Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

To: Members, Committee on Small Business
From: Committee Staff
Date: May 8, 2015
Re: Full Committee Hearing: "*Bridging the Small Business Capital Gap: Peer-to-Peer Lending*"

On Wednesday, May 15, 2015, at 11:00 am in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet for the purpose of receiving testimony on the effects of peer-to-peer (P2P) lending on small business. The hearing will examine the rise of P2P lending platforms that seek to satisfy the demand for debt capital that is currently not being met by banks and other conventional lenders.

I. Introduction

According to economists, the United States experienced an economic recession from December 2007 through June 2009.[1] This recession, often referred to as the "Great Recession," lasted 18 months and was the longest recession experienced in the United States since World War II.[2] Although the Great Recession officially ended in June of 2009, the United States experienced its peak of unemployment at 10 percent in October 2009.[3]

While the exact cause of this recession may be debated, a substantial contributor was the collapse of various financial institutions due to subprime lending and risky derivative swapping.[4] As Lehman Brothers slipped into bankruptcy, lawmakers passed the Emergency Economic Stabilization Act of 2008 which allowed the federal government to purchase troubled assets rather than allow certain financial institutions to succumb to the same fate as Lehman Brothers.[5] The need for this action led several commentators, including most importantly, the then Chairman of the Board of Governors of the Federal Reserve System, Ben Bernanke, to express

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[1] http://www.nber.org/cycles/sept2010.pdf. It is important to note this organization is not affiliated with the federal government.
[2] *Id.*
[3] http://data.bls.gov/timeseries/LNS14000000.
[4] *See* http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article; *see also* http://www.nytimes.com/2008/10/24/business/economy/24panel.html?_r=0.
[5] Pub. L. No. 110-343, Div. A., § 2, 112 Stat. 3765, 3766 (2008), codified at 12 U.S.C. § 5201.

concerns regarding banking practices and whether the industry was properly regulated.[6] It also fostered a general level of distrust and dissatisfaction with the banks.[7]

To ensure that banks and other financial institutions were adequately regulated and would not cause another collapse of the financial system, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.[8] The law provides for a comprehensive reorganization of the regulatory structure surrounding the financial services industry.[9] Since its passage, this law has been highly controversial, particularly given the potential it has to impose a disproportionate impact on both small business lending and small financial institutions through increased regulations such as reporting requirements, risk retention, limitation of certain fees, and restructured resolution authority.

The goal may have been to improve bank soundness in order to generate greater consumer confidence in banks, but a year after its passage, an August 2011 Gallup Poll revealed "fewer than one in three small-business owners trust banks."[10] Further, big banks, tending to be more risk-averse lenders in general, approved less than 20% of all small business loan requests submitted to them in January 2014; for their part, small banks approved only about 50% of those requests that they received during the same period.[11] Given the lack of trust and reductions in lending associated with stricter regulations of banks' lending practices, conventional markets appeared inadequate to meet the needs of small business borrowers. As a result, the market created its own innovative approaches, known as alternative lenders. These emerging options are rapidly filling the void left by conventional financial institutions, approving nearly 65% of small business loan requests, thereby generating more opportunities for small businesses to access needed capital.[12]

II. Crowdfunding

In the world of emerging alternative financial options available to most small businesses,[13] crowdfunding has dominated the discussion and the term has come to encompass a

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[6] *See, e.g,.* http://www.federalreserve.gov/newsevents/speech/bernanke20091023a.htm; http://www.wsj.com/articles/SB120675834275673863; http://www.heritage.org/research/reports/2008/10/congresss-investigation-into-the-subprime-mortgage-meltdown-the-so-called-search-for-the-truth.

[7] TRACI L. MACH, COURTNEY M. CARTER, & CAILIN R. SLATTERY, DIVISIONS OF RESEARCH & STATISTICS AND MONETARY AFFAIRS, FEDERAL RESERVE BOARD, PEER-TO-PEER LENDING TO SMALL BUSINESSES 1 (2014), *available at* http://www.federalreserve.gov/pubs/feds/2014/201410/201410pap.pdf [hereinafter MACH P2P].

[8] Pub. L. No. 111-203, 124 Stat. 1376.

[9] *The Costs of Implementing the Dodd-Frank Act: Budgetary and Economic Before Subcomm. on Oversight and Investigation of the H. Comm. on Fin. Services*, 112th Cong. (March 30, 2011) (Statement of Douglas W. Elmendorf, Director, Congressional Budget Office).

[10] http://www.gallup.com/businessjournal/148049/rebuilding-trust-banks.aspx.

[11] http://www.nytimes.com/2014/03/06/business/smallbusiness/cant-get-a-bank-loan-the-alternatives-are-expanding.html?_r=1.

[12] *Id.*

[13] In the world of financial alternatives, derivatives and swaps still predominate with their estimated notional (face) value of outstanding instruments to be approximately $220 trillion in the United States (which is more than 12 times the size of the American economy). OFFICE OF THE COMPTROLLER OF THE CURRENCY, QUARTERLY REPORT ON BANK TRADING AND DERIVATIVE ACTIVITIES 9 (2014) *available at* http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq414.pdf. In comparison, the total value of commercial loans and leases in the United States is estimated to be $8 trillion. http://research.stlouisfed.org/fred2/series/TOTLL.

variety of financing activities. In general, crowdfunding entails obtaining small amounts of money from large numbers of individuals, generally through various types of Internet portals, rather than from a traditional financial institution.[14] Crowdfunding can be further subdivided depending on the type of transaction between the seeker of funds and those providing funds: rewards-based, equity funding, and debt-based.

A. Rewards

Initial crowdfunding efforts involved rewards. Online platforms, such as Kickstarter, allowed an individual to contribute funds in exchange for a copy of a book or perhaps a new type of watch being manufactured by a small business. In this model, the fund recipients do not re-pay the funds in a traditional sense nor do they pay interest.[15]

B. Equity

The concept logically moved to equity funding, in which a small business sells shares of their company in exchange for funds. However, this type of crowdfunding ran into the obstacle of federal securities law. Every sale of a security[16] in interstate commerce is controlled by the strictures of the Securities Act of 1933 (colloquially referred to as the "33 Act"). Thus, the sale of shares of stock by a small business through crowdfunding would run afoul of the "33 Act" because the seller would not have registered with the Securities and Exchange Commission (SEC).

The potential benefit from the ever-burgeoning crowdfunding marketplace[17] was not lost on a Congress seeking to reduce barriers for small businesses to raise equity financing. In the spring of 2012, Congress passed, and the President signed, the Jumpstart Our Business Startups Act of 2012 (JOBS Act).[18] This Act allows small firms to solicit investors without being deemed a public offering and also allows small firms to utilize crowdfunding as a private placement exemption under § 4(2) of the "33 Act," among other things.[19] While Congress authorized equity-based funding, the SEC has yet to promulgate regulations that will allow portals to conduct equity-based crowdfunding.[20]

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[14] MACH P2P, *supra* note 7, at 1-2 (2014).

[15] *Id.* at 2; *see also* http://www.entrepreneur.com/article/231085.

[16] The Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb, has a broad definition of the term security, *see* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 231, 247 (5th ed. 2004). For purposes of this memorandum, the terms "stock," "shares," and "securities" are used interchangeably even though that is technically not correct.

[17] Joan Heminway & Shelden Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 881, and Table 6.

[18] Pub. L. No. 112-106, 126 Stat. 306 (2012), codified at scattered sections of Chapters 2A and 2B of Title 15, United States Code.

[19] For a more comprehensive description of the JOBS Act and its effect on small firms, please see the Committee's hearing memorandum on the *JOBS Act Implementation Update Before the Subcomm. on Investigations, Oversight, and Regulations of the H. Comm. on Small Business*, 113th Cong. (Apr. 11, 2013), *available at* http://smallbusiness.house.gov/uploadedfiles/4-11-2013_hearing_memo.pdf.

[20] *See* http://www.forbes.com/sites/kevinharrington/2015/02/03/will-jobs-act-equity-crowdfunding-ever-happen/; http://www.crowdfundinsider.com/2015/03/64148-jobs-act-state-of-the-union-whats-become-of-regulation-a-and-

C. P2P Lending

The final type of crowdfunding is debt-based; commonly referred to as P2P lending.[21] In P2P lending, individuals fund small portions of a total amount of debt "and receive their principal plus interest when the borrower repays the loan."[22] Typically, an intermediary, commonly referred to as a P2P lending platform, connects these individuals and charges a fee for this verified connection service.[23]

Given this model, P2P lending generally takes place online, where a P2P lending company will match borrowers with the individuals who will supply funds. The basic idea is simple: a borrower needs money and goes to a P2P lending platform and applies for credit online. Next, the P2P lending platform evaluates the borrower's risk, establishes their credit rating, and assigns them an interest rate. Investors then review the loans listed on the P2P lending platform's website and compete for those in which they wish to lend, with higher risk associated with higher interest rates.[24]

P2P lending first began the United Kingdom (UK) with a company called Zopa in 2005.[25] In 2006, Prosper was launched in San Francisco, quickly followed by Lending Club in 2007 as well as other platforms in the United States.[26] P2P lending has grown steadily since its inception[27] and continues its rise today,[28] though its presence in the lending market is still miniscule on the whole.[29] Since 2007, loan volume at P2P lending platforms has grown an average of 84 % each quarter.[30] Total loan value for the industry hit the $5.5 billion mark in 2014, and market analysts project that number to reach $150 billion or more by 2025.[31]

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crowdfunding/; http://venturebeat.com/2015/03/25/with-the-new-reg-a-what-type-of-fundraising-is-right-for-your-startup/.

[21] MACH P2P, *supra* note 7, at 2 (2014).

[22] *Id.*

[23] http://www.shakelaw.com/blog/peer-to-peer-lending-a-smart-funding-source-for-your-small-business/.

[24] PETER RENTON, LEND ACADEMY, UNDERSTANDING PEER TO PEER LENDING 6 (2015), *available at* http://www.lendacademy.com/Understanding-Peer-to-Peer-Lending.pdf.

[25] *Id.* at 5.

[26] *Id.*

[27] There was a brief hiccup in P2P lending growth in 2008 due some groups, such as Prosper and Lending Club, being reclassified as securities by the SEC, which triggered some regulatory headaches within the industry and slowed expansion for a period. However, once Prosper and Lending Club properly registered with the SEC expansion continued. MACH P2P, *supra* note 7, at 2 (2014).

[28] Further, "small business owners often intermingle their personal and business finances so as overall P2P lending [grows], so too [does] P2P borrowing for small business purposes." *Id.* at 1.

[29] America's two largest P2P lending platforms have together lent only $5 billion out of the United States' $1.8 trillion personal-loan market. http://www.economist.com/news/special-report/21601625-without-banks-baggage-shadow-banks-find-it-easier-oblige-customers-we-try-harder.

[30] PRICEWATERHOUSECOOPERS, PEER PRESSURE: HOW PEER-TO-PEER LENDING PLATFORMS ARE TRANSFORMING THE CONSUMER LENDING INDUSTRY 2 (2015), *available at* http://www.pwc.com/en_US/us/consumer-finance/publications/assets/peer-to-peer-lending.pdf. And the amount loaned is an even smaller portion of the commercial loan market. *See supra* note 13.

[31] *Id.* at 1.

For small businesses, P2P lending has allowed access to a new form of debt capital and has dramatically increased since the industry's birth.[32] The company with the largest market share, Lending Club, has seen the value of its total loans funded for small businesses explode from around $850,000 in 2007 to over $22 million in 2012.[33] Small business was the stated loan purpose for 3.5% of all funded Lending Club loans from 2007 to 2012, ranking sixth, with debt consolidation leading the request for funds.[34] Overall, the company has seen its loan volume approximately double each year since the company's founding.[35] Another large P2P lending portal is Funding Circle, which began in the UK and focuses specifically on small business. Funding Circle has lent approximately $850 million and served some 8,000 small businesses around the globe since its founding in 2010.[36] In 2013, Funding Circle UK joined with "San Francisco-based business lender Endurance Lending Network Inc. to form a new company, Funding Circle USA."[37] Funding Circle matches investors with companies and takes a "1% service fee from the investors and 2% to 4% service fee from the company."[38] Similarly, across the United States other P2P lenders like Dealstruck, Daric, and Fundation[39] seeing market opportunities for lending to small businesses, have recently begun operations to compete with the more established market leaders.

III. Conclusion

Although recent data show levels of small commercial loans and creditworthiness of borrowers on the rise compared to the previous few years, they are still lower than those of the pre-recession period of 2007 and the first two quarters of 2008. Researchers have pointed to a variety of factors keeping small business lending from returning to pre-recession form. In the meantime, reductions in conventional avenues for borrowing have been filled by new financing vehicles. For P2P lending specifically, it is important as Congress moves forward that they understand the benefits and challenges associated with this alternative form of debt financing.

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[32] MACH P2P, *supra* note 7, at 1 (2014). As noted in the report, much of this data was taken from Lending Club loans and applications.

[33] *Id.* at 5.

[34] *Id.* at 5.

[35] http://www.americanbanker.com/magazine/124_02/p2p-lending-2b-or-not-2b-1065594-1.html?pg=2.

[36] Funding Circle, now headquartered in London and San Francisco, launched in the United States in 2013. https://www.fundingcircle.com/us/about ; https://www.fundingcircle.com/us/contact.

[37] http://blogs.wsj.com/tech-europe/2013/10/23/funding-circle-closes-37-million-round-expands-into-u-s/.

[38] *Id.*

[39] Fundation is slightly different from traditional P2P platforms. Fundation does not connect prospective borrowers with anyone interested in providing capital. Rather, Fundation uses capital supplied by a partner firm. It then uses its portal to offer loans to small businesses. Technically, since it is not organizing a person-to-business loan it is not a classic P2P lender. http://www.nytimes.com/2014/03/06/business/smallbusiness/cant-get-a-bank-loan-the-alternatives-are-expanding.html?_r=1.