial. At their core, all of the sites are focused on helping borrowers obtain financing. The sources of those loans (whether from family, friends, or anonymous benefactors), and the profit earned on those loans, is less a reflection of clear differences among the companies than a long continuum of possibilities. Furthermore, as will be described below, some sites primarily focused on achieving a monetary return for investors are interested in branching out in ways that will allow them to help those further down on the credit spectrum. Some sites primarily focused on furthering social goals also have a profit component built in.

Sites that focus on achieving a return for investors: Key players include Prosper, based in San Francisco (currently operating nationwide), LendingClub, based in Sunnyvale (currently operating nationwide), Zopa (not operating as a P2P lender in the U.S.; currently operating in the United Kingdom, Italy, and Japan), Loanio (not currently operating; its application with the Securities and Exchange Commission [SEC] is pending), IOUCentral (not currently operating; its application with the SEC is pending), and Pertuity Direct (based in Pittsburgh, Pennsylvania; had been operating in the US until very recently; its licensing and operating status are unknown).

Sites that facilitate loans between family and friends: Virgin Money (based in Waltham, Massachusetts and operating in both the U.S. and Europe). Prosper and LendingClub can also facilitate loans between people with a shared affinity, but are less focused on affinity lending than Virgin.

The social investing/microfinance model: Key players include Kiva (based in the U.S., but focused on alleviating poverty in foreign countries throughout the world), and MicroPlace (a business owned by eBay, which focuses on alleviating poverty in the U.S. and foreign countries).

The remainder of this paper will focus primarily on the two largest for-profit P2P lenders – Prosper and LendingClub – as they currently control most of the P2P lending market in the U.S. However, after the Prosper and LendingClub models are discussed, the paper briefly summarizes the lending models of some of the other participants listed above. Readers wishing more information about any of the individual sites should utilize the web sites, cited below.

PART I. P2P BUSINESS MODELS

PROSPER

Prosper (www.prosper.com) has originated more P2P loans through its web site than any other P2P lender in the world. From its inception to the present, it has attracted over 870,000 members and funded over $181 million in P2P loans. Launched in February 2006, it offers unsecured loans between $1,000 and $25,000 to U.S. borrowers with credit scores of 640 and above. All of the loans originated through Prosper's web site are three-year, fixed-rate, fully amortizing loans, with no prepayment penalties and simple-to-understand terms. Origination fees range from 0.50% for borrowers with the best credit to 3% for most other borrowers. Loans are serviced by Prosper, by electronically debiting borrower's accounts each month (though borrowers also have the option of using a pre-authorized bank draft, instead). Late payments do not trigger an increase in interest rate; each borrower receives a 15-day grace period every month, after which a late fee equal to the greater of 5% of the unpaid installment or $15 is imposed. Prosper borrowers use their loans for a variety of purposes, including debt consolidation (45-50% of Prosper's loan total), small business (20-25%), home improvement (approximately 8%), education financing (approximately 6%), automobile financing (approximately 3%), and other personal uses (approximately 17%).

Interest rates paid by Prosper borrowers are set through a Dutch auction model, in which combination of borrower choice and investor willingness both come into play. Borrowers request loans by posting a listing on Prosper's platform, indicating a requested loan amount and the maximum interest rate they are willing to pay, up to a maximum interest rate of 36%, and subject to a minimum interest rate calculated by Prosper based on the borrower's credit score and other risk factors. Borrowers are encouraged to tell their story on Prosper's web site, and provide as much information as possible to those who will be bidding to fund the loan.

Prosper services all loans made through its web site, for a 1% annual fee charged against the outstanding principal balance. Mechanically, this servicing fee decreases each investor's yield by 1 percentage point, relative to the interest rate paid by the borrower.

Investors who wish to fund a portion of the borrower's loan place bids corresponding to the amount they are willing to fund (most investors bid on portions of a borrower's loans, rather than the entire loan) and the lowest yield they are willing to receive. The yield percentage equals the borrower's interest rate, minus Prosper's 1% loan servicing fee. Bidding starts at the yield percentage that corresponds to the maximum interest rate the borrower would be willing to pay, and proceeds until the loan is fully funded (i.e., until the total amount of bids placed by investors in the auction equals or exceeds the initial loan amount). From that point forward, investors must place bids at least 0.05% below the current "winning yield percentage" in order to bump an investor who bid at a higher yield percentage. In the event that two investors bid the same yield percentage, the bidder who placed his or her bid earlier wins.

Investors may not bid the yield rate down below a yield floor, which is calculated by Prosper for each loan, using a formula intended to ensure that investors cannot bid any loan down below that associated with a risk-free investment. Each borrower listing (and the auction associated with it) closes after two weeks.

An example of how bidding would work is as follows: Borrower A is seeking a $5,000 loan and is willing to pay up to 10% interest. There are twenty investors, each willing to fund $500 of Borrower A's loan (i.e., the loan is oversubscribed). All twenty investors would be willing to accept a yield of 9% (which corresponds to the interest rate the borrower is willing to pay; i.e., the borrower's interest rate of 10% minus the 1% servicing fee). However, ten of the investors would also be willing to accept a yield of 8.5%. Under Prosper's Dutch auction model, those ten investors are able to bid the borrower's interest rate down half a point, to 9.5%. The rate could be bid down lower, if there were a sufficient number of investors willing to fully fund the loan at a lower rate, but could not be lowered any further, if there were insufficient investors to fully fund the loan at a lower rate.

In the event a listing does not receive bids totaling 100% of the loan amount, the loan does not fund, and investors who bid on the loan get their money back. Prosper does not offer partially funded loans.

Loans arranged on the Prosper web site are physically made by WebBank, a Utah-based industrial loan company regulated by the Utah Department of Financial Institutions and the Federal Deposit Insurance Corporation (FDIC). Once bidding on a loan closes, WebBank funds the loan, the loan funds (minus the origination fee) are electronically deposited into the borrower's bank account, and WebBank sells and assigns the loan to Prosper, without recourse, in exchange for the principal amount of the borrower's loan.

Investors who successfully bid on a loan are technically making purchase commitments for Borrower Payment Dependent Notes issued by Prosper. By bidding, an investor is committing to purchase a note from Prosper in the principal amount of the investor's winning bid. The investors designate that the sale proceeds be applied to facilitate the funding of the corresponding borrower loan. The notes (considered securities by the SEC and capable of being bought and sold on a secondary market platform, described below) are dependent on payments received from the corresponding borrower.

Investors receive monthly payments of principal and interest into their bank accounts, which are electronically transferred by Prosper, as the servicer. Because most investors bid on multiple loans to spread their risk, they will typically have multiple payments coming into their Prosper account on different days. Prosper offers online tools for use by investors to track their investments and manage their funds.

The minimum bid amount is $25. Once a bid is placed, it is irrevocable, except if the loan fails to fully fund or the investor is bumped by another investor willing to accept a lower yield rate. Investors may bid on loans manually (i.e., one-by-one) or in multiples, using an automated tool called a portfolio plan, designed by Prosper to help investors who wish to automate the bidding process. Portfolio plans allow investors to indicate a maximum amount of funds to be bid on listings that meet certain criteria. The criteria, which are individually selected by, and are unique to each investor, can involve borrower characteristics (such as credit score, Prosper rating, debt-to-income ratio, employment characteristics, group affiliations, etc.), to loan characteristics (maximum loan size or intended use), or minimum yield percentage. Investors may have more than one portfolio plan in place at once and may make manual bids while one or more portfolio plans are in place.

If a loan becomes more than 30 days past due, Prosper typically sends the loan to a third-party collection agency, which is authorized by Prosper to charge a collection fee of between 15% and 30% of any amounts obtained. The amount of principal and interest ultimately received by an investor on a past-due loan is reduced by an amount equal to the collection agency's fee, and any legal costs incurred in pursuing collection.

Loans more than 120 days past due are charged off. Depending on market conditions, Prosper either sells charged off loans to an unaffiliated third party debt purchaser, continues to attempt to collect on the account, or initiates legal proceedings to collect the debt. Prosper does not offer or agree to make payments to the holders of the notes dependent on borrower payment.

Investors who wish to sell their notes may do so on a note trading platform run by Folio*fn* Investments, Inc., an SEC-registered broker-dealer. Although Prosper warns all investors that they must be prepared to hold their notes to maturity, this secondary market platform has so far worked quite well to increase the liquidity of Prosper's Borrower Payment Dependent Notes. If a note is sold, the proceeds of the sale, minus a 1% transaction fee retained by Folio, accrue to the note seller. The note is transferred to its new owner, with no change in loan terms. Prosper retains the servicing rights on all of its notes sold through the Folio*fn* note trading platform. Although loan terms cannot be changed through a note sale, there is no restriction against a seller discounting or even increasing the price of a note sold through the trading platform. On the platform, the price of a note is one to which a willing buyer and willing seller agree.

How are Prosper Borrowers Vetted?

Each California borrower who wishes to borrow on the Prosper platform must be at least 18 years of age, a U.S. resident, with a social security number, a bank account, and a credit score of 640 or above (though, as noted below, this credit score requirement is relatively recent). Borrowers must agree to have their credit reports pulled and their identities verified, before they may post a listing.

Each listing is assigned a proprietary credit rating by Prosper, known as the Prosper Rating. There are currently seven letter ratings, denominated as AA, A, B, C, D, E, and HR. Each rating is derived from two scores – a consumer credit reporting agency score and an in-house custom score, calculated using the historical performance on the Prosper platform of previous borrower loans with similar characteristics. Each Prosper Rating is assigned an estimated loss rate, which is intended to help investors gauge the relative risk of each loan on which they choose to bid.

Although Prosper borrowers are strongly encouraged to tell their stories in their listings, Prosper does not typically verify a borrower's stated income, employment, or occupation, nor the borrower's stated use for loan funds. It derives each borrower's debt-to-income ratio (DTI) from the borrower's self-reported income and information contained on his or her credit report. Homeownership status is also derived from information on the borrower's credit report.

Prosper does, however, undertake income and employment verifications on certain borrowers, as an additional credit and fraud screening mechanism. Its results suggest that borrowers are not always entirely honest in their postings. For example, between September 1, 2007 and August 31, 2008, Prosper verified employment and income on approximately 23% of borrower listings that had bids totaling 70% or more of the requested loan amount. Approximately 56% of the borrowers contacted by Prosper provided satisfactory responses and received funding. Approximately 38% failed to provide satisfactory responses to Prosper and had their listings cancelled. Approximately 6% withdrew their listings or failed to receive bids totaling the amount of their requested loan. Prosper expects the percentage of loans on which it verifies income and employment will decline, as the number of site users increases.

Prosper's Statistics

A summary of key statistics regarding Prosper's borrower and lender community is contained in Appendix A.

A Few Notes on Prosper's Evolution

Although Prosper has offered loans in California since February 2006, its path to the present was not without hurdles. The nature of its offerings has changed over time, in part for business reasons, and in part due to regulatory intervention by the SEC. The following history is intended for those interested in how Prosper evolved into its present-day form.

Prosper was incorporated in the State of Delaware in March 2005. It received a CFL license from DOC in December 2005 and began lending as Prosper Marketplace, Inc. in California and several other states February 2006. Initially, the company did not require its borrowers to have a minimum credit score; the company set out to be more inclusive than traditional sources of credit, by offering loans (in part) to those who had not yet developed credit histories or whose low credit scores did not accurately reflect the credit risks they posed. However, as a new business, Prosper also recognized that its success was dependent on achieving economies of scale, and it struggled to cost-effectively and adequately evaluate unrated or poorly rated borrowers. It also quickly realized that borrowers with the lowest ratings often failed to receive sufficient bids on their listings, and that the loss rates among those who did obtain funding were extremely high.

In February 2007, Prosper established a minimum credit score of 520. It increased that score to 640 in July 2009 (though some borrowers with scores of 600 or more, who have outstanding performing loans through Prosper, may also qualify).

The lending side of Prosper's business model also evolved over time. Initially, Prosper funded loans directly, using lending licenses it had obtained in several states throughout the country (such as its CFL license in California). However, this model was unwieldy, because interest rate caps differed from one state to another, depending on each individual state's lending laws. In hopes of obtaining license under which it could lend under uniform terms, Prosper initially sought out state regulators (including California's DFI Commissioner Bill Haraf) and the FDIC, in an attempt to obtain an industrial loan company charter. Although Prosper's attempts to charter its own bank fell short, Prosper was successful in partnering with Utah-based WebBank in April 2008, an agreement that continues to this day. Because all Prosper loans are now made through WebBank, individual state usury caps do not apply; instead, Prosper and WebBank voluntarily adopted an interest rate cap of 36%, which applies to all loans made through the Prosper platform. (The annual percentage rate is slightly higher than 36%, when origination fees are taken into account).

From February 2006 through mid-October 2008, Prosper also handled its relationships with investors differently. When a loan funded, it would be evidenced by a series of promissory notes, each in the amount of a bidder's winning bid. Winning bidders would purchase promissory notes from Prosper, and would receive monthly principal and interest payments into their bank accounts from Prosper, who acted as the loan servicer. This promissory note model was created by Prosper's legal team in a manner intended to avoid securities law regulation, by using case law as a guide to distinguishing its offerings from securities that would trigger SEC regulation.

In early 2007, Prosper entered into discussions with the SEC about its then-existing business model, and an augmentation it wished to make to its model, to allow investors more liquidity (an idea that subsequently morphed into the Note Trading Platform run by Folio*fn*). Despite several months of phone and mail correspondence between Prosper's legal counsel and SEC staff, the company and regulator failed to resolve their outstanding legal and regulatory dispute. In October 2008, Prosper temporarily ceased offering new loans on its platform. In November 2008, the SEC issued a cease and desist order against Prosper, laying out its case for why it believed that Prosper's model fell within the Securities Act of 1933, and, consequently, why Prosper had violated that federal act by failing to register its securities with the SEC. Prosper agreed to settle with the SEC later that month, but neither admitted nor denied liability as part of the settlement.

Shortly after issuance of the cease and desist order, and in response to several states who were concerned that Prosper's model may have involved the sale of unregistered securities, the North American Securities Administrators Association (NASAA) formed a working group that negotiated and executed a settlement term sheet, intended for use by states who wished to pursue regulatory action against Prosper for illegally selling unregistered securities through its site prior to October 2008. Under the terms of the settlement, Prosper agreed to pay up to $1 million (depending on how many states sign onto the agreement) to resolve all states' securities law claims arising from Prosper's pre-October 2008 business activities. California elected not to participate in the NASAA settlement. Instead, DOC Commissioner DuFauchard signed a separate agreement with Prosper, in which Prosper was not accused of having violated California's securities laws and was not required to pay any penalty.

The SEC ultimately approved Prosper's application to sell securities, and Prosper resumed business, using the Borrower Payment Dependent Note model described earlier, in July 2009.

Other than a brief period from April 28, 2009 through May 8, 2009, during which the company's wholly owned California subsidiary (Prosper Marketplace CA, Inc.) attempted to resume business in California, the company did not accept new borrowers or investors until it re-opened for business in July 2009. During its period of cessation, it continued to service outstanding loans.

LENDINGCLUB

LendingClub is currently originating more loans per month than any other P2P lender in the U.S. Although it has originated fewer P2P loans than Prosper over its short lifetime (since its inception, LendingClub has facilitated over $58 million in loans, compared to Prosper's $181 million loan volume), LendingClub now facilitates more loans per month than Prosper. From August 1, 2009 through October 8, 2009, LendingClub issued nearly $12 million in loans; Prosper originated $2.5 million loans over the same time period. (See Appendix A for additional statistics regarding LendingClub loans).

The lending model employed by LendingClub is sufficiently similar to that of Prosper that only the key differences will be discussed here. A table comparing some of the key characteristics of the two models also follows.

As shown on that table, the sizes, types, and uses of loans available through LendingClub are identical to those available through Prosper. As is the case with Prosper, loans obtained through the LendingClub platform are made by Utah-based WebBank, then assigned and sold to LendingClub on a nonrecourse basis. Also like Prosper, LendingClub investors who successfully bid to fund loans listed on the site purchase Borrower Payment Dependent Notes from LendingClub, and may trade those notes on a note trading platform run by Folio*fn*. LendingClub offers its investors an automated investment tool called LendingMatch, which is similar to the portfolio plans offered by Prosper, and helps investors automatically bid on multiple notes using criteria they select.

There are, however, significant differences between the two models. LendingClub applies more stringent qualification criteria to its borrowers than Prosper (it accepts only borrowers with FICO scores of 660 and above, and requires all applicant borrowers to have a non housing-related DTI of less than 25%).

Unlike Prosper, LendingClub rejects a significant number of the borrower applicants who seek its site out. From October 2008 through March 2009, fewer than 10% of individuals seeking loans through the LendingClub sit met the company's credit criteria to post their loan requests. This ratio has remained roughly constant over time. Since its inception, LendingClub has received $586 million in loan applications and issued $59 million in loans – thus funding approximately 10% of its applicants.

Prosper is more inclusive in its attitudes toward borrowers than is LendingClub; some borrowers who fail to meet the credit score or DTI ratio imposed by LendingClub would not be prevented from listing their loans on Prosper. While this has its upsides for borrowers (more borrowers can seek funding on Prosper than on LendingClub), it also results in a greater percentage of Prosper borrowers failing to receive funding. According to LendingClub, once a borrower has been accepted onto its platform, that borrower has a 95% change of receiving full funding from LendingClub's investor community. In contrast, only 20% of the borrowers who post listings on Prosper's web site receive full funding.

Not surprisingly, given the more stringent requirements applied by LendingClub to its borrowers, historic LendingClub delinquency and loss rates are much lower than those of Prosper, which began as a company that offered loans to nearly all borrowers, as long as there were lenders available to fund those loans (see statistics in Appendix A).

Like Prosper, LendingClub verifies income for only a portion of the borrowers who qualify to use its site (generally those considered to pose the highest fraud or credit risks). The results of LendingClub's verification are quite similar to those experienced by Prosper. For example, between June 2007 and March 2009, 45% of borrowers from whom additional information was sought by LendingClub provided satisfactory responses; 49% failed to respond or refused to provide the requested information and had their listings removed; and 6% provided information that failed to verify their stated information, and had their listings removed.

Unlike Prosper, which uses an auction model to set the interest rates paid by borrowers, LendingClub sets borrower interest rates upfront, using its own model, which is intended to price loans according to the risk they pose to investors. Thus, unlike the Prosper site, where investors are expected to know how to price loans, and where a borrower can benefit if there are a sufficient number of members willing to bid down that borrower's interest rate, there is no such bidding process allowed on the LendingClub site.

Each borrower's interest rate is set by LendingClub, based on a LendingClub formula that takes into account the borrower's credit characteristics, the amount that borrower wishes to borrow, the general economic environment, the balance of supply and demand on the LendingClub platform, and competitive factors, which take into account the rates set by other social lending platforms and major financial institutions. LendingClub adjusts its interest rates from time to time, to take the non borrower-specific factors into account.

Compared to Prosper's auction-based model, the LendingClub model appears to place a higher premium on ensuring that risk is carefully priced. On Prosper, investors are generally able to price the risk they are willing to take (and are expected to have the knowledge necessary to appropriately price that risk). Similar such risk pricing decisions are performed for investors by LendingClub on the LendingClub site.

There are also other significant differences between the two sites. Prosper will not partially fund loans; LendingClub will. On LendingClub, as long as there are investors willing to fund at least $1,000 of a borrower's loan request, that borrower may opt to accept partial funding (or may decline the loan or relist their request or a revised loan request for another two-week period). On Prosper, any loan requests that are not fully funded by the end of a two-week listing are cancelled; borrowers may re-list their loan request, change their loan request, or remove their listing entirely.

LendingClub will not allow borrowers to post their photos on the site, believing this restriction to be important for borrow privacy. Prosper encourages borrowers to post their photos, believing such personalization consistent with the social aspect of P2P lending.

Notes on LendingClub's Evolution

LendingClub received a CFL license from DOC in January 2008. It did business as a P2P lender from May 2007 until April 2008, using a similar business model as the one used by one of the early versions of Prosper (i.e., issuing promissory notes backed by loans made through WebBank).

From April 7, 2008 until October 13, 2008, LendingClub ceased accepting new investment commitments, in order to register as a securities issuer with the SEC and the states in which it wished to sell notes to investors. During this period, it continued issuing new loans, using a $9 million credit facility it obtained through Silicon Valley Bank. It also continued to service its outstanding loans. LendingClub resumed accepting new investment commitments and began offering Borrower Payment Dependent Notes on October 12, 2008.

Unlike Prosper, LendingClub never received a cease and desist order from SEC, nor was it the subject of a NASAA settlement agreement. When contacted by Committee staff in connection with this hearing, both companies speculated about possible reasons for their different treatment by the SEC. However, when SEC staff were contacted in connection with this hearing, they declined to elaborate on those reasons. Thus, an explanation for why one firm (LendingClub) was approved as a securities issuer around the same time as the other firm (Prosper) was issued a cease and desist order will likely only be known, if the SEC makes its rationale public.

A table summarizing the key similarities and differences between the two sites is below.

	Prosper	**LendingClub**
Size of Loans Available	$1,000 to $25,000	$1,000 to $25,000
Loan Terms	Unsecured, fully-amortizing, fixed-rate, three-year loan, payable monthly, no prepayment penalty	Unsecured, fully-amortizing, fixed-rate, three-year loan, payable monthly, no prepayment penalty
Borrower Requirements	Minimum Experian Scorex score of 640, US resident at least 18 years of age, with a bank account and a social security number	Minimum FICO score of 660, US resident at least 18 years of age, with social security number, debt-to-income (DTI) ratio, excluding mortgage debt, of less than 25%, and a credit profile with no current delinquencies, no more than 10 credit inquiries in the last six months, and a minimum credit history of 36 months
Borrower interest rate	Set by online auction; capped at 36%	Set by LendingClub, based on the grade assigned to the borrower; no cap, but highest interest rate currently allowable is 21.21%
Number of different ratings assigned to borrowers	7 (AA, A, B, C, D, E, and HR); letter ratings reflect an estimated average loss rate and are based on credit score and a grade given to each borrower. The Prosper grade is calculated using a proprietary formula that takes into account Prosper's history with borrowers that share similar credit characteristics, who are seeking similar-sized loans.	35 (A1 to A5, through G1 to G5); ratings are based on a borrower's FICO score, requested loan amount, currently open accounts, number of credit inquiries in the prior six months, utilization of credit limit, and length of credit history
Borrower ability to take out multiple simultaneous loans	Yes, capped at a maximum of two loans with a total outstanding principal balance of $25,000	Yes, capped at a maximum of two loans. Each loan may be up to $25,000, but a borrower is not eligible to obtain the second loan until after making six successful payments on their first loan.
Fees paid by borrowers	No fee to post a borrower listing; if the loan funds: closing fee = the greater of 3% or $50, deducted from the loan proceeds (0.5% with no minimum for borrowers of AA grade); late fee (15-day grace period; greater of 5% of the unpaid installment amount or $15, paid to the investor); failed payment fee of $15, paid to Prosper	No fee to post a borrower listing; if the loan funds: processing fee = 1.25% of the loan amount for an A grade, 3.25% for a B grade, and 3.75% of the loan amount for C through G grades, deducted from the loan proceeds, prior to disbursement; late fee (15-day grace period; greater of 5% of the unpaid installment amount or $15, paid to the investor; failed payment fee of $15, payable to LendingClub, $15 fee to process payments by check (no fee for ACH withdrawals)
Fees paid by investors	1% annual percentage rate, charged against the outstanding	1% of all amounts paid to LendingClub, deducted by

	Prosper	**LendingClub**
	principal balance, deducted by Prosper from payments transmitted to investors	LendingClub from payments transmitted to investors
Estimated loss rates	0-1.99% for AA-rated borrowers; 6-9% for C-rated borrowers; >15% for HR-rated borrowers.	0.16% to 0.79% for A-rated borrowers; 2.53% to 3.16% for D rated borrowers; 4.90% to 5.53% for G-rated borrowers
Loans actually made by	WebBank, a Utah-chartered industrial bank regulated by the Utah Department of Financial Institutions and the FDIC; each loan is subsequently sold and assigned to Prosper on a non-recourse basis	WebBank, a Utah-chartered industrial bank regulated by the Utah Department of Financial Institutions and the FDIC; each loan is subsequently sold and assigned to LendingClub on a non-recourse basis
Investor (lender) requirements	US resident at least 18 years old, with a bank account and a valid SSN; must successfully pass identity verification tests and meet California suitability requirements (see section below)	US resident at least 18 years old, with a bank account and a valid SSN; must successfully pass identity verification tests and meet California suitability requirements (see section below)
Ways to invest	Direct Peer-to-Peer and the Note Trading Platform	Direct Peer-to-Peer and the Note Trading Platform
Ways to bid on direct P2P loans	Search for listings manually or use portfolio plans, which automatically bid on listings based on the loss rate or specific criteria chosen by the bidder, subject to a minimum yield percentage acceptable to the bidder	Search for listings manually or use LendingMatch, a proprietary software program that allows investors to invest in multiple notes at once, based on specific criteria chosen by the bidder
Minimum and maximum bids	$25 minimum; $5 million maximum for individuals, $50 million maximum for institutions; suitability standards also apply	$25 minimum; no stated maximum, other than those imposed through suitability standards
Suitability Standards Imposed on California Investors by DOC	Those who wish to invest in up to $2,500 in Prosper-issued notes may not make investments worth more than 10% of their net worth. Investors who wish to purchase more than $2,500 in Prosper-issued notes must adhere to the 10% cap on investments relative to net worth and must either have 1) a minimum net worth of at least $85,000, and minimum gross income of at least $85,000 during the prior and current tax years; or 2) a minimum net worth, exclusive of homes, home furnishings, and automobiles, of at least $200,000	There is no distinction between investments of up to or over $2,500. All investors are capped at investments of no more than 10% of their net worth, exclusive of their home, home furnishings, and automobile. All investors must either have an annual gross income of at least $100,000 and a net worth (exclusive of their home, home furnishings, and automobile, of at least $100,000); or net worth (exclusive of home, home furnishings, and automobile) of at least $250,000.
Note Trading Platform run by	Folio*fn*, a broker-dealer registered with the SEC and the California DOC	Folio*fn*, a broker-dealer registered with the SEC and the California DOC

	Prosper	LendingClub
Fee to use note trading platform	1% of the resale price of the note, payable to Folio*fn*, taken out of the note seller's proceeds from selling the note; notes that are sold continue to be serviced by Prosper and remain subject to Prosper's 1% annual servicing fee	1% of the resale price of the note, payable to Folio*fn*, taken out of the note seller's proceeds from selling the note; notes that are sold continue to be serviced by LendingClub and subject to LendingClub's 1% servicing fee
In Case the Servicer Goes Out of Business	Outstanding notes will be serviced by an unnamed loan servicing company, which would service all notes to completion	Outstanding notes will be serviced by Portfolio Financial Servicing Corporation (www.pfsc.com), which will service all notes to completion

OTHER THAN PROSPER AND LENDINGCLUB, WHAT ARE SOME OF THE OTHER P2P SITES?

Kiva

Kiva (www.kiva.org), a 501(c)(3) non-profit organization, describes itself as the first person-to-person microlending web site, empowering individuals to lend directly to unique entrepreneurs around the globe. Kiva's model uses four steps – First, potential investors browse online profiles of entrepreneurs in need and select one or more persons to whom they wish to lend. Money, in amounts as small as $25, can be lent using PayPal or a credit card. Kiva collects the funds, and distributes them to one of its many worldwide microfinance partners. The microfinance partners, also known as microfinance institutions, or MFIs, range from small non-profit organizations to large commercial banks, who agree to lend to small entrepreneurs in the location(s) in which they operate. The term "micro" reflects the fact that many of these loans are quite small, at least by western standards. However, because many of these microloans go to help people in countries whose costs of living are considerably lower than the U.S., the microloans can go a long way in the countries to which the money is sent.

Second, Kiva's microfinance partners distribute the loan funds to the entrepreneur selected by the investor. Often, Kiva's partners provide training and other assistance to the entrepreneur borrowers, to maximize the borrower's chances of successfully repaying the loan in full.

Third, and over time, the entrepreneur repays his or her loan. The entrepreneur pays interest to the microfinance partner, but that interest is not passed on to the Kiva investor.

When the loan is fully paid off by the borrower, the Kiva investor receives his or her principal. Unlike most for-profit sites, principal payments are not returned to the investor in installments, but rather in one lump sum, at the conclusion of the loan. Kiva encourages its investors to re-lend the principal to someone else in need or to donate their funds to Kiva, to cover Kiva's operational expenses. Investors may also withdraw their principal for other uses.

The unique aspect of Kiva is its focus on helping others escape poverty, rather than its focus on monetary return (it offers none). Since launching in October 2005, Kiva has facilitated over $95 million in loans to over 235,000 entrepreneurs in 49 countries. The average amount loaned, per lender, is $168, spread across five loans. The current repayment rate is over 98%. Approximately 560,000 social investors in 183 countries have lent through the site.

MicroPlace

MicroPlace (https://www.microplace.com), is a social business owned by eBay, which self-describes itself as a financially sustainable company that has a social mission, and which seeks to alleviate global poverty by offering investments that enable loans to hardworking poor people.

On the surface, MicroPlace works in much the same way as Kiva, by allowing investors to search its site for people or ideas in which they are interested in investing. Investors can lend as little as $20, through PayPal or a bank account debit. Loans are funneled through microfinance institutions based in the foreign countries in which the borrowers live, and borrowers pay back the loans over time, with interest.

Below the surface, however, the two companies are very different. Unlike Kiva, MicroPlace offers investments in which the investor receives a return greater than 0%. While rates of return are not high (the maximum return available on the site at the time this paper was written was 6%), they are higher than those offered at Kiva.

Also unlike Kiva, which connects investors with specific loans, MicroPlace pairs investors with securities. On MicroPlace, several more layers of intermediation exist between the investor and the ultimate recipient of the money. As a broker-dealer registered with the SEC, MicroPlace facilitates the purchase of securities by investors. The securities are issued by one of four issuers with which MicroPlace has established a business relationship. These securities, in turn, are backed by loans issued to poor people by MFIs with whom MicroPlace has partnered.

MicroPlace investors experience losses only if the issuer of the security defaults, something that has not happened since MicroPlace was formed in 2006. Thus, on paper, MicroPlace investors have enjoyed a perfect repayment place since the site’s inception. Like Kiva, investors with MicroPlace receive their principal (and any interest payments) at the end of the loan term, rather than in periodic payments over the life of the loan.

Investors who use MicroPlace may search borrower listings based on the level of poverty they would like to target (poor, very poor, extremely poor), geographic area (Africa, Eurasia, Latin America, Middle East, North America, Pacific, South Asia, Southeast Asia), length of loan (repayment anytime, less than one year, 1 to 3 years, over three years), and loan focus (green, rural development, focus on women, fair trade).

MicroPlace describes its business model, as follows: "When you invest you start a virtuous circle. Organizations that need your money will offer the best return possible so they can attract more of your money to expand their operations. To be attractive, they will improve their operations and expand their services to hard-working poor people. When these people pay back their loans with interest, the institution can then pay you back. And then you can take your original money and your profit and invest again to start the cycle again."

MicroPlace has brokered the sale of more than 30,000 microenterprise securities and worked with microlenders in over 40 countries since its inception.

Virgin Money USA

Virgin Money, which began in 2001 as CircleLending, and rebranded as Virgin Money USA in 2007 (www.virginmoneyus.com), describes itself as the leader in managing loans between relatives and friends.

Virgin Money facilitates personal, business, and so-called social mortgage loans between relatives and friends. "Using us means that the business of your loan – legal documents, transfer of payments, year-end reporting – will be taken care of. Grace periods and deferred payments are up to you and your partner. You pick the terms, we create the documents and manage repayment."

Because it facilitates loans between persons who lack lending licenses, the loans are covered by each state's maximum interest rate, known as the usury limit. According to the Virgin Money web site, California caps the interest rate on loans for personal, family, or household purposes at 10%. The interest rate on other loans may not exceed the greater of 10% or the Federal Reserve Bank of San Francisco discount rate plus 5%. (These rates are those found in Article 15, Section 1 of the California Constitution).

Unlike the other P2P lending sites, which offer only unsecured loans, Virgin Money offers secured real estate loans between individuals, including family mortgage, seller mortgage, and retirement mortgage options. A family mortgage is a private loan from a family member or friend whose proceeds are typically used toward the purchase or refinance of a home mortgage. The family members and friends identify the payment schedules and interest rates to be used, subject to the usury cap described above.

A seller mortgage is a private mortgage between a homeowner and home purchaser, in which the homeowner sells the house but retains a lien on it, and the purchaser makes payments to the seller until the mortgage is paid off. A retirement mortgage is a private reverse mortgage transaction, in which the homeowner (borrower) obtains money from a friend or relative (the lender). The lender gets repaid with home equity. In all three cases, the terms of the loan are agreed upon by the two private parties who enter into the mortgage contract. Virgin Money draws up the loan documents and services the loan.

Virgin Money USA holds both a California Finance Lender license and a California Residential Mortgage Lending Act license, issued by DOC.

Pertuity Direct

Until very recently, Pertuity Direct, based in Pittsburgh, Pennsylvania, offered social investors two different SEC-registered mutual funds, each of which invested in P2P loans (www.pertuitydirect.com). Like LendingClub, Pertuity offered loans to borrowers with strong credit, typically those with FICO scores above 660. Pertuity's chief executive and founder, Kim Muhota, explained to the Wall Street Journal in January 2009 that "the process for borrowers will be similar to applying for credit at traditional banks, but with potentially better rates, ranging from 8.9% to 16.9%. For lenders, the appeal is the ability to invest in an alternative asset class offering potentially higher returns." ("Peer-to-Peer Lending Refuses to Die," by Jane Kim, Wall Street Journal, January 22, 2009).

Unlike both Prosper and LendingClub, Pertuity Direct originated and funded the loans directly. Also unlike Prosper and LendingClub, the loans originated and funded by Pertuity were not bundled into individual securities. Instead, the loans were purchased by one of two closed-end mutual funds (the National Retail Fund II, for borrowers with FICO scores above 720, and the National Retail Fund III, for borrowers with scores above 660). Because Pertuity Direct site users did not have to bid to fund particular loans, borrowers could receive funding much more quickly than through Prosper or LendingClub. If sufficient investor funds were available, a loan approved by Pertuity could fund within 24 hours of verifying a borrower's identity and bank account information.

By investing with Pertuity, investors received instant diversification, and more liquidity than they could with either Prosper or LendingClub (each quarter, investors could redeem up to 25% of the funds' outstanding shares). However, the diversification and liquidity came with a price; the funds charged a sizeable 3.17% in management fees (an amount expected to fall as the funds drew more investors). Investors were also largely separated from the borrowers whose loans were funded by Pertuity; lenders could view the borrower community and read their stories, but weren't required to go through a selection process to fund multiple loans.

Pertuity attempted to retain a social component to its site, by giving investors an opportunity to assign so-called Pertuity Bucks to borrowers whose listings the investors found compelling. Investors received Pertuity Bucks for free when they opened an account and could award their Pertuity Bucks to any borrower with a listing on the site. Borrowers receiving Pertuity Bucks could reduce the principal balance on their loan by the amount of Pertuity Bucks they received.

The minimum investment for lenders through Pertuity was higher than on the other sites -- $250. Borrowers could obtain unsecured loans between $1,000 and $25,000. Loan terms were similar to those offered by Prosper and LendingClub (fixed rate, fully amortizing, three year loans, with closing fees dependent on the borrower's credit score and the amount borrowed, no points, and no prepayment penalties).

Pertuity Direct obtained a California Finance Lender license in March 2008 and relinquished it in August 2009. The company filed registration papers with the SEC in January 2008, but withdrew the request in August 2008. The company's current operational status is unknown. Although the company's web site is still live, attempts to click through to register as a site user returned an error message. Attempts to contact CEO Kim Muhota in September 2009 were also unsuccessful.

THE FUTURE OF P2P LENDING

The lending models presented above are expected to change over time, in both the short- and long-term, as demand within the P2P lending space increases and market participants become more profitable. Both of the P2P lenders contacted by Committee staff during preparation of this background paper expressed tremendous optimism about the possibilities that lie ahead.

Could the sites expand to include borrowers who don't hold social security numbers?

What about borrowers whose credit was significantly damaged as the result of a foreclosure, but who are otherwise good credit risks; might they obtain credit from P2P sites one day?

Will the sites eventually offer secured loans, like mortgages?

Will the for-profit sites eventually offer microfinance loans of the types available through Kiva and MicroPlace?

While neither lender contacted for this paper would commit to making specific changes, nor to specific timelines for modifying their lending models, both lenders were extremely open to new ways of offering credit and to different ways of reaching out to responsible borrowers. Both sites are fledgling, in both years and size, and must therefore focus on growing their core business models and achieving profitability before expanding into others. But, the key players at both companies, as is the case for the key executive staff who lead all of the P2P lenders, are innovators, and have been at the forefront of starting and growing Internet-based companies since very early in the Web's stages of commercial development. Given the leadership of these companies, responsive and innovative evolution of the P2P lending market is almost inevitable.

The Open Market Initiative

The Open Market Initiative is just one example of a possible addition to the P2P lending space. While neither lender could commit to specific changes to its *existing* business model, Prosper enthusiastically described a new addition to its business model that it hopes to make in the future, subject to regulatory approval. Chris Larsen's vision: create a P2P market for loans made by third parties. Envisioned by Larsen as a way to create a new market for community development loans and as a way to add liquidity to an asset backed securities (ABS) industry that is currently languishing during the ongoing credit squeeze, Larsen would like to use the Prosper platform to market loans made by third party lenders to Prosper investors.

As Larsen envisions the Open Market Initiative, the loans would have already been made by third party lenders to third party borrowers, without Prosper's involvement. Prosper would then use its platform to allow investors to bid on the already-made loans. If and when a third-party loan was fully subscribed by willing Prosper investors, Prosper would purchase the loan from the open market loan seller, and issue and sell securities (in the form of Borrower Payment Dependent Notes) to the winning bidder investors. The open market loans would be serviced primarily by the open market loan seller, not Prosper. Loan payments would be sent by the seller/servicer to Prosper, who would then distribute them to the investors on a pro-rata basis.

Larsen promotes his Open Market Initiative as more transparent than the existing, tranched method of packaging asset-backed securities into collateralized debt obligations and then selling them. Whereas the existing method is based upon rating agencies and can obscure the true risk of a security through multiple layers of collateralization, Larsen envisions a market for whole loans, whose risk could be more clearly evaluated by investors.

Larsen sees beneficiaries of his Open Market Initiative as small- to medium-sized businesses seeking Small Business Administration loans, community development groups seeking community development loans, and participants in the existing, illiquid ABS market seeking new influx of capital to resurrect their industry.

A FINAL, CAUTIONARY NOTE

In many places throughout this background paper, staff has discussed the positive potential that P2P lending sites have to pair willing investors with borrowers seeking loans, and to maximize the experience for all participating parties. It is, however, important to acknowledge the youth of the industry and some of its operating risks.

As noted by Prosper in its most recent prospectus, "We have incurred operating losses since our inception and we anticipate that we will continue to incur net losses through 2010….We have financed our operations, to date, with proceeds from the sale of equity securities…We are dependent on raising additional capital or debt financing to fund our current operating plan…We have a limited operating history. As an online company in the early stages of development, we face increased risks, uncertainties, expenses and difficulties."

LendingClub offers virtually identical statements in its prospectus: "We have a limited operating history. As an online company in the early stages of development, we face increased risks, uncertainties, expenses and difficulties...If we are unable to increase transaction volumes, our business and results of operations will be affected adversely…We may need to raise substantial additional capital to fund our operations, and if we fail to obtain additional funding, we may be unable to continue operations…We have incurred net losses in the past and expect to incur net losses in the future."

Any individual who opts to use a P2P site to borrow or invest money needs to be aware of the risks involved. The P2P space is *not* a risk-free environment, and a fact that all of its users must acknowledge and heed. Those readers who are interested in using either of the two lending platforms are strongly encouraged to seek out the prospectuses that each company has posted on its web site.

PART II. REGULATORY ISSUES

HOW ARE THE TWO LARGEST P2P LENDERS REGULATED?

The regulatory oversight of both Prosper and LendingClub is somewhat fragmented (i.e., different regulators focus on different aspects of their business operations). Initially, both companies issued loans to borrowers under lending licenses they obtained from various states. Both companies obtained California Finance Lender (CFL) Law licenses from the Department of Corporations (DOC) for this purpose, and are subject to periodic investigations by the DOC as a condition of their CFL licenses.

However, as the companies evolved, they independently developed relationships with Utah-based industrial loan company WebBank. Under the terms of the agreements that both companies reached with WebBank, WebBank did the lending, and the P2P sites served as origination platforms for the loans. Once the loans were made, WebBank assigned and sold the loans to the P2P lenders, who serviced them. Under this revised model, neither P2P company requires a lending license from California. However, both companies plan on retaining their CFL licenses, in part as a show of good will toward the DOC, and in part because it is easier to retain the licenses than give them up and re-apply, if they require such a license in the future.

Initially, the borrower side of the model was the only side that was regulated. However, before long, the Securities and Exchange Commission (SEC) expressed the opinion that the business models used by both firms involved the sale of securities, and both firms were asked to cease operation until they could complete their appropriate filings with the SEC.

Once the SEC stepped in, both Prosper and LendingClub registered their notes with the SEC. The SEC requires quarterly and annual reporting by both companies, and requires both to make significant amounts of information about their investors available to the public, through the SEC's publicly-searchable database, called EDGAR. The SEC does not perform periodic examinations of the firms; instead, it is reliant on complaints to discover evidence of wrongdoing by its registrants. The SEC focuses only on the investor side of Prosper's and LendingClub's business models; the borrower side is scrutinized only by the FDIC and the State of Utah. The firms are also subject to oversight by any states (including California) in which they hold lending licenses.

Both Prosper and LendingClub have been approved by DOC to sell securities in California. As such, they are required to disclose information to potential investors in a manner acceptable to DOC and ensure that they only allow investments by individuals who meet suitability standards the DOC has imposed.

The DOC's suitability standards for Prosper and LendingClub investors are more stringent than those imposed by any other state regulator. California investors who wish to purchase up to $2,500 in Prosper-issued notes may not make investments worth more than 10% of their net worth. Investors who wish to purchase more than $2,500 in Prosper-issued notes must adhere to the 10% cap on investments relative to net worth and must either have 1) a minimum net worth of at least $85,000, and minimum gross income of at least $85,000 during the prior and current tax years; or 2) a minimum net worth, exclusive of homes, home furnishings, and automobiles, of at least $200,000.

To invest in a LendingClub-issued note, a California investor must either have an annual gross income of at least $100,000 and a net worth (exclusive of their home, home furnishings, and automobile, of at least $100,000); or must have a net worth (exclusive of home, home furnishings, and automobile) of at least $250,000. In addition, individual investors must agree not to purchase notes in an amount that exceeds 10% of their net worth, exclusive of their home, home furnishings, and automobile.

The differences between the two sets of suitability standards imposed on notes issued by the two companies reflects a determination by DOC about the risks of the offerings and the relative financial health of the two companies at the time they applied for permission to sell securities in California (their ability to service debt, their operating history, whether auditors have imposed a "going concern" qualification on their financial statements, and their amounts of current net worth). DOC reviews these requirements (and adjusts them as it deems necessary), when the applicant submits its annual application for approval to sell securities in California.

According to DOC, each of the companies must make a reasonable effort to ensure that the investors who use their site know of and are in compliance with the suitability requirements. Neither company is required to independently verify that individual investors meet the requirement. However, if DOC becomes aware that either site has a systemic flaw that is allowing or encouraging use by unsuitable investors, such action could result in a revocation of the company's right to offer securities in California.

Like the SEC, DOC is reliant on complaints and periodic reporting requirements to drive its investigations of those to whom it has qualified to sell securities in the state; it does not perform periodic examinations of securities issuers.

Interestingly, as Prosper's and LendingClub's business models changed, they no longer required a CFL license to do business in California. However, both companies have made the business decision to retain their CFL licenses, at least for the time being, in part as a show of good faith to state regulators, and in part, because their future business models might one day require a CFL, and it is considerably easier to retain a license than relinquish it and re-apply for a new one.

ARE P2P LENDERS BEING REGULATED APPROPRIATELY?

As described above, the two largest P2P lenders in California (Prosper and LendingClub) are both regulated as securities issuers by California and the federal government. Yet, when their business models are examined, one is left to question whether the current form(s) in which these companies are regulated are the most appropriate. As seen from the borrower side, the Prosper and LendingClub platforms provide online matching tools that pair prospective borrowers with investors willing to lend, at rates the borrowers are willing to pay. As such, both firms are akin to brokers. Yet, neither firm is required to hold a license to regulate this loan origination activity. Both firms hold California CFL licenses (a holdover from their earlier business models), but neither firm lends any money at the present time. Instead, all of the lending is performed by WebBank, a Utah-based industrial loan company regulated by the State of Utah and the Federal Deposit Insurance Corporation.

- Should Prosper's and LendingClub's loan origination activities be regulated, as loan brokerage or otherwise?

WebBank quickly resells all of the loans it makes to Prosper and LendingClub on a non-recourse (non-returnable) basis. Both P2P companies then service the loans, another activity which is currently unregulated.

- Should Prosper's and LendingClub's servicing activities be regulated?

As seen from the investor side, Prosper and LendingClub service personal, business, and student loans that investors indicate they are willing to make. During the initial stages of both firms' existence, Prosper/LendingClub would lend directly to the borrower. Later, as their models evolved, WebBank would make the loan, and sell it to Prosper/LendingClub. Either way, the loan would be evidenced by separate promissory notes, each in the principal amount of an investor's winning bid. These notes would then be sold by Prosper/LendingClub to the winning bidders. As noted earlier, the SEC ultimately rejected this model in favor of one which more closely fit the SEC's regulatory approach.

As their business models were ultimately approved by the SEC, both Prosper and LendingClub purchase loans made by WebBank, and create individual securities, called Borrower Payment Dependent Notes, which are backed by individual loans. The companies then sell the securities to winning investors. (For example, borrower A obtains a $5,000 loan, which is made by WebBank and sold to Prosper. Prosper has five bidders for that loan, each of whom has agreed to commit $1,000 toward the funding of the loan. Prosper securitizes the $5,000 loan and sells five securities, each in the amount of $1,000, to each of the five winning bidders).

Because Prosper and LendingClub are now securities issuers, they are required to comply with all of the reporting requirements applied to other securities issuers (such as quarterly and annual filing), and they are required to file daily reports to the SEC regarding the borrowers who are seeking loans from their sites – information which is publicly available on the SEC's public database, known as EDGAR. Some of the information they are required to file on a daily basis is already available to those who are registered to use their web sites.

Time-consuming and costly reporting requirements are not the only regulatory burdens imposed on P2P lenders as a function of their distinction as securities issuers. As described above, those who purchase securities sold by the sites are also subject to suitability requirements, intended to ensure that only sophisticated investors use the sites, and do so without putting significant portions of their net worth at risk.

Yet, as reviewed by Committee staff during the preparation of this background paper, the suitability requirements imposed on those who invest through Prosper and LendingClub appear somewhat illogical, because they are based on the financial health of Prosper and LendingClub. Under the models used by both companies, it is the borrowers, and only the borrowers, who are responsible for making payments to investors that hold Borrower Payment Dependent Notes issued through the sites. Investors are not reliant on Prosper and LendingClub to make the payments, and, in fact, both companies are clear that they do *not* make payments on loans if borrowers fall behind.

And, while one could make an argument that both Prosper and LendingClub need to be financially viable in order to service the loans made through their sites, both companies have made arrangements with third parties to service outstanding loans, if either company were to go out of business. There does exist the possibility that one or both companies could go bankrupt, and fail to pass on borrower payments to investors. But, this possibility is mitigated (not eliminated, to be sure, but mitigated) by the third party servicing arrangement.

At the very least, it is staff's opinion that the suitability standards should be based *in part* on the financial health of the two companies, and *in part* on the characteristics of the borrowers who use the sites. While it is impractical to impose a different suitability requirement on each and every security sold through these sites, a suitability model that took the risks of different borrowers and different loans into account would make more sense than the current one. Yet, such flexibility is impossible under the current securities issuer-based regulatory scheme.

In part due to their belief that the existing P2P regulatory framework imposes inefficiencies, costs, and restraints on innovation, a group of companies active in the P2P and microfinance lending space have joined together to form the Coalition for New Credit Models. The Coalition is comprised of Prosper, Credit Karma, IOUCentral, Loanio, Progreso Financiero, The Receivables Exchange, and SecondMarket. Its objectives include advocating for regulatory changes that will allow P2P lenders to more rapidly respond to consumer and investor demand. Consistent with that objective, the Coalition is working with Congresswoman Jackie Speier on federal legislation that will designate the Office of the Comptroller of the Currency, rather than the SEC, as the primary regulator for P2P lenders.

Interestingly, LendingClub is not a member of the Coalition. Although LendingClub representatives have also expressed dismay about the significant costs involved in regulation by the SEC, the firm believes that SEC oversight offers protection and important disclosures to investors. LendingClub has spent a significant amount of time and money on complying with SEC regulations, and fears that any change in its regulator or regulatory structure would inject cost and uncertainty, neither of which is desired by the company or its investors. Rather than seeking a change in its regulator, LendingClub would prefer to focus its efforts on being compliant with the existing securities-based regulatory framework.

DO COMPLAINTS ABOUT THE COMPANIES SHED LIGHT ON REGULTORY ISSUES?

The number of complaints filed about P2P lenders doing business in California has been extremely low. The Attorney General's office reports having received a total of eight complaints since 2004 about P2P lenders operating in California. DOC has not received any complaints about any of its P2P licensees. The SEC does not report having received complaints from investors about any of the P2P lenders they oversee.

Both Prosper and LendingClub have internal complaint processes and are registered with the Better Business Bureau. The rate of complaints at both companies is quite low. Most complaints come from borrowers who cannot access the sites, because their states do not allow Prosper or LendingClub to operate in that state; from borrowers who are denied the opportunity to apply for a loan, because their credit score is too low, or because they fail to meet other site criteria; from investors who can't meet the suitability requirements but who wish to invest anyway; and from site users who cannot obtain the information they are seeking from the lender's web site.

Neither Prosper nor LendingClub receives complaints from borrowers who failed to understand the terms of their loan, or who felt they were victimized by "bait and switch" tactics. In this way, both P2P sites represent a refreshing change from the scores of complaints expressed by mortgage holders who obtained loans during the frenetic 2005-2007 lending period, when most borrowers failed to understand the terms of the loans they were receiving.