4-2013

Cyberfinancing for Economic Justice

Lisa T. Alexander
Texas A&M University School of Law, ltalexander@law.tamu.edu

CYBERFINANCING FOR ECONOMIC JUSTICE

LISA T. ALEXANDER*

ABSTRACT

This Article argues for the socially optimal regulation of online peer-to-peer (P2P) lending and crowdfunding to advance economic justice in the United States. Peer-to-peer lending websites, such as Prosper.com or Kiva.org, facilitate lending transactions between individuals online without the involvement of a traditional bank or microfinance institution. Crowdfunding websites, such as Kickstarter.com, enable individuals to obtain financing from large numbers of contributors at once through an open online request for funds. These web-based transactions, and the intermediary organizations that facilitate them, constitute emerging cyberfinancing markets. These markets connect many individuals at once, across class, race, ethnicity, nationality, space, and time in an interactive and dynamic way. During a time of significant economic distress in the United States, these markets also represent an unprecedented economic development opportunity for historically marginalized economic actors. Yet, no legal scholar has addressed the implications of these developments for economic justice in the United States. Drawing from the fields of law and geography, social networking theory, and comparative institutional analysis, this Article conceptualizes these new markets as "cyberspaces," similar to geographic spaces, whose laws, norms, and rules will partially determine who will benefit from the economic opportunities that arise in these spaces. The recently enacted Jumpstart Our Business Startups (JOBS) Act does not facilitate substantial distributive justice in crowdfunding markets. The U.S. Government Accountability Office (GAO), which produced a report in response to the 2010 Dodd-Frank Wall Street Reform Act's mandate that it study the P2P lending industry, has also failed to recommend a regulatory structure

* Assistant Professor of Law, University of Wisconsin Law School; J.D., Columbia University School of Law; B.A., Wesleyan University. I am grateful to Scott Cummings, Nestor Davidson, Rashmi Dyal-Chand, Lisa Fairfax, Hari Osofsky, Michael Schill, Neil Komesar, Mark Sidel, Elisabeth Mertz, Heinz Klug, Alexandra Huneeus, and Susannah Camic-Tahk for their comments on drafts of this Article. I thank, for their comments, participants at the Creativity, Law & Entrepreneurship Conference sponsored by the University of Wisconsin Law School, the Institute for Legal Studies, the Initiative for Studies in Technology Entrepreneurship (INSITE), and the Global Legal Studies Center, who provided comments on early drafts. Lastly, thanks to Michael Solberg and Amy Jahnke for their able research assistance.

that will facilitate economic justice. This Article recommends that a range of federal regulators such as the U.S. Securities and Exchange Commission (SEC), the new Consumer Financial Protection Bureau (CFPB), and the U.S. Treasury Department (Treasury), should collaborate to implement a revised Community Reinvestment Act (CRA) that would promote economic justice in these markets.

TABLE OF CONTENTS

INTRODUCTION

Social networking via the Internet now presents an unprecedented opportunity to link previously disconnected populations. Web 2.0 technologies[1] create participatory communities of interest that link the poor and the wealthy and defy the traditional limitations of geographically-bounded space. Mobile phones now provide inexpensive Internet access, mitigating the digital divide between poorer and richer consumers and enabling poorer individuals to access Web 2.0 technologies.[2] Wealthy individuals can now lend to poorer individuals, residing in any location, via peer-to-peer (P2P) lending websites such as Prosper.com or Kiva.org.[3] These websites enable individuals to lend to one another online without the intermediation of a traditional bank or financial institution. Crowdfunding[4] websites, such as Kickstarter.com, now enable budding entrepreneurs, residing anywhere that has Internet access, to raise capital from individuals by soliciting contributions, or equity investments, through an open online call for funds. These crowdfunding websites help entrepreneurs connect with large numbers of people at once, across the globe, to seek financing.

During a time of economic distress in the United States,[5] these cyberfinancing websites present new economic development opportunities for inexperienced, geographically isolated and historically marginalized economic actors. Yet, no legal scholar has addressed the implications of these developments for economic justice[6] in the United States.[7] Drawing from the

---

[1] The term Web 2.0 generally describes web applications that facilitate "participatory information sharing, interoperability, user-centered design and collaboration on the Internet or World Wide Web." *Web 2.0*, COMPUGAIN, http://www.compugain.com/taxonomy/term/43/0 (last visited Mar. 23, 2013).

[2] RICHARD HEEKS, DEVELOPMENT 2.0: TRANSFORMATIVE ICT-ENABLED DEVELOPMENT MODELS AND IMPACTS 1 (Development Informatics Short Paper No. 11, 2010), *available at* http://www.sed.manchester.ac.uk/idpm/research/publications/wp/di/sh ort/di_sp11.pdf.

[3] *See, e.g.*, PROSPER.COM, http://www.prosper.com (last visited Mar. 23, 2013) ("We connect people who want to invest money with people who want to borrow money."); KIVA.ORG, *Loans That Change Lives*, http://www.kiva.org/home (last visited Mar. 23, 2013) ("Empower people around the world with a $25 loan.").

[4] "Crowdfunding is an approach to raising capital for new projects and businesses by soliciting contributions from a large number of stakeholders" through Internet-based social networking sites. CROWDSOURCING.ORG, http://www.crowdsourcing.org/community/crowdfunding/7 (last visited Mar. 23, 2013).

[5] *See* Hope Yen, *U.S. Poverty on Track to Rise to Highest Since 1960s*, HUFFINGTONPOST.COM (July 22, 2012), http://www.huffingtonpost.com/2012/07/22/us-poverty-level-1960s_n_1692744.html (explaining that economists predict that "[t]he official poverty rate will rise from 15.1 percent in 2010; climbing as high as 15.7 percent," increasing the ranks of America's poor to levels unseen in nearly half a century).

[6] The term, economic justice, as used here includes the concept of distributive justice, defined as "[j]ustice owed by a community to its members, including the fair disbursement

fields of law and geography, social networking theory, and comparative institutional analysis, this Article conceptualizes these websites as "cyberspaces," similar to geographic spaces, whose laws, community norms, and practices will, partially, determine who will benefit from the economic opportunities that occur in these "spaces." These cyberspaces also create new communities online because they connect previously disconnected individuals, facilitate repeat transactions, and allow social networks to rate and evaluate participants. How the federal government regulates these emerging cyberfinancing communities will determine their redistributive potential.

This Article argues that regulating cyberfinancing[8] for economic justice will require a reconceptualization of the process of exchange between the wealthy and the poor, as well as of the traditional legal structures and community economic development practices that regulate exchanges between these groups. The Jumpstart Our Business Startups Act (JOBS Act), recently signed by President Obama,[9] fails to increase, substantially, historically marginalized actors' access to new crowdfunding markets. The GAO's proposed regulatory structure for P2P lending markets also fails to advance economic

---

of common advantages and sharing of common burdens." BLACK'S LAW DICTIONARY 869 (7th ed. 1999).

[7] Legal scholars studying domestic P2P lending have not recommended a regulatory structure to maximize the participation of economic actors historically marginalized from mainstream American markets. *See, e.g.*, Andrew Verstein, *The Misregulation of Person-to-Person Lending*, 45 U.C. DAVIS L. REV. 445 (2011); Eric C. Chaffee & Geoffrey Rapp, *Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry*, 69 WASH. & LEE L. REV. 485 (2012); Sarah B. Lawsky, *Money for Nothing: Charitable Deductions for Microfinance Lenders*, 61 SMU L. REV. 1525 (2008). Some legal scholars have analyzed the implications of P2P lending for international law and development, but do not recommend a specific scheme for U.S. regulation of P2P lending. *See, e.g.*, Kevin E. Davis & Anna Gelpern, *Peer to Peer Financing for Development: Regulating the Intermediaries*, 42 N.Y.U. J. INT'L L. & POL'Y 1209 (2010); Raj M. Desai & Homi Kharas, *Democratizing Foreign Aid: Online Philanthropy and International Development*, 42 N.Y.U. J. INT'L L. & POL'Y 1111 (2010). Legal scholars discussing crowdfunding have not proposed how to regulate the industry to advance distributive justice. *See, e.g.*, C. Stephen Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1 (2012) [hereinafter Bradford, *Crowdfunding*]; Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. PA. J. BUS. L. 973 (2011); Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TRANSACTIONS: TENN. J. BUS. L. 63 (2011). Legal scholars studying U.S.-based community economic development law have also not turned their attention to these markets.

[8] This Article coins the term "cyberfinancing" to describe both online P2P financing and crowdfunding websites that enable financial transactions between users online.

[9] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) [hereinafter JOBS Act].

justice.[10] The U.S. Securities and Exchange Commission (SEC), the primary regulator of P2P lending and crowdfunding websites, is regulating these markets in a manner that restricts marginalized actors' access. This Article proposes that U.S. regulators, and industry self-regulatory groups, should collaborate to implement a revised Community Reinvestment Act (CRA) that would cover the cyberfinancing intermediary organizations that create these websites and that would promote economic justice in these markets. While overregulation could increase the costs of participation, thereby undermining access, the regulatory structure proposed here incentivizes participation, thereby reducing the costs of the regulatory burden.

Part I of this Article analyzes the law's role in creating, and demarcating, economically marginalized, racially identified, and geographically isolated spaces. Part I.A explains how creditworthy or entrepreneurially promising individuals living in such communities are still isolated from American mainstream markets. Part I.B explicates how some residents developed informal and extra-legal responses to that economic and geographic isolation: responses such as face-to-face, peer-to-peer lending or participation in unregulated fringe financial markets. Part I.B also describes how American community economic development (CED) laws incentivize public and private investment in formally disinvested communities and formalize face-to-face peer lending by subsidizing community-based non-profit organizations and microfinance institutions. The advantages and disadvantages of these approaches provide lessons for how to regulate new cyberfinancing markets.

In Part II, the Article highlights examples of online P2P lending and crowdfunding and explains the legal mechanisms and institutions through which such market exchanges occur. It asserts that the SEC's regulation of cyberfinancing websites has led to a contraction of the market that excludes more marginalized borrowers. It also argues that current and proposed U.S. reforms do not substantially advance distributive justice in these markets. Finally, in Part III, the Article draws on theoretical work on space, community, and power in the "networked society," as well as comparative institutional analysis, to propose how cyberfinancing should be conceptualized and regulated.

---

[10] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-613, PERSON-TO-PERSON LENDING: NEW REGULATORY CHALLENGES COULD EMERGE AS THE INDUSTRY GROWS (2011), *available at* http://www.gao.gov/assets/330/320693.pdf [hereinafter GAO REPORT]; *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989F, 124 Stat. 1376, 1947–48 (2010) (requiring that the Comptroller General of the United States and the United States Government Accountability Office should "determine the optimal Federal regulatory structure" for P2P lending).

I. THE LAW AND GEOGRAPHY OF ECONOMIC MARGINALIZATION IN THE UNITED STATES

A. The Social and Legal Construction of Economic Marginality[11]

Critical social theorists have long argued that the societal "meanings" of geographic space are socially produced.[12] Although geographic spaces consist of tangible and natural physical objects, such as land, sky, and trees, the social significance of these geographic formations is the product of social relations. Thus, geographic spaces have socially constructed meanings that are reflections of historical, and present, social allocations of power. Law and geography scholars[13] have long argued that law plays a constitutive role in the spatial allocations of power in various geographic areas.[14] Thus, the social "meanings" assigned to places are partly constituted by legal representations of space. The boundaries, lines, and plats that divide up the physical world are given social significance through the laws of property, ownership, title, and

---

[11] "Marginality is generally used to describe and analyse socio-cultural, political, and economic spheres, where disadvantaged people struggle to gain access (societal and spatial) to resources, and full participation in social life." Ghana S. Gurung & Michael Kollmair, *Marginality: Concepts and their Limitations* (NCCR North South, Working Paper No. 4, 2005), *available at* http://www.nccr-pakistan.org/publications_pdf/General/Marginality.pdf.

[12] *See, e.g.*, Michel Foucault, *Space, Knowledge & Power*, *in* THE FOUCAULT READER 239 (Paul Rabinow ed., 1984) ("Space is fundamental in any form of communal life."); HENRI LEFEBVRE, THE PRODUCTION OF SPACE 26 (Donald Nicholson-Smith trans., 1991) (1974) ("(*Social*) space is a (*social*) product."); EDWARD W. SOJA, POSTMODERN GEOGRAPHIES: THE REASSERTION OF SPACE IN CRITICAL SOCIAL THEORY 79–80 (1989) ("Space in itself may be primordially given, but the organization, and meaning of space is a product of social-translation, transformation and experience.").

[13] The work of law and geography scholars is too voluminous to cite in full, but the following works are representative of the field. *See, e.g.*, THE LEGAL GEOGRAPHIES READER: LAW, POWER AND SPACE xviii (Nicholas Blomley et al., eds., 2001) [hereinafter LEGAL GEOGRAPHIES READER]; LAW AND GEOGRAPHY: CURRENT LEGAL ISSUES 2002 (Jane Holder & Carolyn Harrison eds. 2002) [hereinafter LAW AND GEOGRAPHY]; NICHOLAS BLOMLEY, LAW, SPACE, AND THE GEOGRAPHIES OF POWER (1994); Richard Thompson Ford, *The Boundaries of Race: Political Geography in Legal Analysis*, 107 HARV. L. REV. 1841 (1994) [hereinafter Ford, *Boundaries of Race*]; Hari Osofsky, *A Law and Geography Perspective on the New Haven School*, 32 YALE J. OF INT'L L. 421 (2007); Paul Schiff Berman, *The Globalization of Jurisdiction*, 151 U. PA. L. REV. 311 (2002); Keith Aoki, *Space Invaders: Critical Geography, the "Third World" in International Law and Critical Race Theory*, 45 VILL. L. REV. 913 (2000); *Space Invaders*, Symposium, *Surveying Law and Borders*, 48 STAN. L. REV. 1037 (1996).

[14] *See* LEGAL GEOGRAPHIES READER, *supra* note 13, at xviii ("Boundaries *mean.* They signify, they differentiate, and they unify the insides of the spaces that they mark. *What* they mean refers to constellations of social relational power. And the form that this meaning often takes—the meaning social actors confer on lines and space—is *legal* meaning.").

territory, as well as through jurisdictional boundaries that include certain physical areas within a particular neighborhood, municipality, town or village. These territorialities[15] enable public officials, and residents within geographically defined boundaries, to create political alliances, wield taxing and spending powers,[16] and influence the boundaries and types of markets that operate within certain geographic spaces.[17] These boundaries also empower individuals to include, or to exclude, others in their geographic communities or markets.[18] These "complex territorial configurations"[19] of the physical and material world often reinforce existing allocations of power and opportunity. Space, power, and law, then, are inextricably linked.

Economic marginalization in the United States undeniably has a racial, ethnic, classed, gendered, and spatial dimension.[20] As legal scholar Richard Thompson Ford explains, in America, space "is an 'enabling technology' of race."[21] As David Delaney explains, the practices that established and maintained the racial purity and the political, economic, and social superiority of whites were fundamentally spatial practices such as the "slave quarters," physically segregated housing, schooling, and socializing spaces.[22] Many of these spatial practices were also *legal* practices such as: black codes, racially restrictive covenants, exclusionary zoning, and eminent domain laws, amongst other legal mechanisms.[23] "Much of the meaning that

---

[15] *See, e.g.*, DAVID DELANEY, RACE, PLACE, AND THE LAW, 1836–1948, 6 (1998) (Territoriality is "the assignment of a particular sort of meaning to lines and spaces in order to control, at first glance, determinable segments of the physical world. Upon further reflection, however, it is clear that the objects of control are social relationships and the actions and experiences of people.").

[16] *See id.* at 6–7; *see also* Ford, *Boundaries of Race*, *supra* note 13, at 1844 ("The reification of boundaries in private associations has effects of racial segregation and economic stratification similar to those we uncovered in the public law context.").

[17] *See, e.g.*, Michael E. Porter, *The Competitive Advantage of the Inner City*, 73 HARV. BUS. REV. 55 (May–June 1995) (discussing the relationship between geographic location and business development). *But see* Scott L. Cummings, *Between Markets and Politics: A Response to Porter's Competitive Advantage Thesis*, 82 OR. L. REV. 901, 903 (2003) (arguing that market development is the result of politics as well as individual choices).

[18] *See supra* note 13.

[19] *See* DELANEY, *supra* note 15, at 6 ("[C]omplex territorial configurations—and the codes of access, exclusion, and inclusion of which these configurations are the physical expression—are inseparable from the workings of larger-scale power orders such as those associated with, in our world, gender, race and class.").

[20] *See supra* note 13.

[21] *See* LEGAL GEOGRAPHIES READER, *supra* note 13, at xvi (citing Richard T. Ford, *Urban Space and the Color Line: The Consequences of Demarcation and Disorientation in the Post-Modern Metropolis*, 9 HARV. BLACKLETTER J. 99–123 (1999)).

[22] *See* DELANEY, *supra* note 15, at 10.

[23] *See id.* at 10–11.

is mapped onto lived-in landscapes is specifically *legal* meaning."[24] Certain physical areas, demarcated by legal apparatus such as street names, plats, lines, and titles, as well as incorporation or unincorporation, were designated as black, white, or immigrant areas.[25]

These "racially identified spaces"[26] also often became economically inferior spaces because the U.S. federal government and U.S. financial institutions refused to lend or invest in those areas.[27] In 1933, during the Great Depression, Congress created the Home Owner's Loan Corporation (HOLC) to help underwater homeowners facing foreclosure by refinancing home mortgages and reforming the home mortgage system.[28] The HOLC devised a neighborhood-based rating system for determining home lending risks based upon the presumed credit quality of neighborhoods and their residents.[29] HOLC appraisers "consistently undervalued black and integrated neighborhoods for the purpose of making new mortgage loans."[30] Appraisers identified minority neighborhoods by drawing red lines or circles around them on geographic maps,[31] demarcating them and their residents as substantial credit and investment risks.

U.S. private banks, using those same maps, "redlined"[32] certain low-income, urban, minority, and immigrant communities, designating anyone residing in these areas as a substantial credit risk based primarily upon the

---

[24] *Id.* at 11.

[25] *See* Ford, *Boundaries of Race*, *supra* note 13.

[26] *Id.* at 1845 (defining "racially identified space" as "physical space primarily associated with and occupied by a particular racial group"); *see also* Elise C. Boddie, Racial Territoriality, 58 UCLA L. REV. 401 (arguing that places can have a racial identify based upon socially engrained racial biases about the inhabitants of those places).

[27] *See generally* Keith N. Hylton & Vincent D. Rougeau, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act*, 85 GEO. L. J. 237, 241 (1996) (describing the history of public and private redlining); Richard Marsico, *The Community Reinvestment Act*, *in* BUILDING HEALTHY COMMUNITIES: A GUIDE TO COMMUNITY DEVELOPMENT FOR ADVOCATES, LAWYERS AND POLICYMAKERS 403 (ABA 2009) [hereinafter Marsico, *Community Reinvestment Act*] (explaining that the Community Reinvestment Act (CRA) was enacted to remedy redlining).

[28] Jerry W. Markham, *The Subprime Crisis—A Test Match for the Bankers: Glass Steagall vs. Gramm-Leach-Bliley*, 12 U. PA. J. BUS. L. 1081 (2010).

[29] Olatunde C.A. Johnson, *Stimulus and Civil Rights*, 111 COLUM. L. REV. 154, 163 n.36 (2011) [hereinafter Johnson, *Stimulus and Civil Rights*] (defining "redlining" as "the government and industry practice that began in the 1920s and 1930s of assigning risks to neighborhoods ... based on assessments of their quality").

[30] *Id*. at 163.

[31] *See* Hylton & Roug *supra* note 27, at 241; Marsico, *Community Reinvestment Act*, *supra* note 27, at 403; Johnson, *Stimulus and Civil Rights*, *supra* note 29, at 163 n.36.

[32] *See* Johnson, *Stimulus and Civil Rights*, *supra* note 29, at 163.

racial demographics of the area.[33] Creditworthy individuals who lived in redlined communities were, therefore, discriminated against based upon both their race and their residence. Not only individuals, but also neighborhoods were denied private investment and credit, leading to a widespread disinvestment in certain neighborhoods where there were significant numbers of minorities.[34] This neighborhood-based disinvestment further solidified the poverty of many members of minority groups living in urban centers as jobs, property tax-financed education, and other forms of economic stability and social progress moved to suburban, predominately white communities. The quality of the social and educational services available in these neighborhoods also declined as the economic resources of these communities deteriorated. These dynamics led to an increasing spatial mismatch between low-income, urban minorities, available quality jobs, and financial opportunities.[35]

While de jure discrimination, and intentional racial animus, initially created racially identified spaces, as legal scholar Richard Thompson Ford argues, "even in the absence of racism, race-neutral policy could be expected to entrench segregation and socio-economic stratification in a society with a history of racism."[36] The racial, economic, and geographic isolation caused by formal racism is maintained through the preservation of political and geographic territories. In a capitalistic society that privileges individual economic security, profit maximization by market actors, and state and local taxation as the means through which basic governmental services are provided, individuals and institutions may favor laws and policies that maintain the economic superiority of the geographic spaces they inhabit, even in the absence of intentional racism. Consequently, spaces "racially identified" as Black, for example, and economically marginalized as a result of that designation, would be disadvantaged in competitions with other geographic areas for residents, resources, opportunities, and markets.[37]

---

[33] *See* Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1214 (2012) (defining redlining as "the practice of not offering financial services in minority or low-income neighborhoods, sometimes indicated with a red line on a map").

[34] *See* Johnson, *Stimulus and Civil Rights*, *supra* note 29, at 163 (explaining that redlining contributed to the deterioration of predominately black neighborhoods).

[35] John F. Kain, Housing Segregation, Negro Employment and Metropolitan Decentralization, 82:2 Q. J. OF ECON. 175–97 (defining the spatial mismatch hypothesis).

[36] Ford, *Boundaries of Race*, *supra* note 13, at 1852.

[37] *See, e.g.*, Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418–19, 422 (1956) (arguing that people move from economically, socially, and politically disadvantageous localities to more advantageous ones); Lee Anne Fennell, *Controlling Residential Stakes*, 77 U. CHI. L. REV. 143, 173 (2010) (explaining the Tiebout hypothesis).

To the extent that laws maintain the geographic boundaries of a given racially identified community, and that economic stratification remains pervasive within those areas, traditional financial institutions may still have rational economic reasons for credit and investment rationing in such areas.[38] First, profit-motivated banks may be unable to overcome the inefficiencies associated with lending to economically marginal individuals living in historically disinvested communities.[39] If banks have insufficient branches in certain areas, they may suffer from information asymmetries, precluding them from learning about other factors that may make an otherwise marginal borrower a good credit risk.[40] The transaction costs associated with the due diligence necessary to screen marginal borrowers or to make unsecured loans in relatively small amounts to marginal borrowers, may preclude banks from engaging in such transactions.[41]

Second, banks no longer obtain information about potential borrowers solely through neighborhood-based branches. They also obtain this information about prospective borrowers through automated underwriting computer models and risk profiling programs. Existing risk profiling and underwriting models may steer banks away from individuals who do not meet standardized lending profiles.[42] These automated underwriting models may fail to identify individuals who are good credit risks because there is insufficient computer generated quantitative information about such individuals, such as credit or job histories.[43] Additionally, if individuals residing in historically disinvested communities have not had access to significant educational or job opportunities, then angel or venture capital investors may lack information about their potential as entrepreneurs, and

---

[38] *See, e.g.*, Lan Cao, *Looking at Communities and Markets*, 74 NOTRE DAME L. REV. 841, 853–57 (1999); Joseph E. Stiglitz & Alan Weiss, *Credit Rationing in Markets with Imperfect Information*, 71:3 AM. ECON. REV. 393, 395 (1981).

[39] *See* Cao, *supra* note 38, at 853–57; Stiglitz & Weiss, *supra* note 38, at 393.

[40] *See* Tiebout, *supra* note 37; *see also* JOSH SILVER & ARCHANA PRADHAN, NATIONAL COMMUNITY REINVESTMENT COALITION, WHY BRANCH CLOSURES ARE BAD FOR COMMUNITIES 2 (Apr. 2012) (explaining that during the Great Recession, "bank and credit union branches increased by 1,000 in middle- and upper-income neighborhoods while decreasing by 530 in low-and moderate-income neighborhoods and branches increased in predominately white neighborhoods by 598 while decreasing by 186 in minority neighborhoods where more than 50 percent of the residents are minority").

[41] *See, e.g.*, Rashmi Dyal-Chand, *Reflection in a Distant Mirror: Why the West Has Misperceived the Grameen Bank's Vision of Microcredit*, 41 STAN. J. INT'L L. 217, 266–67 (2005) (explaining the high transaction costs associated with lending to marginal borrowers that preclude traditional banks from lending).

[42] *See* Cao, *supra* note 38, at 856.

[43] *See id.*

may be reluctant to provide start-up capital to them.[44] Third, individuals residing in racially identified and economically marginalized communities may lack the resources to fully understand their credit or financial options. If creditworthy individuals living in historically, or currently, disinvested neighborhoods are unaware of financial options outside of their neighborhoods, because traditional banking institutions do not have a significant presence there, they may self-limit their lending or financing options.

Even if individuals begin to improve their economic circumstances, if their mobility is restricted, because of discriminatory housing practices or a lack of affordable options in more lucrative neighborhoods, then they are still geographically and economically isolated from mainstream markets. An individual may also have familial connections in his or her neighborhood that that dissuade him or her from moving. Further, even as economic conditions improve in a space, previously racially identified (and economically marginalized as a result of that designation), the connotative discourses,[45] which give that geographic space its social signifiers, can still perpetuate a narrative about that community that designates it as a bad investment. Thus, mainstream banks may not locate there, productive high paying industries may continue to resist establishing offices there, and white or wealthier residents may not want to move there.[46] The geographic location in which an individual resides, therefore, can limit his or her access to mainstream market forces even as that individual's economic circumstances improve and economic conditions in the neighborhood progress.[47]

Most importantly, these spatial dynamics of economic marginalization can also affect an individual's ability to access social networks that might lead to greater economic empowerment. The term social capital reflects the sociologically demonstrated truth that individuals' social networks can have economic value.[48] A socially well-connected individual has more opportunities to connect to networks that lead to greater economic opportunities. Scholars have distinguished "bonding social capital" from "bridging social capital."[49] Bonding social capital refers to closely knit networks among

---

[44] Susan Jones, *Supporting Urban Entrepreneurs: Law, Policy and the Role of Lawyers in Small Business Development*, 30 W. NEW ENG. L. REV. 71, 87–88 (2007) (explaining that women and minority entrepreneurs are not part of the old boy or new entrepreneur networks that characterize venture capital and angel investing).

[45] *See, e.g.*, LEFEBVRE, *supra* note 12, at 56; Boddie, *supra* note 26.

[46] *See* Ford, *Boundaries of Race*, *supra* note 13, at 1851–52.

[47] *See id.*

[48] *See, e.g.*, ROBERT D. PUTNAM, BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY 18–20 (2000) (asserting that individuals' abilities to develop positive economic and social networks is largely a result of the geographic spaces they inhabit).

[49] *See id.* at 22.

people who are familiar with one another based upon face-to-face interactions in the same geographic area or through racial, ethnic, gender, or class ties.[50] Bridging social capital indicates a form of networking that enables individuals to connect with broader social networks outside of their immediate geographic, familial, or friendship networks.[51] Some neighborhood effects scholars argue that neighborhoods plagued by concentrated poverty, racial segregation, and geographic isolation from mainstream markets preclude individuals from developing the bridging social networks necessary to connect to opportunity.[52] Individuals who may be promising entrepreneurs, or who are creditworthy based upon their credit scores, may still be geographically isolated from the kind of positive social networks that will lead to financing opportunities.[53] New online cyberfinancing networks hold the potential to help such individuals overcome their isolation, yet these industries do not currently operate, and are not currently regulated, to advance this goal. This history of economic marginalization in the United States should inform approaches to regulating new cyberfinancing markets.

B. Informal and Extra-Legal Responses to Spatial and Economic Marginality

In light of this isolation, certain groups developed alternative informal, face-to-face, peer-to-peer, financing networks. Rotating savings and credit associations (ROSCAs) have long been used by immigrant and ethnic groups in the United States to create savings, to pay for small-scale personal expenses, or to finance micro-entrepreneurial activity.[54] Trinidadian immigrants call such mechanisms a sou-sou;[55] Mexicans, the tanda;[56] West Africans, the esusu; Japanese, the tanomoshi; Chinese, the Hui; Koreans, the gae; Filipinos, the Hulagan; and Vietnamese, the Bui.[57] Through peer financing,

---

[50] *Id.*

[51] *Id.*

[52] *See generally* William Julius Wilson, *Why Both Social Structure and Culture Matter in a Holistic Analysis of Inner-City Poverty*, 629 ANNALS AM. ACAD. POL. & SOC. SCI. 200, 206 (2010) (arguing that neighborhood concentrated poverty increases the likelihood of social isolation).

[53] *See* discussion *infra* Part I.D.

[54] *See* Cao, *supra* note 38, at 884–92 (providing a history of ROSCAs in the United States).

[55] Ralph Holcomb, *Sou Sou Banking in Trinidad: Example of an Informal Mutual Aid Society* (on file with author).

[56] *See* ROSALBA GAMA, DELMA MEDRANO & LUIS MEDRANO, TANDAS & CUNDINAS: MEXICAN AMERICAN & LATINO AMERICAN ROTATING CREDIT ASSOCIATIONS IN CALIFORNIA, http://www.anthro.uci.edu/html/Programs/Anthro_Money/Tandas.htm (last visited Mar. 23, 2013).

[57] *See* Isao Fujimoto & Gerardo Sandoval, *Tapping into California's Central Valley's Hidden Wealth: It's Rich Cultural Capital*, 9 BERKELEY J. AFR.-AM. L. & POL'Y 119, 131

individuals informally come together to make regular cyclical contributions to a common fund, the balance of which is then given as a lump sum to one member in each cycle.[58] Participants often do not invest these funds in a formal bank, rather the funds are held by members of the group and then distributed amongst group members. These forms of peer savings and lending rely on trust among members of the same geographic, racial, or ethnic group to serve as a form of collateral.[59] Individuals must trust that other group members will repay their loans so that there is sufficient money in the pot for their own loans. ROSCAs, therefore, are manifestations of bonding social capital, whereby a tightly knit group of individuals trust each other enough to develop an economic alternative to their geographic, social, racial, ethnic, and economic isolation. ROSCAs also serve a community building function as members meet through face-to-face interactions and are able to vouch for the credit- or trust-worthiness of a particular member because of their friendship with, or history of face-to-face interactions with, that member.[60] This pooling of resources between tightly knit groups serves as a form of community economic development for economically marginalized groups.[61]

Community norms and reputational sanctions also substitute for regulation as a form of censure for failure to repay.[62] Additionally, each participant in a rotating savings and credit association is both a lender and borrower during the life cycle of the ROSCA.[63] This feature of the ROSCA aligns the incentives of borrowers and lenders in a manner that is different from the incentive structures in more traditional credit markets—where lenders are commercial banks with profit maximization concerns and borrowers are individuals in need of credit or capital to fund activities. The ROSCA's incentive structure "is one that [in theory] maximizes group and individual welfare while minimizing the possibility of defection and exploitation, as well as other forms of abuse."[64] In *Looking at Communities and Markets*,

---

(2007); *see also* Barack D. Richman, *How Community Institutions Create Economic Advantage: Jewish Diamond Merchants in New York*, 31 LAW & SOC. INQUIRY 383 (2006).

[58] HARI SRINIVAS, ROSCAS: THE MUTUALITY OF CREDIT: ROTATING CREDIT AND SAVINGS ASSOCIATIONS, http://www.gdrc.org/icm/suppliers/rosca.html (last visited Mar. 23, 2013); *see also* Cao, *supra* note 38, at 877.

[59] *See, e.g.*, Rashmi Dyal-Chand, *Reflection in a Distant Mirror: Why the West Has Misperceived the Grameen Bank's Vision of Microcredit*, 41 STAN. J. INT'L L. 217, 268 (2005) (describing solidarity circles).

[60] *See id.* at 221.

[61] *See, e.g.*, Cao, *supra* note 38, at 875.

[62] *See id.* at 882–84.

[63] *See id.* at 849 ("[A] rotating credit association functions on the basis of aggregation of interests between borrowers and lenders, precisely because the lender *is* the borrower.").

[64] *Id.*

legal scholar Lan Cao argues that ROSCAs can help mainstream banks overcome the information asymmetries and transaction costs that might preclude them from lending to risky borrowers in marginal communities.[65] Cao asserts that the community norms that regulate ROSCAs are reliable, and that states, and presumably the federal government, should defer to these norms and not attempt to regulate these financial transactions.[66] Her analysis of ROSCAs presents an optimistic assessment of the social dynamics among members of ROSCAs.

While face-to-face, peer-to-peer financing can be a positive form of bonding social capital, it can also be exploitative.[67] Studies of the dynamics of ROSCAs in international developing economies often reveal that group members can use exploitative tactics to ensure that members repay.[68] The trust and community norms that substitute for regulation can also surmount to undue peer pressure. Further, ROSCAs and informal peer lending rarely lead to bridging social capital, whereby economically marginal and geographically isolated groups connect to broader economic and social networks that lead to greater economic opportunities. However, ROSCAs do create an alternative market space in which members of historically marginalized groups can obtain limited financing.

C. The Formalization of Peer Financing Through Microfinance

CED[69] lawyers and practitioners in the United States sought to formalize ROSCAs and face-to-face peer lending through the development of non-profit, community-based, microfinance organizations. These organizations provide financing to small and start-up American microenterprises. In the United States, the term microenterprise usually describes "any type of business that has fewer than five employees and is small enough to benefit from loans of under $35,000."[70] Thus, not every small business is a microenterprise; some start-ups require significantly greater initial investment

---

[65] *See id.* at 885–89.

[66] *See id.* at 906–09.

[67] *See* Dyal-Chand, *supra* note 59, at 254–56.

[68] *See id.* at 255–56.

[69] *See* Cummings, *supra* note 17, at 906 (explaining that U.S.-based CED efforts are spearheaded by non-profit organizations that receive public and private subsidies to stimulate economic development in disadvantaged areas to benefit poor residents).

[70] Susan R. Jones & Amanda Spratley, *How Microenterprise Contributes to CED* in BUILDING HEALTHY COMMUNITIES: A GUIDE TO COMMUNITY DEVELOPMENT FOR ADVOCATES, LAWYERS AND POLICYMAKERS 380 (ABA 2009) (quoting Association for Enterprise Opportunity, *Microenterprise Development in the United States: An Overview*, Microenterprise Fact Sheet Series, 1 (2000), http://fieldus.org/publications/fact_sheet1.pdf).

capital than microfinance provides and other small businesses have more than five employees and substantial revenues and profits. The popularity of microfinance as an antidote to poverty and market failure in the United States increased with the Grameen Bank's (the Bank's) success with microlending to low-income, rural, women in the developing world.[71] Founded in 1983 in Bangladesh, by 2006 Nobel Prize winner Muhammed Yunus, the Bank has had significant success in uncollateralized microlending in developing countries.[72] The Bank is a borrowers' cooperative[73] that makes small, unsecured loans often without requiring formal collateral, formal legal instruments, group guarantees, or joint liability for defaults.[74] The interest rate on all loans is sixteen percent and the loans are generally repaid by borrowers in small increments over the course of a year or less.[75] Currently, approximately ninety-six percent of the Bank's loans are repaid by microborrowers.[76]

The Bank formalizes aspects of the informal ROSCA model by establishing branches in low-income communities and requiring all borrowers to be organized into small, homogenous, five-member "solidarity groups."[77] These groups are the mechanisms through which the bank disburses loans. Before loans are disbursed to any one member of the group, all group members must attend a one or two-week-long training session in which they learn the Bank's lending rules as well as how to run a microenterprise.[78]

---

[71] *See, e.g.*, Lewis D. Solomon, *Microenterprise: Human Reconstruction in America's Inner Cities*, 15 HARV. J. L. & PUB. POL'Y 191, 195 (1992); Dyal-Chand, *supra* note 59, at 223–24.

[72] *See* Dyal-Chand, *supra* note 59, at 194–95. Note that Muhammad Yunus departed from the Grameen Bank on May 15, 2011. *See, e.g.*, *A Letter Addressed to Grameen Bank Members from Nobel Laureate Professor Muhammad Yunus on the Occasion of His Departure from Grameen Bank*, GRAMEEN COMMC'NS (May 15, 2011), http://grameen-info.org/index.php?option=com_content&task=view&id=1043.

[73] *See* Solomon, *supra* note 71, at 195 ("[B]orrowers owning 75% and the government owning the remainder of the ... shares.").

[74] *See, e.g.*, *Credit Delivery System*, GRAMEEN COMMC'NS, http://www.grameen-info.org/index.php?option=com_content&task=view&id=24&Itemid=169 (last visited Mar. 23, 2013).

[75] *See id.*

[76] *Bank Monthly Update in USD*, GRAMEEN COMMC'NS, http://www.grameen-info.org/index.php?option=com_content&task=view&id=453&Itemid=527 (last visited Mar. 23, 2013).

[77] *See, e.g.*, GRAMEEN COMMC'NS, *supra* note 74; Solomon, *supra* note 71, at 196.

[78] The Women's Self-Employment Project (WSEP) incorporated in 1986 was one of the first U.S., non-profit, organizations to adopt the Grameen model. During the organization's years of operation it was a substantial source of capital and training for low-income, predominately African-American women microentrepreneurs. *See* Solomon, *supra* note 71, at 202–03. However, WSEP was a subsidiary of the famous Chicago-based ShoreBank, a community bank founded in 1973, to revitalize disinvested and redlined black neighborhoods. The bank was profitable until the foreclosure crisis and the Great Recession when it failed. As a result, WSEP also folded. *See, e.g.*, Becky Yerak, *Chicago's ShoreBank Fails, Is Bought by*

These training sessions emphasize and implement the Bank's "Sixteen Decisions"—a social development agenda that requires borrowers to engage in positive healthy behaviors that promote self-sufficiency, but also positive community development.[79] The solidarity groups and the sixteen decisions are the community-norm generation mechanisms that substitute for collateral and formal laws for failure to repay.[80] While the solidarity group does not guarantee the loans extended to members, another member cannot receive their disbursement until the first lender repays—thus, giving all group members an incentive to enforce one another's repayment.[81] Further, because the Bank lends through groups, rather than individuals, it mitigates the transaction costs associated with making small loans to individual borrowers.

Inspired by the success of the Grameen model, some American microfinance institutions (MFIs) have adopted a similar structure and design.[82] Project Enterprise, based in New York City, is a non-profit MFI that initially served primarily low-income, minority women microentrepreneurs in NYC.[83] It subsequently expanded its operations to serve male and female low-income, minority microentrepreneurs.[84] It also collaborates with other established national MFIs.[85] ACCION USA (ACCION) is another American MFI that adapts the Grameen model in significant ways.[86] It is the domestic

---

Investors, CHI. TRIB., Aug. 20, 2010, at 1, *available at* http://articles.chicagotribune.com/2010-08-20/business/ct-biz-0821-shorebank-20100820_1_fdic-assets-david-vitale.

[79] *See, e.g.*, Dyal-Chand, *supra* note 59, at 233.

[80] *See id.* at 225–30.

[81] *See id.* at 225.

[82] *See, e.g.*, Solomon, *supra* note 71, at 202–06; Dyal-Chand, *supra* note 59, at 234–41.

[83] *See About Us*, PROJECT ENTERPRISE, http://www.projectenterprise.org/About/where.html (last visited Mar. 23, 2013).

[84] *See Mission & History*, PROJECT ENTERPRISE, http://www.projectenterprise.org/About/mission.html (last visited Mar. 23, 2013).

[85] Project Enterprise works primarily in Upper Manhattan, Brooklyn, Queens, and the Bronx. Ninety-nine percent of the businesses PE serves are minority-owned, eighty-eight percent are African-American or Caribbean-American owned, and fifty-six percent are owned by women. *See About Us*, PROJECT ENTERPRISE, *supra* note 83; Interview with Catherine Barnett, Executive Director, Project Enterprise in NY, NY (Jul. 18, 2011). The Grameen Foundation is a U.S.-based 501(c)(3) non-profit microfinance institution based upon the Grameen Bank model. It is a separate organization with an independent board and staff. *See, e.g.*, *Frequently Asked Questions*, GRAMEEN FOUNDATION, http://grameenfoundation.org/faq#whatisgf (last visited Mar. 23, 2013). In the United States, the Grameen Foundation works with partner microfinance institutions such as Project Enterprise. *See, e.g.*, *United States*, GRAMEEN FOUNDATION, http://grameenfoundation.org/americas/united-states (last visited Mar. 23, 2013).

[86] ACCION's active clients are sixty-one percent Hispanic or Latino, twenty-seven percent African-American, and forty percent female. *See, e.g.*, *Our Microloan Borrowers*,

American arm of ACCION International, a global microfinance organization.[87] In total, ACCION provides seventy-five percent of microloan services in the United States.[88] It funds borrowers with credit scores of 525 and above, a lower minimum credit score than most mainstream American financial institutions require.[89] ACCION requires borrowers to obtain asset-based collateral or guarantees for their loans.[90] It does not use a group lending or collateralization model, but it encourages group-administered financial education and refers borrowers to a network of community-based technical assistance providers.[91] ACCION's loan amounts, which range from $700 to $50,000 per loan with an average loan amount of $5100, are generally larger than that of Grameen and other international microfinance institutions.[92] ACCION's loan terms range from six to sixty months; its interest rates, which range from eight to fifteen percent, are also generally lower than those of less established international microfinance institutions.[93] ACCION's borrowers repay their loans more than eighty-nine percent of the time.[94]

ACCION and similar American MFIs[95] represent a trend in U.S. microfinance whereby American MFIs are quasi-financial institutions that intermediate between risky, marginal borrowers and mainstream markets for credit and capital. These institutions adopt some of the features of ROSCAs, but they also utilize more traditional financial measures to determine creditworthiness. While Grameen delegates the selection of borrowers, the determination of borrowers' creditworthiness, and peer financial

---

ACCION USA, http://www.accionusa.org/home/support-accion/learn/meet-our-borrowers.aspx (last visited Mar. 23, 2013).

[87] *See, e.g.*, *Microfinance FAQ*, ACCION USA, http://www.accionusa.org/home/support-accion/about-accion/microfinance-faq.aspx#2 (last visited Mar. 23, 2013).

[88] *Id.*

[89] ACCION USA also only accepts borrowers who have not declared bankruptcy in the past twelve months or foreclosure in the past twenty-four months. Borrowers also may not have any late mortgage or rent payments in the last twelve months. Borrowers must be current on all bills and not have more than $3000 in past due debt because of extenuating circumstances. *See, e.g.*, *Basic Loan Requirements*, ACCION USA, http://www.accionusa.org/home/small-business-loans/about-our-loans/general-loan-requirements.aspx (last visited Mar. 23, 2013).

[90] *See Group vs. Individual Lending*, ACCION USA, http://www.accionusa.org/home/support-accion/learn/microlending-in-the-united-states.aspx (last visited Mar. 23, 2013).

[91] *See Microfinance FAQs*, ACCION USA, http://www.accionusa.org/home/support-accion/about-accion/microfinance-faq.aspx (last visited Mar. 23, 2013).

[92] *See id.*

[93] *See id.*

[94] *See id.*

[95] The Association for Enterprise Opportunity (AEO) is also a national membership organization for microfinance and microbusiness development institutions in the United States. *See, e.g.*, *About AEO,* ASS'N FOR ENTERPRISE OPPORTUNITY (May 22, 2009), http://www.aeoworks.org/index.php/site/page/category/about_aeo/.

education to the solidarity group, many U.S. microfinance institutions retain these functions.[96] Retaining these due diligence and financial education features helps the MFIs mitigate financial risks, but it is also extremely costly for them. Thus, a typical for-profit mainstream financial institution would not want to incur the costs associated with a small $2000 loan. The loan amounts, and the interest earned on them are not substantial enough to cover these retained due diligence costs. Consequently, American MFIs are often non-profits that rely on charitable contributions, and social investments from individuals, corporations and foundations to cover these costs.[97]

The non-profit form permits the microfinance organizations to provide these services, which are consistent with the non-profit forms' charitable purposes, and it enables these MFIs to obtain tax-deductible contributions to cover their costs. Further, the federal and state monitoring that accompanies the process of non-profit formation and maintenance helps to ensure that the MFIs administer funds ethically. The non-profit form also helps formalize the process of peer financing by minimizing the potential for abuse between group members in unregulated ROSCAs or peer financing circles. However, the formalization of peer financing through non-profits also increases borrowers' transaction costs over and above the costs associated with obtaining a loan from a mainstream lender, or a fringe financial services institution.[98] The training that domestic non-profit organizations provide, as precondition of receiving financing, is often more substantial than what international microfinance institutions or informal ROSCAs provide. Consequently, U.S. microborrowers participating in domestic microfinance programs have to attend several meetings.[99] This aspect of non-profit microfinance can dissuade low-income individuals, for whom time is often scarce, from participating in such programs. Microborrowers may prefer to transact with fringe financial institutions, or the new cyberfinancing networks that do not impose these transaction costs.[100]

The above-described features of domestic microfinance also limit the potential sources of capital and investment that can be accessed to promote U.S. microenterprise. First, contributors to American MFIs must either have social motivations or desire a tax-exemption or tax credits to invest in these endeavors.[101] U.S. microfinance institutions also have to

---

[96] *See* Dyal-Chand, *supra* note 59, at 238–39.
[97] *See Microfinance FAQs*, *supra* note 91.
[98] *See, e.g.*, Dyal-Chand, *supra* note 59, at 231.
[99] *See id.* at 238–39.
[100] *See, e.g.*, Chaffee & Rapp, *supra* note 7, at 496; Barnett, *supra* note 85.
[101] *See* Davis & Gelpern, *supra* note 7, at 1238 (explaining the legal features of U.S. non-profit microfinance institutions with which donors have to comply).

compete with international microfinance institutions to obtain donors. Some donors may perceive that smaller contributions can make a greater contribution in international microfinance markets than in American markets.[102] Second, in domestic American microfinance, individual lenders also do not make a direct connection with potential borrowers; rather, they interact and contract with intermediating non-profit organizations in the hope that those organizations will make legitimate loans and provide valuable training to U.S. microentrepreneurs. Third, prospective borrowers have to be aware of existing MFIs in order to access funds. Prospective borrowers are more likely to be aware of microfinance institutions that have a geographic presence in their neighborhoods. Thus, while American MFIs connect economically marginal and geographically isolated individuals to some sources of credit that might not otherwise be available, they do not connect participants to substantially new markets or social networks outside of their geographic areas, demographic profiles, or friendship networks. Lastly, the existing framework of offline American microfinance does not reach the lowest income borrowers nor does it provide the kind of capital needed to help microentrepreneurs grow and sustain their businesses over time.[103] The lowest income borrowers either cannot qualify for microfinance programs or they do not connect with microfinancing institutions.[104] Further, the amount of money obtained by U.S. microentrepreneurs from U.S. microfinance institutions is not enough to sustain a microenterprise as it grows and navigates an increasingly competitive and complex American market.[105] Cyberfinancing, as currently operated, does not substantially overcome these shortcomings of domestic microfinance.

D. Legal Responses to Spatial and Economic Marginality

While domestic peer financing and microfinance developed somewhat independently of formal law, Congress did enact several laws to stimulate private investment and microenterprise in historically disadvantaged communities.

---

[102] Press Release, Kiva.Org, Kiva Launches Online Microfinance in the United States (June 10, 2009), *available at* http://www.marketwire.com/press-release/kiva-launches-on line-microfinance-in-the-united-states-1222313.htm ("Most people think of microfinance as something that helps people in the developing world alone, but the impact of microfinance can be felt in any community that supports creative, industrious entrepreneurs.").

[103] *See, e.g.*, Dyal-Chand, *supra* note 59, at 270; Louise A. Howells, *The Dimensions of Microenterprise: A Critical Look at Microenterprise as a Tool to Alleviate Poverty*, 9 J. OF AFFORDABLE HOUS. & COMMUNITY DEV. L. 161, 171 (2000).

[104] *See, e.g.*, Dyal-Chand, *supra* note 59, at 270; Louise A. Howells, *supra* note 103, at 171.

[105] *See* Dyal-Chand, *supra* note 59, at 270; Louise A. Howells, *supra* note 103, at 171.

Congress enacted the Community Reinvestment Act (CRA)[106] in 1977 to end the practice of "redlining" and to stimulate private bank investment in economically marginalized areas.[107] The CRA also spurred private investment in domestic microfinance when the CRA regulations were revised in 1995,[108] and when the Community Development Financial Institutions Fund (CDFI Fund) was created in 1994.[109] The CRA gives federally insured depository institutions a "continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered, including low- and moderate-income neighborhoods."[110] Covered banks are encouraged to fulfill their CRA obligations in a manner "consistent with the safe and sound operation of such institutions."[111] This requirement, as interpreted and implemented by bank regulators, encourages banks not only to end redlining practices, but also to affirmatively seek opportunities to lend in formally redlined low- and moderate-income neighborhoods.[112]

The CRA's definition of low- to moderate-income communities does not specifically take race into account.[113] Instead, it encourages banks to remedy the geographic and economic isolation caused by historical racism by meeting the credit needs of low- to moderate-income communities within a bank's "assessment areas."[114] The term "assessment area" includes the geographic locations in which the bank has its "main office, its branches, and its deposit-taking ATMs, as well as the surrounding geographies in which the bank has originated or purchased a substantial portion of its loans.[115] The CRA is separate from, but works in conjunction with, other anti-discrimination laws and consumer protection laws. The CRA is enforced by four federal bank regulators.[116] The regulators review a bank's

---

[106] *See generally* 12 U.S.C. §§ 2901–2908 (2000).

[107] Marsico, *Community Reinvestment Act*, *supra* note 27, at 403–14.

[108] Community Reinvestment Act Regulations, 60 Fed. Reg. § 22,156, 22,157 (May 4, 1995) (codified at 12 C.F.R. pts. 25, 203, 228, 345, 563e).

[109] The Riegle Community Development and Regulatory Improvement Act of 1994, 12 U.S.C. § 4701 (1994).

[110] 12 U.S.C. § 2901(a)(3); *see also* Richard D. Marsico, *Democratizing Capital: The History, Law and Reform of the Community Reinvestment Act*, 49 N.Y.L. SCH. L. REV. 717 (2004–2005) [hereinafter Marsico, *Democratizing Capital*].

[111] 12 U.S.C. § 2901(b).

[112] *See* Marsico, *Democratizing Capital*, *supra* note 110, at 717–18.

[113] *See* Raymond H. Brescia, *A CRA for the 21st Century: Congress Considers the Community Reinvestment Act of 2009*, 28 BANK. & FIN. SERV. POL'Y REPORT 1 (2009) [hereinafter Brescia, *CRA for the 21st Century*] (explaining that CRA's provisions do not prohibit racially discriminatory conduct).

[114] 12 C.F.R. § 25.21(b) (2008); *see also* Brescia, *CRA for the 21st Century*, *supra* note 113, at 2 (describing the legislation's definition of assessment areas).

[115] 12 C.F.R. § 25.41(c) (2003).

[116] *See* Marsico, *Democratizing Capital*, *supra* note 110, at 718–19.

determination of its assessment areas,[117] and issue public written reports that rate banks' compliance with their CRA obligations.[118] The regulators consider a bank's CRA rating when determining whether to grant a bank's application to "obtain a charter, obtain deposit insurance, establish a branch, relocate a home office or branch, merge with another bank, or obtain the assets or assume the liabilities of another bank."[119] A negative CRA rating can cause regulators to deny a bank permission to engage in these activities. Any member of the public can participate in the public comment process and oppose any bank's application on the basis of its CRA ratings.[120]

The CDFI Fund was created in 1994 as an arm of the U.S. Treasury Department, to promote economic revitalization and community development through investment in, and assistance to, CDFIs.[121] CDFIs are privately owned financial intermediaries established to advance community economic development in low-income and historically disadvantaged communities in the United States.[122] CDFIs provide financial services to microenterprises, non-profit organizations, commercial real estate development projects, affordable housing, and other community development projects in historically disinvested areas.[123] The CDFI Fund directly invests in, supports, and trains CDFIs.[124] It also administers the New Markets Tax Credit Program (NMTC Program), which provides tax credits to individual and corporate investors who make equity investments in specialized financial institutions called Community Development Entities (CDEs).[125] CDEs provide investment capital to low-income communities and include members of such communities on their governing boards.[126] Many CDFIs seek CDE certification to attract private investment for microfinance and other community development activities. In 1995, revised CRA regulations explicitly recognized loans and investments made by regulated private banks in CDFIs as qualified CRA activities.[127] By investing in CDFIs that screen

---

[117] *See* Brescia, *CRA for the 21st Century*, *supra* note 113, at 2.

[118] *See id.*

[119] Marsico, *Community Reinvestment Act*, *supra* note 27, at 406.

[120] *See id.* at 719.

[121] *About the CDFI Fund*, COMMUNITY DEV. FIN. INST. FUND, http://www.cdfifund.gov/who_we_are/about_us.asp (last updated Jan. 31, 2013).

[122] *See id.*

[123] *Overview of What We Do,* COMMUNITY DEV. FIN. FUND, http://www.cdfifund.gov/what_we_do/overview.asp (last updated Oct. 12, 2011).

[124] *See About the CDFI Fund*, COMMUNITY DEV. FIN. INST. FUND, *supra* note 121.

[125] New Markets Tax Credit Act, 26 U.S.C. § 45D (2012).

[126] *See id.* at § 45D.

[127] These regulations also established a three-part test for large banks "with [a] 50 percent weighted on lending, 25 percent on community development investments, and 25

microfinance institutions, which ultimately screen borrowers, private banks reduce the transaction costs associated with investing in marginal communities. They can also obtain a favorable CRA rating from these activities, which helps them maximize profits in other aspects of their business. This confluence of federal laws and regulations helped stimulate private sector investment in microfinance and community development.

However, the CRA, the CDFI, and the NMTC are all examples of federal legislation designed to stimulate economic development in communities that are defined geographically—the neighborhood, low- and moderate-income areas, the metropolitan statistical area, the qualified census tract, and the assessment area, amongst other designations. Yet, as globalization and technology operate to disentangle markets from geographic boundaries, some of the traditional legal structures and community development practices that remedy prior market failures and facilitate new economic development may need to be reexamined, or at least applied in new contexts. The geographic emphasis of these laws is still necessary, but, perhaps no longer sufficient. A diverse range of financial institutions, in complex economic relationships, now provide banking and financial services. With the advent of the Internet and interactive websites, increasingly, markets and economic opportunities are less tied to local geographic boundaries. Geography is not irrelevant and globalization and technology still have implications for local markets, but new banking and economic development opportunities exist in cyberspace, rather than in geographic space. Our community economic development laws and economic justice incentives must respond to this increasing complexity.

E. Modernizing the Community Reinvestment Act to Respond to Changes in the Financial Services Delivery System

The recent subprime mortgage debacle exemplifies how community economic development laws and incentives need to be modernized[128] and expanded to respond to changing economic conditions. While the subprime mortgage crisis was not caused by innovations in cyberspace, it demonstrates that CRA's protections did not keep pace with significant changes in

---

percent on retail (i.e., branch locations), and community development services (e.g., financial education)." Mark Willis, *It's the Rating Stupid: A Bankers Perspective on the CRA*, *in* REVISITING THE CRA: PERSPECTIVES ON THE FUTURE OF THE CMTY. REINVESTMENT ACT 59–69 (2009) (smaller banks with less than $250 million were only subject to the fifty percent lending test).

[128] *See* John Moon, *CRA Modernization and Impact Investments*, 2010 CMTY. DEV. INV. REV. (FED. RESERVE BANK OF SAN FRANCISCO) 50–54 (2010).

the financial services industry spurred by bank deregulation and capital market innovations. This regulatory slippage had a negative impact on the mortgage industry in general, but also on and low-income, minority, economically marginal and geographically isolated communities, in particular. When the CRA was initially enacted, its covered depository institutions originated most of the mortgages in the United States, and held most household savings in the United States.[129] At that time, individuals' also conducted most of their banking through local bank branches. Fixed-rate, prime, thirty-year mortgages were also the norm for most Americans.

In the 1980s, the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA),[130] the Alternative Mortgage Transaction Parity Act of 1982 (AMTPA),[131] and their accompanying implementing regulations deregulated the mortgage industry.[132] DIDMCA preempted state interest rate caps on mortgages.[133] The AMTPA enabled lenders to offer adjustable rate mortgages.[134] This deregulation enabled mortgage companies to offer more complex products with complicated terms, such as adjustable rate mortgages with teaser rates, mortgages with balloon payments, and mortgages containing higher interest rates and fees.[135] Further, in 1999, the Gramm-Leach-Bliley Act (GLBA), also known as the "Financial Services Modernization Act," made significant changes to the financial services industry, eliminating many regulatory barriers that prevented banks, securities firms, and insurance companies from affiliating.[136] The GLBA allowed banks, securities firms, and insurance companies to consolidate within a financial holding company.[137] These financial holding companies provided a range of financial services at lower costs.[138] This deregulation and other changes in the financial services industry led

---

[129] Roberto Quercia, Janneke Ratcliff & Michael A. Stegman, *The Community Reinvestment Act: Outstanding, and Needs to Improve*, *in* REVISITING THE CRA: PERSPECTIVES ON THE FUTURE OF THE COMMUNITY REINVESTMENT ACT 47–58 (2009).

[130] 12 U.S.C. § 1735f-7a (2006).

[131] 12 U.S.C. § 3803(a)(3) (2006).

[132] *See, e.g.,* Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1190 n.36 (2012); Raymond H. Brescia, *Capital in Chaos: The Subprime Mortgage Crisis*, 56 CLEV. ST. L. REV. 271 (2008) [hereinafter Brescia, *Capital in Chaos*].

[133] Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 226 (2006); *see also* Brescia, *Capital in Chaos*, *supra* note 132, at 108 (describing the act).

[134] Brescia, *Capital in Chaos*, *supra* note 132, at 288.

[135] *See id.*

[136] Neal R. Pandozzi, *Beware of Banks Bearing Gifts: Gramm-Leach-Bliley and the Constitutionality of the Federal Financial Privacy Legislation*, 55 U. MIAMI. L. REV. 163, 165 (2001).

[137] *See id.*

[138] *See id.* at 166.

to a proliferation of mortgage companies that offered a range of complicated financial products that were not regulated by the CRA. While legislators sought to repeal the CRA in their deliberations over the GBLA, the CRA was maintained although modified.[139] Applications by financial holding companies and national banks seeking new financial services or to acquire new companies must be denied where any of the holding companies' banks or thrifts has a low CRA rating.[140] However, "where a parent company's depository institutions all have CRA ratings of at least satisfactory, such applications cannot be denied on CRA grounds."[141] The GLBA also relaxed the CRA burden on mid-sized banks.[142] These changes led to lax enforcement of CRA protections and left the activities of some mortgage companies outside of the regulatory ambit of the CRA.[143] This failure to modernize and expand CRA's protections created a regulatory vacuum that contributed to the crisis.[144] Unscrupulous mortgage brokers originated subprime mortgages with problematic terms to unwitting borrowers and engaged in predatory lending in the same communities once previously redlined.[145] Studies have shown that subprime lenders often engaged in "reverse redlining"— targeting predatory and subprime loans with problematic terms towards minority borrowers, who may not qualify for prime loans or who are inexperienced in mortgage markets.[146] Other studies reveal that subprime and predatory lenders targeted some minority borrowers who otherwise would have qualified for prime loans.[147] While risky loans were initially marketed primarily to low-income, minority communities, and to seniors, the failure to regulate these practices legitimized irresponsible lending practices. Consequently, a growing number of institutions offered these products to individuals living outside of vulnerable, low-income, minority communities, and a growing number of individuals sought

---

[139] *See, e.g.,* Kathleen C. Engle & Patricia McCoy, *The CRA Implications of Predatory Lending*, 29 FORDHAM URB. L.J. 1571, 1574 (2002).

[140] *See id.* at 1575.

[141] *See id.*

[142] *See* Brescia, *CRA for the 21st Century*, *supra* note 113, at 6.

[143] *See id.* at 289.

[144] *See* John Moon, *CRA Modernization and Impact Investments*, *supra* note 128, at 50–54.

[145] *See id.*

[146] *See, e.g.,* Joseph William Singer, *Subprime: Why a Free and Democratic Society Needs Law*, 47 HARV. C.R.-C.L. L. REV. 141, 159–60 (2012).

[147] *See, e.g.*, Brescia, *Capital in Chaos*, *supra* note 132, at 285; Engle & McCoy, *supra* note 139, at 1583–84; Creola Johnson, *Fight Blight: Cities Sue to Hold Lenders Responsible for the Rise in Foreclosures and Abandoned Properties*, 2008 UTAH L. REV. 1169, 1176 (2008); Cheryl L. Wade, *Fiduciary Duty and the Public Interest*, 91 B.U. L. REV. 87, 119 (2011).

or used these products to obtain new sources of income and equity. Thus, relatively few subprime loans even qualified for CRA credit, either because they "were made outside of CRA assessment areas, or because they were made to higher-income borrowers."[148] A study conducted by the U.S. Federal Reserve found that "only 6% of all higher-priced loans in 2006 [the height of the subprime mortgage crisis] were made by CRA-covered institutions or their affiliates to lower-income borrowers or neighborhoods in their assessment areas."[149]

Mainstream banks could indirectly finance subprime lending through relationships with non-affiliated financial institutions not covered by CRA. Further, "census tracts served disproportionately by CRA-covered lenders had less risky loans and lower delinquency rates than those served disproportionately by non-CRA lenders."[150] Despite these facts, many have identified the CRA as the primary or sole cause of subprime and predatory lending in the United States.[151] Instead, the subprime mortgage catastrophe demonstrates that CRA's protections did not keep pace with significant changes in the financial services industry spurred by bank deregulation and capital market innovations. Deregulation in the securities and financial services industries also increased the securitization of subprime mortgages. Securitization created increased demand for subprime products that could be sold to investors.[152] The majority of originators, and the majority of special purpose vehicles that securitized subprime-mortgage products, were not CRA covered depository institutions. These organizations conducted their financial activities outside the ambit of CRA regulators. These entities were, thus, given free rein to engage in irresponsible lending practices, and to market problematic products to individuals and communities that were vulnerable as a result of their economic, social or geographic status. This regulatory slippage also created market opportunities for fringe financial institutions[153] and unscrupulous lenders to locate in, and target, low-income minority neighborhoods.[154] These institutions

---

[148] *See* Levitin & Wachter, *supra* note 33, at 1215.

[149] *See id.* (citing FIN. CRISIS INQUIRY COMM'N, PRELIMINARY STAFF REPORT: THE COMMUNITY REINVESTMENT ACT AND THE MORTGAGE CRISIS 6 (2010)).

[150] *See id.*

[151] *But see* Levitin & Wachter, *supra* note 33, at 1215.

[152] *See id.*

[153] Fringe financial institutions describe financial entities such as payday lenders, check-cashing services, and pawnbrokers.

[154] Payday loans, for example, "are high interest rate, rapidly compounding loans meant to tide over cash-short borrowers until their next paycheck." *See* Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday Loans" in Military Towns*, 66 OHIO. ST. L. J. 653, 660–61 (2005) ("A 455% interest rate is by no means uncommon."); *see also* Creola Johnson, *Payday Loans:*

predominated in low-income, minority communities, because of those communities' histories of disinvestment and their lack of legitimate financial alternatives.[155] While these fringe banking[156] institutions' ultimately raise customers' transaction costs in the long-run, in the short-term, they reduce the transaction costs associated with obtaining cash. Thus, unregulated, fringe financial services are initially efficient for all involved. Low-income, minority, and geographically isolated borrowers may prefer to transact with fringe financial institutions because they can obtain cash quickly without having to endure credit checks, training or other financial and non-financial requirements of mainstream financial institutions and microfinance agencies.[157] Yet, fringe financial services markets are also characterized by opportunism and abuses of trust.[158] A lack of consistent national regulations to facilitate legitimate lending in low-income communities and to curb fraudulent, unfair, and deceptive practices helped to create an alternative market space that undermined trust and limited access to legitimate mainstream markets. This example of regulatory drift demonstrates that a lack of regulation can lead markets to develop in dysfunctional ways that perpetuate existing market failures and replicate existing social allocations of power. Problematic distributive outcomes in markets can occur when law is inattentive to the relationship between communities and markets. Hence, the United States may also need to modernize the CRA to regulate new developments in the financial services delivery system, such as new online cyberfinancing, and to ensure distributive justice in these emerging markets.

II. CYBERFINANCING 2.0: COMMUNITIES, MARKETS AND LAW REVISITED

A. Online Peer-to-Peer Lending 2.0

Online P2P lending describes interactive websites that allow borrowers and lenders to transact with one another online without the traditional involvement of a mainstream financial institution.[159] Some scholars call P2P lending an example of continued disintermediation in lending transactions,

---

Shrewd Business or Predatory Lending, 87 MINN. L. REV. 1 (2002) (describing payday loans as "extremely high-interest, short-term loans offered to cash strapped consumers").

[155] *See* Johnson, *supra* note 154, at 8–9.

[156] *See generally* JOHN P. CASKEY, FRINGE BANKING, CHECK-CASHING OUTLETS, PAWNSHOPS AND THE POOR (1994) (explaining the prevalence of fringe banking institutions in low-income, minority neighborhoods and why the poor are drawn to them).

[157] *See* Graves & Peterson, *supra* note 154, at 661.

[158] *See* Johnson, *supra* note 154, at Part II.

[159] *See, e.g.,* GAO REPORT, *supra* note 10, at 1; Chaffee & Rapp, *supra* note 7, at 491; Verstein, *supra* note 7, at 452.

suggesting that borrowers and lenders can increasingly engage in lending transactions without the intermediating role of a bank or financial institution.[160] Yet, as this Section explains, while P2P lending platforms eliminate some of the traditional intermediating functions of banks, they still intermediate, albeit in a unique way. These platforms not only intermediate differently from traditional banks, but they also intermediate differently than traditional microfinance institutions or ROSCAs.

The three most popular P2P lending platforms in the United States are Prosper.com (Prosper), Lending Club.com (Lending Club) and Kiva.org (Kiva).[161] Prosper and Lending Club are P2P lending platforms owned by two different for-profit companies. Kiva is a P2P microlending platform, owned by a non-profit organization, which enables lenders to make interest-free loans to microentrepreneurs throughout the globe.[162] The for-profit lending platforms primarily facilitate unsecured loans between borrowers and lenders. The non-profit platform facilitates domestic and international microlending. These platforms help borrowers and lenders, identify each other, connect, lend, and borrow online. They also enable users to connect across distance, class, race, gender, and ethnicity.

Notably, online P2P lending increased in popularity, in the United States, along with more famous social networking sites such as Facebook and YouTube.[163] P2P lending also became an increasingly important alternative source of consumer credit in the United States, as credit markets contracted after the financial crisis and during the Great Recession.[164] In 2009, for example, U.S. banks posted the sharpest declines in private lending since 1942.[165] In response, many borrowers turned to online P2P lending. When the for-profit P2P platforms were initially launched, they allowed borrowers with lower credit scores than those required by mainstream financial institutions to publish loan requests on P2P lending sites.[166] This enabled economically marginal and geographically isolated borrowers to obtain

---

[160] *See* Verstein, *supra* note 7, at 449.

[161] GAO REPORT, *supra* note 10, at. 1.

[162] The for-profit companies, Prosper Marketplace, Inc. and Lending Club Corporation, operate Prosper.com and LendingClub.com, respectively. Both companies are incorporated in Delaware with principal offices in California. Kiva Microfunds is a 501(c)(3) non-profit organization, incorporated in California, which operates Kiva.org. *See* GAO REPORT, *supra* note 10, at 1.

[163] *See* Chaffee & Rapp, *supra* note 7, at 501.

[164] *See id.* at 503–05.

[165] Ilya Pozin, *Crowdfunding: Saving the U.S. Economy [INFOGRAPHIC]*, FORBES BLOG (June 28, 2012, 1:49 PM), http://www.forbes.com/sites/ilyapozin/2012/06/28/crowdfunding-saving-the-u-s-economy-infographic/ [hereinafter Pozin].

[166] *See* Chaffee & Rapp, *supra* note 7, at 503–04.

loans on terms that were otherwise difficult for them to obtain through traditional or even fringe financial markets.[167]

Yet, as the SEC began to regulate these websites,[168] Prosper and Lending Club adopted higher minimum credit scores for qualifying borrowers. These requirements will operate to limit traditionally marginalized borrowers' access to these websites. This example shows how SEC regulation led the for-profit P2P lending sites to limit marginalized borrowers' access. It suggests that the United States should embrace a multi-agency and multidisciplinary approach to regulating P2P lending that balances the needs of both lenders and borrowers who participate on these sites. In Part III, this Article proposes such a regulatory structure. The following Sections describe and analyze the premiere for-profit and non-profit P2P lending platforms in the United States. Section 1 of Part II.A describes the for-profit P2P lending process and the intermediary organizations that facilitate it. Section 1 of Part II.A also explains that U.S. regulators are increasingly restricting economically marginal borrowers' access to these websites. Section 2 of Part II.A describes how the non-profit P2P microlend-microlending platform, Kiva.org, intermediates in P2P microlending transactions online. It also outlines the advantages and disadvantages of the current model of non-profit P2P lending for geographically isolated and economically marginal borrowers.

1. For-Profit Peer-to-Peer Lending 2.0

Prosper and Lending Club have similar lending processes. Potential borrowers and lenders must register on the P2P lending platforms and provide basic information to the platforms "to determine their eligibility as a borrower or lender."[169] Prospective borrowers have more stringent requirements for eligibility than prospective lenders. They must complete a loan application to determine their creditworthiness, and must now have minimum credit scores of "at least 640 for Prosper and 660 for Lending Club" to participate.[170] Prosper and Lending Club then assign letter grades to help prospective lenders gauge borrowers' creditworthiness.[171] The letter grades are based upon a combination of the borrower's credit score, credit history, requested loan amount, and past delinquencies.[172] Both

[167] *See id.* at 505.
[168] *See infra* Part II.A.1.a.
[169] GAO REPORT, *supra* note 10, at 10.
[170] *See id.* at 11.
[171] *See id.*
[172] *See id.*

companies then post approved and rated loan requests for lenders to review and select.[173] Prospective lenders, however, are not evaluated for creditworthiness.[174] They only have to provide identity verification and attest that they meet the platforms', or various state regulators', minimum asset requirements.[175]

These platforms allow borrowers to develop, and publish online, once approved, personal narratives that provide non-financial information about the borrower and his or her loan request. Prospective lenders can view this information, in addition to standard financial information, when making lending decisions. Recent studies have shown that this narrative information can make a difference in lenders' decision-making processes.[176] Borrowers whose credit grades are poor will often "strategically provide identities"[177] in this narrative section. The identities that borrowers develop through these narratives can positively influence a lender's decision to lend to a borrower with an otherwise poor credit rating.[178] Thus, users on P2P lending platforms may not know each other before meeting and connecting online, but they come to know a bit more about each other, in this cyberspace, through the information that the P2P lending platforms collect and publish. In making their determinations, lenders can manually peruse individual loan requests, develop portfolios based upon certain criteria, or use automated portfolio building tools offered by the platforms to make their selections.[179]

The platforms also limit the aggregate amount that each lender can lend—up to $5 million dollars for Prosper and no more than ten percent of a lender's total net worth for Lending Club. Both platforms provide participating lenders "a prorated share of any corresponding repayments of principal and interest on the loans they help fund."[180] These platforms, therefore, provide lenders returns on their investments.[181] If the borrowers associated with the lenders' investments fail to repay their loans, however, lenders will lose both their principal and interest investments.[182] These platforms enable lenders to achieve higher returns on their investments.[183]

---

[173] *See id.* at 12.
[174] *See id.* at 11.
[175] *See id.*
[176] *See* Michael Herzenstein et al., *Tell Me a Good Story and I May Lend You Money: The Role of Narratives in Peer-to-Peer Lending Decisions*, 48 J. MARKETING RES. (SPECIAL ISSUE) S138, S147 (2011).
[177] *See id.*
[178] *See id.*
[179] *See id.* at 12.
[180] *Id.* at 1.
[181] *See id.*
[182] *See id.*
[183] *See id.* at 8.

> As of March 31, 2011 Prosper reported that lenders received average annualized returns exceeding 11 percent for loans originated since it completed registration with the SEC in July 2009, while Lending Club reported net annualized returns exceeding 9 percent for all loans since it issued its first loan in June 2007.[184]

These returns exceeded those annual yields available on savings, money market accounts, and certificates of deposit during the same period.[185]

Borrowers use these platforms as alternative sources of credit.[186] Borrowers on these platforms are usually seeking "small unsecured loans for consumer purposes—such as consolidating debts, paying for home repairs, or financing personal, household or family purchases—or to a lesser extent for business purposes."[187] Some economically marginalized borrowers "for whom payday lending may have been the only option," have turned to P2P markets to "consolidate their loans, pay off debts, and improve their credit scores."[188] The interest rates on P2P loans are often lower than those on traditional unsecured bank loans or credit cards.[189] "As of March 31, 2011, the annual percentage rate for a 3-year loan was as low as 6.9 percent for Prosper and 6.8 percent for Lending Club, depending on the borrower's credit ratings or loan grades, while the average annual percentage rate for credit cards around that time was 14.7 percent."[190] While Prosper's annual percentage rates can be as high as 35.6 percent and Lending Club's can be as high as 25.4 percent, "Prosper reported that the average annual percentage rate for all 3-year loans since its inception was 20.6 percent, and Lending Club reported that the same average for its loans was 11.4 percent."[191]

A lender will usually invest in a number of different loans, and may invest in all or part of a given loan request, to diversify its portfolio of investments.[192] Some lenders may give as little as $25 per loan.[193] Notably, lenders on both platforms do not make loans directly to borrowers.[194] Thus, the platforms do intermediate between borrowers and lenders. When

---

184 *Id.* at 9.
185 *See id.*
186 *See id.*
187 *See id.* at 10.
188 *See id.* at 505 (citing Alexandra Todorova, *Peer-to-Peer Lending Offers Solution for Strapped Consumers*, SMARTMONEY (Oct. 15, 2007), http://www.smartmoney.com/spend/family-money/peer-to-peer-lending-offers-solution-for-strapped-consumers-2-1978).
189 *See id.* at 9.
190 *See id.*
191 *See id.*
192 *See id.* at 10.
193 *See id.*
194 *See id.* at 13.

lenders choose borrowers through the P2P lending platforms, they purchase payment-dependent notes from the platforms that correspond to the selected borrower loans.[195] WebBank, an FDIC-insured Utah-chartered industrial bank, issues the loans to borrowers, and then sells and assigns the loans to the respective platforms in exchange for the principal amount that the platforms received from the sale of corresponding notes to the lenders.[196] Thus, the WebBank originates the loans, but does not retain ownership of the loans. Instead, the WebBank transfers the loans and the risk of borrower nonpayment to the respective platforms.[197]

The platforms now are registered with the SEC and sell their notes to lenders via prospectus.[198] Those notes are the platforms' obligations payable upon borrower repayment.[199] "Accordingly, when the lender signals interest in a prospective borrower, and WebBank lends to the borrower, the platform permanently retains ownership of the borrower's indebtedness. The platform then sells its debt instrument to the lender, who becomes a creditor of the platform not the borrower."[200] Prosper and Lending Club retain exclusive rights to service the loans, collect monthly payments from borrowers, and recover any delinquencies.[201] They also determine when to turn over delinquent loans to third-party collection agencies.[202] The platforms take a one percent servicing fee, amongst other fees, and then "credit each lender's account with his or her share of the remaining funds."[203] For both companies, as of March 31, 2011, about two percent or less of the loans in their top three credit grades originated between the first half of 2010 had defaulted.[204]

The P2P lending platforms described above provide a slightly more individualized way for lenders to identify prospective borrowers.[205] As explained earlier, standard banks and lending institutions, including payday lenders, use more "standardized underwriting procedures and risk profiling algorithms"[206] to determine borrowers' creditworthiness and to guide

[195] *See, e.g.*, *id.* at 13; Chaffee & Rapp, *supra* note 7, at 509; Verstein, *supra* note 7, at 477.
[196] *See* GAO REPORT, *supra* note 10, at 13.
[197] *See id.*
[198] *See* Verstein, *supra* note 7, at 476–77.
[199] *See id.* at 477.
[200] *Id.* at 477.
[201] *See* GAO REPORT, *supra* note 10, at 13.
[202] *See id.* at 20.
[203] *Id.* at 13 (emphasis added).
[204] *See id.* at 14.
[205] *See id.* at 20.
[206] Ian J. Galloway, *Peer to Peer Lending and Community Development Finance* 1–15 (Fed. Res. Bank of San. Francisco, Cmty. Dev. Investment Ctr., Working Paper No.

their lending decisions. Using these methods, "[b]orrowers with more standard risk profiles have better access to credit than those that fall outside of traditional parameters."[207] Thus, traditional standardized underwriting can lead to a credit rationing that precludes riskier or economically marginal borrowers, from receiving credit.[208] While the P2P lending platforms' consideration of credit scores and determination of letter grades constitute a form of credit rationing, the platforms also collect, and allow borrowers to provide, other nonfinancial information as part of their customized loan listing, such as what the loan will be used for, a borrower's description of their financial situation, and an explanation of delinquencies, or a high-revolving credit balance.[209] This additional information may help economically marginal borrowers whose economic indicators suggest credit risk convince individual lenders to consider them despite their economic risk factors.[210] Lenders also often fund more than one loan and aggregate loans. Consequently, lenders may be willing to fund some riskier borrowers if that risk is offset by more standard borrowers. Thus, while online P2P lending does not eliminate the barriers to credit access that high-risk borrowers face, it can mitigate them by reducing the costs associated with lending transactions, and overcoming, in part, the geographic and social distance that precludes traditionally marginalized borrowers from participation in mainstream markets.

For-profit online P2P lending platforms also expose economically marginal and geographically isolated borrowers to a broader selection of potential lenders than traditional microfinance institutions, or ROSCAs. Prospective lenders on Prosper and Lending Club are, generally, seeking to obtain better financial returns on their investments, than what might be available through other investment vehicles. As such, investors on these sites are not primarily motivated to assist low-income individuals or groups. Thus, economically marginal borrowers participating on these sites are exposed to a broader social network of potential lenders than would be available through a community-based ROSCA or through microfinance institutions. Marginalized borrowers may also prefer to obtain small amounts of unsecured loans from individuals through P2P lending platforms; this is because they can escape the time-consuming and costly process of community meetings,

---

2009-06, 2009), *available at* http://www.frbsf.org/publications/community/wpapers/2009/wp2009-06.pdf.

[207] *Id.*

[208] *See* Stiglitz and Weiss, *supra* note 38, at 394–95 (defining credit rationing).

[209] *See How to Get a Loan*, PROSPER, http://www.prosper.com/loans/how-to-get-a-loan/step-1/ (last visited Mar. 23, 2013).

[210] This aspect of the process is similar to face-to-face peer lending and microenterprise lending because lenders make their decisions based upon more information than that used by standard banks.

as well as the peer-pressure that characterizes participation in informal ROSCAs or formal microfinance institutions.[211]

P2P lending platforms, therefore, provided borrowers with new sources of credit and investors with new opportunities to lend their capital, and diversify their investments, by reducing the transaction and information costs associated with lending through traditional financial institutions.[212] However, P2P lending platforms now only collect limited non-financial information about borrowers and they do not facilitate the same level of face-to-face interaction and trust-building as do ROSCAs and microfinance institutions. As a result, for-profit P2P lending institutions may not help borrowers establish the tight social bonds and human capital development essential to helping borrowers repay and develop their microenterprises. Another risk is that borrowers, who are inexperienced, may not be able to determine good credit terms. Further, ROSCAs and microfinance institutions attempt somewhat to align the interests of borrowers and lenders by making individuals play both roles, or by requiring borrowers to attend financial and business education seminars that increase the likelihood of repayment. For-profit P2P lending portals do not require borrowers and lenders to align their interests, nor do they force borrowers and lenders to engage in repeat transactions. While this may lower the transaction costs for borrowers and lenders, it may also heighten the risks of non-payment or fraud in online transactions.

P2P lending still represents an opportunity for geographically isolated and economically marginalized borrowers to access new sources of credit by connecting them more directly to new sources of funds. Yet, current U.S. regulation of P2P lending is restricting traditionally marginalized actors' access to these markets. In response to some defaults, but also in response to increased regulatory scrutiny, the leading platforms now require higher minimum credit scores for prospective borrowers, than they required when the platforms were first launched. These higher credit score requirements are designed to protect lenders because they connect lenders to less risky borrowers. While lenders do need protection in these markets, US regulators may need to create incentives that increase marginalized actors access without sacrificing the rights of lenders.

---

[211] This author is not agnostic with respect to the training and community development that non-profit microlending institutions provide. That training is beneficial to the borrowers and also fulfills a social good of educating market participants. However, this training is costly as some low-income economically marginalized borrowers may prefer to transact with lenders who do not have those requirements.

[212] Chaffee & Rapp, *supra* note 7, at 492.

a. SEC Regulation of P2P Lending Restricts Marginalized Borrowers' Access

Given the novel and complex nature of P2P lending transactions, a number of federal and state agencies have responsibility for regulating these transactions.[213] As scholars have noted, because WebBank, an FDIC-insured institution, is involved in the process of intermediation, a number of federal banking and lending statutes apply to these transactions.[214] Thus, lenders who might discriminate against low-income and geographically marginal borrowers based upon illegitimate criteria, such as race, gender or ethnic status, are prohibited from such activities by federal anti-discrimination laws that pertain to lending transactions. Further, consumer protection statutes that apply to lending activities such as the Truth in Lending Act (TILA), the Fair Credit Reporting Act (FCRA), the Fair Debt Collections Practices Act (FDCPA), the Electronic Funds Transfer Act (EFTA), and section 5 of the Federal Trade Commission Act (FTCA) also apply to P2P lending transactions.[215] These statutes, however, do not address the geographic and economic barriers to credit access that often plague traditionally marginalized groups. Thus, the consumer and anti-discrimination focus of existing lending laws are necessary, but are unlikely to address the economic, geographic, and social isolation that precludes many borrowers from participating in mainstream markets.

Notably, the SEC has been the most aggressive agency in regulating P2P lending.[216] This may explain the investor-protection emphasis in the U.S.'s current regulation of P2P lending. In 2008, the SEC issued a cease-and-desist order against Prosper because it determined that the lending notes Prosper issued to investors constituted securities under federal securities laws.[217] Since Prosper had not registered with the SEC prior to the

---

[213] *See* GAO REPORT, *supra* note 10, at 3–6.

[214] *See* Chaffee & Rapp, *supra* note 7, at 508–09 (explaining that the Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Federal Trade Commission Act, the Gramm-Leach- Bliley Financial Modernization Act, the Servicemembers' Civil Relief Act, the Bank Secrecy Act, the Electronic Funds Transfer Act, and the Electronic Signatures in Global and National Commerce Act all apply to P2P lending transactions).

[215] *See id.* at 509.

[216] *See, e.g.*, Chaffee & Rapp, *supra* note 7, at 509; Verstein, *supra* note 7, at 447.

[217] *See* Prosper Marketplace, Inc., Cease-and-Desist Order, Securities Act Release No. 8984, 94 SEC Docket 1913 5–6 (Nov. 24, 2008) [hereinafter Securities Act Release No. 8984] (determining that Prosper's notes are securities because lenders are motivated by a financial return, the loans are offered to the general public through the platform, reasonable

cease-and-desist order, the SEC determined that it was dealing unregistered securities in violation of sections 5(a) and (c) of the Securities Act of 1933.[218] Notably, federal securities laws do not precisely define the term "securities," yet based upon the Supreme Court's precedents in *SEC v. W.J. Howey Co.* and *Reves v. Ernst & Young*, interpreting the Securities Act of 1933, the SEC determined that Prosper was trading unregistered securities and ordered Prosper to cease its activities.[219]

In *Howey*, the Supreme Court devised a test to determine whether a particular transaction qualifies as an "investment contract," or security, and held that "a contract, transaction or scheme whereby a person [i] invests his money [ii] in a common enterprise and is led to expect [iii] profits solely from the efforts of the promoter or a third-party," constitutes an investment contract and is thus subject to U.S. securities regulation.[220] The SEC determined that the payment-dependent notes issued to investors by Prosper satisfied all three elements of the *Howey* test and constituted an investment contract subject to securities regulation.[221] Further, the SEC found that Prosper's notes constituted securities under the tests established by the Supreme Court in *Reves v. Ernest & Young*.[222] In *Reves*, the Supreme Court devised a list of factors to identify which notes do not constitute securities.[223] Since the payment-dependent notes issued to lenders through Prosper did not qualify under any of the factors in the *Reves* list, the SEC also determined that Prosper's notes were securities.[224] Prosper shut down in 2008, in response to the SEC's cease and desist order and resumed operation on July 13, 2009 after filing a registration statement with the SEC.[225] Lending Club then also shut down its notes operation in 2008 pending registration with the SEC, "but it continued to make loans to borrowers using its own funds."[226] Lending Club resumed its notes operation

---

investors consider the loans investments, and there is no other regulator to protect investors against risks).

[218] Securities Act of 1933, 15 U.S.C. § 77e (2006).

[219] *See, e.g.*, S.E.C. v. W.J. Howey Co., 328 U.S. 293, 297–300 (1946); Reves v. Ernst & Young, 494 U.S. 56, 64 (1990); *see also* Chaffee & Rapp, *supra* note 7, at 510–19 (describing the application of *Howey* and *Reves* to P2P lending); Verstein, *supra* note 7, at 478–88 (same).

[220] *W.J. Howey Co.*, 328 U.S. at 298–99.

[221] *See* Securities Act Release No. 8984, *supra* note 217, at 4.

[222] *Id.* at 4–6.

[223] *Reves*, 494 U.S. at 64.

[224] *See id.* at 64. *But see* Verstein, *supra* note 7, at 477. ("While it is plausible that P2P notes were either 'investment contracts' or 'notes' for the purposes of the Securities Acts, there is a strong case that they were neither.").

[225] *See* GAO REPORT, *supra* note 10, at 7–8.

[226] *See id.*

in October 2008 and grew rapidly.[227] As of March 31, 2011, Prosper and Lending Club facilitated about 63,000 unsecured, fixed-term, and fixed-rate loans, totaling approximately $469 million, most of which were consumer loans.[228]

The SEC's effort to regulate the industry created barriers to entry for economically marginal and geographically isolated borrowers. Around the time of increased scrutiny by the SEC, Prosper increased its minimum required credit score to 640.[229] Lending Club began increasing its minimum credit score requirements in 2007 as a way to help build lender confidence, and to respond to increased scrutiny by the SEC.[230] Prosper's and Lending Club's required credit scores of 640 and 660, respectively, are substantially higher than domestic microfinance institutions require.[231] If economically marginal and geographically isolated borrowers can meet these credit requirements, then they may be able to obtain some loans on these platforms, yet those amounts will not help such borrowers fully overcome their economic marginalization. Commentators have also noted that Prosper appears to be "evolving from a comprehensive market toward a market that primarily serves borrowers who have traditional access to credit."[232] Additionally, because the SEC has been the most aggressive regulator of for-profit P2P lending, thus far, borrowers' risks are relegated to the protection of existing consumer protection laws.

b. The GAO's Recommendations for Regulating P2P Lending Are Inadequate to Enhance Marginalized Actors' Access

The Government Accountability Office's (GAO) report[233] on the status of the P2P lending industry included a performance audit of the industry

---

[227] *See id.* at 8.

[228] *See id.* at 1.

[229] Chaffee & Rapp, *supra* note 7, at 494.

[230] *See* Galloway, *supra* note 206, at 12 ("As a way to help build confidence on the lenders' side, we have decided to limit access to borrowers with at least a 640 FICO score and less than 20% debt-to-income ratio .... The flip side is that we have to turn down a fair number of borrowers.") (quoting Allan Stern, Interview of Renaud Leplanche on August 6, 2007).

[231] *Compare* GAO REPORT, *supra* note 10, at 10–12, *with* Erica Dorn, *U.S. Microfinance 101*, KIVA FELLOWS BLOG (Apr. 27, 2009), http://fellowsblog.kiva.org/2009/04/27/usmicrofinance-101/#comments.

[232] Galloway, *supra* note 206, at 12 (quoting Seth Freedman & Ginger Zhe Jin, *Dynamic Learning and Selection: The Early Years of Prosper.com* 7 (Univ. of Md. Dep't of Econ., Working Paper, June 20, 2008), *available at* http://www.prosper.com/downloads/research/dynamic-learning-selection-062008.pdf).

[233] GAO REPORT, *supra* note 10, at 2.

from August 2010 to July 2011.[234] The report identifies two primary regulatory options for P2P lending that distinctly emphasize lender protection.[235] First, it suggests that the United States could continue "with the current bifurcated federal system—that is, protecting lenders through securities regulation and borrowers primarily through financial services regulators, which will include the new [Consumer Financial Protection Bureau] CFPB—or ... consolidating borrower and lender protection under a single federal regulator, such as CFPB."[236] Neither of these regulatory options addresses the operational risk that the contracts, policies, and practices of the P2P lending intermediaries may limit low-income and traditionally marginalized borrowers' participation in this market. The GAO's suggestion that borrowers should be relegated to the existing consumer protection framework, or to the newly established CFPB, is therefore inadequate. This Article asserts that increased SEC regulation primarily protects investors and lenders and restricts economically marginalized borrowers' access to these markets. This Article also contends that the GAO's proposed regulation of P2P markets is not designed to expand economically marginalized borrowers' access; and thereby fails to substantially advance distributive justice in these markets.

Both the U.S. securities law regime and the U.S. consumer protection law regime privilege disclosure as the primary mechanism to protect investors' and consumers' interests in economic markets. Disclosure alone, however, will not address the institutional, economic, communal, and geographic reasons why historically marginalized and geographically isolated individuals may have difficulty accessing and benefiting from P2P markets. Since economically marginal and geographically isolated individuals have not had access to traditional American markets, they may not exhibit the same rational economic actor decision-making behavior upon which disclosure laws are based. Further, while the federal anti-discrimination laws that apply to P2P lending may address individualized instances of blatant discrimination in P2P lending transactions, they do not address the historical legacy of group harms, nor how individuals' geographic locations, as well as their economic, racial, and ethnic circumstances, may affect whether they can access these markets. Thus, the Dodd Frank Act's two suggested regulatory options are insufficient to address the access-to-credit risks that may plague users of for-profit P2P markets.

In sum, while these P2P lending platforms offer borrowers and lenders the possibility of significant financial returns and greater access to credit,

---

[234] *See id.* at 14.
[235] *See id.* at 42.
[236] *See id.*

the U.S.'s current, and proposed, approach to regulating P2P lending is not designed to help economically marginalized and geographically isolated market participants fully realize the benefits of these markets. For those historically marginalized individuals who can access these markets, it is an open question if the trust between individuals, that was abused by sub-prime mortgage brokers and lenders and which is essential to face-to-face peer lending, and domestic microfinance, is present in online P2P, and can therefore, can help economically marginal and geographically isolated borrowers obtain new legitimate sources of financing. Perhaps U.S. regulators should create incentives for these P2P platforms to develop policies that will enhance economically marginalized and geographically isolated actors' access, while still maintaining policies that reduce fraud in these transactions.

2. Non-Profit Peer-to-Peer Lending and Microfinance 2.0

Kiva.org is a microfinance P2P lending platform operated by Kiva Microfunds (Kiva), a 501(c)(3) non-profit organization located in California.[237] Notably, Kiva reports that 81.54% of its borrowers are women, and most of those women borrowers are from developing countries.[238] Kiva launched, in June of 2009, a fledgling U.S. market working with established U.S. microfinance institutions.[239] Kiva currently works with seven U.S. microfinance institutions that fund only low-income microentrepreneurs within the United States.[240] Many of these institutions are the same microfinance institutions described in Part I.B of this Article. Kiva calls its microfinance partner organizations field partners.[241] "As of March 31, 2011, about 570,000 Kiva lenders had funded approximately $200 million for 273,000 microloans across 59 countries."[242] During the same time period, Kiva reported that each of its lenders funds an average of approximately eleven loans for about $380 per borrower.[243] Lenders can fund part of a microloan for as little as $25, or they can fund an entire loan.[244] Loans requested by Kiva borrowers can range from $1200 to as much as $10,000.[245] Kiva uses the

[237] GAO REPORT, *supra* note 10, at 1.
[238] *See Kiva - About Us*, KIVA, http://www.kiva.org/about/stats (last visited Mar. 23, 2013).
[239] *See* Galloway, *supra* note 206, at 4.
[240] *See Kiva-Our Field Partners*, KIVA, http://www.kiva.org/partners (last visited Mar. 23, 2013).
[241] *See About Us*, KIVA, http://www.kiva.org/about/stats (last visited Mar. 23, 2013).
[242] GAO REPORT, *supra* note 10, at 14.
[243] *See id.* at 16.
[244] *See id.* at 15.
[245] *See id.*

third-party payment system, PayPal, to collect and transfer lender funds.[246] Notably, like the for-profit platforms, Kiva does not directly connect borrowers and lenders, yet it performs a unique intermediating function in microfinance transactions. "Kiva facilitates the collection and transfer of capital for interest-free loans, funded by its lenders to approximately 130 microfinance institutions around the world to fund-interest bearing loans to entrepreneurs in their communities."[247]

While Kiva provides prospective lenders with information about microentrepreneurs in various countries, the loan funds contributed by lenders do not go directly to individual microborrowers.[248] Instead, "Kiva aggregates funds from lenders and forwards them to microfinance organizations, which make and manage loans to the borrowers and transmit the repayments to Kiva, which in turn distributes the lenders' shares of the funds received back to the lenders."[249] Thus, loan proceeds from one lender do not directly go to their chosen microborrower.[250] In fact, the loans are often distributed to microentrepreneurs by Kiva's participating microfinance institutions "before the loan details are even posted on Kiva's website for lenders to view."[251] Instead, Kiva's aggregate loan proceeds will replenish the microfinance institutions for loans that they made previously to borrowers who are similarly situated to the ones Kiva marketed to entice a particular lender.[252]

Because Kiva facilitates interest-free loans, Kiva lenders do not receive a return on their investment, although they receive repayments of principal.[253] If a borrower fails to make a loan payment, the microfinance field partner notifies Kiva, and Kiva determines if the lender should receive a late or partial payment or no payment at all.[254] If microborrowers on Kiva fail to repay their loans, lenders will lose their principal, but not any interest.[255] Thus, the SEC determined that Kiva's loans are not securities because, although Kiva provides lenders a return of principal, it does not give lenders the opportunity to earn interest.[256] While lenders provide interest-free

[246] *See How Kiva Works*, KIVA, http://www.kiva.org/?_redirect=true&page=about&action=how (last visited Mar. 23, 2013).
[247] GAO REPORT, *supra* note 10, at 14.
[248] *Id.* at 14–15.
[249] *Id.* at 14.
[250] *Id.* at 15.
[251] *Id.* at 16.
[252] *Id.* at 15.
[253] GAO REPORT, *supra* note 10, at 1.
[254] *See id.* at 16.
[255] *See id.* at 1.
[256] *See id.* at 40.

loans and cannot achieve returns on their investments, the microfinance institutions that ultimately make the loans to microborrowers do charge the microborrowers interest on their loans to cover operating costs.[257] The amount each microfinance field partner charges its borrowers differs, yet Kiva reported that as of "January 7, 2010, 35 percent is the Average Interest Rate and Fees Borrowers Pay (Porfolio Yield) to All Kiva Field Partners."[258] However, Kiva's international or foreign microfinance partners generally charge more to borrowers than Kiva's U.S. domestic microfinance partners, who charge interests rates that typically range from twelve to nine percent.[259]

While Kiva's platform poses less financial risks for lenders than the for-profit P2P platforms, Kiva's platform does present some unique financial and operational risks. One financial risk is that Kiva's selected borrowers will fail to repay their loans. Kiva does not guarantee its lenders' loans, so it, therefore, it transfers the risk of nonpayment to the lender.[260] However, given Kiva's reported repayment rates this risk is very small.[261] Another risk is that Kiva will fail, in its role as intermediator, to obtain repayments from its field partners. Once again, given Kiva's reported repayment rates, this does not appear to be a problem. Kiva could also become insolvent or also engage in some kind of fraud. Yet, since Kiva is a 501(c)(3) organization, U.S. federal and state charities regulation should minimize the likelihood of these risks. Yet, there have been no reports about Kiva's institutional capacity.

The greatest operational risk to Kiva lenders is that Kiva will fail, as an intermediator, to identify field partners and borrowers consistent with the social objectives its lenders' are seeking to further when making their contributions. Kiva retains the responsibility of identifying, screening, and rating all its microfinance field partners. Those field partners may fail in their role by identifying microborrowers who cannot repay, making loans to borrowers on problematic or usurious terms, using abusive techniques to get borrowers to repay, or engaging in other unfair and deceptive practices.[262] Kiva's end-user license agreements absolve the organization of liability for its field partners' failures.[263] While the United States' consum-

---

[257] *See id.* at 16.

[258] *See id.*

[259] *See id.*

[260] *See id.* at 39.

[261] Kiva's current default rate is less than two percent. *See, e.g.*, *About Us*, KIVA, *supra* note 241.

[262] *See* GAO REPORT, *supra* note 10, at 39.

[263] *Kiva's Terms of Use Agreement 1.1 Loan Disbursement*, KIVA, http://www.kiva.org/legal/terms (last updated Aug. 15, 2012).

er protection, usury, and charities laws may deter Kiva's U.S. microfinance field partners from harmful and fraudulent activities, the laws against such activities in other countries vary and can be more lax. Thus, this risk is not as great in the United States as in other countries. Yet in its U.S. efforts, Kiva relies on the existing domestic microfinance network, thereby mitigating the promise that online P2P lending holds for connecting borrowers to substantially new social and financing networks. Kiva eliminated its prior practice of allowing lenders to choose borrowers directly.[264] Now Kiva chooses the microfinance partners, who choose the borrowers.[265] This intermediation somewhat limits the opportunity for direct connection between the wealthy and poor that a P2P network could allow. As discussed later, the P2P platform allows lenders to form lending groups, but that allows for further segmentation of lenders into existing interest groups, thereby diminishing P2P lending's promise for geographically isolated groups to access new lenders outside of their immediate geographic or interest groups.

Another key risk to Kiva borrowers is that lenders will prefer foreign rather than American microborrowers because of a perception that microborrowers in developing countries are in greater need of funding or that smaller donations will go further in developing countries. While it is true that American microborrowers require slightly higher loan amounts because of the higher costs of business operation in the United States,[266] these facts belie the reality that historically disadvantaged and geographically isolated groups in the United States can still be economically marginalized from new markets due to their social, racial, ethnic, and class status. Kiva donors may be unaware of the history of geographic and economic marginalization outlined in previous Sections of this Article. As a result, Kiva's contracts, policies, and practices may not encourage lenders to consider U.S. markets, thereby undermining the utility of online P2P lending for traditionally marginalized groups in the United States. Kiva has only identified seven U.S.-based microfinance field partners out of a total of 154 field partners.[267] This fact suggests that while Kiva is a U.S.-based and incorporated microfinance P2P lending platform, it may not order its cyberspace in a way that maximizes the benefits of its market for historically marginalized groups in the United States.

---

[264] *See* GAO REPORT, *supra* note 10, at 14–15.

[265] *Id.* at 14–15.

[266] *Microfinance in the United States*, ACCION USA, http://www.accionusa.org/home/support-accion/learn/microlending-in-the-united-states.aspx (last visited Mar. 23, 2013).

[267] *See Where Kiva Works*, KIVA, http://www.kiva.org/about/where (last visited Mar. 23, 2013).

B. Crowdfunding 2.0

Crowdfunding is another emerging cyberfinancing market that represents a new opportunity for historically disadvantaged groups and individuals to access capital. Scholars and industry experts generally define crowdfunding as an approach to raising capital for new enterprises by soliciting financial contributions online from a large number of contributors, at once, through an open call for funds.[268] Crowdfunding is distinct from P2P lending in that crowdfunding enables one individual to connect with many individuals at one time online, rather than merely connecting one individual to another. However, many P2P lending intermediaries increasingly consider themselves part of a larger crowdfunding industry, and they are adapting their lending practices to the crowdfunding model. The term crowdfunding, which describes an emerging and evolving industry, derives from the term crowdsourcing.[269] Author Jeff Howe apparently coined the term crowdsourcing in a 2006 *Wired Magazine* article describing the emerging phenomenon of information and ideas solicited and generated by groups through open calls on Web 2.0 social networking sites.[270] An individual or organization seeking a new idea, or a solution to a long-standing problem, can post their need for information on these sites and receive real-time, free responses from large numbers of individuals or organizations located anywhere. Contributors may receive a reward, or financial compensation, for their ideas, or they may voluntarily contribute solutions and ideas with no reward. Just as outsourcing helps companies reduce their fixed labor costs by finding cheaper labor abroad,[271] crowdsourcing helps individuals and enterprises reduce the costs of obtaining ideas and information because they do not have to hire and pay employees, or independent contractors, and they can reduce the costs of transmitting and obtaining information through these sites.[272]

Crowdfunding also enables individuals and groups to bypass the costs and difficulties of obtaining money from investors, traditional banks, or even fringe financial institutions by using crowdfunding intermediary financial

---

[268] *See* Burkett, *supra* note 7, at 66.

[269] *Id*. at 69 (defining crowdsourcing).

[270] *Id.* (quoting Jeff Howe, *The Rise of Crowdsourcing*, WIRED 14.06, at 1 (June 2006), *available at* http://www.wired.com/wired/archive/14.06/crowds.html?pg=2&topic=crowds&topic_set=).

[271] *See id.* Outsourcing, however, can also lead to a loss of job opportunities for domestic workers. Yet, because downsized domestic workers can use crowdsourcing sites they may experience benefits from crowdsourcing that are not present with outsourcing.

[272] *Id.* at 69–70.

portals. Crowdfunding became increasingly important as the health of the U.S. economy declined during and after the Great Recession. Most entrepreneurs and individuals seeking capital for new startup enterprises or innovative ideas were resigned to government small business loans, cash-strapped domestic microfinancing programs, wealthy accredited investors, venture capital funds, or angel investors.[273] Notably, with the exception of microfinance programs and government small business lending, these types of investors decline ninety-five percent of all business plans they receive.[274] Lower income borrowers and entrepreneurs have even fewer options to obtain capital for their endeavors.[275] Hence, crowdfunding represents a new opportunity for marginalized individuals and groups to access capital outside of their traditional geographic, familial, or social networks. The organizations that develop crowdfunding portals act as crowd-crowdfunding intermediaries. According to the Crowdfunding Industry Report's estimates, by December 2013, there will be over 530 crowdfunding platforms and intermediaries.[276] This Article proceeds to provide a typology of different types of crowdfunding intermediaries and their portals. There are three primary types of crowdfunding intermediaries: (1) Patronage Crowdfunding Intermediaries,[277] (2) Equity Crowdfunding Intermediaries,[278] and (3) Lending Crowdfunding Intermediaries.[279] The last category includes the online P2P websites described in the previous Sections. The crowdfunding intermediaries and portals described below were chosen because they are either, founded in the United States or they primarily serve a U.S. market. These portals are also among the most famous, longstanding, and well-established crowdfunding platforms. These intermediaries and portals are also members of, or are accredited by, the Crowdfunding Industry's prime accreditation organization, the Crowdfunding Accreditation for Platform Standards (CAPS).[280] CAPS is "an initiative by Crowdsourcing.org to promote the adoption of best practices for the operation of crowdfunding platforms globally."[281]

---

[273] *See* Galloway, *supra* note 206, at 1–2.
[274] *See* Pozin, *supra* note 165.
[275] *See* Jones, *supra* note 44, at 79.
[276] *Crowdfunding Industry Report: Market Trends, Composition and Crowdfunding Platforms*, CROWDSOURCING.ORG, (May 2012), http://www.crowdsourcing.org/document/crowdfunding-industry-report-abridged-version-market-trends-composition-and-crowdfunding-platforms/14277.
[277] *See* Burkett, *supra* note 7, at 64–65, 71–72.
[278] *Id.* at 64.
[279] *See* Galloway, *supra* note 206, at 1–2.
[280] *See Crowdfunding Accreditation for Platform Standards*, CROWDSOURCING.ORG, http://www.crowdsourcing.org/caps (last visited Mar. 23, 2013).
[281] *Id.*

1. Patronage Crowdfunding Intermediaries

Patronage crowdfunding portals connect businesses, organizations, or individuals with financial contributors. These intermediaries, and their portals, are different in their emphasis, organizational structures, and practices, but generally contributors on these sites do not expect a financial return on their monetary contribution.[282] The prototypical, and most famous, patronage crowdfunding portal is Kickstarter.com (Kickstarter). Launched in 2009, Kickstarter primarily connects artists, musicians, filmmakers, writers, and designers, residing in any location, with financial contributors for their creative projects.[283] Individual or organizational "project creators" sign up with Kickstarter for free.[284] Project creators develop a creative project and then market it to potential contributors on Kickstarter's project portal.[285] A project campaign can be generated by an individual artist, a group or community of artists, a fledgling label, or an organization. Kickstarter's choice of the word "project" to describe the undertaking seeking funding connotes that the endeavor is finite and is achievable within a relatively short timeframe. Project creators retain complete control over the framing, marketing, and design of their creative projects.[286] Kickstarter, however, retains control over which creative projects will be released on the portal for potential funding.[287] Kickstarter develops guidelines for possible projects and prohibits charity and cause funding, as well as projects to raise funds for personal expenses such as to pay bills, tuition, purchase items, or go on vacation.[288] A recent *New York Times* article reported that in a given week, Kickstarter received 1890 proposals that were "each evaluated by a 'community team' of about a half-dozen people. About forty percent are rejected (although most of those flagrantly ignore the site's guidelines—which bar charitable fund-raising, offering financial incentives and of course anything involving Jenny's prom dress—or are incomprehensible)."[289]

---

[282] *See* Burkett, *supra* note 7, at 64.

[283] *Kickstarter Basics*, KICKSTARTER, http://www.kickstarter.com/help/faq/kickstarter%20basics#WhatKick (last visited Mar. 23, 2013).

[284] *See Discover Projects*, KICKSTARTER, http://www.kickstarter.com/discover (last visited Mar. 23, 2013).

[285] *See id.*

[286] *See id.*

[287] *See id.*

[288] *See Project Guidelines*, KICKSTARTER, http://www.kickstarter.com/help/guidelines?ref=footer (last visited Mar. 23, 2013).

[289] *See* Rob Walker, *The Trivialities and Transcendence of Kickstarter*, N.Y. TIMES, Aug. 5, 2011, http://www.nytimes.com/2011/08/07/magazine/the-trivialities-and-transcendence-of-kickstarter.html?pagewanted=all.

When a creative project is approved by Kickstarter, project creators then make an open online call or request for funds on the crowdfunding portal to help bring the project to fruition. The amount of money sought for a project is determined by the project creator. Kickstarter's model is "all-or-nothing funding," meaning that the project must be fully funded and reach its fundraising goals within a specified timeframe in order for any money to change hands.[290] The typical timeframe for full funding is thirty to sixty days.[291] Potential contributors, referred to by Kickstarter as "backers," also do not pay to join Kickstarter.[292] Backers can peruse the different approved project campaigns available on Kickstarter and choose to donate to a particular campaign or campaigns.[293] The "most common" contribution on Kickstarter is $25.[294] A few to thousands of contributors can fund a given campaign. Kickstarter uses the third-party collection service Amazon Payments to transmit funds.[295] The contribution is "validated upon making the pledge, so Kickstarter's collection rate is close to 100 percent."[296]

Project creators entice contributors with the creative strength of their idea, but also with tangible nonmonetary rewards related to the project, such as a copy of the creative project being funded, a limited edition, a free t-shirt, a visit to see the band perform, a free screening, and other rewards.[297] These rewards are analogous to membership benefits that a member of a non-profit, membership organization might receive, yet they are related to the commercial projects being funded. Contributors only receive rewards if the entire project is funded within the specified timeframe. These rewards, however, do not provide contributors a financial return on their investment. Kickstarter takes a five percent commission on any successfully funded campaigns.[298] As a for-profit company, this is how Kickstarter makes its money. Kickstarter's initial success is uncontroverted.[299] It raised $15 million in its first year of existence.[300] In 2011, Kickstarter raised $99 million

---

[290] *See Kickstarter Basics*, KICKSTARTER, *supra* note 283.

[291] *See* Yancey Strickley, *Shortening the Maximum Project Length*, KICKSTARTER BLOG (June 17, 2011), http://www.kickstarter.com/blog/shortening-the-maximum-project-length.

[292] *See Backer Questions*, KICKSTARTER, http://www.kickstarter.com/help/faq/backer%20questions (last visited Mar. 23, 2013).

[293] *Id.*

[294] *See What Is Kickstarter*?, KICKSTARTER, http://www.kickstarter.com/start (last visited Mar. 23, 2013).

[295] *See Kickstarter Basics*, KICKSTARTER, *supra* note 283.

[296] *See id.*

[297] *See Discover Projects*, KICKSTARTER, *supra* note 284.

[298] *See Kickstarter Basics*, KICKSTARTER, *supra* note 283.

[299] *See* Burkett, *supra* note 7, at 72–73.

[300] *Id.* at 73.

for 27,000 projects.[301] Kickstarter raises the most for film and music projects, with $32 million pledged for film projects in 2011, and $19.8 million in 2011 for music projects.[302] Projects generally surpass their goals, "typically hitting 130% of the target amount."[303] The average amount raised per project campaign is $4500.[304] Ambitious and successful projects "routinely muster $100,000 or more,"[305] and the most successful projects raise $1 million or more.[306] Kickstarter represents an opportunity for geographically and economically marginalized individuals, groups, and communities to access new sources of capital for artistic endeavors.[307] However, there is not a substantial community benefit to participating in Kickstarter, as cause funding is not permitted according to Kickstarter's guidelines. Further, the average amount of money raised by each project on Kickstarter is not sufficient to sustain a start-up business endeavor that could alleviate poverty. Yet, the Kickstarter model does expand the financing possibilities for traditionally marginalized economic actors seeking funding for creative projects.

Kickstarter's success has led to a proliferation of other crowdfunding intermediary portals based upon the patronage model such as IndieGoGo.com (Indiegogo) and Rockethub.com (Rockethub). Indiegogo, founded in 2008, initially served as a source of funding for independent filmmakers,[308] but it expanded in 2009 to include many other creative and noncreative industries, including those that Kickstarter does not fund, such as cause funding—environment, education, health, politics, religion community, and entrepreneurial funding—food, small business, sports, and technology.[309] Rockethub.com is a crowdfunding intermediary that serves groups similar to those served by Indiegogo, but also targets scientists.[310] Indiegogo is also a worldwide crowdfunding platform; however, Indiegogo is incorporated in the United States and it only accepts and disburses funds in U.S.

---

[301] *2011: The Stats*, KICKSTARTER BLOG (Jan. 9, 2012), http://www.kickstarter.com/blog/2011-the-stats.

[302] *Id.*

[303] G.F., *Crowdfunding: Micro no more*, BABBAGE (Jan. 22, 2012), http://www.economist.com/blogs/babbage/2012/01/crowdfunding.

[304] *Id.*

[305] *Id.*

[306] *Id.*

[307] *See, e.g.*, Jacques-Jean Tiziou, *How Philly Moves*, KICKSTARTER, http://www.kickstarter.com/projects/jjtiziou/how-philly-moves?ref=most-funded (last visited Mar. 23, 2013).

[308] *See About Us,* INDIEGOGO, http://www.indiegogo.com/about/our-story (last visited Mar. 23, 2013).

[309] *Compare id.*, *with Project Guidelines*, KICKSTARTER, *supra* note 288.

[310] *See Learn More*, ROCKETHUB, http://www.rockethub.com/learnmore/intro#what-is-rockethub-answer (last visited Mar. 23, 2013).

dollars.[311] Receiving $15 million from a recent Series A venture capitalist financing round, Indiegogo has raised a larger amount of equity financing than Kickstarter to support its operations.[312] Indiegogo allows users to create and contribute to campaigns for free, but it has a slightly different funding scheme than Kickstarter that enables campaign creators to retain the funds they raise, even if they do not meet their goal within a scheduled time frame.[313]

Under its flexible funding model, if a campaign does not reach its funding goals, then campaign creators keep all money raised minus a nine percent fee, and creators must fulfill all pledge promises.[314] Indiegogo's funding model enables campaign creators to benefit from any amount of money raised, yet reduces the incentives to meet and set realistic goals. Additionally, some intermediaries more narrowly connect funding seekers and contributors in particular sectors,[315] interest groups,[316] or ethnic communities.[317] As such, they limit the bridging potential of cyberfinancing because individuals seeking funding on these sites can only access more limited social networks than what is possible on portals that support all types of crowdfunding in any location. Thus, the more targeted crowdfunding portals do not have the redistributive potential of their more inclusive counterparts.

Many newer crowdfunding intermediaries include advancing economic and social justice as a primary goal.[318] StartSomeGood.com (StartSomeGood), for example, connects non-profits and social entrepreneurs[319] with seed capital.

---

[311] *Indiegogo FAQ*, INDIEGOGO, http://www.indiegogo.com/indiegogo-faq (last visited Mar. 23, 2013); *see also* Jay A. Ferdandez, *With a $15 Million Infusion, Crowdfunder Indiegogo Angles for World Domination*, INDIEWIRE (2012), http://www.indiewire.com/article/crowdfunding-powerhouse-indiegogo-angles-for-world-domination-with-infusion-of-15-million (last visited Mar. 23, 2013) (explaining that Indiegogo has a presence in more than 190 countries).

[312] *See* Ferdandez, *supra* note 311; Colleen Taylor, *Indiegogo Raises $15 Million Series A to Make Crowdfunding Go Mainstream*, TECHCRUNCH (June 6, 2012), http://techcrunch.com/2012/06/06/indiegogo-funding-15-million-crowdfunding/.

[313] *See* INDIEGOGO, *supra* note 311; Burkett, *supra* note 7 at 73.

[314] *See* INDIEGOGO, *supra* note 311.

[315] *See, e.g.*, Joe Petrucci, *FundingWorks Combines Gamification, Crowdfunding for Local Nonprofits*, FLYING KITE (Mar. 20, 2012), http://www.flyingkitemedia.com/innovationnews/fundingworks0320.aspx.

[316] *See, e.g.*, FAITHFUNDER, https://www.faithfunder.com (last visited Mar. 23, 2013); INLU, https://www.inlu.com (last visited Mar. 23, 2013).

[317] *See, e.g.*, JEWCER, http://jewcer.com (last visited Mar. 23, 2013) (a crowdfunding platform for projects, ideas, and causes benefitting the global Jewish community and Israel).

[318] Frank Barry, *9 Social Media for Social Good Sites You Should Know About*, NETWITSTHINKTANK (Jan. 11, 2011), http://www.netwitsthinktank.com/online-fundraising/9-social-media-for-social-good-sites-you-should-know-about.htm.

[319] *About StartSomeGood*, STARTSOMEGOOD, http://startsomegood.com/Help/About (last visited Mar. 23, 2013); *see also* Thomas Kelley, *Law and Choice of Entity on the*

"StartSomeGood allows all forms of social good initiatives, nonprofit and for-profit, one-off and ongoing, local and international ...."[320] As with other intermediaries, StartSomeGood determines which campaigns qualify as social ventures and which will be released to the public on the portal.[321] Campaigns on StartSomeGood establish a total fundraising goal and a "tipping point" goal, which is the minimum amount of money the campaign creator determines is needed to "start doing good."[322] Without this amount, the social venture cannot happen at all. Fundraising for the "tipping point" is conducted under the "all or nothing model," such that if the tipping point is not reached, no money changes hands.[323] Once the tipping point is reached, campaign creators can keep whatever amount is raised above the tipping point.[324] StartSomeGood charges a five percent fee of total funds received by a campaign after the tipping point is reached, and after a third-party payment processing fee of three percent is levied.[325] Notably, StartSomeGood is a for-profit organization.[326] Most donations from campaign supporters are not tax-deductible, barring some exceptions (for example, donations to non-profits).[327] Although StartSomeGood has advancing social and economic justice as its mission because it targets socially motivated audiences, it may limit economically and geographically isolated social entrepreneurs' financial networking options. Contributors who are not interested in social good may not learn about these projects if they use only for-profit-oriented portals. Thus, StartSomeGood's targeting can limit the potential audiences that social venture promoters can access to support their causes and endeavors.

2. Equity Crowdfunding Intermediaries

Patronage crowdfunding was the predominant model of crowdfunding[328] prior to President Barack Obama's signing of Congress's bipartisan Jumpstart

---

Social Enterprise Frontier, 84 TUL. L. REV. 337, 339 (2009). (quoting David Gergen, *The New Engines of Reform*, U.S. NEWS & WORLD REP., Feb. 20, 2006, at 48, who defines social entrepreneurs as "people who envision widespread, systemic change ... with an entrepreneurial and innovative spirit").

320 *How It Works: Crowdfunding*, STARTSOMEGOOD, http://startsomegood.com/Help/HowItWorks (last visited Mar. 23, 2013).

321 *FAQ*, STARTSOMEGOOD, http://startsomegood.com/Help/FAQ (last visited Mar. 23, 2013).

322 *How It Works,* STARTSOMEGOOD, *supra* note 320.

323 *FAQ*, STARTSOMEGOOD, *supra* note 321.

324 *How It Works*, STARTSOMEGOOD, *supra* note 320.

325 *FAQ*, STARTSOMEGOOD, *supra* note 321.

326 *Id.*

327 *Id.*

328 Adrienne Burke, *Crowdfunding a Promising Option for Businesses Seeking Loans and Investors, Report Indicates*, SMALL BUSVOTE BLOG (May 9, 2012), http://smallbus

Our Business Startups Act on April 5, 2012.[329] As described below, this new legislation makes it legal for crowdfunding portals to allow entrepreneurs to provide their online contributors with an equity, profit or revenue sharing interest in their endeavors. Since the JOBS Act's recent enactment, equity crowdfunding portals are developing rapidly. It is unclear how these newcomers will affect the popularity of the patronage model, and whether their presence will be a positive or negative development for marginalized economic actors. Prior to the enactment of the JOBS Act, most venture or campaign promoters seeking crowdfunding were unwilling to grant equity interests to contributors because granting such interests required promoters to comply with complex, and costly, federal and state securities laws.[330] As explained earlier, U.S. securities laws do not define the term "security."[331] According to the tests established by the Supreme Court in *Howey*, transactions facilitated through an equity crowdfunding portal would likely qualify as "investment contracts" because investors contribute through the portal with the expectation that they will make a profit solely from the efforts of the campaign promoters or the crowdfunding intermediaries themselves.[332]

Before the JOBS Act, crowdfunding intermediaries that allowed venture promoters to offer investors a financial return would have had to comply with the SEC's registration requirements.[333] These transactions could also qualify as private placement offerings, which are exempt from the full registration requirements of the Securities Act of 1933; however, private placement offerings are primarily available to wealthy and sophisticated "accredited investors," who have some prior relationship to the venture or campaign promoter, or to the promoter's affiliate.[334] The private placement laws also allow a company to have only up to 500 non-accredited investors before it must register its offerings with the SEC and qualify as a public company.[335] Companies seeking funding through equity crowdfunding portals could easily violate this restriction, forcing a company

iness.yahoo.com/advisor/blogs/smallbiz-vote/crowdfunding-promising-option-businesses-seeking-loans-investors-report-165903781.html (explaining that "452 crowdfunding platforms worldwide raised a total of $1.5 billion for more than 1 million campaigns in 2011.... [T]he majority of those campaigns were in the donation-based crowdfunding category ...").

329 *See* JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

330 Burkett, *supra* note 7, at 64.

331 *See* S.E.C. v. W.J. Howey Co., 328 U.S. 293, 297 (1946).

332 Burkett, *supra* note 7, at 80–84.

333 Prior to the JOBS Act, only a few crowdfunding intermediary portals either violated, or attempted to navigate, the complicated U.S securities law regime. *See* Pope, *supra* note 7, at 979–81.

334 *See* Burkett, *supra* note 7, at 84–85.

335 JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

to go public upon receiving a certain number of non-accredited investors via the portal. Lastly, crowdfunding's redistributive promise lies in its ability to connect fledgling enterprises to new economic and social networks. Forcing companies to comply with the private placement requirements would have undermined the industry's redistributive potential.

The JOBS Act, however, creates a new crowdfunding exemption that permits newly defined "emerging growth companies" (EGCs) to raise up to $1 million of capital from a large pool of investors through crowdfunding portals.[336] The Act defines an EGC as an issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year.[337] The Act enables EGCs to provide contributors with equity interests in their ventures by selling securities that are exempt from traditional registration and exemption requirements.[338] The Act also legalizes "general solicitation,"[339] enabling EGCs to use crowdfunding portals and other social networking sites, such as Facebook and LinkedIn, to raise investment capital for their enterprises. Crowdfunding transactions can only be conducted through a broker or crowdfunding portal that is registered with the SEC.[340] The Act provides that crowdfunding intermediary portals cannot provide investment advice or recommendations to investors, as can brokers.[341] Further, the crowdfunding portals must ensure that investors review certain educational material and acknowledge that investors both understand the risks of the investment and can internalize or handle those risks.[342] The crowdfunding portals must also take steps to reduce fraud in these transactions.[343]

The JOBS Act also permits EGCs to stay private for a longer period of time and makes it easier for them to go public on the securities markets when ready. Prior regulations made it difficult for small companies to obtain equity investments from a large numbers of small non-accredited investors without registering with the SEC.[344] The existing securities registration

---

336 Securities Act of 1933 § 4(a)(6)(A), *amended by* JOBS Act § 302(a).

337 Securities Act of 1933 § 2(a)(19), *amended by* JOBS Act § 101(a).

338 JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

339 *See* JOBS Act, § 201(a)(1), (b). Prior to this law, Regulation D of Rule 502(c) prohibited the offering or selling of securities "by any form of general solicitation or general advertising." Securities Act Rule 502(c), 17 C.F.R. § 230.502(c) (2012); *see also* C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfilled*, 40 SEC. REG. L. J. 195, 222–23 (2012), *available at* http://ssrn.com/abstract=2066088 (explaining how the JOBS Act revises the prior rules on general solicitation).

340 *See* Securities Act of 1933 § 4A(a)(1), *amended by* JOBS Act § 302(b).

341 *See* Securities Exchange Act of 1934 § 3(a)(80), *amended by* JOBS Act § 304(b).

342 *See* Securities Act of 1933 § 4A(a)(3), *amended by* JOBS Act § 302(b).

343 *See* Securities Act of 1933 § 4A(a)(5), *amended by* JOBS Act § 302(b).

344 *See* Bradford, *Crowdfunding*, *supra* note 7, at 42–43.

exemptions do not directly fit the crowdfunding model.[345] Regulatory hurdles also increased the costs associated with becoming a public company.[346] The JOBS Act resolves these problems by raising the number of non-accredited investors an EGC can have to 2000, and excluding employee shareholders in that number.[347] This permits EGCs to obtain more investors through crowdfunding portals without having to comply with the costly traditional securities regime. The Act also extends the number of years EGCs have to comply with Sarbanes-Oxley[348] to five years and reduces the number of required audited financial statements.[349] To reduce fraud and protect unsophisticated investors, the Act also limits the amount each individual investor can invest as well as the aggregate value of securities that a particular EGC issuer can offer through a crowdfunding intermediary.

During any twelve-month period, an EGC issuer may sell up to $1 million of its securities.[350] Investors with income or net worth of less than $100,000 are only permitted to invest the greater of $2000 or of five percent of their annual or net worth or income in any twelve-month period.[351] Investors with an income or net worth greater than $100,000 can invest the greater of $100,000 or ten percent of their annual income or net worth in any twelve-month period.[352] Investors are also limited to investing up to $100,000 in crowdfunding issues in a given twelve-month period.[353] Further, investors who purchase securities in a crowdfunding transaction are restricted from transferring or selling those securities for a period of one year.[354] Finally, consistent with the SEC's focus on disclosure as a method of investor protection, EGC issuers of securities must also comply with a number of disclosure requirements. The Act requires EGC issuers to provide investors through the crowdfunding portal with the following: (1) a description of the issuer, its members, including the name, legal status, physical address, and names of directors and officers holding more than twenty percent of the shares of the issuer; (2) the anticipated business plan of the issuer, the target offering amount and the deadline to reach the target

[345] *See id.* at 43.
[346] *See id.*
[347] *See, e.g.*, JOBS Act, Pub. L. No. 112-106, § 501, 126 Stat. 306 (2012) (to be codified at 15 U.S.C. § 78l(g)(1)(A)); *see also* Bradford, *Crowdfunding*, *supra* note 7, at 92, 97 (explaining the JOBS Act's changes to prior provisions).
[348] *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (enacting a heavy disclosure burden on public companies).
[349] *See* JOBS Act § 102(b) (to be codified at 15 U.S.C. §§ 77g(2), 78m(2)).
[350] JOBS Act § 302(a) (to be codified at 15 U.S.C. § 77d(6)(A)).
[351] *See* JOBS Act § 302(b) (to be codified at 15 U.S.C. § 77d-1(h)).
[352] *See id.*
[353] *See id.*
[354] JOBS Act § 302(b) (to be codified at 15 U.S.C. § 77d-1(e)(1)).

offering amount, and the price of the securities to the public; (3) the ownership and capital structure of the issuer, including the terms of the securities being offered.[355]

Many equity crowdfunding intermediaries now have increased confidence to enter the market as a result of the JOBS Act reforms and the impending SEC implementing regulations.[356] Several new crowdfunding intermediaries are entering the market and will begin operating after the SEC introduces its regulations.[357] While crowdfunding options are expanding in the wake of the JOBS Act, there is still a great deal of uncertainty surrounding the forthcoming SEC regulations. There is some concern that the SEC could overregulate and essentially undo any benefit of the crowdfunding provisions.[358] In response, the Crowdfunding Intermediary Regulatory Advocates (CFIRA) are advocating for rules and regulations that are consistent with the purpose of the JOBS Act—"improving access to the public capital markets for emerging growth companies" that will be job creators.[359] The group includes several crowdfunding intermediary executives and innovators, including the co-founder of Crowdfunder.com.[360] Until the SEC issues its regulations, many crowdfunding intermediaries are delaying their plans to develop portals that permit equity interests. RockthePost.com, for example, is a crowdfunding portal that is currently only using the patronage model.[361] Rock the Post is still interested in allowing investors to contribute funds in exchange for equity, but it will wait until the SEC regulations are published.[362] Kickstarter also does not plan to ever allow contributors to receive equity, profit, or revenue sharing interests in exchange for their contributions.[363] Kickstarter's

---

[355] *See* Bradford, *supra* note 339, at 222–23 (describing all the requirements).

[356] The SEC missed its January 1, 2013 deadline to promulgate regulations. Given the SEC's backlog, industry experts estimate that the regulations may not come out until next year. Kathleen Pender, *Crowdfunding Awaits Key Rules from SEC*, SFGATE (Feb. 8, 2013), http://www.sfgate.com/business/networth/article/Crowdfunding-awaits-key-rules-from-SEC-4264631.php#page-1.

[357] Julie Bort, *Crowdfunding Sites Are Springing Up Like Dandelions*, BUS. INSIDER (Apr. 2, 2012), http://articles.businessinsider.com/2012-04-02/tech/31274211_1_crowdfunding-kickstarter-jobs-act.

[358] Carl Franzen, *Not So Fast: Companies Retool as Crowdfunding Bill Hits Snag*, TPMIDEALAB (June 13, 2012, 5:02 AM), http://idealab.talkingpointsmemo.com/2012/06/uncertainty-over-crowdfunding-bill-leads-website-to-retool-approach.php.

[359] JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[360] Brian Dengler, *SEC Says Companies Cannot Use Crowdfunding to Raise Funds from Investors Until SEC Issues Rules*, CFIRA.ORG (June 22, 2012, 12:51 AM), http://www.cfira.org/?p=533.

[361] Franzen, *supra* note 358.

[362] *See id.*

[363] *See* Sarah Kessler, *This Kickstarter for Startups Will Trade Equity for Funding*, MASHABLE.COM (May 22, 2012), http://mashable.com/2012/05/22/fundable/.

founder stated, "[w]e're not gearing up for the equity wave if it comes ...."[364]

3. *Lending and Debt-Based Crowdfunding Intermediaries*

Lastly, lending or debt-based crowdfunding intermediaries are portals that allow lenders to receive a return on their investment in the form of "fixed periodic income [payments] and ... repayment of the original principal investment."[365] Lending or debt-based crowdfunding includes P2P lending, peer-to-business lending, and social lending.[366] This form of crowdfunding enables borrowers—both individuals and businesses—to appeal to the crowd rather than a traditional financial institution for loans or debt-based securities. SoMoLend.com (SoMoLend), for example, is an accredited crowdfunding platform that "connect[s small businesses] with banks, corporations, Chambers of Commerce, and cities to get small business loans ... at lower than average rates."[367] It endeavors "to serve small businesses that are not being served by traditional funding,"[368] and to provide investors "higher-than-market return[s]."[369] Like other P2P lending platforms,[370] SoMoLend gives its lenders payment-dependent notes and works with a partner bank to execute transactions.[371] Entrepreneurs sign up for SoMoLend by completing a loan application and creating a web-based SoMoLend profile.[372] Borrowers provide credit information to SoMoLend, plus other information about their personal and business finances, and SoMoLend generates a star-based risk level rating based upon that information.[373] Star ratings range from one to five stars.[374] A one-star borrower must at least have a personal credit score above 550 and a five-star borrower must have a personal credit score above 800.[375] The commercial

---

364 *Id.*

365 Burke, *supra* note 328.

366 *Id.*

367 *Borrowing Money Is Easy with SoMoLend!*, SOMOLEND, https://www.somolend.com/Borrow/borrow.aspx (last visited Mar. 23, 2013).

368 *About: Company*, SOMOLEND, https://www.somolend.com/About/Company.aspx (last visited Mar. 23, 2013).

369 *Lending Money Is Easy with SoMoLend!*, SOMOLEND, https://www.somolend.com/Lend/Lenderinfo.aspx (last visited Mar. 23, 2013).

370 *See supra* Part II.A.

371 *Lending Money Is Easy with SoMoLend!*, SOMOLEND, *supra* note 369.

372 *How to Apply for a Loan*, SOMOLEND, https://www.somolend.com/How-It-Works/Apply.aspx (last visited Mar. 23, 2013).

373 *How to Understand Your Score*, SOMOLEND, https://www.somolend.com/How-It-Works/Your-Score.aspx (accessed by searching the Internet Archive index for Nov. 1, 2012).

374 *Id.*

375 *Id.*

loans available to business borrowers range from $100 to $1 million.[376] According to SoMoLend, the site still facilitates loans to individuals with little to no credit history[377] and providing individual and commercial loans to underserved entrepreneurs is one of the company's stated goals.[378] Yet, it is unclear how the company will square this goal with its for-profit mission. SoMoLend's approach to lending also has a geographic dimension. SoMoLend's "technology platform uses a GPS location tracking system (think foursquare) so investors can view a map of approved business borrowers in their [geographic] community."[379] Interestingly, this feature encourages lenders to lend to entrepreneurs in their immediate geographic community.[380] This feature may limit the networking potential of crowdfunding by facilitating connections only between lenders and entrepreneurs in the same geographic area.

C. New Identities, Reputations, and Communities 2.0

Cyberfinancing sites create new cyberspaces for repeated economic activity. Borrowers and lenders, or investors and entrepreneurs, can now engage in repeat transactions on the same site and craft new identities in this cyberspace. Borrowers and entrepreneurs previously marginalized from mainstream American markets can now develop new identities and reputations online based upon the strength of their ideas, the popularity of their campaigns, and their repayment and credit histories. Lenders and investors, as well as borrowers and entrepreneurs, can form groups online and evaluate one another's economic performance. As such, cyberfinancing markets enable individuals and groups to create new communities online. Scholars and practitioners who view these economic exchanges merely as discrete one-time transactions may ignore the complexity and community building potential of these spaces and their redistributive consequences.

Prosper, for example, facilitates the creation of groups of prospective borrowers and lenders on its platform. Individuals or organizations can register on the site as "group leaders" and, upon signing a registration statement, can head a group of prospective borrowers or lenders.[381] Individuals form groups and communities of interest, as well as communities

---

[376] *How It Works*, SOMOLEND, https://www.somolend.com/How-It-Works/How-It-Works.aspx (last visited Mar. 23, 2013).

[377] *How to Apply for a Loan*, SOMOLEND, *supra* note 372.

[378] *About: Company*, SOMOLEND, *supra* note 368.

[379] *How It Works*, SOMOLEND, *supra* note 376.

[380] *See Lending Money Is Easy with SoMoLend!*, SOMOLEND, *supra* note 369.

[381] *Group Leader Registration Agreement*, PROSPER, *available at* http://www.prosper.com/prm/legal/14aug2008/Registration_Agmt_Group_Leader.pdf.

based upon identities or geographic location. Group leaders or borrower groups do not guarantee other members' payments.[382] However, group leaders are responsible for establishing the group, recruiting members, acting as a liaison between Prosper and group members, and monitoring, protecting, and promoting the integrity of their group.[383] One of the purposes of borrower groups is to use group social norms to encourage borrowers to repay on time.[384] Prior to September 2007, group leaders received a finder's fee for each loan resulting from its group listing, but Prosper canceled that feature.[385] These groups develop an identity and reputation within Prosper's cyberspace. Prosper enables users to search groups[386] and rates the various groups based upon their performance.[387]

LendingClub does not use group leaders, but individual borrowers and lenders do develop a reputation on the site based upon their repayment histories or funding activity.[388] Kickstarter promotes campaigns and creates communities of interest by categorizing campaigns and highlighting featured campaigns.[389] Among the featured campaigns are staff picks, recently launched, most funded, curated pages, popular pages, and ending soon campaigns.[390] It also segments campaigns by cities.[391] Indiegogo, similarly, segments campaigns by cities[392] and facilitates the creation of new identities, reputations, and communities online through its Gogofactor Exposure.[393] Gogofactor is a "merit-based algorithm that tracks the level of activity of each campaign based on how much you share, update, and attract funding."[394] Based upon a campaign creator's "gogofactor activity," Indiegogo offers to expose the campaign through social media outreach in

---

[382] *Id.*

[383] *Id.*

[384] *See* Seth Freedman & Ginger Zhe Jin, *Dynamic Learning and Selection: The Early Years of Prosper.com* 7 (Univ. of Md. Dep't of Econ., Working Paper, June 20, 2008), *available at* http://www.prosper.com/downloads/research/dynamic-learning-selection-06 2008.pdf.

[385] *Id.* at 8.

[386] *Quick Invest*, PROSPER, http://www.prosper.com/invest/quick-invest.aspx (last visited Mar. 23, 2013).

[387] *Id.*

[388] GAO REPORT, *supra* note 10.

[389] *Discover Projects*, KICKSTARTER, http://www.kickstarter.com/discover (last visited Mar. 23, 2013).

[390] *Id.*

[391] *Id.*

[392] INDIEGOGO, http://www.indiegogo.com/ (click on "browse" at top of screen) (last visited Mar. 23, 2013).

[393] *Features of Indiegogo*, INDIEGOGO, http://www.indiegogo.com/features-of-indiegogo (last visited Mar. 23, 2013).

[394] *Id.*

their community, through the content creation process, and by giving the campaign press access.[395] Both crowdfunding platforms also highlight campaigns through blogs and through partner crowdfunding sites or organizations.[396]

Like Kickstarter and Indiegogo, StartSomeGood also promotes campaigns through a blog and links to other social networking communities.[397] StartSomeGood has similar features to help funders segment their contributions to different types of social entrepreneurs.[398] It also allows users to filter campaigns by country, cause, or partner.[399] Kiva also facilitates the creation of "lending teams."[400] Lending teams are groups of lenders with common interests, demography, or geography.[401] Members of Kiva's lending teams continue lending as individuals, but they have the option to count their individual loans towards the loan totals for their lending team.[402] Any lender can create a lending team.[403] Currently, there are 626 domestic lending teams out of the 23,467 lending teams on Kiva.[404] However, Kiva does not facilitate the creation of borrower groups. Because Kiva works with microfinance field partners, they likely do not feel the need to facilitate borrower groups, but it is interesting that the microfinance field partners and their respective borrowers are denied a networking opportunity provided to lenders. These groups facilitate limited social networking among members, but more importantly, they enable users to segment their cyberfinancing experience. Just as public officials create jurisdictional boundaries, zoning, and land use laws to segment and create markets in geographic space, cyberfinancing intermediaries' access and interactional rules order cyberfinancing markets and enable users to segment cyberspace. Yet, the public has little control over these practices, except to give the intermediaries feedback about their sites.

---

[395] *Id.*

[396] *Kickstarter Blog*, KICKSTARTER, http://www.kickstarter.com/blog (last visited Mar. 23, 2013); *Indiegogo Blog*, INDIEGOGO, http://www.indiegogo.com/blog/ (last visited Mar. 23, 2013).

[397] *StartSomeGood: The Blog*, STARTSOMEGOOD, http://startsomegood.tumblr.com/ (last visited Mar. 23, 2013).

[398] *Support Campaigns*, STARTSOMEGOOD, http://startsomegood.com/Campaigns (last visited Mar. 23, 2013).

[399] *Id.*

[400] *Community*, KIVA, http://www.kiva.org/community (last visited Mar. 23, 2013).

[401] *See id.*

[402] *Kiva Help: Lending Team FAQ*, KIVA, http://www.kiva.org/help/lendingTeams #LendingTeamUsage (last visited Mar. 23, 2013).

[403] *See id.*

[404] *Community*, KIVA, *supra* note 400.

III. REGULATING CYBERFINANCING FOR ECONOMIC JUSTICE

A. Social Networking, Internet Intermediaries and Trust

1. Expanding Social and Financial Networks—The Strength of Weak Ties

If properly operated and regulated, cyberfinancing networks can enhance an individual's or a community's weak social ties.[405] Weak social ties describe connections between individuals or communities who do not interact frequently and who know each other only vaguely.[406] Strong social ties describe bonds between members of closely knit, friendship, or familial networks.[407] As sociologist Mark Granovetter explained in his seminal article, *The Strength of Weak Ties*, "weak [social] ties are an important resource in making possible mobility opportunity."[408] Individuals and groups are better able to connect to new financing, job, or economic networks though weak ties than through strong ones.

However, the policies, practices, and contracts of the cyberfinancing intermediaries will determine, in part, how much an individual or group can develop weak ties that bridge to new opportunities. Cyberfinancing intermediaries that develop minimum credit scores or minimum capitalization requirements will inevitably limit access. Cyberfinancing intermediaries that encourage users to seek crowdfunding or loans through their existing familial or friendship networks will also limit the bridging capacity of these networks. If Kiva does not adequately develop its American capacity, then American microentrepreneurs may not be able to connect to new microfinancing networks. Thus, while these cyberfinancing networks undoubtedly provide marginalized groups in the United States opportunities to develop more weak social ties, the market practices of these intermediaries may limit the bridging opportunities that cyberfinancing can provide. Marginalized borrowers and entrepreneurs must now trust the cyberfinancing intermediaries to structure their operations to maximize access.[409] Yet, lenders and investors will also trust that the intermediaries

---

[405] *See* Mark Granovetter, *The Strength of Weak Ties*, 78 AM. J. OF SOCIOLOGY 1360, 1360 (1973).

[406] *See generally id.* "The fewer indirect contacts one has the more encapsulated he will be in terms of knowledge of the world beyond his own friendship circle; thus, bridging weak ties (and the consequent indirect contacts) are important ...." *Id.* at 1371.

[407] *See id.* at 1361.

[408] *See id.* at 1373.

[409] *See* Mark Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, 91 AM. J. SOCIOLOGY 481, 481 (1985) (critiquing Oliver Williamson's "markets and hierarchies" research program).

will limit their financial and operational risks. These interests will often conflict, and in the absence of regulation, it is likely that lenders' and investors' interests will prevail, since the majority of cyberfinancing intermediaries are for-profit organizations designed to maximize profits. While users will rely on their own positive experiences with these cyberfinancing intermediaries to evaluate the intermediaries' trustworthiness, they will also rely on the reputations of the Internet intermediaries, and the intermediaries' corporate or organizational forms.

2. Trusting the Intermediaries and Hybrid Organizational Forms

Investors seeking a monetary return from their participation in cyberfinancing markets must trust that the for-profit cyberfinancing intermediaries will identify good investment opportunities and minimize fraud and abuse on these sites, because the cyberfinancing intermediaries are profit-maximizing entities. In unregulated complex markets, the neoclassical and new institutional economic presumption is that with full disclosure and perfect information, market competition between profit-oriented cyberfinancing intermediaries will provide sufficient discipline against poor quality, opportunism, or malfeasance.[410] Yet, the recent subprime mortgage crisis illustrates that in complex and unregulated markets, pursuit of profit alone does not provide sufficient deterrents to opportunism, fraud, and abuse. Further, first-time investors, borrowers, and entrepreneurs often will not have perfect information in these markets, and thus cannot be assured that the institutional or organizational forms of the for-profit cyberfinancing intermediaries will deter opportunism and fraud.

Moreover, contributors on these sites, who are not seeking a financial return on their investment, have even less assurance that the organizational forms of the cyberfinancing intermediaries will provide adequate protection against opportunism or will adequately advance social returns. Henry Hansmann, in his definitive article on the non-profit organizational form, *The Role of Non-Profit Enterprise*, explained that a traditional justification for the existence of non-profit organizations is contract failure.[411] In the

[410] *See id.* at 489 ("Malfeasance is here seen to be averted because clever institutional arrangements make it too costly to engage in, and these arrangements—many previously interpreted as serving no economic function—are now seen as having evolved to discourage malfeasance.").

[411] *See, e.g.*, Henry B. Hansmann, *The Role of Non-Profit Enterprise*, 89 YALE L. J. 835, 845 (1980) ("I am suggesting that nonprofit enterprise is a reasonable response to a particular kind of 'market failure,' specifically the inability to police producers by ordinary contractual devices, which I shall call 'contract failure.'"); Usha Rodrigues, *Entity and Identity*, 60 EMORY L. J. 1257, 1276 (2011).

past, individuals seeking to advance social goals by providing financing and/or goods and services to low-income individuals could often not contract directly with the individuals they were seeking to serve.[412] Contributors had no direct connection with the beneficiaries, so non-profit—rather than for-profit—producers or intermediaries were a more sensible choice because non-profit organizations must advance social goals and are prevented from using any excess profit to provide financial returns to insiders or investors.[413] Because non-profit intermediaries' non-distribution constraints eliminate competing financial objectives, they are more likely to fulfill social objectives.[414] Contributors can also reduce their monitoring costs because the state monitors the behavior of the intermediaries.[415]

While these justifications for the non-profit form still hold true in many instances, the operation of cyberfinancing markets complicates these assumptions. Cyberfinancing intermediaries allow contributors and beneficiaries to interact and to contract more directly than before the development of Web 2.0. Further, many cyberfinancing intermediaries purporting to provide social returns are for-profit organizations. StartSomeGood is a for-profit organization designed to help social entrepreneurs.[416] It seeks certification as a B corporation to indicate to investors that advancing social objectives is a central part of its mission, but it still must cater to the needs of its investors.[417] SoMoLend is a for-profit lender who provides investors a return on their investment, but also seeks to expand access to credit for traditionally marginalized entrepreneurs.[418]

Kiva is a non-profit organization whose intermediation in microfinance transactions reflects the existing structure of microfinance; however, it also

---

[412] *See* Hansmann, *supra* note 411, at 847 ("Because of this separation between the purchasers and the recipients of the service, the purchasers are in a poor position to determine whether the service they paid for was in fact ever performed, much less performed adequately.").

[413] *See id.*

[414] *See id.*

[415] *See id.* at 853 ("The advantage of the nonprofit form, then, is that it economizes on contracting and enforcement.").

[416] *The StartSomeGood Difference,* STARTSOMEGOOD, http://startsomegood.com/Help/Difference (last visited Mar. 23, 2013).

[417] *See, e.g.*, *StartSomeGood* FAQ, STARTSOMEGOOD, http://startsomegood.com/Help/FAQ (last visited Mar. 23, 2013); J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital Raising, and Capital Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 20 n.101 (2011) (defining B Corporations).

[418] Adrian Burns, *SoMoLend.com Aims to Be Startups' Financing Matchmaker*, COLUMBUS BUSINESS FIRST (Dec. 16, 2011, 6:00 AM), http://www.bizjournals.com/columbus/print-edition/2011/12/16/somolend-to-be-startups-match-maker.html?page=all.

fulfills a financial function.[419] Kiva also provides contributors a return of principal, while endeavoring to advance the social cause of economic empowerment.[420] Notably, Kiva's founders originally intended Kiva to be a for-profit LLC.[421] Yet, "given the legal issues around securitization and charging interest, they 'decided that the 501(c)(3) status would help [them] form a bond with [their] users and raise a small amount of donation capital to get the idea off the ground.'"[422] Presumably, Kiva's choice of the non-profit form provides a "signaling" function to Kiva's lenders, field partners, and microborrowers that Kiva is a "trustworthy" intermediary who will fulfill its social mission.[423] Yet, it may be equally beneficial for Kiva to eventually adopt an LC3 organizational form, or to adopt a corporate form that would enable it to qualify as an equity crowdfunding intermediary under the new crowdfunding exemption.

As cyberfinancing markets increasingly blur the lines between for-profit and non-profit organizations, cyberfinancing intermediaries' organizational forms alone do not provide sufficient market discipline to enhance trust and to minimize opportunism in these markets. Disclosures provided to state and federal regulators also may be insufficient to capture how benign rules and organizational structures operate to prevent poorer, or traditionally marginalized economic actors, from participation in these markets. As Mark Granovetter eloquently explained, "both order *and* disorder, honesty *and* malfeasance [in economic markets] have more to do with structures of such relations than they do with organizational form."[424]

In complex economic transactions, the economic interactions and social relations that occur between and within hierarchically integrated organizations can produce or inhibit trust or malfeasance. Thus, as cyberfinancing markets involve an increasingly complex proliferation of organizational and institutional forms that provide similar and/or related functions and that work collaboratively,[425] the interactions and relations between cyberfinancing

[419] *How Kiva Works: The Long Version*, KIVA, http://www.kiva.org/about/how/even-more (last visited Mar. 23, 2013).

[420] *Id.*

[421] *See* Murray & Hwang, *supra* note 417, at 13.

[422] *See id.* (quoting Matthew Flannery, *Kiva and the Birth of Person-to-Person Microfinance*, INNOVATIONS, Winter & Spring 2007, at 31).

[423] *See* Rodrigues, *supra* note 411, at 1264 ("[T]his Article posits that nonprofits create a different kind of identity, one that provides a distinctive warm glow that ordinary corporations cannot offer for the very reason that they are for-profit firms.").

[424] *See* Granovetter, *supra* note 409, at 502–03.

[425] In other words, certain crowdfunding intermediaries provide links to Kiva or non-profit and for-profit crowdfunding intermediaries view themselves as part of a larger crowdfunding industry.

intermediaries may become as relevant as the interactions within a cyberfinancing intermediary or between a cyberfinancing intermediary and its customers. In that event, organizational structures are inadequate to ensure accountability to traditionally marginalized economic actors. While the recent SEC-focused regulation of cyberfinancing industries should provide investors some protection from fraud and abuse in these markets, inexperienced borrowers and entrepreneurs cannot rely on the current regulatory structure of cyberfinancing markets to protect their interests.

3. Laws, Practices, and Norms in Cyberspace

It is evident that cyberspace enables "ways of interacting that were not possible before" its development.[426] Yet, there are similarities between the social construction of geographic space and the social construction of cyberspace. Laws, norms, and community practices in cyberspace give human interaction in that space meaning. Laws both influence and reflect the social allocations of power within geographic and cyberspace. Just as jurisdictional boundaries and zoning and land use laws define space, constitute markets within space, and include and exclude certain individuals from markets, the visible and invisible codes of cyberfinancing websites order social relations within those spaces and reflect certain political and value choices.[427] The visible codes of cyberfinancing markets that determine who can and who cannot participate in cybermarkets are the end user license agreements, privacy policies, group leader agreements, organizational structures, selection and participation requirements, segmenting practices, and interactional rules. The invisible codes of cyberspace are those program decisions that order cyberspace that cannot be seen by consumers.[428] These codes also determine the quality of users' experiences in that space.

The cyberfinancing markets discussed in this Article tend to promote transparency, regarding their visible codes, by publishing financial and non-financial information about users, by providing their contracts and policies on the web, and by seeking customer feedback. Yet, the institutional concerns of these cyberfinancing intermediaries will inevitably influence how they order their cybermarkets. Cyberfinancing intermediaries

---

[426] LAWRENCE LESSIG, CODE: VERSION 2.0 83 (2006) ("[T]hese communities have always produced something close to what I will describe cyberspace to have produced. But these cyberspace communities create a difference in degree that has matured into a difference in kind. There is something unique about the interactions in these spaces, and something especially unique about how they are regulated.").

[427] *See id.*

[428] *See id.*

are private organizations that are making value choices about how cyberfinancing markets should be structured. The consumer public has limited control over cyberfinancing intermediaries' choices. Initially, the technological advances and practices of these cyberfinancing intermediaries provided benefits to, and advanced efficiency for, all users by reducing the transaction costs associated with connection, selection, lending, and financing. In fact, because these intermediaries did not have physical bank branches, were unregulated, and could facilitate transactions across time and space in an efficient way, they had a competitive advantage over other financial institutions.[429]

However, motivated by profits, and in response to increased SEC scrutiny and regulation, the for-profit P2P lending intermediaries tended to direct more benefits to lenders and to restrict marginal borrowers' access to these markets.[430] Prosper and LendingClub further intermediated in transactions and increased their minimum credit score requirements. Prosper stopped giving bonuses to group leaders to discourage fraud.[431] The non-profit platform Kiva chose to work within the existing framework of microfinance institutions—rather than to connect microborrowers and lenders directly—to minimize lenders' and Kiva's financial risks. Additionally, the United States' current and proposed regulation of crowdfunding markets appears to privilege investors' interests and impose costs on entrepreneurs. Although the JOBS Act does partially increase inexperienced actors' access to capital markets by removing some regulatory and transaction cost barriers, it still creates significant disclosure and regulatory burdens for issuers of equity interests on crowdfunding portals.[432]

In order to protect investors, the JOBS Act provides that "[i]ssuers must furnish full financial statements for even the smallest offerings. Those financial statements must be reviewed by independent public accountants if the offering is for $100,000 or more, and audited if the offering is for more than $500,000."[433] It will be difficult for many start-up companies and

---

[429] These institutions had a competitive advantage precisely because they operated independently of any physical location, and could connect individuals across space and time and reduce the transaction costs associated with facilitating financial transactions in geographic space. *But see* Porter, *supra* note 17, at 57 (defining economic actors' competitive advantage as being based upon their geographic location).

[430] This was partially a response to regulation, but also because the for-profit platforms experienced a large number of defaults, and Kiva came under increased user scrutiny.

[431] PROSPER GROUP LEADER REGISTRATION AGREEMENT, PROSPER.COM, 1–2 (2008), http://www.prosper.com/prm/legal/14aug2008/Registration_Agmt_Group_Leader.pdf; *see also Prosper Group Leader Registration Agreement*, PROSPER.COM, http://www.prosper.com/account/common/agreement_view.aspx?agreement_type_id=9 (last updated Feb. 1, 2013).

[432] *See* Bradford, *Crowdfunding*, *supra* note 7, at 29–30.

[433] Bradford, *supra* note 339.

first-time issuers, who have no prior experience with capital markets, to understand and comply with these disclosure requirements.[434] The Act does not include a "substantial compliance" provision as do other securities exemptions, leaving inexperienced entrepreneurs potentially liable for "innocent and immaterial" violations.[435] The Act also does not contain protections for issuers who "reasonably believed" that they complied with the requirements of the disclosure rules.[436] Lastly, the Act's limits on how much each investor can invest are high and do not distinguish between the disclosure requirements for small investments of, say, less than $500 and investments ranging from $500 to $2000.[437] Consequently, the Sustainable Economies Law Center—through the umbrella organization, the American Sustainable Business Council (ASBC)—proposed that the SEC create a "two-tier regulatory system ... with a reduced regulatory burden for small, *local* offerings."[438] They propose that smaller investments of up to $250 per investor from investors who live in the same state or within a 200-mile radius should be subject to reduced disclosures since the risk of loss and fraud is less for smaller investments from issuers in close proximity to investors.[439] This regulatory suggestion provides a solution to the increased disclosure burdens that the JOBS Act imposes on small, inexperienced issuers.

Further, the increased presence of equity crowdfunding intermediaries may affect the popularity of the patronage model, which currently provides opportunities for economically marginalized individuals and groups to obtain funding. As venture capital funds and wealthier accredited investors have more confidence to enter the crowdfunding market, they may dominate the direction of the market and encourage intermediaries to develop rules, practices, and norms that disadvantage smaller, first-time issuers, investors, and entrepreneurs. Historically disadvantaged groups also often have difficulty obtaining capital from mainstream American capital markets.[440] This is not typically the result of intentional racial animus, but rather because start-up minority and urban entrepreneurs frequently do not have access to the social and financial networks that lead to angel investment

---

[434] *See id.*

[435] *See, e.g.*, *id.*

[436] *See, e.g.*, *id.*

[437] *See id.*

[438] American Sustainable Business Council, *Revised Proposal for a Two-Tier Approach to Crowdfunding Regulation Under the JOBS Act*, U.S. SEC. & EXCHANGE COMM'N 1 (July 24, 2012), *available at* http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-105.pdf (emphasis added).

[439] *See id.*

[440] *See* Jones, *supra* note 44, at 74.

or venture capital.[441] Thus, these new players on the crowdfunding scene may divert attention and interest away from inexperienced EGCs towards the kinds of start-up and Internet companies that angel investors and venture capital funds traditionally invest in—those with the quickest potential for the highest returns. Additionally, venture capital investors, and increasingly angel investors, often require significant control over the entities in which they invest. EGCs owned by individuals traditionally marginalized from mainstream American markets should be wary that their participation in these markets may leave them susceptible to investors who will require substantial control of their companies in exchange for relatively small investments. Thus, these cyberfinancing intermediaries' policies and practices, and the United States' efforts to regulate these markets, reflect tradeoffs between the interests of mainstream and wealthy market actors and the interests of poorer and more marginalized economic actors. Without a regulatory adjustment, these trends will persist, thereby undermining economic justice.

4. *Weblining in Cyberfinancing Markets*[442]

The invisible codes of cyberspace are "how the software and hardware (i.e., the 'code' of cyberspace) that make cyberspace what it is also regulate cyberspace as it is."[443] Thus, software programs that determine who can enter cyberspace, what they can extract from it, who owns what is produced there, and whether that product can be shared, operate to regulate cyberspace and shape cybermarkets.[444] Like land use laws and jurisdictional boundaries in geographic space, the invisible codes of cyberspace also reflect certain value choices that are the result of existing social allocations of power. Yet, unlike land use laws and jurisdictional boundaries in geographic

[441] *See, e.g.*, *id.* at 79 ("The problems that urban entrepreneurs encounter include, for example, access to financial, social, and human capital, regulatory hurdles, and high taxes."); Nicole S. Dandridge, *Racial Etiquette and Social Capital: Challenges Facing Black Entrepreneurs*, 32 W. NEW ENG. L. REV. 471, 472 (2010) ("Limited social capital translates into limited opportunities for black entrepreneurs to convert valuable social business relationships into financial support that will ultimately fuel successful market entry and growth.").

[442] *See* Steven C. Bennett, *Regulating Online Behavioral Advertising*, 44 J. MARSHALL L. REV. 899, 906 (2011) (defining weblining as "a practice whereby online companies use behavioral profiling data to determine prices for goods and services in a manner that is "comparable to redlining in the real estate and financial markets").

[443] *See* LESSIG, *supra* note 426, at 5.

[444] *See id.* at 84 ("Code is a regulator in cyberspace because it defines the terms upon which cyberspace is offered. And those who set those terms increasingly recognize the code as a means to achieving the behaviors that benefit them best.").

space, the invisible codes of cyberspace are not made public and are not subject to public comment or review. Invisible codes are now shaping cybermarkets. Banks, retailers, social networking sites, and Internet browsers now use invisible programming and tracking codes to influence who can participate in and benefit from certain cybermarkets. Some companies use this information to segment and customize markets to meet both consumers' and companies' needs.

Yet, just as banks and other market actors used to "redline" consumers based on their demographic and geographic profiles, e-commerce companies are increasingly using "weblining" to target and segment e-customers based on their demographics and Internet use patterns. Companies with an online presence, such as banks, may develop account profiles of individual customers. These profiles "help the firm determine how much time, effort, or investment should be devoted to those customers."[445] These companies give customers who generate, or who are likely to generate, more money for the firm higher ratings. The ratings often determine whether the company will refuse to serve certain customers, charge higher fees or prices to certain customers, or give certain customers lower quality products and substandard customer service. These ratings consist of standard financial information such as credit scores, but often also include demographic and other information obtained through data mining. Programs track "[i]ndividuals' race, ethnicity, sexual orientation, personal habits, web-browsing practices, lifestyle choices, health status, political persuasion," zip codes, and other information.[446] As with redlining, the negative effect of weblining is to make some customers pay more for the same service or to deny some customers service based on proxies for value. Companies use this data to predict customers' behavior and then to segment markets based on that presumed behavior. As redlining made a geographic map of individuals' residences and presumed certain economic behavior based on their race and their residence, weblining makes a "map of your travels across the Web" and may deny you opportunities based on presumptions about your digital self.[447]

Economically marginalized and historically disadvantaged individuals can be weblined as a result of using cyberfinancing markets. Other e-commerce sites can obtain not only the personal and financial information users provide to cyberfinancing sites, but also the ratings that those sites produce about their borrowers' creditworthiness or their entrepreneurs' popularity. The ratings and reputations that economically marginalized

[445] *Weblining (Internet Redlining)*, FREE ENCYCLOPEDIA OF ECOMMERCE, http://ecommerce.hostip.info/pages/1078/Weblining-Internet-Redlining.html (last visited Mar. 23, 2013).
[446] *Id.*
[447] Lori Andrews, *Facebook Is Using You*, N.Y. TIMES, Feb. 5, 2012, at SR7.

and geographically isolated market actors develop through their participation in cyberfinancing can begin to define their "digital" selves. As economic activity increasingly moves online, these determinations can impact how they will be rated or received on other e-commerce sites. These determinations can either enhance or undermine an individual's economic and social mobility. Most importantly, this will occur unbeknownst to the individuals affected and may remain largely out of their control.

B. Comparative Institutional Analysis for Economic Justice

The SEC and the Financial Industry Regulatory Authority (FINRA),[448] as the predominant institutions regulating the development of these cyberfinancing markets, are privileging lenders' and investors' interests over those of borrowers and entrepreneurs. As a result, this Article argues that several American regulators must coordinate to advance economic justice and to halt the unjust evolution of cyberfinancing markets. Since not all economic actors in cyberfinancing markets are similarly situated, and because these markets represent an unprecedented economic development opportunity for historically marginalized economic actors, the United States must balance the regulatory goal of economic justice against the competing objective of efficiency in order to promote the socially optimal regulation of these markets. Substituting economic justice as a regulatory goal, however, does not resolve the important question of institutional choice. Law and economics scholar Neil Komesar explains, "the choice of goals standing on its own dictates virtually nothing about law and public policy."[449] Comparative institutional analysis requires scholars to compare the relative merits of various large-scale institutions—the market, the legislature, or the judiciary—in accomplishing a given goal. The operative question is: given distributive justice as an additional or competing goal, which large-scale institutions should cooperatively regulate to attain that goal or, at least, to balance that goal against the competing choice of efficiency?

The initial trajectory of cyberfinancing markets revealed that these markets, in pursuit of efficiency gains, did privilege all market actors' access as an operative goal to gain a competitive advantage over other financial

---

[448] The Financial Industry Regulatory Authority (FINRA) is the largest independent regulator for all securities firms doing business in the United States and is seeking public comments on the new crowdfunding regulation under the New JOBS Act by August 31, 2012. *See Regulatory Notice 12-34*, FINRA (July 2012), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p131268.pdf.

[449] NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY 34 (1994).

institutions. Yet, as these markets evolved and courted more mainstream economic actors, they created benefits for lenders and investors and restricted marginalized actors' access. Thus, an unregulated market—operating alone—is insufficient to actualize long-term distributive justice. The non-profit organizational structure, which used to primarily facilitate exchange between the poor and the wealthy, is now insufficient—acting alone—to regulate all financial interactions between the poor and the wealthy in cyberspace.

Because cyberfinancing intermediaries adopt a variety of organizational forms and endeavor to advance both profit-making and social goals, state charities' regulators and the IRS—acting alone—are insufficient regulators of these market processes. Thus far, the political process—in the form of legislation to regulate P2P lending and crowdfunding—has let regulatory institutions that privilege mainstream economic actors' interests shape regulatory responses. The SEC's effort to regulate P2P lending led the intermediaries to restrict marginalized actors' access and impose additional costs and burdens on borrowers. Although the JOBS Act holds promise for enhancing marginalized actors' participation in these markets, it too imposes costs on small, fledgling entrepreneurs in order to provide benefits to mainstream investors. Thus, the regulatory process is leading to an ossification of a pro-lender and investor bias. Regulatory capture may also affect the SEC's rulemaking process, enabling the interests of more established equity investors to predominate over the interests of first-time entrepreneurs seeking alternative sources of capital for their endeavors.[450] Given the emerging and complex nature of cyberfinancing markets, the judiciary—acting alone—also does not seem well-positioned to monitor systemic change and facilitate the actualization of this goal. Thus, this Article posits that all these institutions must coordinate to further economic justice in cyberfinancing markets. In particular, the legislature and administrative agencies seem best positioned to lead the charge and to help the other institutions respond. This is essential if cyberfinancing markets are to realize their distributive potential.

1. Revising JOBS Act Provisions for Economic Justice

Through its rulemaking authority, the SEC should create implementing regulations that protect inexperienced EGCs from unintentional and

[450] While the creation of a crowdfunding exemption in the JOBS Act was initially spearheaded by grassroots groups, the SEC is now seeking public comments in anticipation of its upcoming rulemaking. Wall Street bankers and mainstream financial intermediaries could lobby the SEC to create rules that make it more difficult for smaller, first-time issuers to comply. *See* Bradford, *Crowdfunding*, *supra* note 7, at 23.

insignificant violations of the JOBS Act's disclosure and reporting requirements. Just as Rule 508 of Regulation D contains a "substantial compliance rule," which provides private placement securities issuers a defense against innocent and immaterial violations of the exemption's disclosure and reporting requirements,[451] the SEC should create a "substantial compliance rule" that provides EGCs issuing crowdfunding securities an innocent and immaterial defense.[452] While this rule may sacrifice benefits to investors by limiting the distribution of perfect information, it will advance distributive justice by eliminating barriers to the participation of smaller, unsophisticated EGCs.

The SEC should also create a "two-tier system" for the crowdfunding exemption that provides EGCs obtaining relatively small investments from a large number of investors with a reduced disclosure burden.[453] However, unlike the approach recommended by the ASBC, this reduced disclosure burden should apply to *all* small offerings instead of only *local* offerings. The rationale for a small *local* offering exemption is that those who invest in companies in close geographical proximity can more easily obtain information about issuing EGCs because they can "see the products, visit the local office, meet with management and staff—all of which are difficult for long-distance investments."[454] Although this may be true, for many economically and geographically marginalized EGCs, these geographic limitations will undermine crowdfunding's redistributive potential.

Consequently, the SEC should also create a reduced regulatory burden for ECGs that sell an aggregate of up to only $100,000 to investors in a twelve-month period and who do not sell more than an aggregate of $250 to any one investor in a twelve-month period.[455] Although this proposal leaves intact higher disclosure requirements for marginalized EGCs who receive higher investments, it reduces the regulatory burden for smaller amounts. Two hundred fifty dollars from 1000 investors each can be a significant amount for a first-time entrepreneur, whereas the risk of loss of $250 to one individual is not as great as the benefit to the entrepreneur.[456] Finally, the SEC's role as regulator is limited to enforcing and monitoring information disclosures in the sale of crowdfunding equity interests, an appropriate role for the SEC. However, other regulators should also monitor crowdfunding intermediaries' performance in facilitating economic justice in these markets. Yet, the existing regulatory structure does not identify a regulator for this function.

---

[451] 17 C.F.R. § 230.508 (2012).

[452] *See* Bradford, *supra* note 339, at 218–19.

[453] *See* American Sustainable Business Council, *supra* note 438, at 1.

[454] *Id.*

[455] *See id.* at 1–2.

[456] *See id.*

2. Modernizing the CRA and Facilitating Regulatory Coordination

Given that cyberfinancing intermediaries adopt a range of organizational forms and perform some of the intermediating functions of banks and other financial services institutions, the existing legal framework of consumer protection, financial access, community economic development, and financial education should be harmonized with and adapted to the new institutional realities of cyberspace and e-commerce. As globalization and financial modernization extricate financial markets from the restrictions of insti-institutional and geographic boundaries, the law must also adapt. The CRA is the preeminent statute that expands geographically isolated and economically marginalized economic actors' access to legitimate financial institutions. CRA accomplishes this because by forcing large traditional banks and thrifts to lend in low-income minority communities, in a responsible way, it remedies both the geographic and non-geographic market failures that preclude low-income and economically marginalized actors from accessing mainstream markets.[457] CRA responds to geographic market failures by increasing the number of transactions to low-income communities; and thereby enhancing the information about, and "market thickness" for, lending and investing to low-income individuals and communities.[458] CRA could also help promote market thickness and minimize information asymmetries about lending and investing to low-income, geographically isolated, and economically marginalized individuals in cyberspace.

Yet the CRA's protections have not kept pace with institutional changes in the financial services delivery system in the United States. The controversial Community Reinvestment Modernization Act of 2009 (CRMA),[459] which died in committee, held the most promise to extend CRA obligations to other financial institutions. Borrowing from CRMA's innovations, this Article recommends that the CRA's protections should be extended to cover a range of non-depository institutions and nonbank affiliates that engage in "banking products and services,"[460] such as mortgage lenders, securities companies, insurance companies, and large credit unions.[461] Further, the CRA should cover new large cyberfinancing intermediary portals and the

[457] *See* Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. Rev. 534, 534–44 (2005) (describing how the CRA responds to market failures in low-income communities).

[458] *See id.* at 541 (explaining the market thickness benefits of the CRA).

[459] H.R. 1479, 111th Cong. (2010).

[460] *See* Brescia, *supra* note 113, at 6 (citing H.R. 1479, § 102).

[461] *See id.* at 7–8. CDFIs should be excluded and financial institutions generating less than $100 million in total assets would not be covered under this definition.

banking institutions with whom they partner. Despite a particular crowdfunding intermediary's organizational structure (that is, for-profit or non-profit), if the organization fulfills a substantial financial function, such as Kiva, then it should be covered by CRA's provisions.[462] However, CRA's implementing regulations should create a reduced regulatory burden for non-profit or for-profit intermediaries that are primarily established to advance charitable or social justice goals. Additionally, federal and state laws regulating charitable non-profits should be harmonized with existing federal and state securities laws and regulations.[463] Currently, non-profits formed for charitable purposes are exempt from certain securities registration requirements.[464] As a result, it is unclear if non-profits would be covered by the JOBS Act's crowdfunding provisions covering "funding portals," and "EGCs."

The revised CRA statute, proposed here, would acknowledge that all financial sectors, such as mortgage banks, securities companies, insurance companies, large credit unions, and new cyberfinancing intermediaries, have affirmative obligations to meet the financial needs of the communities they serve, including low- to moderate-income neighborhoods and economically marginal and historically disadvantaged users of cyberfinancing markets. Like the CRMA, the CRA statute would include a revised "assessment area" definition that includes not only the geographic areas where covered financial institutions have a physical presence, have ATMs, or where they purchase or originate loans, but also geographic areas and cyberspaces where the institution "enjoys 0.5 percent of the market share of the business in a particular community, and where 'the great majority' of [its] ... business originates."[465] This rule would force cyberfinancing intermediaries to find ways to financially serve American markets and users from low- to moderate-income geographic areas in the United States.[466]

Equity crowdfunding intermediaries would be securities companies under the statute, and therefore, the SEC would have additional responsibilities to ensure that such institutions fulfill their CRA obligations.[467] Mortgage banks, insurance companies, and large credit unions would be regulated by the CFPB, but other regulators—such as the Treasury, the Secretary of

[462] *See, e.g.*, Davis & Gelpern, *supra* note 7, at 1261 (advocating for regulatory schemes that go beyond the securities disclosure model and that cover intermediaries that are charitable entities).
[463] *See id.* at 1242–44.
[464] *See id.* at 1241 (explaining that charities are not exempt from the anti-fraud provisions of U.S. securities laws).
[465] *See* Brescia, *supra* note 113, at 8.
[466] *See id.* at 8.
[467] *See* H.R. 1479, § 107(c)(1).

Housing and Urban Development (HUD), and the Federal Reserve System—would coordinate with the CFPB. Similar to the reporting requirements under CRMA, the revised CRA statute should require all covered financial institutions to collect and report to regulators important demographic data on users, the distribution of loans to borrowers, and investments to entrepreneurs. This data would be made available to the public for three years.[468] Further, like the CRMA, the CRA statute proposed here would expand the CRA ratings process to include more gradations and to generate multiple assessment ratings as well as an overall rating. The proposed CRA statute would add the ratings of "low satisfactory" and "high satisfactory," and it would adopt the CRMA's requirement that all institutions that receive a "low satisfactory" or "needs to improve" rating submit to the CFPB a "CRA improvement plan" that would be made public and available for comment."[469] The revised CRA statute would also authorize regulators to impose significant penalties on covered institutions for substantial compliance failures. Notably, smaller P2P lenders or cyberfinancing intermediaries that generate less than $20 million in revenue would not be subject to these requirements because the costs of the regulatory burden would preclude such organizations from participating in cyberfinancing markets. Further, the revised CRA statute would not provide private litigants a private right of action to submit agency implementation of the act to judicial review because the costs of such a right, in terms of increased litigation, might outweigh the benefits.

3. Public Subsidies and Market Incentives

The revised CRA proposed here should also give covered institutions credit for lending to or investing in CDFIs that invest in P2P lending sites or crowdfunding intermediaries that substantially serve low- to moderate-income individuals or communities, or that are established to serve an economic justice mission. This would harmonize the existing framework of American CED laws with changes in the financial services delivery system occurring in cyberspace. Further, P2P lending or crowdfunding intermediaries that substantially facilitate loans and investments to economically marginal or historically disadvantaged borrowers or entrepreneurs, and that include such individuals on their boards, could qualify as CDEs under the NMTC. As CDEs, these cyberfinancing intermediaries could receive tax credits from the Treasury to spur private investment for socially beneficial

[468] *See* H.R. 1479, § 203(b)(1).
[469] *See* H.R. 1479, § 103(a)(D)–(E).

economic activities. The public subsidies provided through tax credits could spur private investors seeking tax breaks on profits to finance the costs of the cyberfinancing intermediaries' compliance with laws that encourage them to facilitate lending and investing to marginal and historically disadvantaged economic actors. This would partially offset the costs of the regulatory burdens suggested above. This framework would also incentivize cyberfinancing intermediaries to develop laws, interactive rules, and policies that will incentivize their users to interact with historically marginalized economic actors. Smaller cyberfinancing intermediaries, which are not covered under the revised CRA statute, could also qualify as CDEs under a revised NMTC Act, thereby incentivizing them to develop laws, policies, and interactive rules that facilitate lending and investing to marginalized economic actors.

4. Self-Regulation, Community Education, and Legal Infrastructure[470]

As these cyberfinancing industries evolve and professionalize, self-regulation alone will not ensure economic justice. Thus far, the P2P lending industry has moved away from innovations that serve a comprehensive market. As the SEC is developing its rulemaking to implement the JOBS Act provisions, various industry self-regulatory associations such as the National Crowdfunding Association—started by a financial lawyer—and the Crowdfunding Professional Organization—started by an industry player—are already vying for control of the crowdfunding market.[471] The CFIRA,[472] which helped sponsor the crowdfunding exemption, also endeavors to lead the industry.[473] Self-regulation in other industries has often

---

[470] This Article adopts the term "legal infrastructure" from Gillian K. Hadfield's article, *Legal Infrastructure and the New Economy*, which defines legal infrastructure as "the socially available set of legal materials that economic actors can use to help govern relationships." *See* Gillian Hadfield, *Legal Infrastructure and the New Economy*, 8 ISJLP 1 (2012), *available at* http://moritzlaw.osu.edu/students/groups/is/files/2012/02/Hadfield.pdf. She argues that this legal infrastructure has not kept pace with the transformations in the economic demand for law spurred by Internet-driven technological innovations that cross firm and jurisdictional boundaries. *See id.*

[471] Robert Schmidt, *Lobbying to Become Lobbyists for Crowdfunding*, BLOOMBERG BUSINESS WEEK (May 24, 2012), http://www.businessweek.com/articles/2012-05-24/lobbying-to-become-lobbyists-for-crowdfunding (explaining the struggle between the National Crowdfunding Association and the Crowdfunding Professional Association to be the primary lobbyist for crowdfunding).

[472] *See supra* note 360 and accompanying text.

[473] *See, e.g.*, *About CFIRA*, CFIRA, http://www.cfira.org/?page_id=17 (last visited Mar. 23, 2013).

led to a subordination of the interests of marginalized groups.[474] Although industry self-regulators can identify best practices for economic justice in crowdfunding industries, U.S. regulators will need to encourage these industries to advance economic justice. Further, some industry self-regulatory groups, such as the CFIRA or the Sustainable Economies Law Center—a non-profit, public interest, legal organization—must provide community legal education to help marginalized economic actors navigate this new terrain. This training should not be required because it will inevitably raise cyberfinancing participants' transaction costs, but it should be available for those first-time economic actors who desire it.

Additionally, as legal scholar Gillian Hadfield eloquently explained, the legal infrastructure needed to support efficient transactions in technology-driven markets that cross firm and jurisdictional boundaries has not kept pace with technological innovations.[475] The regulatory structure for cyberfinancing described here will require the development of such a legal infrastructure. Lastly, the regulatory scheme recommended above requires significant regulatory coordination among agencies. The CFPB, acting as a primary regulator, would help facilitate coordination, but U.S. agencies must also collaborate. Coordination with international financial regulators must also occur as the geographic boundaries between these markets continue to disintegrate.[476] Regulatory coordination is always difficult, but the regulatory framework suggested above begins to facilitate the cooperation necessary to advance economic justice in these emerging markets.

CONCLUSION

As new cyberfinancing markets facilitate exchange across boundaries and among economic and demographic groups, the law must adapt. Although cyberfinancing markets present opportunities for individuals and groups historically marginalized from American mainstream markets to access new sources of financing, they must be regulated to facilitate distributive justice. Existing proposals to regulate P2P lending and crowdfunding in the United States do not advance economic justice. This Article provides a framework for regulating cyberfinancing for economic justice that requires

---

[474] *See* Lisa T. Alexander, *Stakeholder Participation in New Governance: Lessons from Chicago's Public Housing Reform Experiment*, 16 GEO. J. ON POVERTY L. & POL'Y 117, 121 (2009); Wendy A. Bach, *Governance, Accountability, and the New Poverty Agenda*, 2010 WIS. L. REV. 239, 241 (2010).

[475] *See* Hadfield, *supra* note 470.

[476] *See* Davis & Gelpern, *supra* note 7, at 1249–50.

regulators to re-conceptualize the process of exchange between the wealthy and the poor, as well as the legal structures that facilitate exchange between these groups. Just as jurisdictional boundaries and land use laws order markets in geographic space, cyberfinancing intermediaries' laws and interactional rules order who can benefit from the markets that occur in cyberspace. The United States must incentivize these intermediaries to encourage the participation of marginalized economic actors in these markets. American regulators must also harmonize existing laws that regulate financial transactions in the United States with the new technological and organizational innovations that cyberfinancing markets create. Just as space, power, and law are linked in geographic space, so they are linked in cyberspace. The United States must develop a regulatory structure that advances economic justice in these markets before they substantially evolve.