2015

The Future of Direct Finance: The Diverging Paths of Peer-to-Peer Lending and Kickstarter

Kathryn Judge
Columbia Law School, kjudge@law.columbia.edu

The Center for Law and Economic Studies
Columbia University School of Law
435 West 116th Street
New York, NY 10027-7201
(212) 854-3739

The Future of Direct Finance: The Diverging Paths of Peer-to-Peer Lending and Kickstarter

Kathryn Judge

Working Paper No. 520
50 Wake Forest Law Review __ (forthcoming 2015)

September 17, 2015

THE FUTURE OF DIRECT FINANCE: THE DIVERGING PATHS OF PEER-TO-PEER LENDING AND KICKSTARTER

Kathryn Judge∗

This Article explores why the technologies that have transformed a range of industries by facilitating a dramatic rise in direct transactions—as reflected in the rapid growth of eBay, Etsy, and Airbnb, among others—have yet to similarly transform banking and other modes of financial intermediation. Its primary focus is the evolution of peer-to-peer ("P2P") lending from a sector that promised to bring similarly radical changes to financial intermediation to one in which the relationship between the supplier and recipient of the capital is increasingly attenuated. The analysis reveals a number of market and regulatory forces that tend to favor intermediation and work against direct finance when the exchange is purely financial. Yet the Article also considers areas where direct finance appears to be gaining more of a toehold. This examination reveals ways that technology is increasingly enabling capital raising to be bundled with other undertakings, like garnering publicity or gathering information about the demand for a potential project. The analysis suggests that when the exchange involves more than just capital, direct finance may yet thrive, as individuals can bring attributes to the table that intermediaries cannot readily replicate.

The conjecture that direct finance is most likely to be viable when the provision of capital is part of a thicker bundle, while inherently speculative, has ramifications for both theory and policy. Such a development runs contrary to the prevailing wisdom that innovations will lead to ever greater specialization and result in capital raising being increasingly divorced from risk bearing and other commitments. It also presents an interesting regulatory challenge, as thicker bundles are more likely to raise policy and legal issues traditionally addressed through disparate bodies of law and often enforced by agencies with different aims and inclinations.

∗ Associate Professor of Law and Milton Handler Fellow, Columbia Law School. The author is grateful to Mariana Pargendler, Fred Benenson, and participants at the *Wake Forest Law Review* Symposium on the Future of Financial Intermediation for helpful comments and conversations.

Introduction

For centuries, the trend has been toward longer and more complex intermediation chains in a wide array of contexts.[1] The growing length and complexity of intermediation chains were both the byproducts and drivers of ever-greater globalization and specialization. In recent years, however, there has been a shift in the opposite direction.[2] In a wide array of markets, suppliers and consumers increasingly transact directly with one another. Many of these developments have arisen from technological innovations that reduce search costs and other hurdles to transacting, like verifying information and negotiating the terms of a transaction. Airbnb, Etsy, and their kin, for example, so lower transaction costs as to enable a wide range of transactions to occur that would have been unimaginable a mere decade ago. Bedrooms that previously sat empty are now regularly occupied by a rotating cast of short-term visitors; artisans can now make a living by reaching would-be clients in faraway places.

Other forces that seem to be contributing to the rise of direct transactions are changing consumer preferences and growing appreciation for the ways that the nature of the intermediation chain separating a consumer and a producer affects the nature of the goods produced. For example, the dramatic resurgence of farmers' markets seems to reflect growing consumer demand for foods that are locally and organically produced and consumer appreciation of the fact that the vegetables available at a farmers' market are different than those one can get at the average grocery store.[3]

Shifting the focus to finance, one can find signs of both of these trends. For example, the strong interest in P2P lending following the 2007–2009 financial crisis seemed to be a byproduct of both new technologies that could facilitate the ability of individual borrowers and lenders to connect directly with one another and a heightened distrust of banks. As explained in 2007 by the co-founder of a leading P2P lending platform, Prosper, "there's a growing trend toward 'people taking care of other people and a growing trend away

1. *See* Tamar Frankel, *The Failure of Investor Protection by Disclosure*, 81 U. CIN. L. REV. 421, 427–30 (2013) (discussing the development of markets and later banks as intermediation channels).

2. *See infra* Subpart I.A.

3. *E.g.*, Stephen Vogel, *Number of U.S. Farmers' Markets Continues to Rise*, ECON. RES. SERV., U.S. DEP'T OF AGRIC., http://ers.usda.gov/data-products/chart-gallery/detail.aspx?chartId=48561&ref=collection&embed=True&widgetId=37373 (last updated Aug. 4, 2014) ("The number of farmers' markets rose to 8,284 in 2014, up from 3,706 in 2004 and 1,755 in 1994."). Etsy also embodies this growing consumer trend toward direct transactions. *See* Hiroko Tabuchi, *Armies of Artisans*, N. Y. TIMES, Mar. 16, 2015, at B1.

from reliance on corporations, banks[,] and large institutions."[4] He viewed P2P lending as embodying the promise of this new era.

P2P lending has taken off, but in the process it has evolved to become both more like and more reliant on the large financial intermediaries it originally promised to supplant. Yet time has also revealed other niches where true direct finance seems to be flourishing. By exploring how and why P2P lending has evolved and comparing that evolution to these other domains, this paper explores the intertwined questions of the benefits financial intermediaries provide and when direct interactions between the suppliers and recipients of capital might be able to create value in excess of the benefits that reliance on intermediaries can confer. While speculative, the analysis here suggests that direct finance is likely to thrive only when the exchange of capital—a good that is fungible—is coupled with the exchange of other goods that are not—such as feedback about the value consumers place on a proposed project or the ability to support the creation of a public good not easily financed through other mechanisms.

To separate hope from reality, it is necessary to begin by considering the promise that P2P lending seemed to embody when it first emerged. Early advocates depicted P2P lending as poised to fundamentally transform multiple dimensions of the lending process. With respect to the providers of capital, P2P held out the promise of providing ordinary individuals the opportunity to invest directly in unsecured loans, an activity that historically belonged almost exclusively to banks. It was simultaneously heralded as potentially expanding the pool of persons who could obtain credit, enabling persons who might not readily qualify for a bank loan to nonetheless obtain needed financing.[5] In addition to altering the providers and recipients of credit, P2P promised to transform the nature of the relationship between these ends of the investment chain, directly connecting retail lenders to those receiving their funds.[6]

While the industry has grown dramatically in recent years, its promise along each of these dimensions has diminished at an equally rapid clip. The lender base has shifted from consisting almost exclusively of individuals making modest investments to now being dominated by large institutional investors.[7] The individual investors that remain increasingly rely on automated tools to

4. Pamela Yip, *Person-to-Person Lending Is Networking Its Way Up*, DALL. MORNING NEWS, Dec. 10, 2007, at 1D, 2007 WLNR 24391872 (quoting John Witchel).

5. *See infra* Subpart I.A.

6. *See infra* Subpart I.A.

7. Nav Athwal, *The Disappearance of Peer-to-Peer Lending*, FORBES (Oct. 14, 2014, 12:28 PM), http://www.forbes.com/sites/groupthink/2014/10/14/the-disappearance-of-peer-to-peer-lending/; *see also infra* Subpart I.B.

allocate their funds, eliminating personalized review of the specifics of each loan request.[8] At the same time, platforms have become increasingly discriminating in the borrowers they allow to seek funds, and the metrics that platforms use to make this determination are strongly correlated to those long used by banks and other credit providers.[9] Coupled with the changing lender base, the result is that would-be borrowers are now evaluated in ways akin to banks' traditional underwriting processes, and the borrower base consists largely of borrowers able to get credit elsewhere. Finally, because of changes triggered by regulatory concerns, P2P loans no longer create a direct relationship between lenders and borrowers even when the capital comes from an individual. Instead, lenders typically receive an unsecured claim against the P2P platform, the value of which is set by reference to the performance of the associated loan. Other changes in P2P platforms are further blurring the bounds between these platforms and traditional financial intermediaries.[10] In short, P2P platforms have become a link in complex, highly intermediated chains that bear little resemblance to the potential they once embodied.

While far from conclusive, the evolution of P2P lending does not bode well for the future of widespread direct finance. While the changes in P2P lending may be due in part to efforts by established intermediaries to use their informational and positional advantages to entrench their positions in socially suboptimal ways, they may also reflect the genuine gains that specialized intermediaries can provide when the exchange is purely financial.[11] Data-driven algorithms have proven relatively effective at assessing borrower creditworthiness and the limited data suggest that individuals are unlikely to have any natural advantages in this process.[12] The regulatory intervention, while potentially poorly executed, was also motivated by legitimate concerns about investor protection.[11] The changes in P2P lending may also indicate that when acting solely as a borrower or lender, individuals care more about the expected cost of a loan or return on their investment than they do about the nature of their relationship to the party on the side.

This account is positive, not normative, and it does not discount the potential for technology to transform and improve lending

8. *See infra* Subpart I.B.

9. *See infra* Subpart I.B.

10. *E.g.*, Athwal, *supra* note 7 (stating that "institutions have managed to infiltrate this once retail industry from every angle"—including taking board seats on and investing in the major P2P platforms—and noting that institutional investors now provide "80–90% of the capital deployed through Prosper and Lending Club," the two leading P2P platforms); *see also infra* Subpart I.B.

11. *See infra* Part I.

12. *See infra* Subpart II.A.

11 *See infra* Subpart II.B.

practices. While P2P lending has not changed intermediation in the ways many first hoped, its rapid growth suggests that P2P platforms can serve as a useful mechanism for credit creation. The particular niches where P2P lending is thriving may well serve as a roadmap of shortcomings in the way banks have approached lending.[13] Moreover, other financial intermediaries are finding innovative and potentially productive ways to harness technology in their underwriting procedures, and these efforts may well transform the standards used to assess the creditworthiness of would-be borrowers and expand the pool of eligible borrowers able to access capital on terms they can afford.[14] Nonetheless, these technologies generally require resources to develop and thus tend to support the use of intermediaries who can afford such investments.

Recognizng the market and regulatory forces favoring intermediated finance does not, however, answer the question of whether true direct finance has a future. In the same speculative spirit that animates the rest of the analysis here, the paper identifies and seeks to learn from niches where it appears to have more potential. The focus here is on the success of the platform Kickstarter, which connects artists and entrepreneurs with persons who provide financing in exchange for non-financial rewards and a nascent "locavesting" movement. While these two niches look quite different from each other, and the various types of exchanges facilitated by Kickstarter often bear little resemblance to each other, they all share in common that the exchange involves something more than the provision of capital.[5] Those seeking funding may get publicity, information about the demand for a project they are considering, or the ability to connect with potential customers; those providing the capital enjoy benefits like tangible goods that cannot be acquired elsewhere or the intrinsic satisfaction that comes from helping an artist create a public good. These nonfinancial dimensions seem to be significant because they provide a new reason for the involvement of individuals. While financial intermediaries may have a superior capacity to assess the expected financial return on a particular loan or to aggregate a diversified investment portfolio, only individuals know the subjective value they place on a particular product, and those values may vary significantly from one individual to another. Similarly, a capital-raising process that entails having a thousand (or a million) individual potential investors watch a video clip about a project can generate significant publicity, enhancing the probability of success in a way not easily replicated when the appeal is made solely to a handful of institutional investors. These are just a couple of the many ways that direct transactions that bundle capital raising with

13. *See infra* Subpart II.B.
14. *See infra* Subpart II.A.

other undertakings might create value in ways that depend on the direct nature of the exchange.

The notion that technological and other innovations may enable new types of bundling, and that such bundling will at times be optimal, has implications for both theory and policy. Conventional wisdom has generally assumed that that technological and other innovations will result in capital raising being increasing unbundled from other commitments, and a number of historical developments support this wisdom.[16] The analysis here suggests that there may be a second, simultaneous trend in the opposite direction. For certain firms, bundling capital raising with other undertakings in ways historically not possible may prove to be optimal.[17] If the rise of direct finance does indeed lead to greater bundling, this raises some interesting policy challenges. In the United States and many other jurisdictions, the agencies and experts that oversee the capital markets overlap little with those who specialize in consumer protection, and there may well be benefits of crowdfunding that are not readily cognizable within any of the established frames. Without purporting to offer any solutions, this article concludes by identifying some of the challenges that lie ahead if these predictions about where direct finance has the greatest potential to flourish prove accurate.

This article proceeds in four parts. Part I describes the evolution of P2P lending—the promise it embodied and the ways reality has fallen short. Part II considers the reasons for this evolution and what has been lost and gained in the process. Part III addresses alternative domains where direct finance appears poised to remain viable, focusing on Kickstarter and "locavesting." Part IV explores the theoretical and policy implications of these developments.

I. The Evolution of P2P

A. The Promise

In an increasing number of domains, technology and changing consumer preferences have resulted in the rise of new, and often shorter, intermediation chains.[18] For example, eBay now serves

16. *See infra* Subpart IV.A.

17. *See infra* Subpart IV.B.

18. Any person or entity that provides value by reducing a barrier to transacting is, at least in part, functioning as an intermediary. *See, e.g.*, Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 148 (1979); Robert C. Ellickson, *The Case for Coase and Against "Coaseanism"*, 99 YALE L.J. 611, 615 (1989). As reflected in the account of eBay, even many "direct" transactions entail the use of one or more intermediaries; and, as reflected in the evolution of P2P lending, the line between direct and intermediated transactions is far from clear-cut. Nonetheless, this Article classifies transactions as direct when the intermediary facilitates the transaction but does not stand between the persons on both sides.

functions once fulfilled almost exclusively by secondhand shops—enabling persons to sell used but still useful goods and allowing collectors and others to acquire products that are not available or are more expensive in the market for new products. Rather than just serving as a substitute for an established set of intermediaries, however, eBay also enables thousands (if not millions) of transactions that would never have been possible under the traditional, more heavily intermediated mode of exchange. By providing a platform that is easy for both sellers and buyers to navigate, charging relatively low fees, and attracting large numbers of both buyers and sellers, the site actually expands the pool of would-be sellers and would-be buyers. Someone who would have allowed knick-knacks to accumulate dust in an attic rather than accept the low price that a secondhand shop would offer for the goods might today find it worthwhile to sell them directly on eBay. The volume of transactions conducted on eBay suggests that the relatively modest effort required to sell goods, combined with the ability to sell them at prices close to their best-use values, makes selling goods on eBay a worthwhile undertaking for many.[19] Similarly, and relatedly, the ability to locate a large number of goods that meet specified criteria with relatively little effort appears to enable eBay to attract buyers who would not otherwise peruse secondhand shops. eBay thus exemplifies the ways that technology has evolved beyond enabling teams of specialized intermediaries to move goods between disparate buyers and sellers toward enabling a new mode of intermediation, in which a platform operates primarily to connect buyers and sellers so that they can enter into an exchange directly with one another.

The rise of P2P lending in the mid-2000s seemed to fit neatly within this mold. A 2007 news article about this then-emerging sector explained: "Prosper, based in San Francisco, aspires to do for money what eBay did for your grandmother's teapot collection—create a person-to-person marketplace for consumer loans, and in the process, turn average people into bankers."[20] As the co-founder of Prosper, at that time the leader in P2P lending, explained that same year:

> When you go to Prosper, you are afforded the opportunity to tell a large picture, to talk about why you want the money, to tell your story, to invite your friends to give you endorsements, which is different from asking a friend to guarantee a loan . . . . You

19. *E.g.*, eBay Inc., Annual Report (Form 10-K) 50 (Feb. 6, 2015), http://www.sec.gov/Archives/edgar/data/1065088/000106508815000054/ebay201410-k.htm (showing that the net revenue for the company's marketplace division was nearly $7 billion for 2014).

20. Annys Shin, *Want to Loan Me Money? Here's a Picture of My Dog,* WASH. POST, Jan. 27, 2007, at D1.

> have an opportunity to tell a more complete picture, which leads to a better loan for everyone.[21]

Inherent in this description is an assumption that giving would-be borrowers the opportunity to tell their stories in their own terms—and giving would-be lenders the opportunity to read such stories and assess competing requests—would fundamentally transform the factors driving the process of determining who should receive credit and on what terms.

The founder of Lending Club, which soon overtook Prosper as the leading P2P platform in the United States, expressed similar sentiments. He proclaimed, "The idea is to simplify the process and operate a Web site where people who have money can lend directly to people who need the money."[22] Popular press accounts of P2P lending similarly highlighted its capacity to directly connect individuals seeking funds with others looking to invest, and how that might transform the process for both parties involved. A 2009 article, for example, opened by telling the stories of "Colin Nash, 35, [who] was struggling with $12,000 in credit card debt," and "Michael Fisher, 24, [who] was looking for a new investment."[23] The article explained that while "[t]he two men . . . had never met," each had his needs fulfilled when "Fisher loaned Nash $200" through Prosper.com.[24] As the story explained, while serving the economic needs of lenders and borrowers, "Prosper's . . . appeal . . . goes beyond the bottom line" thanks to the "[p]hotos and personal narratives [that] accompany borrowers' requests."[25]

Popular accounts and early research on the potential of P2P lending often also echoed the claims made by Prosper's founder regarding the capacity for P2P lending to provide credit to those who could not qualify for a loan from more traditional lenders. A 2009 news story, for example, illustrated how P2P lending platforms worked by telling the story of Lara Sargent, a woman who "needed about $15,000 to meet payroll and other expenses . . . as she prepared to open a group foster home for boys."[26] Lara obtained the needed financing from Lending Club "after her lender, Bank of America, declined to extend her line of credit."[27]

21. Yip, *supra* note 4.

22. Paul Donsky, *Finding Credit: Social Lending Firms Broker Buddy Loans*, ATLANTA J. & CONST., Jan. 18, 2009, at D1, 2009 WLNR 995242; *see also* John Gapper, *The Lenders of the Revolution Look Familiar*, FIN. TIMES, June 18, 2015, at 9 (explaining that "[t]he idea of these initiatives was to democratise finance, taking on banks by removing a layer of complexity, costs and risk from the system and replacing them with a set of Ebays for lending").

23. *Banks Watching Latest Online Trend: Strangers Asking Strangers for Loans,* TIMES TRENTON, Nov. 28, 2007, at A15, 2007 WLNR 24100300.

24. *Id.*

25. *Id.*

26. *See* Donsky, *supra* note 22.

27. *Id.*

Explaining how P2P lending might expand the pool of would-be borrowers able to access credit, the San Francisco Federal Reserve Bank began by recognizing that the use of "standardized underwriting procedures and risk profiling algorithms," combined with other economies of scale, enabled financial intermediaries, like banks, to "dramatically increase[] the availability of credit."[28] Nonetheless, the primary beneficiaries have been "[b]orrowers with standard risk profiles."[29] P2P lending, by contrast, could enable credit to be allocated "on the basis of trust, albeit trust between people that have only met in cyberspace."[30] Another expert opined in 2008 that "P2P players aren't cutting the banks out of consumer lending . . . . They are creating a new market for lending that the banking community doesn't play in efficiently."[31] Implicit, and sometimes explicit, in these depictions of P2P lending is the idea that the wisdom of crowds could, at least some of the time, do a better job than the standardized underwriting criteria used by most banks.

Another defining feature of P2P, as originally conceived, is that the architecture of the exchange was consistent with the emphasis on the peer-to-peer nature of the exchange. As Lending Club explained, "[f]rom the launch of our platform . . . until April 7, 2008 . . . our platform allowed members to purchase assignments of unsecured member loans directly."[32] During this period, for each loan that was made, the loan would be divided "into separate promissory notes in amounts that matched the purchase commitments from members for the particular member loan. At

28. Ian J. Galloway, *Peer-to-Peer Lending and Community Development Finance* 1 (Fed. Reserve Bank of S.F., Working Paper No. 2009-06), http://www.frbsf.org/community-development/files/wp2009-06.pdf.

29. *Id.*

30. *Id.* at 2.

31. David Migoya, *Help from Friends: Peer-to-Peer Lending Websites Fill the Gap Left by Banks*, DENVER POST, Nov. 16, 2008, at K1; *see also* Alan B. Krueger, *In Credit Crisis, Some Turn to Online Peers for Cash*, N.Y. TIMES: ECONOMIX (Oct. 14, 2008, 9:17 AM), http://economix.blogs.nytimes.com/2008/10/14/in-credit-crisis-some-turn-to-online-peers-for-cash/?_r=0 ("P2P lending is a way to link lenders to borrowers without intermediation by a bank, much the way that eBay matches buyers and sellers of goods without a store in between."); Amy B. Simpkins, *Growing the Pie: Nontraditional Lenders Aim to Increase Opportunities for Small Businesses*, BRIDGES, Fall 2010, at 6, https://www.stlouisfed.org/~/media/Files/PDFs/publications/pub_assets/pdf/br/2010/br_fall_10.pdf ("Nontraditional service providers are attempting to respond to what they see as increasing market demand that is not being met by commercial banks and the traditional model of small business lending.").

32. LendingClub Corp., Annual Report (Form 10-K) 55 (June 29, 2011), https://www.lendingclub.com/fileDownload.action?file=10-K-MAR-31-2011.pdf&type=sf10k.

closing, WebBank indorsed the promissory notes to [Lending Club], and [Lending Club] assigned each promissory note to the applicable member."[33] This meant that P2P loans were structured to provide each lender a direct interest in each of the loans he or she had chosen to back.

In highlighting the promise of P2P lending, it is critical to distinguish the expectations regarding how it might transform finance from the first generation of financial disintermediation. Long before the recent trend toward direct interactions, financial and technological innovations dramatically altered the ways in which credit was created and disseminated. Securitization, whereby loans typically are packaged with others loans into a securitization vehicle against which one or more classes of securities are issued, helped give rise to a shadow banking system.[34] Banks typically still originated the loans, but the banks often sold those loans to securitization vehicles, and the securities issued were used as collateral in a range of transaction structures that collectively enabled maturity transformation, the provision of liquidity, and other functions traditionally performed by banks to be performed instead through the capital markets.[35] Because banks are the prototypical financial intermediary, the rise of a market-based system that replicated many of the economic functions traditionally performed by banks was seen as a move toward disintermediation.

This first-generation disintermediation was enabled and accelerated by technological and other innovations. Yet the spirit of this first generation of disintermediation was quite different than that animating the rise of platforms like eBay, Airbnb, and those facilitating P2P lending. Through a wide variety of mechanisms, the shadow banking system created by the first generation of financial disintermediation was deeply interconnected with the regulated banking sector; there was significant overlap in the key players in both worlds; and, while purporting to help consumers obtain credit on better terms, it was never meant to empower

33. LendingClub Corp., Registration Statement under Securities Act of 1933 (Form S-1) 79 (Oct. 7, 2011), http://www.sec.gov/Archives/edgar/data/1409970/000119312511266917/d237605ds1.htm#rom237605_22. WebBank is an Utah-chartered industrial bank that works with both Prosper and Lending Club. *See* Andrew Verstein, *The Misregulation of Person-to-Person Lending*, 45 U.C. DAVIS L. REV. 445, 476 (2011).

34. ERIK GERDING, LAW, BUBBLES, AND FINANCIAL REGULATION (2013); ZOLTAN POZSAR ET AL., FED. RESERVE BANK OF N.Y., SHADOW BANKING: STAFF REPORT NO. 458, at 1 (Feb. 2012), http://www.newyorkfed.org/research/staff_reports/sr458.pdf; Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk,* 64 STAN. L. REV. 657, 659–60 (2012).

35. *E.g.*, POZSAR ET AL., *supra* note 34.

individuals or create more direct relationships between the suppliers and recipients of capital.[36] Rather, it typically led to much longer and more complex intermediation chains that made the relationship between the providers and suppliers of capital more attenuated than the relationship that arises when a bank operates in its traditional capacity.[37]

P2P lending, by contrast, initially promised a radically different "second generation" of disintermediation. It was promoted by Silicon Valley visionaries seeking to disrupt the prevailing regime rather than players within that regime who sought to increase profits by minimizing their regulatory burdens. As reflected in the description above, P2P lending promised to be more like Etsy and the farmers' market.

B. Evolution

Since its inception less than a decade ago, P2P lending has grown dramatically. In 2012, the total market reached just over $1 billion.[38] By the end of 2014, Lending Club alone had originated $6 billion in loans through its platform, and Prosper had originated more than $2 billion.[39] P2P is also growing in other countries. In the United Kingdom, for example, the volume of P2P loans doubled in 2014 to more than £1.2 billion, and some suggest it is likely to do the same in 2015.[40] In conjunction with this growth, however, the very notion of what constitutes P2P lending has evolved so dramatically that serious questions are being raised about whether the term "person-to-person" even remains an apt moniker for the type of transaction these platforms are facilitating.

1. Suppliers of Capital

One of the most striking changes in P2P lending has been a rapid increase in the proportion of capital provided by institutions rather than individuals. As noted in a recent *Wall Street Journal* article, one reason that the term "'peer-to-peer' lending" is "rapidly

36. *Id.*

37. Judge, *supra* note 34, at 660.

38. Chris Barth, *Lend Thy Neighbor*, FORBES, June 6, 2012, at 172.

39. J.D. Alois, *Prosper: $493 Million in Peer to Peer Loans for Q3 2014*, CROWDFUND INSIDER (Nov. 20, 2014, 7:06 AM), http://www.crowdfundinsider.com/2014/11/56564-prosper-493-million-in-peer-to-peer-loans-for-q3-2014/; Theron Mohamed, *Peer-to-Peer Lending: The Next Gold Rush?,* INV. CHRONICLE (Jan. 2, 2015), http://www.investorschronicle.co.uk/2015/01/02/comment/chronic-investor-blog/peer-to-peer-lending-the-next-gold-rush-QE0RtVNsYyOPFZfJo8ud4I/article.html.

40. Ed Ballard, *P2P Lending Gets a Fresh Boost from the Mainstream,* WALL STREET J.: MONEYBEAT (Jan. 30, 2015, 11:34 AM), http://blogs.wsj.com/moneybeat/2015/01/30/p2p-lending-gets-a-fresh-boost-from-the-mainstream/; *see also* Sebastian C. Moenninghoff & Axel Wieandt, *The Future of Peer-to-Peer Finance*, ZEITSCHRIFT FUR BETRIEBSWIRTSCHAFTLICHE FORSCHUNG, Aug./Sept. 2013, at 466, 474.

heading into obsolescence . . . is that Prosper, like its peers, sells roughly two-thirds of its loans to institutions."[41] According to another source, a full 80% of the loans originated by Lending Club or Prosper are funded by institutional investors.[42] Describing the evolution, one commentator recently observed that, while P2P lending started out as "a place for small investors to loan to other individuals, the field is now dominated by institutions, including hedge funds."[43] As a result, the term "marketplace lending" is now frequently being employed in lieu of P2P lending, as the term more accurately describes the nature of the transactions these sites typically facilitate.[44]

Large, sophisticated institutional investors who are deploying capital that ultimately belongs to others look very different than 24-year-old Michael Fisher, but institutionalization affects more than just aesthetics. Perhaps the most striking difference between institutional and individual investors is the tools they bring to bear in assessing would-be borrowers. While Michael Fisher may have been willing to, and may even have enjoyed, spending hours in front of his computer reading the life stories of potential borrowers and deploying money based on his instincts about how much he trusted a particular borrower,[45] institutional investors are unlikely to do the same. Instead, they are deploying financial and technological resources that, over time, might well enable them to screen borrowers more effectively than the underlying platforms, leaving many concerned that they will leave only lemons in their wake.[46]

The major P2P companies have recognized the potential for this influx of new capital to transform their business model. In 2013, for example, Lending Club asked a sovereign wealth fund seeking to lend $250 million via its platform to spread that amount over two years to minimize the distortions that might result.[47] Nonetheless, these scruples seem to have dissipated rather quickly, and it is not clear that Prosper and Lending Club could maintain their competitive edge in the field if they impose such limits.

---

41. Telis Demos, *P2P Lender Prosper Buying Medical Loan Provider*, WALL STREET J.: MONEYBEAT (Jan. 27, 2015, 2:15 PM), http://blogs.wsj.com/moneybeat/2015/01/27/p2p-lender-prosper-buying-medical-loan-provider/.

42. Jonathan Ford, *Wall Street's Siren Song Lures P2P Lenders into Treacherous Seas*, FIN. TIMES, Oct. 6, 2014, at 16.

43. Ianthe Jeanne Dugan & Telis Demos, *For Peer Lending, a Change in Financing,* WALL STREET J., Oct. 21, 2014, at C3.

44. *Id.*

45. *See supra* Subpart I.A.

46. *Cf.* Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. 281, 285 (2014).

47. *Lending Club: Peer Review*, ECONOMIST: SCHUMPETER BLOG (Jan. 5, 2013, 4:48 PM), http://www.economist.com/blogs/schumpeter/2013/01/lending-club.

Looking beyond the source of the capital flowing into the two leading lending platforms reveals further indicia that these types of changes are underway and will affect other dimensions of the P2P lending process. For example, leading members of the banking industry are backing a start-up that links institutional investors with P2P loan opportunities.[48] Such additional intermediaries may prove efficient, but they will necessarily use routinized mechanisms for identifying creditworthy borrowers and will further attenuate the relationship between the provider and recipient of capital, reflecting the way that the changing lender base inevitably will also transform who receives loans, how they are selected, and the ultimate intermediation chain that results. These tendencies are accentuated by two other developments, discussed further below—that some loans which originated on P2P platforms are now being packaged into securitization structures and that individual investors increasingly rely on automated tools to select which loans to fund.[49]

Another way that established financial intermediaries are transforming the lender base and traditional P2P lending is by setting up their own lending platforms. The most prominent example is the announcement from Goldman Sachs that it intends to create its own "marketplace lending" platform, in which it will use its already advanced risk-assessment technologies to assess who will receive a loan, and it will itself provide the capital to fund it.[50] While the actual ramifications of this development are not yet known, commentators have already identified it as yet another sign that the "peer" in peer-to-peer is likely a thing of the past.[51]

2. Recipients of Capital and Screening Process

In conjunction with the fluctuating lender base, there have been notable changes in the borrower base and the mechanisms for determining which would-be borrowers actually receive funding. These shifts are reflected in changes in Prosper's business model. When it first launched in 2006, 25% of those seeking funds through Prosper were subprime borrowers—a figure that fell to just 5% by 2008.[52] This was in part because Prosper's original business model allowed most people seeking credit to post a loan request, and the role of determining whether to extend credit to a particular borrower and on what terms was given to the original would-be lenders reviewing the requests.[53]

48. Dugan & Demos, *supra* note 43.
49. *See infra* Subpart I.B.3.
50. *E.g.*, Gapper, *supra* note 22.
51. *Id.*
52. Richard Burnett, *Need a Loan? Web May Come to Rescue*, ORLANDO SENTINEL, July 14, 2008, at A1.
53. Verstein, *supra* note 33, at 453.

As originally designed, Prosper was thus meant to function in a manner akin to Airbnb—as a relatively passive intermediary that provides a technologically sophisticated platform through which those supplying a good connect with those who want it. For Airbnb, the good is a place to stay, while in P2P lending, the good is capital; but the overall design was meant to be similar. Airbnb does not engage in any ex ante screening with respect to those posting places to rent or would-be renters. Anyone can post a listing and anyone can make an offer to stay in a place so listed. The obligation to distinguish the good from the bad and to assess the value proposition of any particular good lies primarily in the hands of the individual users. Airbnb facilitates this process in a number of ways, but it is the parties to the transaction that ultimately must decide whether they have received sufficient assurances that they are willing to enter into an exchange with the party on the other side.

While Prosper's original business model was quite similar, Prosper soon changed its approach. It turned out that while individual lenders had some ability to screen would-be borrowers, they were not particularly good at this task.[54] As a result, lenders on Prosper faced a relatively high default rate—16.5% on loans that originated between November 2005 and October 2008.[55]

The process for determining who gets funded has since evolved in a number of ways. Many of the changes have come from the changing makeup and behavior of the lender base. An early study revealed that while borrowers with poor credit histories constituted the bulk of would-be borrowers in Prosper's early days, even during that period, such borrowers were substantially less likely to receive a loan than borrowers with stronger credit histories.[56] Another early study found that the parties providing loans altered their lending behavior over time—increasing their reliance on "hard" data and reducing their willingness to have funding decisions swayed by the full story beyond that data.[57] As a result, Prosper made corresponding changes in its business model—in response to the greater demand for hard data, Prosper began to supply more of it.[58]

54. Michael S. Maier, Lending to Strangers: Does Verification Matter? 19–20 (Jan. 15, 2014), http://ssrn.com/abstract=2379593 (prepared for the 2014 Canadian Academic Accounting Association Annual Conference).

55. Paul Katzeff, *Pros, Cons of Peer-to-Peer Lending*, INV. BUS. DAILY (June 12, 2009, 2:15 PM), http://news.investors.com/investing-mutual-funds/061209-479444-pros-cons-of-peer-to-peer-lending.htm.

56. Gao Ruiqiong & Feng Junwen, *An Overview Study on P2P Lending,* 8 INT'L BUS. & MGMT. 14, 15–16 (2014).

57. Seth Freedman & Ginger Zhe Jin, *Do Social Networks Solve Information Problems for Peer-to-Peer Lending? Evidence from Prosper.com* 25 (NET Institute, Working Paper No. 08-43, 2008).

58. *Id.*

In addition to learning that their instincts about who might be a credit risk were less reliable than hard data indicative of such, the composition of would-be lenders and their processes for choosing which loans to fund also had profound effects on the screening process. Institutional investors and any new intermediaries that they employ bring data and resources to the process of trying to determine which would-be borrowers to fund. The rise of a new firm created with the sole aim of helping such investors with this process suggests that lenders will play a very active role in determining who gets funded, but they will likely be using proprietary algorithms and other mechanisms that necessarily reduce each request to a standardized set of measures.[59]

The processes through which the remaining individual lenders choose would-be borrowers have also evolved dramatically, and in ways that further whittle back the number of people doing any type of individualized analysis of the requests. The most significant change here has been the introduction of new features on Prosper and Lending Club that allow individual lenders to invest using an automated feature that allows would-be lenders to identify the types of loans in which they want to invest—effectively choosing how much capital they want to allocate among the different risk categories and then leaving the rest to the platform.[60] In order to encourage investors to use this automated feature, Lending Club touts that "[w]ith just $2,500 you can spread your investment across 100 Notes" and "99.9% of investors that own 100+ Notes of relatively equal size have seen positive returns."[61] It further highlights that this feature provides lenders with "[a]ccess to the latest listed loans," while saving them time and requiring less effort to put their capital to work.[62] This approach is rational for most individual investors, but by its nature it strips the process of determining which borrowers get funded from any individualized review by individual lenders.

When loans are funded in this way, the only screening process used by the platform is to determine which would-be borrowers actually get to post their requests. This is the second way that the process has evolved dramatically over the short lifespan of P2P lending. Both Prosper and Lending Club have become increasingly stringent in this regard. Prosper has evolved from a passive platform that allows any would-be borrower to make a request and have that request reviewed by would-be lenders to an active filter

59. *See infra* Subpart II.B.

60. LENDINGCLUB, https://www.lendingclub.com/ (last visited Sept. 11, 2015); PROSPER, https://www.prosper.com/ (last visited Sept. 11, 2015).

61. *Understanding the Basics*, LENDINGCLUB, https://www.lendingclub.com/public/build-portfolio.action (last visited Sept. 11, 2015).

62. *Id.*

that allows only a limited portion of the requests to ever be seen by would-be lenders . Moreover, the metrics it uses to do so strongly resemble those long used by banks and traditional financial intermediaries.[63]

Lending Club always played an active screening role, but it too has become more stringent in its requirements over time. These changes reduce the number of would-be borrowers who have the opportunity to tell their whole story, as originally envisioned.[64] It also uses traditional metrics of creditworthiness in making these determinations. For example, the primary metric that Lending Club considers is a would-be borrower's FICO score.[65] Depending on that score, the platform also considers the borrower's debt-to-income ratio; the number of credit accounts currently open; the current balance on revolving accounts; whether the borrower has current or recent delinquencies or other problems on his credit report; and the length of the person's credit history.[66]

As one would expect, as the platforms have altered the lending process in ways that make it increasingly resemble the process used by banks, the borrower base has evolved to consist primarily of persons who could obtain credit, albeit at a potentially higher price, from banks. As Lending Club touted to investors, at year-end 2014, the average Lending Club borrower has a personal income of $73,278, which the site suggests is the "top 10% of US population"; a FICO score of 700 (which is a little below the national median of 723); and a lengthy 15.9 years of credit history.[67] More generally, the notion that P2P platforms will enable borrowers to be evaluated on nontraditional metrics and service segments of the population unable to access credit elsewhere has largely disappeared.

3. Relationship between Supplier and Recipient

A number of the changes already described have altered the relationship between the suppliers and recipients of capital away from the direct connection originally promised. In particular, the institutional investors that now dominate the lending base are typically investing capital for the benefit of others, thus creating at least one additional node separating the ultimate suppliers and recipients of capital.

63. *See* Freedman & Jin, *supra* note 57, at 33.

64. *See* LendingClub Corp., *supra* note 33, at 80–81.

65. *Id.* FICO scores are used by various lenders to evaluate the credit risk of consumers. *FICO Score*, FICO, http://www.fico.com/en/products/fico-score (last visited Sept. 11, 2015).

66. *How It Works*, LENDINGCLUB , https://www.lendingclub.com/public/how-peer-lending-works.action (last visited Sept. 11, 2015).

67. *Earn Solid Returns,* LENDINGCLUB, https://www.lendingclub.com/public/steady-returns.action (last visited Sept. 11, 2015); Lori Lamb, *What Is a Good Credit Score?*, CREDIT.ORG (Jan. 22, 2014), http://credit.org/blog/what-is-a-good-credit-score-infographic/.

At the same time, a massive change in the regulatory treatment of P2P loans has brought about an even more radical change in P2P loans, one that adds yet another node between the supplier and recipient of capital. In 2008, the Securities and Exchange Commission ("SEC") deemed the notes embodying P2P loans to be securities that needed to be registered under the Securities Act.[68] In order to comply with SEC regulations, Lending Club and eventually Prosper agreed to register the notes as securities.[69] Lending Club provided the following simplified depiction of the new relationship between the individual lenders and in the securities filings that accompanied those offerings[70]:

[Flow Chart]

As this image reflects, today's lenders have no direct relationship with the borrower receiving the funds provided. Rather, they have a claim only against the lending platform. Moreover, while the value of that claim depends on the performance of the reference loan, it is not secured by it. Thus, when looking at the structure of the relationship—as opposed to the expected return on the investment—it begins to look a lot more like a traditional bank.

Another recent development that further transforms intermediation chains created through P2P platforms is that such loans are starting to be securitized.[71] The trend started with unrated securitization transactions but recently has expanded into rated transactions. The P2P platform Social Finance, which specializes in P2P student loans, has consummated two securitization transactions rated by Standard & Poor's,[72] and in February 2015, Blackrock sponsored a securitization transaction backed by unsecured loans from Prosper that was rated by Moody's.[73] The ability to obtain ratings further increases the types of institutional investors that can invest in P2P-originated loans.[74] It is also likely to further accelerate the trend toward

68. Prosper Marketplace, Inc., Exchange Act Release No. 8984, 2008 WL 4978684 (Sec. Exch. Comm'n Nov. 24, 2008).

69. Prosper originally challenged the designation, but ultimately lost, forcing it to follow Lending Club. *See id.*

70. LendingClub Corp., Registration Statement Under the Securities Act of 1933 (Form S-1) 6 (June 20, 2008), http://www.sec.gov/Archives/edgar/data/1409970/000089161808000318/f41480orsv1.htm.

71. Joy Wiltermuth & Andrew Park, *BlackRock Sets New P2P Consumer Loan Benchmark*, INT'L FIN. REV. (Feb. 5, 2015), 2015 WLNR 3627152.

72. *SoFi Completes $303 MM 'A' Rated Securitization of Refinanced Student Loans*, YAHOO! FINANCE (Nov. 10, 2014, 12:30 PM), http://finance.yahoo.com/news/sofi-completes-303-mm-rated-173039163.html.

73. *Id.*

74. Tracy Alloway, *Bankers Work on Rated P2P Securitisations*, FIN. TIMES, Nov. 4, 2014, at 20.

reliance on standardized metrics in determining which borrowers get funded, as standardization is key to making securitization work and to enabling rating agencies to make the estimations of default required to rate a security.

Connecting these developments to the changing lender base reveals just how far P2P has strayed from the original vision. In the majority of situations, there are now at least two permanent nodes—the P2P platform or securitization vehicle and the institutional investor—separating the individuals on both sides of the chain. Additionally, both of these nodes pool capital from multiple sources and invest it in multiple projects. While enabling diversification and other benefits, this also further attenuates the relationship between the individuals supplying the capital and the individuals and small businesses receiving it.[75]

4.Looking Ahead

The changes in P2P lending in recent years have been rapid and dramatic. Given the dynamism of the industry thus far, it may well continue to evolve, potentially in unexpected ways. Nonetheless, other indications suggest it is unlikely to return to the initial vision as a forum for direct finance, free from the influence of banks and other established financial intermediaries. Even beyond the changes described above, other dimensions of the P2P industry today further undermine its potential as a radical alternative to Wall Street and the established banking regime. For example, John Mack, the former head of Morgan Stanley, now serves on Lending Club's board of directors.[76] Similarly, an increasing number of banks are entering into partnerships with P2P platforms pursuant to which the banks will sometimes refer customers to the platform and other times acquire whole loans originated through the platform.[77] And many anticipate that the entry of Goldman Sachs both will further transform what had been P2P and is also indicative of the way P2P lending is evolving into something that resembles the first generation of disintermediation and that will evolve to become part of the shadow banking system.[78] Thus, while it is hard to know what the future will look like, P2P lending seems

75. *See* Judge, *supra* note 34, at 659.

76. LendingClub Corp., Registration Statement Under the Securities Act of 1933 (Form S-1) 101 (Aug. 27, 2014), http://www.sec.gov/Archives/edgar/data/1409970/000119312514323136/d766811ds1.htm.

77. *Community Banks Face Risks, Opportunities in P2P Alliance*, FITCH RATINGS (Feb. 17, 2015, 12:31 PM), https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Community-Banks-Face?pr_id=979915; Matt Scully, *Banks Heat Up Bidding for Peer-to-Peer Loans*, ORIGINATION NEWS (Oct. 7, 2014, 4:52 PM), http://www.nationalmortgagenews.com/news/origination/banks-heat-up-bidding-for-peer-to-peer-loans-1042818-1.html.

78. *E.g.*, Gapper, *supra* note 22.

deeply entangled in long intermediation chains and increasingly interconnected with the established regime. This period may very well mark the death knell of the original promise of P2P lending and the term itself may soon fade along with that promise.

II. Assessing the Evolution

Today, P2P lending bears little resemblance to the vision touted less than a decade ago. Not surprisingly, many have been dismayed by this failure to live up to its original potential. As one commentator recently noted, "some see the institutional and bank interest . . . as a cynical takeover by Big Bizness of a grass-roots social movement that grew out of the rubble of the global financial crisis and deep mistrust of the banks."[79] Yet the magnitude of these changes, coupled with the dramatic growth of the industry, may suggest that the value created by P2P arises from sources other than those originally envisioned. This Part identifies some early-stage lessons—that may yet be proven wrong—based on the evolution thus far. In light of the preliminary stage of this analysis and the challenge of reaching any normative conclusions without examining the broader landscape in which these changes are occurring, the account is largely positive.

I suggest that the demise of the promise initially embodied in P2P may indicate that the benefits that arise from direct transactions in other domains are not present in the same way in finance. Etsy and eBay succeed by connecting disparate buyers and sellers who are exchanging idiosyncratic goods on which different people place radically different subjective values. As explained by Chris Anderson, these sites are part of a larger phenomenon whereby the Internet is facilitating the rise of "new niche market[s]."[80] However, the same is not true for capital. Unlike a secondhand clock or a handmade tea towel, capital is fungible. The parties at each end of the spectrum rarely have any idiosyncratic preferences—each wants to provide or receive capital on competitive, risk-adjusted terms. This Part considers the ways that the fungibility of capital may limit the transformative potential of direct transactions when the exchange is a pure investment. Yet, as the final Part addresses, direct finance may yet be viable, and could even thrive, when the exchange has noninvestment dimensions, for it is along these other dimensions that the presence of individuals is most likely to have tangible benefits that cannot be easily replicated at a lower cost by an intermediary.[81]

A. The Wisdom of Crowds v. the Resources of Experts

---

79. Keith Mullin, *Peer-to-Peer Lending Takes Off . . . P2PABS Anyone?,* IFR ASIA (Mar. 6, 2015), http://www.ifrasia.com/peer-to-peer-lending-takes-off-p2pabs-anyone?/21188145.article.

80. CHRIS ANDERSON, THE LONG TAIL: WHY THE FUTURE OF BUSINESS IS SELLING LESS OF MORE 6 (2008).

81. *See infra* Part IV.

There continues to be a lot of hype surrounding the potential for crowdfunding to fundamentally transform debt and equity markets.[82] It is far too early to conclude that such hype is unwarranted, but the transformation of the P2P market in recent years casts doubt on whether crowdfunding is likely to be as transformative as some suggest. In particular, one purported benefit of crowdfunding, which was reflected in early depictions of P2P, is that bringing the wisdom of crowds to the table might enable the identification of meritorious undertakings that would otherwise go unfunded.[83] P2P, for example, was never intended to replace banks, but it was heralded as likely to overcome shortcomings in the standardized approaches banks employ for most small-scale lending decisions. The assumption was that those approaches, precisely because of their impersonal and routinized nature, had to overlook some creditworthy borrowers, and the wisdom of crowds could identify creditworthy borrowers that did not fit the traditional mold. The subsequent evolution of P2P lending suggests otherwise: the loans underperformed when individuals used their subjective judgments of who seemed creditworthy.[84] Lenders and platforms quickly responded in ways that increased the performance of the loans extended but undermined the degree to which the wisdom of crowds played any role in the screening process.[85]

This does not undermine the possibility that technology and data might succeed in identifying borrowers who are more creditworthy than their credit scores and other traditional metrics suggest. For example, there are a number of start-ups that are experimenting with using new tools to assess whether a borrower is likely to be a good credit risk. Rather than relying heavily on credit scores, these start-ups are exploring ways that new information and technology may be used to develop quite different metrics for assessing a borrower's propensity to repay.[86] One such lender uses a "software-based lending platform" which enables it to consider "thousands of data points" and helps "to reduce the risk of fraud as

82. Ben Sisario, *Pop Acts Go to Highest-Bidding City,* N.Y. TIMES, Oct. 23, 2012, at C4; Nevin Martell, *How to Buy a Little Slice of a Bakery, and Get More Than Crumbs If It's a Hit*, WASH. POST (May 13, 2015), https://www.washingtonpost.com/lifestyle/food/how-to-buy-a-little-slice-of-a-bakery-and-get-more-than-crumbs-if-its-a-hit/2015/05/13/7eab6f58-f811-11e4-a13c-193b1241d51a_story.html.

83. Tanya Prive, *What Is Crowdfunding and How Does It Benefit the Economy*, FORBES (Nov. 27, 2012, 10:50 AM), http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy/.

84. Elaine Moore & Tracy Alloway, *Peer-to-Peer Lending: The Wisdom of Crowds*, FIN. TIMES, May 20, 2014, at 9.

85. *Id.*

86. Steve Lohr, *Creditworthy? Let's Consider Capitalization*, N.Y. TIMES, Jan. 19, 2015, at A1.

well as borrower defaults."[87] The application process is also tailored to the applicant. A borrower who wants money for a security deposit, for example, is asked about when they are moving, where they are moving to, and whether they are changing jobs in the process.[88] These lenders incorporate factors not previously considered—like whether an applicant uses proper capitalization in filling out a form—and alter the weight accorded to other factors that have long played a role in assessing a borrower's propensity to repay a loan, such as missed payments in the past.[89] Longer term, big data may end up devising more accurate criteria for assessing a person's propensity to repay a loan and may transform underwriting in the process. As the screening process improves, the costs of borrowing should go down and the pool of eligible borrowers may well expand. Nonetheless, it is resource-intensive research and development that is allowing for this innovation, not the wisdom of the masses.

Viewing these developments from a different angle, the fact that P2P screening processes increasingly resemble banks' underwriting processes may suggest that banks actually do a pretty good job in determining to whom to allocate credit. New types of expertise may further refine and improve the process, but the wisdom of crowds does not appear poised to fill in meaningful gaps, much less displace established modes of intermediation.[90] If anything, it is intermediaries investing the money of others who will most likely be able to justify the investments required to develop and refine this new technology.

Another necessary coda is that bringing the wisdom of crowds to credit decisions could have some undesirable consequences. At least one study found that that when would-be black borrowers included a picture with their loan request, they were less likely to have their loans funded than would-be white borrowers with similar credit ratings, and, conditional on receiving a loan, black borrowers were likely to pay a higher rate of interest.[91] In addition to finding what the authors characterize as "significant racial discrimination," the

87. *How It Works*, EARNEST, https://www.meetearnest.com/how-it-works (last visited Sept. 11, 2015).

88. *Personal Loans*, EARNEST, https://www.meetearnest.com/personal-loans (last visited Sept. 11, 2015).

89. Lohr, *supra* note 86.

90. The potential for the wisdom of crowds to outperform experts may be greater with respect to other types of crowdfunding. *See, e.g.*, Ethan R. Mollick & Venkat Kuppuswamy, *After the Campaign: Outcomes of Crowdfunding* 13 (UNC Kenan-Flagler, Working Paper No. 2376997, 2014), http://ssrn.com/abstract=2376997; Ethan R. Mollick, Swept Away by the Crowd? Crowdfunding, Venture Capital, and the Selection of Entrepreneurs 2 (Mar. 25, 2013) (unpublished manuscript), http://ssrn.com/abstract=2239204.

91. Devin G. Pope & Justin R. Sydnor, *What's in a Picture? Evidence of Discrimination from Prosper.com,* 46 J. HUM. RESOURCES 53, 55–56 (2011).

study found that lending platforms also "discriminate[] somewhat against the elderly and significantly overweight, but in favor of women and those that signal military involvement."[92] In sum, while the evolution of P2P lending over the brief time examined herein is far too limited of a data set from which to draw any strong conclusions, it does suggest that there is reason to be skeptical that crowdfunding—as opposed to other innovative approaches to underwriting—is likely to be an effective mechanism for identifying creditworthy borrowers overlooked by banks.

B. Banks—Good But Not Perfect

Even if P2P lending today bears little resemblance to the vision initially promised, it has grown at a remarkable pace and seems poised to continue its ascent. That rate of growth suggests that there is real value being created by P2P lending relative to other modes of intermediation. If not from the wisdom of crowds, the question remains from where that value is coming. At least part of the answer likely harkens back to the forces driving the first generation of disintermediation and suggests that there may be more similarities between P2P and securitization and its ilk than was evident initially, even apart from the recent merging of the two innovations.

One inescapable answer regarding value creation is regulation, or rather the avoidance thereof. The United States and other leading countries are in the midst of imposing a broad reform agenda designed to create a more resilient financial system.[93] The 2007–2009 financial crisis served as a reminder that weaknesses in the financial system can have significant and devastating consequences for the real economy. Many of these reforms have targeted banks, particularly large ones.[94] By increasing the amount of capital banks must hold and imposing a number of other new regulatory burdens on banks, the reforms may well strengthen the banking system.[95] Nonetheless, by imposing new costs on banks, the reform agenda has the inevitable effect of increasing the value that can be created by moving activity out of the highly regulated banking sector. Other ways that P2P lending seems to be creating value are by eschewing many of the operational expenses associated with running a bank and expanding the types of investors who can provide capital for personal and other loans.[96]

The rapid growth of P2P lending may also suggest that it is meeting consumer demands that were not adequately addressed by

92. *Id.* at 55.

93. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (codified as amended in scattered sections of 12 U.S.C.).

94. *Id.*

95. *Id.*

96. Moore & Alloway, *supra* note 84.

traditional banks. One of the primary reasons that borrowers seek money from P2P platforms is to pay off credit card debt.[97] The credit card market is competitive, and credit card companies regularly seek to attract new clientele—or expand the business they receive from current, creditworthy clients—by allowing clients to transfer balances from other credit cards and even to receive favored interest rates on those balances.[98] Nonetheless, the terms banks offer to entice clients to transfer existing balances typically also include other features that can substantially increase the effective cost of their credit, particularly if a borrower is not sufficiently discerning.[99] That such structures are so commonplace suggests that even though the credit card market may be highly competitive, competition has led to terms that are attractive along dimensions that are most likely to be salient to potential borrowers but has not necessarily resulted in lowering the cost of funds in the manner one might expect based on a simplified model of competition and credit creation.[100]

Viewed in these terms, P2P loans may offer a different type of product to consumers, one for which there appears to be significant demand. Paying off an outstanding credit card balance with a three-year or five-year loan from a P2P platform avoids any such complications and typically enables the borrower to pay a rate of interest that is significantly lower than the interest rate she had been paying on that balance.[101] Particularly for borrowers who have been burned, or know others previously affected, by failing to be sufficiently wary when using a balance transfer to pay off credit card debt, this may be quite attractive. Lending Club seems to recognize that the structure may be part of what makes P2P loans attractive, as it advertises to would-be borrowers the fact that

97. Ann Carrns, *Online Lending Sites Offer Alternative to Traditional Borrowing*, N.Y. TIMES (Oct. 1, 2014), http://www.nytimes.com/2014/10/02/business/online-lending-sites-offer-alternative-to-traditional-borrowing.html.

98. Sumit Agarwal et al., The Age of Reason: Financial Decisions over the Life-Cycle with Implications for Regulation 13 (Oct. 19, 2009) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=973790.

99. *Id.* (describing one of the most common structures used to encourage borrowers to transfer balances, how borrowers can end up overpaying, and how long it takes different borrowers to figure out the optimal strategy).

100. *See* Oren Bar-Gill & Ryan Bubb, *Credit Card Pricing: The CARD Act and Beyond*, 97 CORNELL L. REV. 967, 978–79 (2012).

101. According to Lending Club, "[b]orrowers who used a personal loan via Lending Club to consolidate debt or pay off high interest credit cards report in a survey that the interest rate on their loan was an average of 7.0 percentage points lower than they were paying on their outstanding debt or credit cards." *Pay Off Credit Cards*, LENDINGCLUB, https://www.lendingclub.com/public/credit-card-loans.action (last visited Sept. 11, 2015).

lending clubs have "[f]ixed rates and payments with no hidden fees."[102]

Whether there are other gaps in the provision of credit by traditional banks that P2P might be able to fill remains to be seen. There have been long-standing debates about whether banks do an adequate job of providing loans to small businesses, and many viewed this potential deficiency as another area where P2P lending might be primed to thrive. The data available, while preliminary, cast doubt on this proposition.[103] A recent study from economists at the Federal Reserve using data from Lending Club found that small business loans were less likely to get funded and more than twice as likely to perform poorly if funded than other types of loans.[104] P2P lending appears to be gaining traction in providing loans for medical needs—a niche that seems to have been serviced, at least in part, outside the banking system even before the entry of P2P.[105]

The aim here is not to provide an exhaustive account of where P2P lending is most likely to succeed but rather to note that the ways in which it has started to emulate traditional financial intermediaries may be a testament to the efficiency of their underwriting procedures. While the particular niches in which P2P lending is growing most rapidly may serve as a roadmap to those sectors of the credit market that have not been as well served by banks and other established intermediaries, the data available support the notion that banks seem to do a pretty good job with screening and credit-allocation decisions.

C. Intermediation Chains Not Easily Shortened

Another implication of the rapid and dramatic changes in P2P lending is that long, complex intermediation chains seem unlikely to disappear anytime soon. Nor do the established players, from banks to institutional investors, seem likely to be displaced. While these firms were not the drivers of the second generation of disintermediation, they have quickly infiltrated and changed the course of the revolution it embodies in the process. This is likely due in part to intermediary influence—that is, the tendency and capacity of entrenched intermediaries to distort the processes

102. *Personal Loans*, LENDINGCLUB, https://www.lendingclub.com/public/personal-loans.action (last visited Sept. 11, 2015).

103. *See* TRACI L. MACH ET AL., PEER-TO-PEER LENDING TO SMALL BUSINESSES (Fed. Res. Bd. Fin. & Econ. Discussion Series, Working Paper No. 2014-10, 2014), http://www.federalreserve.gov/pubs/feds/2014/201410/201410pap.pdf.

104. *Id.* at 5–7.

105. Demos, *supra* note 41; *see also* Mark Calvey, *Lending Club Debuts Education and Patient Financing Services*, S.F. BUS. TIMES (Nov. 12, 2014, 5:42 PM), http://www.bizjournals.com/sanfrancisco/blog/2014/11/lending-club-consumer-finance-education-loans.html.

through which institutions evolve in self-serving ways.[106] But there also appears to be a variety of less troubling forces operating to impede a shift to direct finance.

One factor is that institutional investors enjoy genuine informational and resource advantages over retail investors. As just discussed, it is not yet clear whether the wisdom of crowds can outmatch the advantages enabled by the scale and scope enjoyed by large institutional investors.[107] Screening, monitoring, and diversification are just a few of the many important and otherwise costly services that intermediaries can provide.

The regulatory regime and the policy concerns that animate it also tends to favor intermediation, as reflected in the ways the SEC effectively mandated that P2P lending platforms remain as a node separating those providing and receiving capital through P2P loans. Some informed observers have critiqued the changes the SEC mandated with respect to P2P loans. Professor Andrew Verstein, for example, has persuasively argued that the SEC's approach to regulating P2P lending imposes an "ill-fitting framework" on the industry, and he has identified numerous shortcomings in its approach.[108] The analysis here supports concerns that the SEC may be poorly suited to address many of the challenges posed by direct finance.[109] Nonetheless, the investor protection concerns that underlie the SEC's approach are legitimate and are not going to disappear anytime soon.[110]

D. Looking Ahead

A critical factor underlying the evolution of P2P is that both would-be lenders and borrowers are entering into the transaction for primarily financial reasons. Borrowers want a lower interest rate or a different loan structure than they can readily obtain elsewhere; whether the money comes from an institutional investor or an individual matters less than its availability and terms. Similarly, despite at times being depicted in more romantic terms, the short history suggests that most lenders provide capital for such loans because they expect an attractive rate of return on a risk-adjusted basis. The positive account here suggests that when an exchange is only about capital, the many advantages enjoyed by established intermediaries will make them difficult to displace completely. Capital is fungible. Moreover, even when new modes of intermediation arise, the advantages that established players and modes of intermediation enjoy may well enable them to infiltrate the new domain.

106. Kathryn Judge, *Intermediary Influence*, 82 U. CHI. L. REV. 573, 577 (2015).

107. *See* Parsont, *supra* note 45, at 321–23; *see also supra* Subpart II.A.

108. Verstein, *supra* note 32, at 488.

109. *See infra* Part IV.B.

110. *See infra* Part IV.B.

Yet it does not follow that the move to direct transactions observable in other settings is destined to bypass capital raising. Stepping back from the focus on P2P lending to take in the broader landscape reveals that this movement is starting to infiltrate the process of raising capital in ways that may prove more enduring. Examining the success of Kickstarter and the ascendant "locavesting" movement, this next Part suggests that direct transactions may yet thrive. The key distinguishing factor is likely to be whether the exchange entails at least some nonfinancial dimensions.

III. Looking Beyond P2P

The analysis thus far has focused almost exclusively on P2P lending. Its evolution may well have lessons for crowdfunding more generally, but there are limits to what can be inferred from one domain of this broader phenomenon. The importance of looking beyond P2P to develop a more balanced assessment of the viability of crowdfunding is reflected in signs that the wisdom and participation of crowds may have value in some settings. For example, a recent study on the outcomes of equity crowdfunded firms in Europe found that "the firms on average experience a peak in both sales and sales growth during the year after the campaign, and that this tends to be positively impacted by a larger number of investors through the campaign."[111] The study further found that "the campaign on average helped the firms to gain press attention and publicity."[112] In other words, equity crowdfunding may be beneficial for firms and may also provide benefits to retail investors in ways that go beyond the pure investment dynamics of the exchange. Without purporting to provide a comprehensive account, this Part focuses on a few areas where crowdfunding appears to be gaining traction in order to consider the limits to the assessment here that true direct finance is unlikely to displace established financial intermediaries and long, complex intermediation chains anytime soon.

A. Kickstarter

Among the most successful crowdfunding platforms is Kickstarter.[113] Billing itself as "a new way to fund creative projects," Kickstarter enables filmmakers, musicians, artists, videogame designers, and other types of entrepreneurs to propose

111. Maxence Décarre & Emelie Wetterhag, Uncovering the Outcomes of Equity Crowdfunding: Post-Funding Outcomes of Equity Crowdfunded Firms in Europe 6 (Dec. 8, 2014) (unpublished M.S. thesis, Stockholm School of Economics), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2545276.

112 *Id.* at 7.

113. *E.g.*, Stephen Heyman, *Keeping up with Kickstarter,* INT'L N.Y. TIMES, Jan. 15, 2015, at 11. For an overview of Kickstarter and crowdfunding more generally, see Ethan R. Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1 (2014).

"projects, big and small," and it has helped entrepreneurs finance projects ranging from a theatrical production[114] to a new line of yoga clothing.[115] A typical proposal features some information about the entrepreneur and the proposed project, but also includes an array of other material—like pictures, videos, and stories—intended to capture the spirit of the proposal and otherwise engage with would-be funders.

There are many similarities between Kickstarter and the original paradigm for P2P lending. The platforms in both settings facilitate connections between would-be suppliers of capital and those seeking capital. In both settings, technology plays a critical role connecting persons who may be geographically and otherwise quite distant. Platforms in both settings allow would-be funders to search for particular types of projects or would-be borrowers and to choose the size of the commitment that they are willing to make. Similarly, funding of a Kickstarter project, just like the funding of a P2P loan, is contingent upon the project receiving commitments that satisfy the amount requested, and most commitments cover only a small portion of the amount requested, so it is only when there is broad support for a project or loan that it gets funded.

Yet there are also notable differences between Kickstarter and P2P lending. Most importantly, in contrast to P2P lending and many other forms of crowdfunding, the persons providing the capital to support a project do not get any economic rights in exchange for that capital, nor do they have any rights with respect to the project. Rather, funders are typically provided a promise of an opportunity or good related to the project being funded along with any utility they may derive from feeling like they are part of the creative process or supporting the person or project they have committed to support.[116] The opportunities and goods that funders of various levels will receive are established by the entrepreneur when he or she proposes a project and are often closely tethered to the proposed undertaking. Other motivations, according to one serial funder, include "providing encouragement" and "trying to help someone bring their project to life."[117] Kickstarter similarly

114. *The Grand Paradise*, KICKSTARTER, https://www.kickstarter.com/projects/thirdrailprojects/the-grand-paradise (last visited Sept. 11, 2015).

115. *Go Commando with Dear Kate Yoga Pants*, KICKSTARTER, https://www.kickstarter.com/projects/1527229560/go-commando-with-dear-kate-yoga-pants (last visited Sept. 11, 2015).

116. For this reason, Kickstarter and its kin are deemed "reward-based crowdfunding" in the relevant literature. *See, e.g.*, Décarre & Wetterhag, *supra* note 111, at 6.

117. Philip Reed, *Five Reasons I Back Kickstarter Projects*, BATTLEGRIP.COM (Apr. 9, 2013), http://www.battlegrip.com/five-reasons-i-back-kickstarter-projects/.

highlights that while some funders are "motivated to pledge by a project's rewards," others are motivated by aims like "supporting a new effort from someone they've long admired," and, in each instance, a commitment of support is a way to "pledg[e] . . . support to a creative idea that [the funder] want[s] to see exist in the world."[118]

The range of projects is far more diverse and colorful than the range of loan opportunities one typically can find on a P2P platform, and the overall process of reviewing options is a very different experience for the would-be Kickstarter funder than the would-be P2P lender. Reviewing potential loans on Lending Club entails sorting through a lot of numbers, letter credit ratings assigned by the platform, and some additional information, which today tends to be quite limited and dry. The Kickstarter interface, by contrast, takes a user into a visually rich and stimulating environment full of videos, pictures, and stories. This is relevant to the analysis here as it highlights that the service Kickstarter is providing to both funders and entrepreneurs has dimensions that have little to do with the capital exchanged. In order to explore further, it is helpful to consider some of the types of projects that get proposed.

Some projects are small- to medium-scaled endeavors in the arts. For example, "The Being of Nothingness Project" is a proposal for a "7.20 min dance film of the 2013 creation *Being and Nothingness (Part 1)*, set on Prima Ballerina Greta Hodgkinson and choreographed by Guillaume Côté."[119] Supporting material included a video with a discussion by the creators, dance clips, and reviews of the dance when it was performed live. Funders providing $10 received "THANKS!" from the creators, while those providing $200 were treated to a personal "thank you" on the creator's Twitter handle, unlimited viewing access to the video upon release, recognition as a 'Supporter' in the film credits, and "an autographed pointe shoe from Greta Hodgkinson."[120] The project, which aspired to raise at least CAD $14,900, exceeded its goal and raised CAD $19,408.[121]

In these instances, Kickstarter is making patronage of the arts accessible even to those with modest amounts to give while also providing supporters with preferential access to the project created or its creators. From the perspective of the creators, obtaining funding in this way can also serve as a marketing device, a

118. *Kickstarter Basics: Kickstarter 101*, KICKSTARTER, https://www.kickstarter.com/help/faq/kickstarter%20basics (last visited Sept. 11, 2015).

119. *The Being and Nothingness Project*, KICKSTARTER, https://www.kickstarter.com/projects/740176627/the-being-and-nothingness-project/description (last visited Sept. 11, 2015).

120. *Id.*

121. *Id.*

mechanism to broadcast information about the undertaking to a receptive audience and to build enthusiasm for the project in the process.[122] Particular features of the Kickstarter site, like the ability of a funder to broadcast through various forms of social media her decision to fund a project, amplify these effects, enabling the funders to advertise their patronage while simultaneously spreading information about, and endorsing, the project. Kickstarter also serves as a valuable mechanism for creators to gauge the level of interest in a proposed project. When a project fails to achieve its minimum funding goal—which precludes the creators from receiving even the funds that have been offered—the entrepreneurs learn valuable information about the degree of interest in the project. While it may be disappointing for a creator to learn that there is little interest in the short documentary he was hoping to make with funds from Kickstarter, the filmmaker may be well served to learn this before undertaking the project than after investing his own money and time in it.

At other times, the exchange is more akin to a sale, contingent upon the project being funded and the good created. For example, when DrinkTanks, a small company in Bend, Oregon, that aims to "revolutionize personal beer containers,"[123] sought to create a new product that would be the "world's largest growler & personal keg," it turned to Kickstarter.[124] To encourage would-be funders to give money to support the development of the proposed 128-ounce Juggernaut Growler, the company included a video featuring the company's founder and CEO, in a plaid shirt and baseball cap, explaining his vision and drinking beer with friends. The company also promised different types of goods depending on the level of support provided. Funders providing twenty-five dollars would receive their choice of a branded baseball cap or fitted tee, while early funders who provided ninety-nine dollars or more received a Juggernaut Growler in their choice of "12 stylish finishes" along with a Kegulator that could be attached to provide carbonation.[125]

While the nature of the exchange for these types of projects is more akin to a retail sales transaction than patronage of the arts, the benefits that inure to both the funder and the entrepreneur go beyond the exchange of capital in similar ways. The entrepreneur gets feedback about the market demand for the proposed project

---

[122] Venkat Kuppuswamy & Barry L. Bayus, *Crowdfunding Creative Ideas: The Dynamics of Project Backers in Kickstarter* 26 (UNC Kenan-Flagler, Working Paper No. 2013-15, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2234765.

[123] *About Us*, DRINKTANKS, http://www.drinktanks.com/about-us/ (last visited Sept. 11, 2015).

124 *DrinkTanks Offers the World's Largest Growler & Personal Keg*, KICKSTARTER, https://www.kickstarter.com/projects/584321487/drinktanks-offers-the-worlds-largest-growler-and-p (last visited Sept. 11, 2015).

125. *Id.*

while also generating publicity and demand when a project is positively received. Similarly, the funders usually commit at levels that allow them to obtain prototypes or other tangible goods related to the project proposed. Just as in other sales transactions, the commitments likely indicate that the subjective value that the funder places on the good exceeds the amount he is willing to commit to the undertaking. The transaction is still capital raising—the creator is seeking funds in order to pursue a particular project—and because it is occurring at a point in time before the good is actually created, the person providing the funds is necessarily assuming a degree of risk that would not be present in a retail transaction. Yet the process of raising capital is bundled with an exchange of other goods that are also valuable to the creator and the funder. Also notable is that the party providing the capital does not receive an equity or debt claim in the firm or undertaking; the funder receives something in exchange, but not the right to a financial return on the capital she provides.

The importance of Kickstarter's capacity to incorporate capital raising into a thicker exchange that entails nonfinancial components is reflected in the increasing tendency for entrepreneurs who may have had access to financing through other avenues to instead raise funds through Kickstarter. For example, a recent study of hardware start-ups suggests that Kickstarter may be starting to function as a complement to the angel investors or venture-capital firms that entrepreneurs in this space traditionally relied on for financing.[126] The study found that using Kickstarter enabled such firms to delay seeking capital from angels or venture capitalists, while also garnering excitement and demonstrating their promise to potential investors.[127] Based on interviews with more than eighty entrepreneurs who raised funds on Kickstarter, the author concluded that most entrepreneurs believed that "the biggest takeaway they had was in fact the [funders]."[128] This is because those funders and others who contemplate supporting a project provide "comments, feedback, and FAQs" that can "shift[] and shape[] the entire direction of the company going forward."[129] From

126. Matt Ward, *Why Hardware Startups Should Screw VC and Go Straight to Crowdfunding*, VENTURE BEAT (Nov. 29, 2014, 10:55 AM), http://venturebeat.com/2014/11/29/why-hardware-startups-should-screw-vc-and-go-straight-to-crowdfunding/.

127 *Id.*

128. *Id.*; *see also How Much Venture Capital Are Kickstarter and Indiegogo Hardware Projects Raising?*, CB INSIGHTS (Aug. 11, 2014), https://www.cbinsights.com/blog/crowdfunded-venture-capital-hardware/ (finding that "Kickstarter-backed hardware projects have raised over $268M" from venture capitalists and that 9.5% of hardware startups raising at least $100,000 through Kickstarter or Indiegogo subsequently get venture capital funding).

129. Ward, *supra* note 126.

the perspective of the author, this feedback and the changes it triggers is "invaluable and it's something no venture-capital firm can replicate."[130]

B. "Locavesting"

Another domain where direct connections between the suppliers and recipients of capital are gaining some traction is an activity known as "locavesting." Building on the "shop local" movement, the "invest local" movement encourages individuals to preferentially deploy capital to fund local businesses. As explained by Amy Cortese, who coined the term, "[t]he idea is that, by investing in local businesses, rather than, say, a faceless conglomerate, investors can earn profits while supporting their communities."[131] Like the original paradigm of P2P lending, the movement arose in part to appeal to persons with capital to invest who were "[t]ired of . . . Wall Street," and the aim was to provide investors at least some return on their capital.[132] Yet, once again, there are differences.

Locavesting was always about providing funders with something more than just an economic return on investments. It also sought to facilitate the opening and ongoing operation of independent businesses, to forge stronger relationships between businesses and members of the communities they serve, to promote economic activity in a region, and to otherwise promote community engagement.[133]

While some examples of locavesting arise from person-to-person interactions, technology is also playing a role in expanding opportunities for both would-be funders and borrowers. For example, residents of Seattle who want to support local businesses can now do so through Community Sourced Capital, a crowdfunding platform through which residents can make loans to local

130. *Id.* (noting that crowdfunding through a site like Kickstarter can create "a community of incredibly supportive and innovative early adopters"); Jing Cao, *How VCs Use Kickstarter to Kick the Tires on Hardware Startups*, BLOOMBERG BUS. (Aug. 11, 2014, 11:03 AM), http://www.bloomberg.com/news/2014-08-08/how-vcs-use-kickstarter-to-kick-the-tires-on-hardware-startups.html ("A crowdfunding campaign allows a VC to 'talk to customers, track return and/or failure rates, and then fund expansion with real data,' said Barry Schuler, managing director at DFJ Growth.").

131. Amy Cortese, *Locavestors*, N.Y. TIMES MAG., Dec. 12, 2008, at 63.

132. AMY CORTESE, http://www.amycortese.com/Amy_Cortese_homepage.html (last visited Sept. 11, 2015).

133. Anne Field, *'Locavesting' Meets Crowdfunding Meets Social Entrepreneurship*, FORBES (Nov. 24, 2013, 10:07 AM), http://www.forbes.com/sites/annefield/2013/11/24/locavesting-meets-crowdfunding-meets-social-entrepreneurship/; Danielle Sacks, *"Locavesting": Investing in Main Street Instead of Wall Street,* FAST COMPANY (Aug. 3, 2011, 12:40 AM), http://www.fastcompany.com/1771064/locavesting-investing-main-street-instead-wall-street (interview with Amy Cortese).

enterprises.[134] Would-be lenders commit to support a project at a level between $50 and $250 and would-be borrowers can seek loans of up to $50,000.[135] In its first year, the site raised "$175,000 in loans for 12 businesses from over 1,000 community lenders."[136]

Connecting to the broader picture, the assumption underlying locavesting is that many individuals with capital to deploy place a positive subjective value on living in a community with particular attributes or derive pleasure from feeling like they are helping particular types of businesses. Some individuals may prefer to live in a community where there are a lot of small businesses and relatively few conglomerates. Apart from moving, which may be quite costly and even impossible depending on a person's circumstances, these are not goods that individuals can easily acquire or support in isolation. Expressing these preferences through a willingness to accept a significantly lower economic return on capital invested may thus be a compelling combination for some investors. While there are intermediaries, like Community Sourced Capital and local stock exchanges, that play a role in connecting the supplier and recipients of the capital, the nature of the relationship is premised on geographic proximity and a greater effort to promote a sense of connection within a community. Relatively short intermediation chains are thus central to making the design work. Whether locavesting will take off and how it might evolve in the process remains to be seen, but it does appear to be another area where direct finance may be gaining a foothold.

IV. The Future of Direct Finance

All of the different transactions described here, along with a host of others, fall under the general rubric of crowdfunding. In each, the provision of capital remains central—individuals (and now others) are providing capital to other individuals or small-scale enterprises as part of an agreement that provides that they will receive something in exchange, and the probability that the person will actually receive the good promised often depends on the capacity of the entrepreneur to successfully undertake the project proposed. Yet there are significant differences between P2P lending on one hand, and Kickstarter and locavesting on the other. P2P is primarily a financial exchange. While early adopters may have derived some nonpecuniary utility from knowing that they were providing a loan to someone who they felt deserved it, the rapid evolution of P2P lending and the increasing reliance of even individual investors on automated tools when making loans suggest that the nonfinancial dimensions were far outweighed by the financial ones. The same is not true with respect to the typical

134. Field, *supra* note 132.
135. *Id.*
136. *Id.*

Kickstarter or locavesting opportunity. Locavesting is based on the premise that the persons providing capital are willing to forego some return or assume greater risk because that person providing the capital derives some nonpecuniary utility from the exchange. The nonpecuniary dimensions are even more central to the exchanges that occur through Kickstarter, as even when the provider of capital expects something tangible in exchange for the capital provided, that person has no economic stake in the firm or project he is helping to fund. That Kickstarter has been so successful suggests that there may be advantages to packaging the provision of capital in a bundle with these other goods and services. Similarly, locavesting demonstrates the ways that bundling the provision of capital with other idiosyncratic preferences may enable retail investors to express preferences and acquire goods that are not readily accomplished in other ways. This Part very briefly considers the theoretical and policy implications of the demise of P2P lending alongside the success of platforms like Kickstarter.

A. Theoretical Implications

While crowdfunding may seem like a new trend, it has deep roots. People loaning money to people is far from a new phenomenon; neither is raising capital from persons who have a stake in an undertaking apart from the financial returns on their investment. As Henry Hansmann and Mariana Pargendler have shown in a wonderful account on the evolution of shareholder voting rights for many late eighteenth- and early nineteenth-century corporations, "the principal shareholders were also the firm's principal customers."[137] This is because "local merchants and farmers were apparently the most effective source of capital" at the time.[138] Yet, Hansmann and Pargendler's account also suggests that legal and other innovations during the intervening years help explain the decline of customer-owned firms and the prominence of investor ownership today.[139] The overall account, which is not limited to the United States, suggests a progressive movement toward "business corporations" in which "shareholders . . . are generally investors whose primary, and typically only, interest in the firm is to obtain a financial return."[140]

Recent theory suggests that ongoing innovations may result in even more extreme unbundling. For example, Charles Whitehead and Ronald Gilson suggest that "the continued development of increasingly complete capital markets, in which working capital can be separated from risk capital and discrete slices of risk can be

137. Henry Hansmann & Mariana Pargendler, *The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption,* 123 YALE L.J. 948, 951 (2014).

138. *Id.*

139. *Id.* at 991–1001.

140. *Id.* at 1007.

separately transferred, pooled, and shared among market participants, has called . . . into question . . . the traditional need for residual shareholders, whose risk exposure spanned the marketplace."[141] The literature thus largely highlights the ways that increasingly robust legal institutions and financial innovations may enable ever-greater splicing of interests, which in turn should lower the cost of capital by allowing persons to hold just the slice that they are best suited to provide. In short, the assumption has largely been that innovation should enable ever-greater specialization, and that will benefit all involved.

The growth of Kickstarter as a funding model suggests that these analyses, while not wrong, are incomplete. They accurately highlight the way that financial, technological, and institutional improvements enable interests to be separated into ever-more narrow components. And it will often be optimal in light of these developments for rights and obligations previously bundled together to be unbundled and allocated in ways that optimize the different interests and institutional capacity of an ever-growing array of stakeholders. In some ways, Kickstarter represents a point further along this continuum—entrepreneurs often go to Kickstarter to obtain capital for projects that they likely will not undertake without the fresh capital, and the ability to offer nonfinancial commitments in return may well enable fundraising that would not have occurred otherwise. Yet among the reasons for an entrepreneur to use Kickstarter in lieu of an alternative mode of raising capital is that the site allows her to do more than just raise capital. By seeking capital through a channel that is designed to simultaneously further other aims, like enabling the entrepreneur to learn more about the demand for her proposed undertaking and building excitement for it, an entrepreneur may be able to obtain a package of desired goods at a much lower price than she would be able to if she sought these various goods unbundled from the others.

Locavesting, while still in its infancy, represents a particularly intriguing form of bundling as it illustrates the ways that bundling may be used to promote the creation of goods that are not otherwise easily funded through private mechanisms. Many individuals today seem to place genuine value on living in a town with a high number of small, locally owned businesses or in a region with a vibrant local economy. Yet, like many public goods, the challenges that regularly impede collective action may make it difficult for these attributes to be produced and maintained at the socially optimal level. Bundling the creation of such goods with capital raising does not overcome the collective action challenges—even individuals who desire such public goods might be better off free riding on the efforts of others to

141. Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets,* 108 COLUM. L. REV. 231, 232–33 (2008).

support them—but it does provide an innovative way for persons in the community to support small businesses that might not be viable otherwise.

The niches where direct finance appears to be taking hold highlight the ways that nonfinancial innovations may shape the future of finance. Thanks to improvements in social media, for example, a person who decides to fund a particular venture or to support a local undertaking can immediately broadcast that decision to all of his friends, family, and followers through an array of digital networks. In such an environment, the ability to couple capital provision with publicity that enhances the reputation of both funder and undertaking may well be more efficient than efforts to acquire these goods outside the capital-raising process, and such bundling might also enable the expression of preferences and the attainment of benefits that are not readily conveyed or captured in other ways. The process of providing capital in the early stages of an enterprise might also enable funders to feel as though they are part of the undertaking—shouldering the risks and sharing in the gains—in a way that was rarely accessible to those with limited means prior to the rise of Kickstarter and similar platforms.

Juxtaposing this brief examination with the changes that have occurred in P2P lending suggests that direct finance may be on the rise, but it is more likely to thrive when one or both parties enjoy nonpecuniary gains from the transaction. It is along these nonfinancial dimensions that the presence of individuals, who know their own idiosyncratic preferences better than any intermediary and who can provide other information or goods that no intermediary can readily replicate, is most likely to yield sufficient value to outweigh the benefits that intermediaries can provide.

The data points examined here are too few and too dynamic to enable any meaningful conclusions to be drawn about whether and where direct finance will be viable. Nonetheless, the additional data available are consistent with the notion that direct finance is more likely to thrive when the exchange involves something more than a pure investment. Another successful crowdfunding site, for example, is Kiva.[142] The site works with non-governmental organizations and other organizations to identify persons across the globe who may benefit from microloans. Lenders screen the profiles of would-be borrowers, choose how to allocate their funds, and while they typically earn their money back, they receive the satisfaction of knowing that they helped create credit and thereby opportunity for someone in need in lieu of any interest.[143] Similarly, the failure of

142. *E.g.*, Verstein, *supra* note 33, at 513–17.

143. *Id.*; *see also* Natricia Duncan, *Crowdfunding Development: 'Kiva's Aim Is to Make Microfinance Easy'*, GUARDIAN (June 10, 2014, 6:13 AM), http://www.theguardian.com/global-development-professionals-network/2014/jun/10/crowdfunding-for-development; Scott E. Hartley, Kiva.org:

P2P equity crowdfunding to take off despite the hype surrounding the Jumpstart Our Business Startups ("JOBS") Act does not bode well for its viability as a mode of financing, unless it can be used to simultaneously build excitement or provide firms something more than access to capital.[144]

B. Policy Implications

The main policy discussions about crowdfunding thus far have focused on how to enable crowdfunding despite the rigorous disclosure and other obligations that securities laws typically impose on any firm that seeks to raise capital from the public.[145] As reflected in the JOBS Act and the SEC's recently adopted rules, colloquially known as Regulation A+, there are efforts underway to facilitate crowdfunding.[146] At the same time, it took the SEC years to promulgate rules implementing the crowdfunding provisions of the JOBS Act, and experts believe that the crowdfunding allowed pursuant to the final rules will "only make sense for more established companies seeking at least several million dollars in capital."[147] The question of how to appropriately balance the investor protection concerns, the value of enabling smaller companies to raise funds directly from the public and the other issues implicated in current debates about equity crowdfunding, while far from resolved, have been the subject of extensive and ongoing discussion among the SEC, academics, and other commentators.[148]

The analysis here should contribute to that ongoing discussion. The SEC and the securities laws it enforces are likely going to impose frictions on any exchange in which rights that could be deemed a security are among those provided to parties providing

---

Crowd-Sourced Microfinance and Cooperation in Group Lending 14–15 (Mar. 2010) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572182.

144. *See supra* Subpart II.A.

145. *See* 17 C.F.R. § 230 (2015).

146 Jumpstart Our Business Startups ("JOBS") Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.); *see generally* Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735 (2012) (discussing the impact of the JOBS Act on crowdfunding).

147 Daniel Huang, *Small Crowds Get Their Day in Investing Sun*, WALL STREET J., June 18, 2015, at C3.

148 *See, e.g.*, Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Exchange Act Release No. 33-9741, 2015 WL 1788375 (Mar. 25, 2015); C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1 (2012); Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879 (2011); Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457 (2013).

capital, but the speculations here also open up a range of other potentially interesting policy issues. The trend of uncoupling the provision of capital from other dimensions of an undertaking not only affected the evolution of shareholder voting, but also the evolution of the institutions that evolved to support the capital-raising process. One reason the SEC is already so deeply enmeshed in these debates is that most capital raising in the United States now falls under its jurisdiction. Consumer protection issues, by contrast, are typically addressed by the Federal Trade Commission ("FTC") and state consumer protection laws. And, to the extent the law plays any role in patronage for the arts and other creative endeavors, it is typically through contract and state laws enabling the creation of nonprofit firms.

There is meaningful overlap in the aims animating these disparate bodies and sources of law. Concerns about fraud, for example, arise across these different domains and are likely to arise in connection with direct finance as well. Whenever someone is giving money today in exchange for promises that will only be fulfilled at some point in the future, fraud is likely to be a concern. In addition to being an issue with respect to which disparate bodies of law likely pursue a common aim, this is also an area with respect to which the current legal and regulatory scheme suffices. The FTC, for example, has already gotten involved in this space when it identified a Kickstarter campaign in which the entrepreneur used the money received for personal and other expenses unrelated to the proposed undertaking.[149]

Yet there are also significant differences in these regimes, the aims they seek to further, and in the types of benefits cognizable in each. The notion of market efficiency that animates much of securities law, for example, has no parallel in the world of patronage for the arts, and may even seem contrary to the spirit of such patronage. When the return on an investment thus includes both economic rights and intrinsic satisfaction, it may become far more difficult for any single agency or actor to assess and understand the legitimacy of an exchange.

A related issue is that even with the recent changes promulgated pursuant to the JOBS Act, these disparate regimes and the requirements typically imposed on the issuance of anything that might be deemed a security significantly curtail the types of bundles entrepreneurs can offer to potential funders. In particular, entrepreneurs today cannot readily raise capital by offering packages of rights that include both nonpecuniary benefits of the types typically offered through Kickstarter and economic rights in the project that would enable funders to enjoy a portion of the

[149] Rebecca R. Ruizjune, *F.T.C. Reaches Settlement in a Kickstarter Scheme*, N.Y. TIMES, June 11, 2015, at B2.

upside should a project prove exceptionally successful. This limitation may be justified by investor protection concerns and is likely mitigated somewhat by the capacity for an entrepreneur to engage in multiple rounds of capital raising from different types of sources. Nonetheless, there may be projects that could get funded if there was greater flexibility across these different lines. For example, a filmmaker who could promise capital providers the opportunity to be part of the creative process and a sliver of the upside should the film prove to be exceptionally successful, might be able to fund a project she could not fund if unable to offer such a bundle or forced to comply with even the more lenient obligations imposed by Regulation A+.

Also noteworthy is that the fuzziness between these lines is creating problems even within the current regulatory scheme. This is illustrated in funder responses to both extremely successful and exceptionally unsuccessful Kickstarter-funded projects. When virtual-reality firm Oculus Rift was acquired by Facebook for $2 billion after raising capital through a Kickstarter campaign and from venture capitalists, for example, many of the persons who had provided capital through the Kickstarter campaign were angry that the venture capitalists enjoyed "20-fold return on their initial investments" while the Kickstarter funders received nothing more than the prototypes and other goods they had been promised when they made their commitments.[150] Kickstarter funders who supported a project to create a new type of espresso machine in exchange for promises that they would receive the machine once it went into production similarly rallied together in frustration when that firm followed a very different trajectory—failing to produce the promised espresso machines, and then just failing.[151] That some funders are unhappy does not necessarily mean there are issues that the law should address, but these various voices of discontent suggest that consumers/investors may be as unfamiliar as regulators and other policymakers with the new paradigm embodied in Kickstarter and its kin.

Crowdfunding and new forms of direct finance remain young and dynamic, making it difficult to foresee how these practices will evolve and the policy issues that will prove most pressing. Making it easier for smaller firms to raise capital and otherwise ensuring that the disclosure and other obligations designed for larger companies do not excessively stifle the capacity for other types of firms and entrepreneurs to raise capital from the public may well be

---

150 *E.g.*, Jillian Berman, *I Backed Oculus Rift on Kickstarter and All I Got Was This Lousy T-Shirt*, HUFFINGTON POST (Mar. 26, 2015, 10:17 AM), http://www.huffingtonpost.com/2014/03/26/oculus-rift-kickstarter_n_5034511.html.

151 *E.g.*, Gideon Lewis-Kraus, *ZPM Espresso and the Rage of the Jilted Crowdfunder*, N.Y. TIMES MAG., May 3, 2015, at MM61.

the appropriate focal point for current debate. Nonetheless, the analysis here does suggest that policy discussions focused solely on how to expand the scope of firms that can use crowdfunding to raise capital may miss some of the more interesting policy issues that direct finance might raise, and may inadvertently curtail the forms of direct finance most likely to create value that cannot be realized in other ways. The benefits and drawbacks of exchanges that bundle equity or debt issuances with nonpecuniary rewards, for example, are topics that may merit more attention than they have received thus far. Policymakers may also be better positioned to gauge the full range of issues at stake in such exchanges if these issues are explored by multi-disciplinary groups of regulators who may be attuned to different benefits and challenges.

Conclusion

In contrast to a long-standing trend in the opposite direction, recent innovations have enabled more direct transacting between the suppliers and recipients of capital. Many of the social and technological advances driving this trend in other domains have also started to transform finance, leading many to hope that we may be on the dawn of a new era of direct finance. The rapid evolution of P2P lending suggests that the promise of a world in which individuals regularly exchange capital among themselves with little aid from established financial intermediaries is unlikely to be realized anytime soon. Intermediation chains remain long and complex, and institutional investors continue to enjoy a number of regulatory and other advantages over individuals seeking to invest funds in productive undertakings. Yet there are also indications that direct finance may yet thrive. Particularly as technology is harnessed to couple the provision of capital with publicity or other goods or services, the suppliers and recipients may each derive additional benefits upon which they place unique subjective values. Once the exchange takes on these additional dimensions, the benefits of direct finance may outweigh the other factors that weigh in favor of longer chains. Ultimately, these gains may be realized only if regulators are willing to go outside of their comfort zones and work across agency bounds to understand the benefits and drawbacks of such bundling.