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Funding the Future: Marketplace Lending, Equity Crowdfunding, and Bank Lending

I. INTRODUCTION

In October 2017, Arthur Moye, CEO of Full Circle Brewing Co., needed a \$1 million loan to upgrade and expand his brewery in Fresno, California.¹ His expansion plan included purchasing larger brewing tanks to quadruple the brewery's capacity, renovating the brewery's building, and going beyond brewing kegs of beer to producing cans of beer to sell in stores such as Safeway and Costco.² Initially, Moye sought a traditional bank loan.³ However, instead of providing Full Circle with a \$1 million loan, Fresno First Bank suggested that the company work with crowdfunding firm Breakaway Funding LLC to raise enough capital to reduce the bank's risks of lending.⁴ The crowdfunding campaign allowed the average person to purchase a stake in the brewery with a minimum investment of only \$500.⁵ As of January 2018, Full Circle raised \$124,000 through equity crowdfunding, which then allowed the company to obtain a \$685,000 traditional loan from Fresno First Bank.⁶ In October 2019, Full Circle estimated that over the past two years, its production capacity increased fifteen-fold, and its revenues increased by 335%.⁷

Small businesses and startups such as Full Circle traditionally face great difficulty in raising money from customary sources of business finance, such as bank lending and venture capital.⁸ Although bank

1. David Castellon, *Full Circle Brewing Taps Success from Equity Crowdfunding*, THE BUSINESS J. (Jan. 26, 2018, 9:09 AM), <https://thebusinessjournal.com/full-circle-brewing-taps-success-equity-crowdfunding/> [<https://perma.cc/Q2NS-5BUF>].

2. *Id.*

3. *Id.*

4. *Id.*

5. *Id.*

6. *Id.*

7. *About Us*, FULL CIRCLE BREWING CO., <https://fullcirclebrewing.com/pages/about-us> [<https://perma.cc/2VU7-MGFD>] (last visited Oct. 11, 2019).

8. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5 (2012).

lending remains a major source of funds for entrepreneurial ventures,⁹ banks are commonly concerned about businesses' creditworthiness.¹⁰ This concern makes banks hesitant to provide loans to businesses before they have a proven track record, consistent cash flows, and an adequate amount of tangible assets they can use as collateral.¹¹ The 2008 financial crisis only increased these concerns.¹² Although venture capital and angel investors address a portion of this need for funding, these investors are extremely selective and often only invest in companies with the potential for explosive growth.¹³ From 1981 to 2005, an average of only 0.1% of startups per year in the United States received venture capital funding.¹⁴ In response to this gap, crowdfunding developed as a method of alternative finance for these small businesses and startups.¹⁵

Through the use of online platforms, crowdfunding projects are able to largely bypass bank intermediaries.¹⁶ The recent growth of crowdfunding—particularly lending-based and equity-based crowdfunding platforms—calls into question traditional lending models used by banks.¹⁷ The rising crowdfunding industry has replaced some

9. Xavier Walthoff-Borm et al., *Equity Crowdfunding: First Resort or Last Resort?*, 33 J. OF BUS. VENTURING 513, 515 (2018).

10. *Id.*

11. Allen N. Berger & Gregory F. Udell, *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*, 22 J. OF BANKING & FIN. 613, 623–24 (1998) (stating that banks will generally not lend to small businesses until “they achieve a level of production where their balance sheets reflect substantial business assets that might be pledged as collateral . . .”).

12. See Walthoff-Borm et al., *supra* note 9, at 515 (explaining the rise of crowdfunding as an alternative to traditional bank finance following the 2008 financial crisis).

13. *Id.*

14. Manjur Puri & Rebecca Zarutskic, *On the Life Cycle Dynamics of Venture-Capital and Non-Venture-Capital-Financed Firms*, 67 J. OF FIN. 2247, 2255 (2012) (examining venture capital statistics for the period 1981 to 2005).

15. See Walthoff-Borm et al., *supra* note 9, at 516 (explaining how crowdfunding provides entrepreneurs with an alternative to traditional forms of equity financing and bank financing).

16. See Raymond Michaels, *How Crowdfunding is Challenging the Banking Sector*, INT’L BANKER (Sept. 14, 2015), <https://internationalbanker.com/banking/how-crowdfunding-is-challenging-the-banking-sector/> [<https://perma.cc/9Z69-FQ48>] (“Investment crowdfunding appears to be filling a gap for small businesses deemed too risky to obtain financing through traditional banking methods.”).

17. See *id.* (“As a consequence of this explosive growth, crowdfunding has been asking several pertinent questions of the traditional lending models used by banks.”).

conventional banking functions.¹⁸ Banks must decide whether to compete against or collaborate with this new and growing practice.¹⁹

This Note examines current forms of crowdfunding and explores competition between crowdfunding and bank lending. This Note proceeds in four parts. Part II explains crowdfunding and various methods of crowdfunding.²⁰ Part III examines the current impact of crowdfunding on traditional bank lending.²¹ Part IV explores existing partnerships between banks and crowdfunding platforms.²² Part V offers recommendations for how banks should adapt to the crowdfunding industry.²³

II. CROWDFUNDING

Crowdfunding is a method of raising money for projects or ventures from a large number of people.²⁴ Today, this is typically performed via the Internet.²⁵ Crowdfunding is a mode of crowdsourcing.²⁶ While many believe crowdfunding to be a new phenomenon, forms of crowdfunding were used throughout history.²⁷ For example, in 1885, New York City was short on funds for a pedestal

18. *See id.* (providing examples of banks being bypassed for by small businesses seeking financing).

19. *See id.* (“Banks have been deciding whether this revolutionary industry should be regarded as friend or foe, and as a result, have had to choose between collaborating or competing with [online crowdfunding platforms].”).

20. *See infra* Part II.

21. *See infra* Part III.

22. *See infra* Part IV.

23. *See infra* Part V.

24. *Crowdfunding*, OXFORD UNIV. PRESS: OXFORD ENG. DICTIONARY ONLINE (3d ed. 2015), [https://www-oed-com.libproxy.lib.unc.edu/view/Entry/429943?rskey=hxdLYt&result=2&isAdvanced=false#eid \[https://perma.cc/H475-R76F\]](https://www-oed-com.libproxy.lib.unc.edu/view/Entry/429943?rskey=hxdLYt&result=2&isAdvanced=false#eid [https://perma.cc/H475-R76F]) (defining crowdfunding as “the practice of funding a project or venture by raising money from a large number of people, each of whom contributes a relatively small amount, typically via the Internet.”).

25. *Id.*

26. *Crowdsourcing*, OXFORD UNIV. PRESS: OXFORD ENG. DICTIONARY ONLINE (3d ed. 2013), [https://www-oed-com.libproxy.lib.unc.edu/view/Entry/376403?rskey=2wuyt8&result=2&isAdvanced=false#eid \[https://perma.cc/ZL84-4994\]](https://www-oed-com.libproxy.lib.unc.edu/view/Entry/376403?rskey=2wuyt8&result=2&isAdvanced=false#eid [https://perma.cc/ZL84-4994]) (defining crowdsourcing as “[t]he practice of obtaining information or services by soliciting input from a large number of people, typically via the internet and often without offering compensation.”).

27. *See* JD Alois, *Kickstarter: On This Date, Joseph Pulitzer Completed Crowdfunding Project for Statue of Liberty*, CROWDFUND INSIDER (Aug. 11, 2014, 5:19 PM), <https://www.crowdfundinsider.com/2014/08/46581-kickstarter-date-joseph-pulitzer-completed-crowdfunding-project-statue-liberty/> [<https://perma.cc/3NML-DBWX>] (describing the story of crowdfunding for the pedestal of the statue of liberty).

for the Statue of Liberty, recently gifted from France.²⁸ In response, Joseph Pulitzer led a successful rewards-based crowdfunding campaign to secure funding for the pedestal, rewarding gifts of one dollar or more with twelve-inch replicas of the Statue of Liberty.²⁹ Today, crowdfunding sites such as Kickstarter.com,³⁰ GoFundMe.com,³¹ and Indiegogo.com³² receive considerable attention as methods for entrepreneurs to fund their ideas.³³

Crowdfunding intermediaries represent platforms that “act as matchmakers between capital-seeking agents and capital-giving agents, funneling the funding from the investors to the capital-seeking enterprises.”³⁴ Unlike traditional financial intermediaries, crowdfunding platforms merely facilitate funding instead of borrowing or lending on their own account.³⁵ Crowdfunding platforms are examples of financial technology (“fintech”) companies.³⁶ Crowdfunding is generally split into five categories: (1) donation-based crowdfunding, (2) rewards-based crowdfunding, (3) pre-purchase-based crowdfunding, (4) marketplace lending, and (5) equity-based crowdfunding.³⁷ Although donation-

28. *Id.*

29. *Id.*

30. KICKSTARTER, kickstarter.com [https://perma.cc/EDY5-NTRE] (last visited Oct. 5, 2019).

31. GOFUNDME, gofundme.com [https://perma.cc/WH4K-SPSG] (last visited Oct. 5, 2019).

32. INDIEGOGO, indiegogo.com [https://perma.cc/JFM6-QCXM] (last visited Oct. 5, 2019).

33. Ed Oswald, *The Best Crowdfunding Sites for 2019*, DIGITAL TRENDS (Feb. 26, 2019, 3:10 PM), <https://www.digitaltrends.com/cool-tech/best-crowdfunding-sites/> [https://perma.cc/FDS2-PNSS].

34. Kalle Setälä, *Crowdfunding in the Banking Industry: Adjusting to a Digital Era* (2017) (unpublished Master’s thesis, Jyväskylä University School of Business and Economics), <https://jyx.jyu.fi/bitstream/handle/123456789/53061/1/URN%3ANBN%3Afi%3Aaju-201702171470.pdf> [https://perma.cc/4DW8-FVR6].

35. *Id.*

36. “Fintech” is a term that “encompasses all forms of innovative digital and software technologies applied directly to the financial services sector.” Luke G. Thomas, Note, *The Case for A Federal Regulatory Sandbox for Fintech Companies*, 22 N.C. BANKING INST. 257, 260 (2018).

37. Arooj Z. Nazir, *The Development of Real Estate Crowdfunding: Will It Surpass Traditional Real Estate Financing?*, 24 PIABA B.J. 77, 81 (2017).

based,³⁸ rewards-based, and pre-purchase-based crowdfunding³⁹ are popular forms of crowdfunding,⁴⁰ this Note focuses on the for-profit crowdfunding methods of equity crowdfunding⁴¹ and marketplace lending.⁴²

38. Donations-based crowdfunding allows individuals to contribute donations to a crowdfunding effort without receiving anything in return. *See id.* (describing various types of crowdfunding, including donations-based crowdfunding). If a crowdfunding campaign includes no potential for return in exchange for a contribution, then there is no offering of securities. Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws-Why the Specially Tailored Exemption Must be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1739 (2012) (explaining that if there is no “express or implied possibility of a return to the donor, there is no offering of securities.”). Because donors have no possibility of return, this model of crowdfunding does not meet the definition of “investment contract” outlined in *SEC v. W.J. Howey Co.* and therefore does not implicate securities laws. *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946) (defining “investment contract” as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . .”). Donations may fund for-profit enterprises, but most donation sites focus on non-profit organizations. Bradford, *supra* note 8, at 15–16. Popular donations-based crowdfunding sites include globalgiving.org, GLOBALGIVING, globalgiving.org [https://perma.cc/2QPM-E22G] (last visited Sept. 21, 2019), and donorschoose.org, DONORSCHOOSE.ORG, donorschoose.org [https://perma.cc/M765-B7V8] (last visited Sept. 21, 2019). Pure donations-based crowdfunding sites are rare. *Id.* at 15.

39. Rewards-based crowdfunding provides contributors to a crowdfunding effort with a “tangible benefit in exchange for their donation.” Nazir, *supra* note 37, at 81–82. Pre-purchase-based crowdfunding is similar to rewards-based crowdfunding and is where contributors receive the product that the business or entrepreneur creates. Bradford, *supra* note 8, at 16. In order to avoid implicating securities laws, the benefit for both forms of crowdfunding cannot involve a financial return such as “interest, dividends, or part of the earnings of the business.” *Id.* Rewards and pre-purchase-based crowdfunding are the most common forms of crowdfunding. Nazir, *supra* note 37, at 81. Popular platforms that use these forms of crowdfunding include Kickstarter, GoFundMe, and Indiegogo. Jackie Zimmermann, *Rewards-Based Crowdfunding: What it is, When it Works*, NERDWALLET (Dec. 6, 2017), <https://www.nerdwallet.com/blog/small-business/reward-crowdfunding/> [https://perma.cc/887R-2FFM]. Examples of rewards given to backers include t-shirts, digital downloads of albums, and “thank you” calls. Bradford, *supra* note 8, at 18. In its first case involving crowdfunding, the Federal Trade Commission (“FTC”) took legal action in 2015 against a project creator who raised funds through Kickstarter for a board game but spent most of the funds on himself. Press Release, Fed. Trade Comm’n, *Crowdfunding Project Creator Settles FTC Charges of Deception* (June 11, 2015) <https://www.ftc.gov/news-events/press-releases/2015/06/crowdfunding-project-creator-settles-ftc-charges-deception> [https://perma.cc/QSN4-DF6Q] (describing the first crowdfunding case the FTC became involved in). In the campaign, the defendant raised over \$122,000 from 1,246 backers, promising them rewards of a copy of the game or a figurine. *Id.* The case settled and represents an ongoing effort by the FTC to protect consumers involved in fintech and the potential for the FTC to become involved in this form of crowdfunding in the future. *Id.*

40. *See* Nazir, *supra* note 37, at 81–82 (describing that the pre-purchase-based crowdfunding is the most common form of crowdfunding, while providing examples of successful donations-based crowdfunding platforms and rewards-based crowdfunding campaigns).

41. *See infra* Part II.A.

42. *See infra* Part II.B.

A. *Equity Crowdfunding*

Equity crowdfunding is a process that allows investors to purchase ownership interests in companies.⁴³ Because this form of crowdfunding involves the sale of a security,⁴⁴ it implicates federal securities laws and is subject to regulation by the Securities and Exchange Commission (“SEC”).⁴⁵ In general, any sale or offering of securities must qualify for an exemption in order to avoid registration under the Securities Act of 1933 (“1933 Act”).⁴⁶ Prior to 2012, equity crowdfunding platforms were primarily governed by the Regulation D (“Reg D”) and Regulation A (“Reg A”) 1933 Act exemptions.⁴⁷ These exemptions decrease regulatory obligations for issuers, reducing their costs and time to raise capital.⁴⁸

On March 27, 2012, Congress enacted the Jumpstart Our Business Startups Act (“JOBS Act”) in order to expand access to public capital markets for emerging growth companies.⁴⁹ Congress designated Title III of the JOBS Act as the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (“CROWDFUND Act”).⁵⁰ The CROWDFUND Act served as the foundation for equity crowdfunding in the United States.⁵¹ This Act provided an exemption from registration with the SEC for the offer and sale of up to \$1 million of securities in a twelve-month period to non-accredited investors.⁵²

43. John S. (Jack) Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists’ Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 589 (2013).

44. S.E.C. v. W.J. Howey Co., 328 U.S. 293, 297–99 (1946).

45. Bradford, *supra* note 8, at 33.

46. 15 U.S.C. § 77d (2018).

47. SCOTT BAUGUESS ET AL., U.S. SEC. AND EXCH. COMM’N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF THE MARKET FOR UNREGISTERED SECURITIES OFFERINGS, 2009-2017 5 (2018), https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf [<https://perma.cc/BH2R-F43W>].

48. *Id.* at 3.

49. Jumpstart Our Business Startups Act (“JOBS Act”), Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in various sections of 15 U.S.C.).

50. *Id.*

51. Max E. Isaacson, Note, *The So-Called Democratization of Capital Markets: Why Title III of the Jobs Act Fails to Fulfill the Promise of Crowdfunding*, 20 N.C. BANKING INST. 439, 440 (2016).

52. A non-accredited investor is any investor who does not meet the income or net worth requirements to be an accredited investor as defined by the SEC. 17 C.F.R. § 230.501(a) (2019). For natural persons to be considered accredited investors, the current standard is an individual net worth or joint net worth with that person’s spouse of over \$1,000,000 excluding the value of the primary residence, *id.* at § 230.501(a)(5), or an individual income of \$200,000

On October 15, 2015, the SEC adopted a rule called Regulation Crowdfunding (“Reg CF”) that became effective on May 16, 2016 and implemented the requirements of the CROWDFUND Act.⁵³ Under the rule as updated in 2017, issuers can raise up to an aggregate of \$1.07 million over a twelve-month period without registering their offering with the SEC.⁵⁴ The aggregate amount individuals may invest in offerings shall not exceed the greater of \$2200 or five percent of the investor’s annual income if the investor’s annual income is less than \$107,000.⁵⁵ If the investor’s annual income and net worth are equal to or greater than \$107,000, then the individual can invest up to the lesser of either ten percent of his or her annual income, or ten percent of his or her net worth, up to a maximum of \$107,000.⁵⁶ Reg CF also introduced the funding portal, a new kind of entity that acts as an intermediary in transactions involving the offer or sale of securities on behalf of others.⁵⁷ This regulation allows ordinary retail investors to invest in private businesses as a crowd through these funding portals.⁵⁸

Companies relying on Reg D are exempt from registering their offerings but must file “Form D”, which includes information about the issuer’s identity, principal place of business, related persons, industry group, and other basic information.⁵⁹ Currently, Reg D consists of three

or more annually, or a joint income of \$300,000 or more including the income of a spouse. *Id.* at § 230.501(a)(6).

53. Crowdfunding, 80 Fed. Reg. 71387 (Nov. 16, 2015) (codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269 & 274).

54. 17 C.F.R. § 227.100(a)(1). Under the original rule, issuers could raise up to an aggregate of \$1 million over a 12-month period without registering their offering with the SEC. Crowdfunding, 80 Fed. Reg. 71387, 71391 (Nov. 16, 2015) (codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269 & 274).

55. 17 C.F.R. § 227.100(a)(2)(i). Under the original rule, the aggregate amount individuals could invest in offerings could not exceed the greater of \$2,000 or five percent of the investor’s annual income if the investor’s annual income was less than \$100,000. Crowdfunding, 80 Fed. Reg. 71387, 71392 (Nov. 16, 2015) (codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, & 274).

56. 17 C.F.R. § 227.100(a)(2)(ii). Under the original rule, if the investor’s annual income and net worth are equal to or greater than \$100,000, then the investor could invest up to the lesser of ten percent of his or her annual income or ten percent of his or her net worth, with a maximum of \$100,000. Crowdfunding, 80 Fed. Reg. 71387, 71390 (Nov. 16, 2015) (codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269 & 274).

57. Crowdfunding, 80 Fed. Reg. 71387 (Nov. 16, 2015) (codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269 & 274).

58. Georgia Quinn, *Title III Crowdfunding: Talking About a Revolution*, CROWDFUND INSIDER (Oct. 30, 2015, 12:32 PM), <https://www.crowdfundinsider.com/2015/10/76506-title-iii-crowdfunding-talking-about-a-revolution/> [https://perma.cc/4FBY-HKGY].

59. Examples of other basic information required in Form D includes issuer size, federal exemptions and exclusions claimed, type of filing, duration of offering, type(s) of securities

rules: Rule 504,⁶⁰ Rule 506(b),⁶¹ and Rule 506(c).⁶² Between 2009 and 2017, almost all of the reported offerings through Reg D used Rules 506(b) and 506(c).⁶³ Rule 506(b) prohibits general solicitation and advertising and limits investors to accredited investors and up to thirty-five sophisticated, non-accredited investors.⁶⁴ Rule 506(c), as amended by the SEC pursuant to Title II of the JOBS Act,⁶⁵ permits general solicitation and advertising if the offering is limited to accredited investors.⁶⁶ In 2017, \$1.8 trillion of capital was raised using Rules 506(b) or 506(c),⁶⁷ with an overwhelming majority raised pursuant to Rule 506(b).⁶⁸

Reg A⁶⁹ was amended in 2015 pursuant to Title IV of the JOBS Act.⁷⁰ The amended regulation (“Reg A+”) increased the exemption for registration requirements for private offerings from up to \$5 million to up to \$50 million over a twelve-month period.⁷¹ Reg A+ splits offerings into two tiers.⁷² Each tier is subject to certain reporting requirements and regulatory compliance.⁷³ Tier 1 requires only exit reports, while Tier 2 requires annual reports, semiannual reports, current event reports, audited

offered, whether the offer involves a business combination transaction, minimum investment, sales compensation, offering and sales amount, sales compensation, offering and sales amounts, investors, sales commissions and finders’ fee expenses, and use of proceeds. Form D: Notice of Exempt Offerings of Securities, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/about/forms/formd.pdf> [https://perma.cc/X9DK-45ZU].

60. 17 C.F.R. § 230.504 (2015).

61. 17 C.F.R. § 230.506(b).

62. 17 C.F.R. § 230.506(c); BAUGUESS ET AL., *supra* note 47, at 4.

63. Between 2009 and 2017, 99.9% of the reported offerings through Reg D used Rules 506(b) and 506(c). BAUGUESS ET AL., *supra* note 47 at 2.

64. 17 C.F.R. § 230.506(b)(2)(i).

65. Jumpstart Our Business Startups Act (“JOBS Act”) § 201, Pub. L. No. 112-106, 126 Stat 306 (2012) (codified as amended in various sections of 15 U.S.C.).

66. 17 C.F.R. § 230.506(c).

67. BAUGUESS ET AL., *supra* note 47, at 4.

68. From September 23, 2013, to December 31, 2017, only 4.4% of Rule 506 offerings have raised capital pursuant to Rule 506(c), with 95.6% of offerings having raised capital pursuant to Rule 506(b). *Id.* at 15.

69. 17 C.F.R. § 230.251 (2017).

70. Jumpstart Our Business Startups Act (“JOBS Act”), Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in various sections of 15 U.S.C.).

71. Isaacson, *supra* note 51, at 448.

72. 17 C.F.R. § 230.251. Tier 1 allows issuers to offer up to \$20 million over a 12-month period and Tier 2 allowing issuers to offer up to \$50 million over a 12-month period. *Id.* Tier 1 does not put a limit on non-accredited investors investing in a Tier 1 offering, while Tier 2 limits the amount that non-accreditors can invest to no more than 10% of the purchaser’s net worth or annual income, whichever is greater. *Id.* at § 230.251(d)(2)(i)(C).

73. Isaacson, *supra* note 51, at 448.

financial statements, and exit reports.⁷⁴ Reg A+ acts as an alternative to a small Initial Public Offering or other securities offering methods under the 1933 Act.⁷⁵ However, the cost of regulatory compliance creates a high barrier for Reg A+ offerings, making this exemption unlikely to trump Reg D for raising capital.⁷⁶ Compared to Reg CF and Reg A offerings, Reg D offerings raise more capital and occur more frequently.⁷⁷

B. Marketplace Lending

Marketplace lending⁷⁸ involves contributors who loan money and expect their loans to be returned in the future, normally with interest.⁷⁹ This form of crowdfunding involves the “crowd” lending to borrowers through unsecured loans.⁸⁰ These loans are typically made to individuals or small businesses.⁸¹ The most common form of marketplace loans are unsecured consumer loans, while small business loans are a growing second.⁸² The two most popular marketplace lenders are LendingClub⁸³ and Prosper.⁸⁴ As of June 30, 2019, LendingClub issued over \$50 billion in loans⁸⁵ while Prosper facilitated more than \$16 billion in loans as of

74. 17 C.F.R. § 230.257 (2019).

75. ANZHELA KNYAZEVA, SEC. AND EXCH. COMM’N, REGULATION A+: WHAT DO WE KNOW SO FAR? 2 (2016), https://www.sec.gov/files/Knyazeva_RegulationA%20.pdf [<https://perma.cc/QYB2-LRQG>] (analyzing Regulation A+ activity for approximately 16 months after the amendments to Regulation A became effective).

76. Isaacson, *supra* note 51, at 449.

77. BAUGUESS ET AL., *supra* note 47, at 9.

78. Marketplace lending is also known as peer-to-peer lending. John L. Douglas, *New Wine into Old Bottles: Fintech Meets the Bank Regulatory World*, 20 N.C. BANKING INST. 17, 27 (2016). This practice is also referred to as debt crowdfunding, person-to-person lending, P2P lending, or lending-based crowdfunding. Wroldsen, *supra* note 43, at 588–89.

79. Wroldsen, *supra* note 43, at 588–89.

80. David M. Freeman & Matthew R. Nutting, *A Brief History of Crowdfunding*, 1, 3 (2015), <http://www.freedman-chicago.com/ec4i/History-of-Crowdfunding.pdf> [<https://perma.cc/ND2B-TTST>].

81. David W. Perkins, *Marketplace Lending: Fintech in Consumer and Small-Business Lending*, CONG. RES. SERV. 1 (2018), <https://fas.org/sgp/crs/misc/R44614.pdf> [<https://perma.cc/D2PF-75LD>].

82. *Marketplace Lending 2.0*, DELOITTE (2017), <https://www2.deloitte.com/us/en/pages/financial-services/articles/marketplace-lending-and-banks-report.html> [<https://perma.cc/66DU-7CVN>].

83. LENDINGCLUB, <https://www.lendingclub.com/info/statistics.action> [<https://perma.cc/L6X6-8TYU>] (last visited Sept. 21, 2019).

84. PROSPER, <https://www.prosper.com/about> [<https://perma.cc/M88S-KNLC>] (last visited Sept. 21, 2019).

85. LENDINGCLUB, *supra* note 83.

September 15, 2019.⁸⁶ To provide a loan, the marketplace lending platform must approve the borrower.⁸⁷ Once approved, the borrower receives a credit risk score and an interest rate determined by the platform.⁸⁸ Because most of the platform's services are automated, getting a loan can be easier, faster, and more cost effective than borrowing from a bank.⁸⁹

In 2008, the SEC issued a cease and desist order against Prosper.⁹⁰ The SEC declared that Prosper, and by extension other marketplace lending platforms, were offering securities.⁹¹ Following the SEC's cease and desist order, marketplace lending platforms had to shelf register⁹² each loan before a lender's investment.⁹³ Details of each funded loan are now recorded on EDGAR.⁹⁴

The cease and desist order also changed how marketplace lending platforms conduct their transactions.⁹⁵ Before the SEC's order, platforms such as Prosper and LendingClub originated loans to borrowers, and WebBank, a Utah-chartered industrial bank⁹⁶ funded the loans.⁹⁷ WebBank then assigned the note to the lender through the platform.⁹⁸ After the order, notes issued by Prosper and similar marketplace lending

86. PROSPER, *supra* note 84.

87. Freeman & Nutting, *supra* note 80, at 3–4.

88. *Id.* at 4.

89. *Id.*

90. Prosper Marketplace, Inc., Exchange Act Release No. 8984, 2008 WL 4978684, at *1 (Nov. 24, 2008), <http://www.sec.gov/litigation/admin/2008/33-8984.pdf> [<https://perma.cc/DA6X-D5QJ>].

91. *Id.* at *4.

92. Shelf registration is a method for issuers to register new offerings on a delayed basis without having to issue them immediately. *See* 17 C.F.R. § 230.415 (2019) (describing the process of shelf registration). Shelf registration allows an issuer to register a group of securities and then issue them in parts. *See* Andrew Verstein, *The Misregulation of Person-to-Person Lending*, 45 U.C. Davis L. Rev. 445, 489 (2011) (explaining the advantages of shelf registration for peer-to-peer lending platforms). Shelf registration is essential for peer-to-peer lending platforms because it allows issuers “economies of scale in registration.” *Id.*

93. *See* Benjamin Lo, *It Ain't Broke: The Case for Continued SEC Regulation of P2P Lending*, 6 HARV. BUS. L. REV. 87, 89 (2016) (describing the shelf registration process for peer-to-peer loans).

94. EDGAR is the SEC's publicly accessible disclosure database. *Id.*

95. Verstein, *supra* note 92, at 476–77.

96. An industrial bank is “a financial institution deriving funds from the sale of investment certificates and from deposits made by individual savers and investing such funds in personal loans often secured by a comaker note or chattel mortgage.” *Industrial Bank*, MERRIAM-WEBSTER ONLINE DICTIONARY, <https://www.merriam-webster.com/dictionary/industrial%20bank> [<https://perma.cc/AFJ2-ZB2U>] (last visited Oct. 25, 2019).

97. Verstein, *supra* note 92, at 476.

98. *Id.*

platforms continue to remain the platform's obligation.⁹⁹ These notes, also known as "borrower payment dependent notes,"¹⁰⁰ are debt instruments sold to lenders who then receive money contingent on borrower repayment.¹⁰¹ After the SEC's cease and desist order, all marketplace lending platforms either registered with the SEC or failed.¹⁰² While the marketplace lending platform now formally retains loans that are funded and selected by investors, in practice investors bear the credit risk because the notes offered by the platforms are only payable once borrowers make payments on their loans.¹⁰³ Despite these changes in regulation and transactions following the SEC's order in 2008, marketplace lending remains popular.¹⁰⁴

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") tasked the U.S. Government Accountability Office ("GAO") with studying marketplace lending in order to develop an "optimal federal regulatory structure."¹⁰⁵ The GAO study was completed in 2011 and found two primary regulatory options for marketplace lending, which offered different approaches to lender protection.¹⁰⁶ The two options recommended by the GAO included: "(1) continuing with the current bifurcated federal system—that is, protecting lenders through securities regulators and borrowers primarily through financial services regulators . . . or (2) consolidating borrower and lender protection under a single federal regulator, such as CFPB."¹⁰⁷ However, the report was inconclusive on which option Congress should select, so marketplace lending platforms remain regulated by the SEC.¹⁰⁸

99. *Id.* at 476–77.

100. *Id.* at 477.

101. *Id.* at 476–77.

102. Chang-hsien Tsai, *To Regulate or Not to Regulate? A Comparison of Government Responses to Peer-to-Peer Lending Among the United States, China, and Taiwan*, 87 U. CIN. L. REV. 1077, 1085 (2018).

103. *Id.* at 1084.

104. Lo, *supra* note 93, at 90. For example, LendingClub has issued over \$50 billion in loans as of June 30, 2019, LENDINGCLUB, *supra* note 83, while Prosper has facilitated more than \$16 billion in loans as of September 15, 2019. PROSPER, *supra* note 84.

105. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Pub. L. No. 111-203, § 989F(a)(1), 124 Stat. 1376, 1947 (2010) (tasking the GAO with conducting a study to determine the optimal federal regulatory structure for person to person lending).

106. U.S. GOV'T ACCOUNTABILITY OFFICE REP. NO. 11-613 42 (2011), <https://www.gao.gov/new.items/d11613.pdf> [<https://perma.cc/AM7B-T999>].

107. *Id.*

108. *Id.*

The proper regulation of marketplace lending and other fintech companies remains open to debate.¹⁰⁹ In 2016, the Office of the Comptroller of the Currency (“the OCC”) offered guidance on the possibility of creating a special purpose national bank charter for fintech companies,¹¹⁰ including marketplace lending platforms.¹¹¹ The OCC declared that a fintech company must, at minimum, receive deposits, pay checks, or lend money to receive a special purpose bank charter.¹¹² However, in May 2019, the U.S. District Court for the Southern District of New York held that the OCC could not issue a special purpose bank charter to a fintech company that does not receive deposits.¹¹³ The court held that the National Bank Act¹¹⁴ was unambiguous that the “business of banking” requires receiving deposits.¹¹⁵ While this decision calls into question the OCC’s ability to issue a special purpose bank charter for a fintech company, it remains unclear whether marketplace lending platforms are included in the OCC’s definition of a fintech company.¹¹⁶

III. THE IMPACT OF CROWDFUNDING ON BANK LENDING

While bank lending continues to be a major source of capital for businesses, banks remain concerned about firm creditworthiness and are hesitant to provide loans to businesses without proven track records, consistent cash flows,¹¹⁷ or sufficient assets to pledge as collateral.¹¹⁸ This reluctance increased as a result of the 2008 financial crisis,¹¹⁹ as banks became more “risk-averse” and faced tightened regulations in its

109. See Tsai, *supra* note 102, at 1084–87 (discussing various approaches to the regulation of marketplace lending and fintech companies from 2011 to 2016).

110. OFFICE OF THE COMPTROLLER OF THE CURRENCY, *Exploring Special Purpose National Bank Charters for Fintech Companies* 4 (2016), <https://www.occ.gov/publications-and-resources/publications/banker-education/files/pub-special-purpose-nat-bank-charters-fintech.pdf> [<https://perma.cc/6CQL-TT6S>].

111. See Thomas, *supra* note 36 (describing fintech as including “all forms of innovative digital and software technologies applied directly to the financial services sector.”).

112. OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 110.

113. *Vullo v. Office of Comptroller of Currency*, 378 F. Supp. 3d 271, 298 (S.D.N.Y. 2019).

114. 12 U.S.C. §§ 21–43 (2018).

115. *Vullo v. Office of Comptroller of Currency*, 378 F. Supp. 3d at 298.

116. Tsai, *supra* note 102, at 1088.

117. Walthoff-Borm et al., *supra* note 9.

118. See Berger & Udell, *supra* note 11, at 624 (stating that banks will generally not lend to small businesses until “they achieve a level of production where their balance sheets reflect substantial business assets that might be pledged as collateral . . .”).

119. See Walthoff-Borm et al., *supra* note 9 (explaining changes in bank lending after the 2008 financial crisis).

aftermath.¹²⁰ Growing demand for alternative funding established crowdfunding methods like marketplace lending and equity crowdfunding as popular sources of funding for startups and small-to-medium sized businesses.¹²¹

Under traditional “pecking order theory,”¹²² information asymmetries typically drive entrepreneurs to use internal funds whenever available.¹²³ However, when these funds are lacking, entrepreneurs turn to debt financing, which includes marketplace lending.¹²⁴ Entrepreneurs usually prefer debt financing to equity financing because equity financing normally involves a dilution of their ownership share.¹²⁵ If debt financing is neither available nor a practical option, entrepreneurs turn to external equity financing.¹²⁶ Equity crowdfunding, a form of external equity financing, is therefore employed as a last resort under traditional pecking order theory.¹²⁷

A. *The Impact of Marketplace Lending on Bank Lending*

Marketplace lending represents a developing non-bank activity that competes with the traditional financial intermediation conducted by commercial banks.¹²⁸ In 2015, the two largest marketplace lending platforms originated \$12 billion in personal unsecured loans,¹²⁹ compared to \$241 billion of outstanding personal loans in the United States.¹³⁰ A

120. Setälä, *supra* note 34.

121. *See id.* (exploring the potential use of crowdfunding as an alternative to bank lending).

122. In corporate finance, the pecking order theory postulates that “the costs related to information asymmetry drive entrepreneurs to first employ internal funds whenever available. When internal funds are lacking, entrepreneurs will search for debt financing and choose only external equity financing, including equity crowdfunding, as a last resort.” Walthoff-Born et al., *supra* note 9.

123. *Id.*

124. *Id.*

125. Andy Cosh et al., *Outside Entrepreneurial Capital*, 119 THE ECON. J. 1494, 1498 (2009).

126. Walthoff-Born et al., *supra* note 9.

127. *Id.*

128. *See* Brian Wolfe & Woongsun Yoo, *Crowding Out Banks: Credit Substitution by Peer-to-Peer Lending* 28 (2017), <https://www.fdic.gov/bank/analytical/cfr/bank-research-conference/annual-17th/papers/13-wolfe.pdf> [<https://perma.cc/E7KK-6DHK>] (explaining the effect of peer-to-peer lending on bank credit).

129. The two largest marketplace lending platforms are LendingClub, LENDINGCLUB, Lendingclub.com [<https://perma.cc/96EM-S9SU>] (last visited Sept. 21, 2019), and Prosper, PROSPER, Prosper.com [<https://perma.cc/73ZQ-DTEH>] (last visited Sept. 21, 2019).

130. Wolfe & Yoo, *supra* note 128, at 1.

2016 report found that the global marketplace lending market was \$26.6 billion in 2015, but it anticipates that this market will be worth \$897.85 billion by 2024.¹³¹ This projected growth is attributed to the after-effects of the 2008 financial crisis, including low interest rates and lack of sufficient funding for businesses.¹³² Technological advances, improved online interfaces, and numerous partnerships between crowdfunding platforms are also expected to contribute to this industry's growth.¹³³

For borrowers, loans from marketplace lenders generally charge lower interest rates than similar bank loans because a majority of marketplace lending services are automated, resulting in lower overhead for the platforms.¹³⁴ Because marketplace lending represents an alternative to bank lending, marketplace lenders compete with banks.¹³⁵ These lenders are able to provide loans to high-risk borrowers who cannot obtain credit from traditional financial intermediaries.¹³⁶ This facilitates credit expansion for borrowers who are deemed too risky by commercial banks.¹³⁷ Marketplace lending also affects small commercial banks through these banks' losses in loan volume and acceptance of riskier borrowers.¹³⁸ Most of these losses in loan volume come from high-risk loans, as low credit borrowers seek marketplace loans in place of commercial bank loans.¹³⁹ Large commercial banks do not currently appear to be losing loan volume to marketplace lenders.¹⁴⁰ Marketplace lending is likely to progressively affect bank lending in the future as the

131. TRANSPARENCY MKT. RESEARCH, *Increasing Small Business Units to Act as Building Blocks for Peer-to-Peer Lending Market*, TRANSPARENCY MKT. RESEARCH (Aug. 31, 2016, 9:30 AM), <https://www.globenewswire.com/news-release/2016/08/31/868470/0/en/Increasing-Small-Business-Units-to-Act-as-Building-Blocks-for-Peer-to-Peer-Lending-Market.html> [https://perma.cc/4BUP-5ZAN].

132. *Id.*

133. *Id.*

134. Freeman & Nutting, *supra* note 80, at 4.

135. See Wolfe & Yoo, *supra* note 128 (showing that “peer-to-peer lending represents an emerging competitor to traditional depository lenders such as commercial banks.”).

136. *Id.* at 1.

137. *Id.*

138. *Id.* at 4 (defining small commercial banks as banks with assets less than \$300 million).

139. Jess Cornaggia et al., *Crowding Out Banks: Credit Substitution by Peer-to-Peer Lending* 2 (2018), https://www.newyorkfed.org/medialibrary/media/research/conference/2019/fintech/Yoo_Cornaggia_Wolfe_FinTech [https://perma.cc/9B2L-GDHN].

140. *Id.* at 3.

global marketplace lending industry increases in size and more borrowers choose marketplace loans.¹⁴¹

B. The Impact of Equity Crowdfunding on Bank Lending

While marketplace lending directly competes with bank lending,¹⁴² equity crowdfunding is in less direct competition with bank lending because entrepreneurs traditionally choose debt financing over equity financing.¹⁴³ Although still in its infancy, equity crowdfunding is becoming an increasingly popular source of external finance for early stage companies,¹⁴⁴ as banks restricted lending after the 2008 financial crisis.¹⁴⁵ Following the implementation of Reg CF and Reg A+, the “crowd” became more involved in equity crowdfunding campaigns.¹⁴⁶ However, Reg D offerings continue to raise significantly more capital and occur more frequently compared to Reg CF and Reg A+ offerings.¹⁴⁷ Reg

141. See TRANSPARENCY MKT. RESEARCH, *supra* note 131 (providing statistics that display the growth of marketplace lending).

142. See Wolfe & Yoo, *supra* note 128 (explaining that marketplace lending is a form of a “non-bank activity competing with traditional deposit-taking lenders.”).

143. See Walthoff-Borm et al., *supra* note 9, at 515 (explaining the rise of crowdfunding as an alternative to traditional bank finance following the 2008 financial crisis and the pecking order theory in corporate finance).

144. *Id.*

145. *Id.* at 516.

146. See Isaacson, *supra* note 51, at 463–64 (arguing that Regulation D, Regulation A+, and Title III of the JOBS Act have failed to accomplish the JOBS Act’s goal of increasing investment opportunities for the average investor).

147. Between September 23, 2013, and December 31, 2017, there were 7,110 Rule 506(c) filings initiated, raising almost \$183.3 billion in initial Form D filings. BAUGUESS ET AL., *supra* note 47, at 15. During the same period, there were 87,890 Rule 506(c) filings initiated, raising almost \$1.8 trillion in initial Form D filings. *Id.* Under Reg A+, securities offerings outpaced the rate of those under Reg A in the period from June 19, 2015, to October 31, 2016. KNYAZEVA, *supra* note 75, at 1. During that time period, issuers filed 147 offerings under Reg A+ seeking a total of \$2.6 billion. *Id.* Although issuers only reported earning an approximate total of \$190 million during this time period, this is likely understated due to the limit on the reporting timeframes. *Id.* The SEC estimates that there were 1,351 equity offerings under Reg CF between its implementation on May 16, 2016, and December 31, 2018. STAFF OF U.S. SEC. AND EXCH. COMM’N, REPORT TO THE COMMISSION, REGULATION CROWDFUNDING 4 (2019) (providing a detailed report on crowdfunding for the first three years following the implementation of Regulation Crowdfunding). The approximate number of offerings increased each year, with 292 initiated in the first 12 months, 557 in the second 12 months, and 502 from May 16, 2018 through December 31, 2018. *Id.* During this entire period, 105 issuers also returned to crowdfunding for follow-on offerings. *Id.* The median amount reported raised for completed offerings was \$107,367. *Id.* As of the end of 2018, there were 45 funding portals registered with the Financial Industry Regulatory Authority (“FINRA”). *Id.* at 27. Since Reg CF’s implementation, the total proceeds from crowdfunding campaigns and the number of successful campaigns utilizing this regulation grew significantly. CROWDFUND CAPITAL ADVISORS, *The 2018 State of Regulation Crowdfunding*

D offerings under 506(b) and 506(c) only apply narrowly in scope to accredited investors¹⁴⁸ and a limited number of non-accredited investors.¹⁴⁹ Because Reg CF and Reg A+ do not limit the number of non-accredited investors who can invest in an equity crowdfunding campaign, they are viewed as a step in the right direction towards allowing the “crowd” to engage in investment opportunities.¹⁵⁰

Entrepreneurs usually prefer debt financing to equity financing because equity financing usually involves a dilution of their ownership share.¹⁵¹ If debt financing is neither available nor a practical option, entrepreneurs turn to external equity financing.¹⁵² A 2018 study examined data from 277 firms that searched for equity crowdfunding on Crowdcube, a UK crowdfunding platform, to determine how equity crowdfunding fits into traditional pecking order theory.¹⁵³ The study found that firms which are less profitable, lack internal funding, have excessive debt levels, and have high levels of intangible assets are more likely to search for crowdfunding.¹⁵⁴ This indicates that firms tend to choose equity crowdfunding as a last resort.¹⁵⁵ Therefore, the study suggests that equity crowdfunding does not directly compete with bank lending because entrepreneurs typically choose debt over equity financing.¹⁵⁶ However, equity crowdfunding can help banks close the gap on informational asymmetries that typically cause banks to avoid lending to startup companies without a proven track record.¹⁵⁷ A successful equity crowdfunding campaign signals to banks that the

– *U.S. Securities-Based Crowdfunding under Title III of the JOBS Act*, 1, 2 (2019), <https://cdn.crowdfundinsider.com/wp-content/uploads/2019/02/CCA-2018-State-of-Regulation-Crowdfunding-Summary-FINAL.pdf> [<https://perma.cc/QJ9A-U8CM>]. Between 2017 and 2018, proceeds from successful crowdfunding campaigns rose from \$71.2 million to \$109.3 million, an increase of 54% within a year. *Id.* The number of successful offerings also rose from 221 in 2017 to 417 in 2018 and the total number of investors in these successful offerings increased from 77,558 in 2017 to 147,448 in 2018. *Id.*

148. 17 C.F.R. § 230.506(c) (2019).

149. 17 C.F.R. § 230.506(b)(2)(i) (2019).

150. *See* Isaacson, *supra* note 51, at 463–64.

151. Cosh et al., *supra* note 125, at 1498.

152. Walthoff-Borm et al., *supra* note 9.

153. *Id.*

154. *Id.* at 513.

155. *Id.* at 514.

156. *Id.*

157. *See id.* (“Because of information asymmetries, entrepreneurs prefer to use internal financing whenever possible; next they will raise external debt financing; and, finally, when their debt capacity is exhausted, they will raise external equity financing, but only as a last resort.”).

startup company will be profitable in the future and less likely to default on a loan.¹⁵⁸

IV. PARTNERSHIPS BETWEEN BANKS AND CROWDFUNDING PLATFORMS

A. *Bank Partnerships with Marketplace Lending Platforms*

Although marketplace lending platforms primarily affect banks through losses in loan volume and the acceptance of riskier borrowers by small commercial banks,¹⁵⁹ there are opportunities for partnerships and collaboration between marketplace lenders and banks of all sizes.¹⁶⁰ As the global marketplace lending market exhibits a high potential for growth,¹⁶¹ some banks have noticed marketplace lending and become involved in the industry.¹⁶² Banks commonly partner with marketplace lenders to facilitate loan transactions.¹⁶³ Banks and marketplace lenders have also formed partnerships through acquisitions, joint ventures, and hybrid lending practices.¹⁶⁴

While many marketplace lenders lend directly to borrowers, some partner with banks to facilitate loan transactions.¹⁶⁵ In this partnership, the marketplace lender collects borrower applications, provides credit grades, and then refers the application to its partner bank.¹⁶⁶ Once the partner bank receives the application, the bank makes the loan to the

158. See John Reosti, *Ex-Banker's Crowdfunding Firm Finds Its Missing Link: A Bank*, AM. BANKER (Sept. 29, 2016) (explaining how Fresno First Bank's partnership with Breakaway Funding helps close the "information gap" between the bank and its prospective borrowers).

159. Wolfe & Yoo, *supra* note 128, at 1.

160. Julapa Jagtiani & Kose John, *Fintech: The Impact on the Consumer and Regulatory Responses*, 100 J. OF ECON. AND BUS. 1, 2 (2018).

161. TRANSPARENCY MKT. RESEARCH, *supra* note 131 (describing the growth of marketplace lending).

162. See Olivier Garrett, *Goldman Sachs' Recent Move Marks the End of Traditional Banking*, FORBES (Feb. 22, 2017, 7:00 PM), <https://www.forbes.com/sites/oliviergarret/2017/02/22/goldman-sachs-recent-move-marks-the-end-of-traditional-banking/#657d265669aa> [<https://perma.cc/3UKD-Y4JT>] (describing banks' increasing involvement in marketplace lending and Goldman Sachs' development of Marcus, an online lending platform).

163. Angela Herrboldt, *Marketplace Lending* 13 (2015), https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin15/si_winter2015-article02.pdf [<https://perma.cc/434C-5AKK>].

164. Jagtiani & John, *supra* note 160, at 2.

165. Herrboldt, *supra* note 163, at 13.

166. *Id.* at 14.

borrower and then sells the loan back to the marketplace lender.¹⁶⁷ The marketplace lender issues securities notes to the investors who pledged to provide funding for the loan.¹⁶⁸ The borrower then makes monthly payments to the marketplace lender, who issues payments to the investors and charges a fee.¹⁶⁹

Acquisitions and joint ventures between banks and marketplace lenders reduce banks' lending costs through the implementation of technology that provides banks with automated services and makes lending easier, faster, and more cost effective.¹⁷⁰ As of 2019, PNC Bank's partnership with digital lender OnDeck Capital allows U.S. businesses to apply for lines of credit up to \$100,000 on PNC's website and receive an answer almost immediately through the use of OnDeck's technology.¹⁷¹ PNC's goal is to make credit access easier and faster for small businesses.¹⁷² Similarly, JP Morgan and OnDeck Capital began a partnership in 2016, wherein OnDeck provided its technology to JP Morgan for the bank to offer online loans to small businesses.¹⁷³ When the partnership ended in 2019, JP Morgan developed its own platform to continue to offer these online loans to small businesses.¹⁷⁴

Banks and marketplace lending platforms also partner at the community banking level.¹⁷⁵ The BancAlliance network, a national group of community banks ranging from \$200 million to \$10 billion in assets, and LendingClub formed a partnership in 2015.¹⁷⁶ This partnership offers BancAlliance members access to co-branded personal loans through the LendingClub platform and the ability purchase some of

167. *Id.*

168. *Id.*

169. *Id.*

170. See Freeman & Nutting, *supra* note 80, at 4 (describing the history and development of crowdfunding).

171. Anna Irrera, *PNC Partners with OnDeck for Online Small Business Lending*, REUTERS (Oct. 22, 2018, 12:17 AM), <https://www.reuters.com/article/us-pnc-ondeck/pnc-partners-with-ondeck-for-online-small-business-lending-idUSKCN1MW0E6> [<https://perma.cc/MP8U-XPT3>].

172. See *id.* (describing PNC Bank's partnership with OnDeck Capital).

173. Kevin Wack, *JPMorgan Chase Ends Business Loan Partnership with OnDeck*, AM. BANKER (July 29, 2019, 9:53 AM), <https://www.americanbanker.com/news/jpmorgan-chase-ends-business-loan-partnership-with-ondeck> [<https://perma.cc/2WYX-6UYV>].

174. *Id.*

175. *Id.*

176. *Lending Club Partners With BancAlliance, a National Consortium of 200 Community Banks*, PR NEWSWIRE (Feb. 9, 2015, 7:00 AM), <https://www.prnewswire.com/news-releases/lending-club-partners-with-bancalliance-a-national-consortium-of-200-community-banks-300032620.html> [<https://perma.cc/4FK8-7BQ2>].

the loans for their own portfolios.¹⁷⁷ The partnership pairs LendingClub's low cost of operations with the community banks' low cost of capital to decrease the cost of credit for consumers.¹⁷⁸

Another potential partnership between banks and marketplace lending platforms involves a practice called "hybrid lending."¹⁷⁹ Hybrid lending combines normal balance sheet lending with off-balance sheet lending through marketplace lending platforms.¹⁸⁰ Normal balance sheet lending refers to the traditional financial intermediation of loans by banks through withdrawable deposits, where banks lend to a borrower and hold the loan on their balance sheet to maturity.¹⁸¹ Off-balance sheet lending refers to loans that have been moved off of a bank's balance sheet through pooling and securitization.¹⁸² The combination of balance sheet and off-balance sheet lending allows businesses to finance part of a loan through a marketplace lending platform and the rest through traditional bank lending.¹⁸³ Rabobank, a Dutch bank, is one of the first banks in the world to adopt a hybrid model through its own hybrid platform called Rabo & Co.¹⁸⁴ The bank offers businesses the ability to finance part of their loan on the bank's balance sheet, while providing the remaining funding through co-financing from institutional investors and banking clients.¹⁸⁵ Currently, this hybrid model is used by many of the leading marketplace lending platforms.¹⁸⁶

Hybrid lending is advantageous for banks involved in lending to riskier businesses such as startups and small businesses because it

177. *Id.*

178. *Id.*

179. Auke Douwe Veenstra, *Why Hybrid Lending Will Become Mainstream*, BANKNXT (Sept. 16, 2016), <https://banknxt.com/57969/hybrid-lending-mainstream/> [<https://perma.cc/ADT7-MRB6>].

180. *Id.*

181. See Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System 2* (Nat'l Bureau of Econ Research, Working Paper), available at <http://ssrn.com/abstract=1676947> [<https://perma.cc/AY64-378V>] (describing balance sheet lending).

182. See *id.* at 3 (describing off-balance sheet lending).

183. See Veenstra, *supra* note 179 (explaining the advantages and potential of hybrid lending).

184. *Id.*

185. See *id.* ("[W]ith its own hybrid lending marketplace, the bank could take a portion of that loan as part of its standard balance sheet lending (the amount that fits its balance sheet risk model), and put the remainder in its marketplace for investors to fund.")

186. Jason Jones, *The Pure Marketplace Lending Model is Dead, the Hybrid Takes its Place*, LENDACADEMY (Sept. 26, 2016), <https://www.lendacademy.com/the-hybrid-marketplace-lending-model/> [<https://perma.cc/Z94R-A4L6>].

mitigates the lender's risk.¹⁸⁷ This model is also advantageous for investors.¹⁸⁸ When the originator of a loan retains some risk on their balance sheet, investors have more confidence in the loans because their incentives are aligned with the originator's.¹⁸⁹ Additionally, the model helps lenders survive periods of capital scarcity in the marketplace lending market.¹⁹⁰ As small commercial banks have been affected the most by marketplace lending through losses in loan volume and the acceptance of riskier borrowers, they stand to gain the most from hybrid lending.¹⁹¹

B. Bank Partnerships with Equity Crowdfunding Platforms

While equity crowdfunding may be a last resort for firms in search of capital,¹⁹² some banks such as Fresno First Bank have formed partnerships with equity crowdfunding platforms.¹⁹³ In general, banks are hesitant to provide loans to unproven startups and small businesses that do not have significant assets.¹⁹⁴ Therefore, the primary advantages of bank partnering with equity crowdfunding sites are reducing information asymmetries that cause banks to avoid lending to startups and small businesses, and providing startups and small businesses with collateral.¹⁹⁵ The popularity of an equity crowdfunding campaign signals to the bank that a venture can be successful,¹⁹⁶ while the campaign can

187. See Veenstra, *supra* note 179 (explaining the advantages and potential of hybrid lending).

188. Nate Huebscher, *Marketplace Lending and the Three Bears: A Fintech Tale*, MEDIUM (Feb. 20, 2017), <https://medium.com/wharton-fintech/marketplace-lending-and-the-three-bears-a-fintech-tale-5c1e835e6897> [<https://perma.cc/V4XC-N2CN>].

189. *Id.*

190. *Id.*

191. See generally Wolfe & Yoo, *supra* note 128 (explaining the effect of peer-to-peer lending on bank credit).

192. Walthoff-Borm et al., *supra* note 9, at 514.

193. See Reosti, *supra* note 158 (explaining the partnership between Fresno First Bank and Breakaway Funding).

194. Berger & Udell, *supra* note 11, at 623–624.

195. See *id.* (stating that banks will generally not lend to small businesses until “they reach a level of production where their balance sheets reflect substantial tangible business assets that might be pledged as collateral.”).

196. See Reosti, *supra* note 158 (explaining the partnership between Fresno First Bank and Breakaway Funding).

also provide the business with sufficient capital to pledge as collateral for a loan.¹⁹⁷

In 2016, Fresno First Bank formed a partnership with equity crowdfunding platform Breakaway Funding.¹⁹⁸ This partnership was designed to allow the bank to evaluate prospective clients earlier in the capital cycle than it could otherwise.¹⁹⁹ First, Breakaway Funding receives important business information such as business plans, financial projections, and financial statements.²⁰⁰ Then, Breakaway Funding packages the information for review by the bank.²⁰¹ This information, along with the support that a crowdfunding project receives from backers, helps close the information gap that normally causes banks to avoid lending to these businesses.²⁰² Full Circle Brewing Co. utilized this partnership to receive a traditional bank loan from Fresno First Bank after its successful equity crowdfunding campaign.²⁰³

V. CONCLUSION AND RECOMMENDATIONS

Although crowdfunding does not yet rival traditional bank lending, there is clear demand for alternative funding that poses a threat to the banking industry.²⁰⁴ Banks now realize the business potential for crowdfunding and are becoming involved in the industry through their own platforms or through partnerships with existing platforms.²⁰⁵

197. See Berger & Udell, *supra* note 11, at 624 (stating that banks will generally not lend to small businesses until “they reach a level of production where their balance sheets reflect substantial business assets that might be pledged as collateral.”).

198. Reosti, *supra* note 158.

199. *Id.*

200. *Id.*

201. *Id.*

202. *Id.*

203. Castellon, *supra* note 1. A similar partnership formed in 2013 between BNP Paribas, a French international bank, and Ulule, Europe’s first crowdfunding platform. BNP Paribas, *Banking and Crowdfunding: a Complementary Relationship* (Apr. 4, 2018), <https://group.bnpparibas/en/news/banking-crowdfunding-complementary-relationship> [<https://perma.cc/S2AT-RJGM>]. The bank similarly uses information from a crowdfunding campaign to make loans to the business, believing that a “successful crowdfunding campaign provides a strong guarantee: it demonstrates the existence of a market, the entrepreneur’s professionalism and their capacity to mobilize future customers.” *Id.* In 2017, BNP Paribas and Ulule created a financing system where successful crowdfunding campaigns on Ulule obtain a bank loan from BNP Paribas for an amount equal or greater to the total amount raised by their campaign. *Id.*

204. See Setälä, *supra* note 34 (describing the rise of crowdfunding and its competition with the banking industry).

205. See *id.* (exploring the potential use of crowdfunding in the banking industry).

Although banks face less direct competition from equity crowdfunding than from marketplace lending,²⁰⁶ banks have the opportunity to benefit through partnerships with equity crowdfunding platforms.²⁰⁷ These partnerships expand bank lending to startups and small businesses through campaigns that provide ventures with capital that can be used as collateral²⁰⁸ and help close the information asymmetry gap between these borrowers and banks.²⁰⁹

Marketplace lending, on the other hand, directly competes with bank lending.²¹⁰ Nevertheless, partnerships between banks and marketplace lending platforms can position banks to benefit from the rise of the marketplace lending industry.²¹¹ Banks should choose to partner with marketplace lending platforms directly through facilitating loan transactions, acquisitions, or joint ventures,²¹² or adopt hybrid lending practices which allow banks to lend to riskier borrowers such as startups and small businesses.²¹³ As marketplace lending increases,²¹⁴ these partnerships will provide a growing source of revenue for banks and allow them to play a central role in this emerging industry.²¹⁵

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206. See Walthoff-Borm et al., *supra* note 9 (explaining how business first choose debt finance over equity finance under traditional pecking order theory).

207. See Reosti, *supra* note 158 (explaining the advantages of the partnership between Fresno First Bank and Breakaway Funding).

208. See Berger & Udell, *supra* note 11, at 624 (stating that banks will generally not lend to small businesses until “they reach a level of production where their balance sheets reflect substantial business assets that might be pledged as collateral.”).

209. See Reosti, *supra* note 158 (explaining how the partnership between Fresno First Bank and Breakaway Funding allows Fresno First Bank to decrease the information gap between it and its borrowers).

210. Wolfe & Yoo, *supra* note 128.

211. See Jagtiani & John, *supra* note 160.

212. See generally Freeman & Nutting, *supra* note 80, at 4 (describing the history and development of crowdfunding).

213. See Veenstra, *supra* note 179 (explaining the advantages and potential of hybrid lending).

214. TRANSPARENCY MKT. RESEARCH, *supra* note 131.

215. See Herrboldt, *supra* note 163, at 18 (describing bank participation in marketplace lending as an attractive source of revenue for banks).