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

Memorandum

To:	Members, Subcommittee on Investigations, Oversight and Regulations
From:	Committee Staff
Date:	June 3, 2013
Re:	Hearing: Financing America's Small Businesses: Innovative Ideas for Raising Capital

On Thursday, June 6, 2013 at 10:00 a.m., the Subcommittee on Investigations, Oversight and Regulations of the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building to receive testimony on innovation in small business finance. Small businesses are taking advantage of new and innovative methods that use technology to access lenders and investors. Lenders and investors are also taking advantage of technology to lower their costs in finding new investment opportunities. This hearing will examine several of these innovations.

I. Introduction

One of the primary obstacles that entrepreneurs face is accessing capital.[1] Businesses struggle to raise capital for many reasons including not having sufficient resources to self-fund, lacking a sufficient credit history or collateral to obtain a loan, or not having the proper connections to find investors. Given these difficulties, businesses are turning to alternative means of raising capital by taking advantage of technology that allows them to share business information and connect with both lenders and investors through the Internet.

II. Computer Algorithm-Based Credit Determinations

Traditionally, if a business seeks to borrow money, it applies for credit from a lender. If approved, funds are provided in exchange for a promise to repay the amount borrowed, plus interest. To access a loan, a small business borrower must find a lender and convince the lender that the loan will be repaid. The lender then assesses the credit risk associated with making the loan, decides whether to fund the loan, and sets an interest rate that takes into account the risk in making the loan. The process can be inefficient; businesses must identify willing lenders, submit

[1] Letter from Karen Mills, Administrator, United States Small Business Administration to President Obama, *available at* http://www.sba.gov/sites/default/files/Startup%20America%20Reducing%20Barriers%20Report.pdf.

information (which may be voluminous), and lenders must painstakingly examine this data. If a lender rejects the loan, this process must start anew.

Technology is helping to improve the decision-making process for lenders by making it more cost-effective and efficient to determine a borrower's creditworthiness. Computer accounting programs such as Quickbooks and TurboTax help businesses organize and manage their finances. This is helpful to borrowers because keeping data about the business in a format that is easily shared allows borrowers to quickly pull together financial information that may be required by a lender or an investor.

Lenders also are taking advantage of this technology to improve the loan application process. Online loan applications are helping to reduce paperwork and lower costs. Utilizing information provided by accounting software also assists lenders in making loan decisions.[2]

Algorithmic lending is one of these financing models that takes information about a business, derived primarily from accounting software as well as other data, and analyzes it through a proprietary computer algorithm that helps the lender determine whether the business has sufficient cash flow to make periodic loan payments.[3] This method of underwriting reduces the amount of time that it takes the lender to review the loan application and allows the borrower to receive funds in a matter of days rather than weeks.[4]

Algorithm lending is gaining popularity among lenders for its ability to reduce costs and provide a more accurate picture of the ability of a business to repay a loan. Recently, the Association for Enterprise Opportunity, a trade association representing community development financial institutions, launched an initiative called TiltForward which is offering mircobusinesses working capital loans using algorithmic lending to underwrite the loans.

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[2] Robin Sidel, *Wells Fargo Reimagines the Bank Branch*, WALL ST. J., April 11, 2013, *available at* http://online.wsj.com/article/SB10001424127887324010704578416551373900508.html.

[3] Aldo Svàldi, *OnDeck Capital Will Bring 200 Jobs to Denver, Paying $63,000 Average*, DENVER POST, Feb. 26, 2013, *available at* http://www.denverpost.com/breakingnews/ci_22671795/deck-capital-will-bring-200-jobs-denver-paying.

[4] J.J. Colao, *Need A Business Loan? Impress the Algorithm, Not the Loan Officer*, FORBES, April 15, 2013, *available at* http://www.forbes.com/sites/jjcolao/2013/03/27/need-a-business-loan-impress-the-algorithm-not-the-loan-officer/.

III. Peer-to-Peer Lending

Businesses do not necessarily need to go through a lending institution to borrow money; they can connect to non-institutional lenders (other than family and friends) through peer-to-peer lending networks. These Internet-based networks, operated by firms such as Prosper and Lending Club, enable borrowers and potential lenders to connect with each other.[5]

Borrowers who either do not meet the credit risk profile of regulated financial institution lenders or who do not wish to use them can obtain loans through these peer-to-peer lending sites.[6] Borrowers log on to the site, enter information about their business, the amount of capital they are seeking, and other information that enables the lender to assess the creditworthiness of the borrower.[7] Loans then are funded by multiple lenders, each contributing a portion of the loan amount.[8] Once fully funded, the peer-to-peer lender originates the loan and the lenders receive their pro rata share of principal and interest until the loan is repaid.[9] Peer-to-peer lenders intermediate with borrowers and the ultimate providers of capital so that no provider of capital is in direct contact with a business borrower.[10]

Peer-to-peer lending is growing dramatically. In 2008, peer-to-peer lenders provided about $200 million in loans; by May of 2012, that had grown to a total of over $1 billion.[11] Growth and profits have been so significant that institutional investors are moving to provide funds rather than individuals.[12] As a result, peer-to-peer lending's growth is likely to continue and provide a viable alternative to conventional bank loans for small businesses.

IV. Angel Investors

Small businesses seeking an investment frequently turn to angel investors for funding. Angel investors are typically high net-worth individuals who invest in all stages of business, but frequently focus on startup small businesses.[13] An angel investment can come from either an

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[5] *End of the Peer Show*, THE ECONOMIST, June 1, 2013, *available at* http://www.economist.com/news/finance-and-economics/21578670-peer-peer-lending-needs-new-name-end-peer-show.

[6] I. GALLOWAY, PEER-TO-PEER LENDING AND COMMUNITY DEVELOPMENT 1-2 (Fed. Res. Bank of San Francisco Working Paper 2009-06), *available at* http://www.frbsf.org/publications/community/investments/0912/galloway_ian.pdf.

[7] *Id.* at 2.

[8] *Id.*

[9] *Id.*

[10] *Id.* The setting of interest rates will vary depending on the business model used by the peer-to-peer lender. *Id.* at 2-3. In addition, different lending sites will impose various financial means tests on potential lenders. *Id.* at 3.

[11] Peter Renton, *Peer-to-Peer Lending Crosses $1 Billion in Loans Issued*, TECHCRUNCH, May 29, 2012, *available at* http://techcrunch.com/2012/05/29/peer-to-peer-lending-crosses-1-billion-in-loans-issued/.

[12] *Id.*; *accord End of the Peer Show*, THE ECONOMIST, June 1, 2013, *available at* http://www.economist.com/news/finance-and-economics/21578670-peer-peer-lending-needs-new-name-end-peer-show.

[13] R. HISRICH, M. PETERS & D. SHEPHERD, ENTREPRENEURSHIP 374 (7th ed. 2008).

individual angel or a group of individual angels who have joined together to invest.[14] The average angel investment can range from less than $10,000 to as much as $500,000.[15] There are currently over 250,000 individuals making angel investments each year and over eight million investors qualified to be angel investors.[16] In 2011, angel investors provided over $23 billion in financing to 66,000 early stage companies.[17]

Internet websites are serving to connect businesses with angel investors. These websites serve as a repository for information about angel investing and play a matchmaking role for private transactions. Using websites like AngelList,[18] a business can create an online profile which provides potential investors with information about the company including a description of the business, the founders and key management, fundraising goals and other investors involved with the company. Angel investors then can view the profile of a business and decide whether they want to learn more about the company prior to investing.

Through partnerships with registered securities dealers, some angel investing websites now allow accredited investors the opportunity to invest directly in small businesses through the Internet.[19] This funding method can be offered after a change in the law (made by the Jumpstart Our Business Startups (JOBS) Act) that exempts social media and Internet websites from the prohibition on general solicitation and advertising of securities.[20] This longstanding ban was lifted to improve efficiency in capital formation by allowing businesses to inform potential investors about new investment opportunities.[21]

V. Crowdfunding

Businesses also can raise money on the Internet from a large number of people through crowdfunding.[22] Businesses that choose to use crowdfunding can create a profile on a crowdfunding website,[23] which provides potential donors visiting the site information about the

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[14] W. BYGRAVE & A. ZACHARAKIS, ENTREPRENEURSHIP 390 (2d ed. 2011).

[15] R. HISRICH, M. PETERS & D. SHEPHERD, ENTREPRENEURSHIP 374 (7th ed. 2008).

[16] *JOBS Act Implementation Update: Hearing Before the Subcomm. on Investigations, Oversight, Investigations and Regulations of the H. Comm. on Small Business*, 113th Cong. (statement of Jean Peters, Managing Director, Golden Seeds), *available at* http://smallbusiness.house.gov/uploadedfiles/4-11-2013_peters_testimony.pdf.

[17] *Id.* at 2.

[18] https://angel.co/

[19] Sarah Needlemand & Lora Kolodny, *Site Unseen: More 'Angels' Invest via Internet*, WALL ST. J., Jan. 23, 2013, *available at* http://online.wsj.com/article/SB10001424127887323301104578258651038480358.html.

[20] http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.

[21] J.J. Colao, *Crowdfunding For Food: CircleUp Raises $7.5M From Union Square Ventures*, FORBES, April 7, 2013, *available at* http://www.forbes.com/sites/jjcolao/2013/05/07/crowdfunding-for-food-circleup-raises-7-5m-from-union-square-ventures/.

[22] C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 4 (2012).

[23] Examples of crowdfunding websites include www.indiegogo.com, www.kickstarter.com and www.fundable.com. There are estimates that over 250 similar sites are now actively seeking investors. *See Crowdfunding: Many Scrappy Returns*, THE ECONOMIST, Nov. 21, 2011, *available at* http://www.economist.com/node/21538770.

business and how the donated money will be used. Potential donors are then able to review the business's information, post questions about the business and make a determination about whether to make a donation to the business. The relatively low cost of raising money makes this financing method attractive to startup businesses that do not have access to other financing.

Crowdfunding currently is available as a donation or pre-sales model, meaning that businesses are able to either receive donations from the public or offer future products or other incentives in exchange for funding.[24] Businesses are not able to sell an ownership stake in their business without registration with the Securities and Exchange Commission (SEC).[25] The JOBS Act amends securities law by establishing a new exemption from registration for securities issued through crowdfunding. To implement the law, the SEC is required to draft regulations, which it has yet to promulgate.[26]

More businesses are harnessing the crowdfunding model to raise money. For instance, one website is offering individuals the opportunity to purchase a small share in a larger real estate development deal.[27] This financing model lowers the cost of entry for investing in real estate development, which helps small businesses by attracting additional capital for neighborhood revitalization.[28]

VI. Conclusion

Innovations in lending spurred by technology are helping small businesses access capital. The ability to connect borrowers with lenders and investors through the Internet is providing more opportunities for small businesses to gain access to capital. Promulgation of regulations fully implementing the JOBS Act will provide additional avenues for small businesses to raise funds. This hearing will examine how technology has helped improve the ability of small businesses to raise capital and steps the Subcommittee can take to support further innovation in small business finance.

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[24] C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 4 (2012).

[25] Catherine Clifford, *JOBS Act, One Year Later: Hang Tight, Equity Crowdfunding is Coming*, ENTREPRENEUR, April 5, 2013, *available at* http://www.entrepreneur.com/article/226287.

[26] *Id.*

[27] Amy Cortese, *Washington Projects Invite the Small Local Investor*, N.Y. TIMES, May 14, 2013, *available at* http://www.nytimes.com/2013/05/15/realestate/commercial/washington-projects-invite-the-small-local-investor.html?_r=0.

[28] *Id.*