Goodmans LLP Update

Technology

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Peer-to-Peer Lending and the Future of Alternative Finance in Canada

The Canadian financing industry is changing alongside developments in technology and communication. New businesses are shifting away from traditional lending institutions and are funding early growth through alternative finance. Market participants who historically sought investments from angel investors, private equity funds and banks are obtaining capital elsewhere. The financing industry has embraced the sharing economy model and is connecting retail users through different models. One such model is the "lending-based" crowdfunding model (often referred to as Peer-to-Peer or P2P lending) which allows members of the "crowd" to lend capital without using traditional financial intermediaries such as large banks.

How Does Peer-to-Peer Lending Work?

The Peer-to-Peer lending model uses online platforms to connect investors with individuals and businesses in search of capital. The model is attractive to borrowers because it allows them to access money at lower interest rates when compared to traditional credit providers such as banks and credit card companies. As Peer-to-Peer lending has evolved into a distinct asset class, this model also provides a new investment opportunity for retail investors. P2P service providers typically earn money by charging a service fee on each facilitated loan.

The use of technology in the P2P application process decreases transaction costs, making P2P lending more efficient and user-friendly than conventional lending. Borrowers apply for a P2P business or personal loan by completing a comprehensive online profile. Required application information typically includes name, address, yearly income, bank account information, desired loan amount, purpose for the loan and credit score (among other information). While the P2P model specifics can vary depending on the service provider, most Peer-to-Peer lending companies share the same basic business structure. Generally, loans range from approximately $1,000 - $35,000 (though some service providers offer business loans for up to $500,000). The loans are broken down into smaller "notes" that are then resold to investors. This allows each loan to be funded by several lenders. Individual investors can then select which loans to fund. To assist lenders in making an informed investment, most P2P platforms disclose basic information about each loan, such as the borrower's interest rate and purpose for the loan. The notes are also rated by the Peer-to-Peer service providers based on the corresponding loan's risk profile. Borrowers repay the loans by making monthly payments that represent both principal and interest. These payments are rateably distributed to the investors who hold the underlying notes. In this financing model, loans are typically unsecured. Therefore, if a borrower fails to repay a loan, the lender loses its initial principal investment as well as any potential interest payments.

Peer-to-Peer Lending Regulatory Framework in Ontario

The lending-based crowdfunding model has been the source of recent debate among regulators and service providers in Ontario. The Ontario Securities Commission (OSC) has warned that Peer-to-Peer lending products may fall within the scope of Ontario securities laws. In a 2009 decision considering one of Ontario's first Peer-to-Peer lending platforms, the OSC stated that a P2P loan agreement evidencing indebtedness of a borrower "is (or is likely) a 'security' as that term is defined under applicable securities legislation."[1] The OSC recently reiterated its concerns in June 2015. It warned that "companies moving into the nascent world of Peer-to-Peer lending…may be subject to regulation and could even be required to register as investment dealers."[2] The OSC's interpretation that the Peer-to-Peer model could constitute trading in securities creates obstacles for P2P lending service providers in Ontario. Ontario securities laws state that "no person or company shall trade in a security on his, her or its own account or on behalf of any other person or company if the trade would be a distribution of the security, unless a preliminary prospectus and a prospectus have been filed and receipts have been issued for them by the Director".[3] Further, section 25(1) of the *Securities Act* (Ontario) requires a person or company engaging or holding himself, herself or itself as engaging in the business of trading in securities to register as a dealer or to be a dealing representative of a registered dealer.[4] Therefore, subject to certain prospectus and registration exemptions, both P2P borrowers and Peer-to-Peer service providers in Ontario may encounter substantial regulatory requirements.

For these reasons, most Canadian Peer-to-Peer service providers have limited lending opportunities to a restricted class of lenders that qualify for securities law prospectus exemptions, such as the Accredited Investor exemption in *National Instrument 45-106 - Prospectus Exemptions*. While the OSC has recently adopted a dedicated regulatory framework to address equity crowdfunding (an alternative to the lending-based model) it has yet to adopt an equivalent model for P2P lending. For a review of the equity crowdfunding prospectus exemption, see our November 10, 2015 Update, *Equity Crowdfunding Exemption Finalized*. Developing a regulatory framework for Peer-to-Peer lending would maintain the competitiveness of Ontario capital markets while prioritizing investor protections.

Goodmans Tech Group

To assist clients in the technology sector, Goodmans brings together our acknowledged expertise in corporate/commercial, private equity, corporate finance, mergers and acquisitions, outsourcing, licensing, intellectual property, privacy, regulatory and media, tax, litigation, human resources, corporate restructuring and administrative law.

Goodmans was a pioneer for many of the contractual relationship formats that now exist in the information technology sector. We also have an extensive history of helping clients enforce their rights with regard to computer software issues and other business disputes. The members of our Technology Group teach internet and communications law at Canada's largest law school, are regular lecturers at technology industry events and legal conferences, and have published articles in the technology law field.

Goodmans continues to lead in the technology space and has recently partnered with The DMZ at Ryerson University. The DMZ is a leading business incubator (selected by BMI as the top-ranked university incubator in North America, and third in the world), which connects its startups with resources, customers, advisors, investors, and other entrepreneurs. Through this partnership, Goodmans will provide mentorship and networking opportunities to assist startups in maximizing their potential.

Please contact any member of our Technology Group for further information.

[1] *CommunityLend Inc., Re* (2009), 32 OSCB 7120 at para 4.

[2] Ontario Securities Commission, News Release, "OSC Sets Out Expectations for Businesses Planning to Operate Peer-to-Peer Lending Websites" (19 June 2015), online: OSC <https://www.osc.gov.on.ca/en/NewsEvents_nr_20150619_peer-to-peer-lending.htm>.

[3] *Securities Act (*Ontario), RSO 1990, c S.5, s 53(1).

[4] *Ibid,* s 25(1).