"Improving Small Business Access to Capital"

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Small Business Lending Panel

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In this statement, I discuss small business lending and some ways to improve the situation with a particular focus on peer-to-peer (P2P) lending. I also very briefly discuss ways to increase small business equity investment levels. And I discuss why this matters to the broader public.

Entrepreneurship Matters

Entrepreneurship matters.[1] It fosters discovery and innovation.[2] Entrepreneurs also engage in the creative destruction of existing technologies, economic institutions and business production or management techniques by replacing them with new and better ones.[3] Entrepreneurs bear a high degree of uncertainty and are the source of much of the dynamism in our economy.[4] New, start-up businesses account for most of the net job creation in the economy.[5] Entrepreneurs innovate,

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[1] For an introduction to the literature, see Paul Westhead and Mike Wright, *Entrepreneurship: A Very Short Introduction* (Oxford University Press: 2013); Russell S. Sobel, "Entrepreneurship," *Concise Encyclopedia of Economics*, 2nd edition (Liberty Fund: 2010) https://www.econlib.org/library/Enc/Entrepreneurship.html.

[2] Israel M. Kirzner, *Competition and Entrepreneurship* (University of Chicago Press: 1973); Israel M. Kirzner, "Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach," *Journal of Economic Literature*, Vol. 35, No. 1 (1997); Randall Holcombe, *Entrepreneurship and Economic Progress* (Routledge: 2006); William J. Baumol, *The Microtheory of Innovative Entrepreneurship* (Princeton University Press: 2010).

[3] See Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (1942; Routledge: 1976), pp. 81-86 http://digamo.free.fr/capisoc.pdf; W. Michael Cox and Richard Alm, "Creative Destruction," *Concise Encyclopedia of Economics* (Liberty Fund: 2010) http://www.econlib.org/library/Enc/CreativeDestruction.html; Henry G. Manne, "The Entrepreneur in the Large Corporation," in *The Collected Works of Henry G. Manne*, Vol. 2 (Liberty Fund: 1996).

[4] Frank H. Knight, *Risk, Uncertainty, and Profit* (Houghton Mifflin: 1921) http://www.econlib.org/library/Knight/knRUP.html; Richard J. Cebula, Joshua C. Hall, Franklin G. Mixon Jr. and James E. Payne, *Economic Behavior, Economic Freedom, and Entrepreneurship* (Edward Elgar: 2015).

[5] Magnus Henrekson and Dan Johansson, "Gazelles as Job Creators: A Survey and Interpretation of the Evidence," *Small Business Economics*, Vol. 35 (2010), pp. 227–244 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1092938; Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda, "The Role of Entrepreneurship in US Job Creation and Economic Dynamism," *Journal of Economic Perspectives*, Vol. 28, No. 3 (Summer 2014), pp. 3–24 http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.28.3.3; Salim Furth, "Research Review: Who Creates Jobs? Start-up Firms and New Businesses," Heritage Foundation Issue Brief No. 3891, April 4, 2013 http://www.heritage.org/research/reports/2013/04/who-creates-jobs-startup-firms-and-new-businesses. In terms of the neo-classical growth model, entrepreneurship is an important factor affecting the rate of technological change and the marginal productivity of capital. See, e.g., Robert M. Solow, *Growth Theory: An Exposition* (Oxford University Press: 2000). Legal institutions, human capital and other factors are also important determinants of economic growth. See N. Gregory Mankiw, David Romer and David N. Weil, "A Contribution to the Empirics of Economic Growth," *The Quarterly Journal of Economics*, Vol. 107, No. 2 (May, 1992), pp. 407-437

providing consumers with new or better products. They provide other businesses with innovative, lower cost production methods and are, therefore, one of the key factors in productivity improvement and real income growth.[6] The vast majority of economic gains from innovation and entrepreneurship accrue to the public at large, rather than entrepreneurs.[7] Entrepreneurs are central to the dynamism, creativity and flexibility that enables market economies to consistently grow, adapt successfully to changing circumstances and create sustained prosperity.[8] High levels of successful entrepreneurship only occur in the private sector. Government attempts at emulating private entrepreneurship usually end badly.[9]

Among the most important factors impeding entrepreneurship are securities laws and banking laws and practices that restrict entrepreneurs' access to the capital needed to launch or grow their businesses. After all, without capital to launch a business, other impediments to entrepreneurial success are moot.

Sometimes, an entrepreneur has sufficient capital to launch and grow his or her business from personal savings, including profits from previous entrepreneurial ventures, and retained earnings.[10] Often, however, an entrepreneurial firm will need capital from outside investors or lenders.[11] Other than friends or family, outside investors are typically described as "angel investors" or "venture capitalists."[12] Typically, "angel investors" are individuals who invest at the early "seed stage"

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https://eml.berkeley.edu/~dromer/papers/MRW_QJE1992.pdf; Robert J. Barro, *Economic Growth*, 2nd edition (MIT Press: 2003).

[6] Ralph Landau, "Technology and Capital Formation," in *Technology and Capital Formation*, Dale W. Jorgenson and Ralph Landau, editors (MIT Press: 1989).

[7] Yale economist William Nordhaus has estimated that 98 percent of the economic gains from innovation and entrepreneurship are received by persons other than the innovator. See William D. Nordhaus, "Schumpeterian Profits in the American Economy: Theory and Measurement," NBER Working Paper No. 10433, April 2004 https://www.nber.org/papers/w10433.

[8] See, Decker *et al*, *supra*; C. Mirjam van Praag and Peter H. Versloot, "What is the Value of Entrepreneurship? A Review of Recent Research," *Small Business Economics*, Volume 29, Issue 4 (December 2007), pp 351-382 http://link.springer.com/article/10.1007%2Fs11187-007-9074-x; G. R. Steele, "Laissez-faire and the Institutions of the Free Market," *Economic Affairs*, September 1999 http://www.lancaster.ac.uk/staff/ecagrs/Laissez%20faire.pdf.

[9] See, for example, Ashe Schow, "President Obama's Taxpayer-Backed Green Energy Failures," *Daily Signal*, October 18, 2012 https://www.dailysignal.com/2012/10/18/president-obamas-taxpayer-backed-green-energy-failures/; the failures of Fannie Mae and Freddie Mac discussed above; David R. Burton, Testimony before the Committee on Small Business, United States House of Representatives, March 4, 2015 ; Nick Loris, "Examining the Department of Energy's Loan Portfolio," Testimony before the Committee on Science, Space and Technology, House of Representatives, March 3, 2016 https://science.house.gov/sites/democrats.science.house.gov/files/documents/Loris_Testimony3_3_16.pdf; Clifford Winston, *Government Failure versus Market Failure* (AEI-Brookings Joint Center for Regulatory Studies: 2006) https://www.brookings.edu/wp-content/uploads/2016/06/20061003.pdf.

[10] 2012 Survey of Business Owners, Statistics for All U.S. Firms by Sources of Capital Used to Start or Acquire the Business by Industry, Gender, Ethnicity, Race, and Veteran Status for the U.S.: 2012, Census Bureau, https://factfinder.census.gov/faces/nav/jsf/pages/searchresults.xhtml?refresh=t.

[11] See, e.g., "2013 State of Entrepreneurship Address: Financing Entrepreneurial Growth," Kauffman Foundation Research Paper, February 5, 2013 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2212743.

[12] See Angel Capital Association http://www.angelcapitalassociation.org/ and National Venture Capital Association http://www.nvca.org/. See also Ibrahim, Darian M., "Should Angel-Backed Start-ups Reject Venture Capital?," *Michigan Journal of Private Equity & Venture Capital Law*, Vol. 2, pp. 251-269 http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=2734&context=facpubs; Abraham J.B. Cable, "Fending For Themselves: Why Securities Regulations Should Encourage Angel Groups," *University of Pennsylvania Journal of Business Law*, Vol. 13, No. 1, Fall 2010, pp. 107-172

while "venture capitalists" are firms or funds that make investments later in the firms' life-cycle after "proof of concept." Firms seeking outside investors are often the most dynamic, high growth companies.[13] The process of raising capital from investors is heavily regulated at both the state and federal level. State laws governing securities are known as blue sky laws.[14]

Access to Capital

More than half of small businesses consider access to capital to be their most important problem or a major problem.[15] Most small firms seeking outside capital are seeking loans (debt capital) rather than equity capital.[16] This is particularly true of the smallest companies, family-owned firms or other closely-hold businesses. Bank lending to small businesses, while improving, is still at pre-crisis levels.[17] In short, small business access to capital is a continuing problem.

The Source of the Problem

The question is why. If, as some argue, it is because regulators (especially bank examiners) have without justification deemed small business loans to be riskier assets and therefore banks struggling to meet capital requirements have become less willing to lend to small firms, then it is a phenomenon caused by regulators.[18] Regulators generally deny this.[19] Community bankers often claim this (especially in private). If the cause of the problem is regulators, a Congressional

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https://www.law.upenn.edu/journals/jbl/articles/volume13/issue1/Cable13U.Pa.J.Bus.L.107%282010%29.pdf; Darian M. Ibrahim, "The (Not So) Puzzling Behavior of Angel Investors," *Vanderbilt Law Review*, Vol. 61, p. 1405-1452 (2008) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984899.

[13] Sampsa Samila and Olav Sorenson, "Venture Capital, Entrepreneurship, and Economic Growth, *Review of Economics and Statistics*, February, 2011, Vol. 93, No. 1, pp. 338-349 http://martinprosperity.org/media/agrawal/3SorensonSamila.pdf; Dane Stangler, "High-Growth Firms and the Future of the American Economy, Kauffman Foundation, March 9, 2010 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568246.

[14] For a discussion of the history of blue sky laws, see Jonathan R. Macey and Geoffrey P. Miller, "Origin of the Blue Sky Laws," *Texas Law Review*, Vol. 70, No. 2, 1991, pp. 347-397 http://digitalcommons.law.yale.edu/fss_papers/1641/ and Paul G. Mahoney, "The Origins of the Blue Sky Laws: A Test of Competing Hypotheses," UVA Law & Economics Research Paper No. 01-11, December 2001 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=296344.

[15] See, for example, Brian Knight, "Small Business Capital Access," Mercatus Survey, 2018, Figure 16, p. 18 https://www.mercatus.org/system/files/knight_-_mercatus_survey_-_chartbook_for_survey_on_small_business_capital_access_-_v1.pdf (54%); "Small Business Credit Survey," Report on Employer Firms, 2019, Federal Reserve, p. 6 https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/sbcs-employer-firms-report.pdf (31%).

[16] Victor Hwang, Sameeksha Desai and Ross Baird, "Access to Capital for Entrepreneurs: Removing Barriers," Ewing Marion Kauffman Foundation, 2019. Figure 1 https://www.kauffman.org/-/media/kauffman_org/entrepreneurship-landing-page/capital-access/capitalreport_042519.pdf; "Small Business Credit Survey," p. 7 (7% equity).

[17] "Small Business Lending in the United States, 2016," Office of Advocacy, U.S. Small Business AdministrationSeptember 2018 https://cdn.advocacy.sba.gov/wp-content/uploads/2019/04/24110545/Small-Business-Lending-in-US-2016-Report.pdf.

[18] See, for example, Candace A. Franks, "Right-sizing Bank Regulation to Preserve our Unique System," *Talk Business & Politics*, May 6, 2015 http://talkbusiness.net/2015/05/right-sizing-bank-regulation-to-preserve-our-unique-system/.

[19] See, e.g., "Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers," February 12, 2010 https://www.fdic.gov/news/news/press/2010/pr10029a.pdf.

response is appropriate. If, as others argue, the decline in small business lending is simply a function of small businesses seeing their balance sheets weaken compared to larger firms and become less credit worthy, then it is a market phenomenon. A Congressional response directed at bank lending per se is unnecessary. More general pro-growth policies and policies directed at other regulatory impediments harming small businesses should be the focus. High regulatory burdens have a disproportionate impact on small firms since regulatory costs do not increase linearly with size. This is the primary reason that small firms are disappearing from highly regulated industries like banking, investment banking (broker-dealers) and health care. Competition and innovation are stifled.

The decline of community banks relative to large money center banks caused by the marked increase in bank regulation is another possible factor. Community banks are often more willing to lend to small firms. To some extent, the rise of alternative lenders, often called marketplace lending, is a sign that the market is responding to the lack of lending from highly regulated banks. In terms of equity finance -- generally of importance to the highest growth potential, young, entrepreneurial firms -- the securities laws and regulators are clearly a problem. I discuss this below. In short, there are multiple reasons for the problem of inadequate small business access to capital.

Securities Laws

Capital formation and entrepreneurship improve economic growth, productivity, and real wages. Existing securities laws impede entrepreneurial capital formation. Congress and the SEC need to systematically reduce or eliminate state and federal regulatory barriers hindering entrepreneurs' access to capital. The regulatory environment needs to be improved for primary and secondary offerings by private and small public companies.[20] Specifically, improvements need to be made with respect to Regulation D, Regulation A, crowdfunding, secondary markets and smaller reporting companies.[21]

Peer-to-Peer Lending

I would like to focus on one issue where the Securities and Exchange Commission has caused damage, but the banking agencies and the CFPB could play a constructive role: Peer-to-peer (P2P) lending to small businesses.

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[20] Concept Release: Harmonization of Securities Offering Exemptions , Securities and Exchange Commission, June 18, 2019 https://www.sec.gov/rules/concept/2019/33-10649.pdf. See also David R. Burton, Comment Letter regarding Concept Release: Harmonization of Securities Offering Exemptions, September 24, 2019 https://www.sec.gov/comments/s7-08-19/s70819-6193328-192495.pdf; SEC Commissioner Daniel M. Gallagher, "Whatever Happened to Promoting Small Business Capital Formation?," September 17, 2014 http://www.sec.gov/News/Speech/Detail/Speech/1370542976550#.VFfbI8mGklQ or http://www.heritage.org/events/2014/09/commissioner-gallagher; see also Stuart R. Cohn and Gregory C. Yadley, "Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns," *New York University Journal of Law and Business*, Vol. 4, No. 1, pp. 1-87 (2007) http://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1257&context=facultypub.

[21] David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth, Heritage Foundation Backgrounder No. 3182, February 14, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf; David R. Burton, "Securities Disclosure Reform," Heritage Foundation Backgrounder No. 3178, February 13, 2017 https://www.heritage.org/sites/default/files/2017-02/BG3178.pdf.

P2P lending represents a way to make financial intermediation for consumer and small business loans much more efficient to the benefit of consumers, small business owners and small lenders.[22] There is a very strong need to cut down the regulatory weeds and allow the potential efficiencies of internet lending and borrowing to take place.

The key substantive, non-legal point here is that a loan is a loan not a security.[23] And whether that loan is from a bank, a credit union, a non-bank lender or an individual via a P2P lending portal should not matter. Under the current regulatory regime and SEC practice, loans to small businesses by banks, credit unions, finance companies or individuals not using a P2P lending platform are almost always treated as exempt from registration requirements. Loans via peer to peer lending platforms are not. This fundamentally irrational disparity in treatment creates a major regulatory impediment to both consumer and small business lending using P2P lending platforms, harming both small business and consumer borrowers and investors seeking a better return. It also protects banks from competition from non-bank financial intermediation and protects the two incumbent consumer P2P lending platforms from competition from new entrants.[24]

Prosper and Lending Club have web platforms allowing consumers to lend money to multiple individuals and enabling consumers to borrow directly from other consumers. This enables lending consumers to achieve a higher rate of return than by depositing money in banks while still having a diversification of risk. It enables borrowing consumers to get better rates than they can at banks. The lending consumer can choose the amount of credit risk they want to take and the returns are commensurately higher for lending to borrowers with lower credit ratings.

Originally, Prosper and Lending Club also lent to small businesses. In 2008, the SEC launched investigations of both Prosper and Lending Club.[25] As the SEC put it:

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[22] See Karen Gordon Mills and Brayden McCarthy, "The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game," Working Paper 15-004, July 22, 2014 http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf.

[23] For a discussion of some of the legal issues involved in drawing lines between loans (or notes or investment contracts) and securities (bonds or debentures), see Andrew Verstein, "The Misregulation of Person-to-Person Lending, *University of California-Davis Law Review*, Vol. 45, No. 2, 2011 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1823763; Elisabeth de Fontenay, "Do the Securities Laws Matter? The Rise of the Leveraged Loan Market," *Journal of Corporation Law* (2014, Forthcoming) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2419668. See Securities Act section 3 for a veritable laundry list of exemptions for securities involving banks. See *Reves v. Ernst & Young*, 494 U.S. 56 (1990) for the Supreme Court's adoption and application of the highly amorphous four part "family resemblance" test drawing the distinction between notes that are and are not securities.

[24] Lending Club and Prosper have now learned how to deal with the current SEC requirements and have reached sufficient size that the regulatory costs can be managed.

[25] Peter Manbeck and Samuel Hu, "The Regulation Of Peer-To-Peer Lending: A Summary of the Principal Issues," White Paper, April 2014 https://www.lendacademy.com/wp-content/uploads/2014/04/Regulation-of-P2P-Lending-Chapman-and-Cutler.pdf; Jack R. Magee, Note, "Peer-to-Peer Lending in the United States: Surviving After Dodd-Frank," *North Carolina Banking Institute Journal*, Vol. 15 (March, 2011) https://pdfs.semanticscholar.org/6c38/b7f7ca93683e165db2f49ba4f18e154be970.pdf.

> The notes offered by Prosper are investments. Lenders expect a profit on their investments in the form of interest, which is at a rate generally higher than that available from depository accounts at financial institutions.[26]

This is a blatant example of the SEC creating a regulatory barrier to entry and protecting incumbent firms (i.e. banks) from competition from a disruptive new entrant.

As a result of the SEC action, Prosper and Lending Club now must file a revised registration statement (prospectus) every few weeks or so.[27] Thus, the regulatory burden on this business is very high.[28] The regulatory burden has caused all of the European companies in this business to exit the U.S. market and none have entered it (so far as the author knows) even though P2P lending is a thriving business in Europe.[29] It is my understanding that Prosper and Lending Club are now raising capital using Regulation D for purposes of lending to small firms to avoid the regulatory thicket created by the SEC. But ordinary consumers are generally prohibited from investing Regulation D offerings.[30]

The mere fact that somebody expects a return should not trigger SEC involvement let alone the requirement to file a registration statement. If that were the test, any business would be caught up in securities regulation and so would every lender, no matter how small, and so for that matter would any real estate, commodities or other investor. Undertaking to make a consumer or small business loan should not trigger Securities Act registration requirements. They generally don't today because the banks are exempted from the registration requirements and the SEC doesn't typically launch enforcement actions for making small private loans. P2P lending platforms, however, don't fit into the existing exemptions.

There are three means of eliminating, or reducing, the regulatory impediments to peer to peer lending generally and P2P small business lending in particular.[31]

First, Congress should exempt peer to peer lending from the federal and state securities laws. The House passed version of the Dodd-Frank legislation adopted a version of this approach.[32] It

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[26] See, Order Instituting Cease-And-Desist Proceedings Pursuant to Section 8a of the Securities Act of 1933 Against Prosper Marketplace, Inc., Release No. 8984 / November 24, 2008. Lending Club also encountered problems with the SEC. Both Propser's and Lending Club's 10-Ks from the relevant period go into detail. Lending Club made its initial public offering on December 10, 2014.

[27] See their web sites https://www.lendingclub.com/info/sec_filings.action and http://www.prosper.com/prospectus/ or EDGAR (https://www.sec.gov/edgar.shtml).

[28] "Person-To-Person Lending: New Regulatory Challenges Could Emerge as the Industry Grows," United States Government Accountability Office, July, 2011 [GAO-11-613] http://www.gao.gov/new.items/d11613.pdf. This report examines the regulatory challenges the industry faces although the proposed solutions generally lack merit.

[29] See, e.g., Peer-to-Peer Lending, European Commission https://ec.europa.eu/growth/tools-databases/crowdfunding-guide/types/p2p_en; P2P Lending Platforms of Europe https://p2pmarketdata.com/p2p-lending-europe/.

[30] David R. Burton, "Congress Should Increase Access to Private Securities Offerings," Heritage Foundation Issue Brief No. 4899, August 29, 2018 https://www.heritage.org/sites/default/files/2018-08/IB4899.pdf.

[31] For a contrary view, arguing that the current regulatory regime is fine, see Benjamin Lo, "It Ain't Broke: The Case For Continued SEC Regulation of P2P Lending," Note, *Harvard Business Law Review*, August 9, 2016 https://www.hblr.org//wp-content/uploads/sites/18/2016/08/B.-Lo_Regulation-of-P2P-Lending.pdf.

[32] The provision provided "primary" jurisdiction to the CFPB. It did not explicitly preempt blue sky laws. Any preemption of state blue sky laws should not preempt state anti-fraud provisions.

exempted "[a]ny consumer loan, and any note representing a whole or fractional interest in any such loan, funded or sold through a person-to-person lending platform" and defined a consumer loan as a "loan made to a natural person, the proceeds of which are intended primarily for personal, family, educational, household, or business use."[33] Such an exemption should also include loans to small businesses. This approach is the preferred approach. To the extent Congress wishes to have a regulator overseeing this market, it could assign that task to the CFPB or one of the bank regulators.[34] Their primary role would be anti-fraud enforcement.

Second, Congress should amend Title III of the JOBS Act to create a category of crowdfunding security called a "crowdfunding debt security" or "peer to peer debt security"[35] whereby the issuer offering securities pursuant to Securities Act section 4(a)(6) – the crowdfunding exemption – would be exempt from much of the continuing disclosure requirements. Continuing disclosure requirements may be appropriate with respect to an equity investment but are entirely inappropriate for debt securities.[36] Valuing equity securities requires making a judgment about expected future returns. Ergo, significant disclosure is appropriate. Moreover, some form of equity security will exist so long as the company exists. In the case of a loan, disclosure related to future earnings prospects is much less appropriate. The question is simply whether the loan is being repaid and, of course, once it is repaid, there is no need for continued disclosure. The exemption should include single purpose entities whose sole purpose is to allow investors to invest in an entity that holds the debt securities of a single issuer. This approach, which should be adopted in addition to the first approach, might give some vitality to lending via Title III crowdfunding platforms. The statutory "peer to peer debt security" exemption should be self-effectuating and not rely on the SEC to issue rules to become effective.

Third, Congress could adopt an alternative regulatory regime for P2P lending. Such an approach has been proposed.[37] It would require some regulatory agency (usually the CFPB is suggested) to promulgate rules and create a division to regulate peer-to-peer lending. This is not the ideal approach and there is the risk that it would bureaucratize the area to a greater degree than the current SEC approach. If there is a way to do it with a light regulatory hand, it should be discussed

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[33] See section 4315 of H.R. 4173, 111th Congress (House passed version) http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173eh/pdf/BILLS-111hr4173eh.pdf.

[34] This is probably unnecessary since such fraud would be a violation of countless existing laws, including state blue sky laws, state consumer protection laws, state banking laws and the common law of fraud.

[35] A debt security would be defined "as any contract that (1) provides for the repayment of the principal amount over a definite period together with interest and (2) provides no payments to the holder other than principal payments, interest payments and penalties for late payments."

[36] "Peer to peer debt security" issuers should be exempt from Securities Act:

(1) section 4A(b)(1)(D)(ii)-(iii);
(2) section 4A(b)(1)(G);
(3) section 4A(b)(1)(H);
(4) section 4A(b)(4); and
(5) section 4A(b)(5).

[37] For two examples, see, Eric C. Chaffee and Geoffrey C. Rapp, "Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd–Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry," Vol. 69, No. 2, *Washington & Lee Law Review*, pp. 485 - 533 (2012) http://scholarlycommons.law.wlu.edu/wlulr/vol69/iss2/4/ and Andrew Verstein, "The Misregulation of Person-to-Person Lending, *University of California-Davis Law Review*, Vol. 45, No. 2, 2011 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1823763.

because the current approach has produced a duopoly for consumer lending and no true P2P lending to small firms.

Section 1071 of the Dodd-Frank Act

Section 1071 of the Dodd-Frank Act[38] requires financial institutions to collect at least seven items of data with respect to every application for a loan to women-owned businesses, minority-owned businesses, or small businesses generally. They must maintain this information separate from the application and accompanying information subject to a wide variety of rules and requirements and report this information to the CFPB. The term "financial institution" is defined about as broadly as it can be to mean "*any* partnership, company, corporation, association (incorporated or unincorporated), trust, estate, cooperative organization, or other entity that engages in *any* financial activity." (emphasis added). Thankfully, the CFPB, "by rule or order, may adopt exceptions to any requirement of this section and may, conditionally or unconditionally, exempt any financial institution or class of financial institutions from the requirements of this section, as the Bureau deems necessary or appropriate to carry out the purposes of this section."

I would like to make some quick observations. First, the CFPB should exercise its authority to substantially narrow the application of this rule. Otherwise, it will impose yet another burden on small firms, especially small lenders, broker-dealers, investment advisers and the like. These firms are already under tremendous financial pressure due to regulatory costs and their numbers are in free fall. This harms competition and innovation. In fact, the definition is so broad that it would include many firms typically not considered financial institutions. Second, those who are required to incur the costs of complying with this provision must recover those costs to remain profitable and to stay in business. The costs will be (must be) recovered by charging small business borrowers more for credit. Thus, narrowing the scope of the provision will reduce the cost of small business borrowing. Third, as regulatory costs escalate, fewer firms will offer less capital to small firms. Thus, the provision will harm small firm access to capital.

[38] 15 U.S. Code § 1691c–2. Small Business Loan Data Collection.