Peer-to-Peer Financing for Development: Regulating the Intermediaries

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PEER-TO-PEER FINANCING FOR DEVELOPMENT:
REGULATING THE INTERMEDIARIES

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I. INTRODUCTION

Until recently, foreign aid was the business of governments, while private actors dominated other forms of financing for developing countries. Member states of the Organisation for Economic Co-operation and Development (OECD) provided foreign aid—that is to say, financing on below-market terms to governments in poor and middle-income states—either directly or through multilateral agencies such as the World Bank and regional development banks.1 Private financing for developing countries, apart from migrant remittances, came in the overlapping forms of project finance, bank loans, foreign direct investment, and portfolio investment, where the private funders received market rates of return.2 Aid from public sources3 was coordinated—primarily through the OECD.4 Private financing was regulated—primarily


2. Public agencies in OECD and recipient countries often participate in such transactions, especially project finance, providing explicit and implicit subsidies. For an example of government participation in such transactions, see Overseas Private Investment Corp., Overview, http://www.opic.gov/about-us (last visited Mar. 8, 2010).

3. See DAC Glossary, supra note 1.

through traditional bank and securities laws in the donor states and, to a lesser extent, through administrative measures in the recipient states.

At the turn of the century, private financial market participants have begun to embrace development policy goals on a significant scale, and to show a greater willingness to trade off financial returns for development outcomes. Major foundations have joined forces with donor governments, and have taken some business from traditional development agencies—funding large-scale public and private-sector programs in health, welfare, and economic development in poor and middle-income countries. Foreign assistance from private sources is estimated to have reached $49 billion in 2007—just short of half of its official counterpart, which stood at nearly $105 billion. By some estimates, private aid for development is approaching the level of bilateral official development assistance.

Private international finance for individual and small business recipients seeking to improve development outcomes is particularly in vogue, and a bewildering variety of intermediaries have emerged to channel the growing capital flows. Some of these intermediaries work much like conventional charities, collecting and transmitting private donations for private recipients advancing development—defined to include both private sector growth and institutional reform. Others work like conventional financial institutions, where creditors expect to get their money back and a return on their


8. For example, the Grameen Foundation solicits donations used to fund microfinance institutions in developing countries. See Grameen Foundation, Take Action, http://www.grameenfoundation.org/take-action (last visited Mar. 10, 2010).
investment. However, some of the new intermediaries operate in a less well-defined space that lies somewhere between the traditional domains of charities, development agencies, and financial institutions. Many of these collect funds from individual members of the general public in high-income countries for ultimate transfer to individuals in poor and middle-income countries, but neither as pure donations nor as market-rate investments.

Mapping the space occupied by these new “peer-to-peer” intermediaries is difficult: it spans multiple jurisdictions and governance regimes and embraces a vast and growing variety of legal forms. Here are some examples:

- Kiva is organized as a charity under U.S. law. It solicits funds primarily from individual lenders through its website by posting portraits of micro-entrepreneurs around the world seeking credit. The entrepreneurs are selected by a microfinance institution (MFI) with which Kiva has established a relationship in the entrepreneur’s country. Kiva’s online lenders designate an entrepreneur whom they wish to support and then lend money to Kiva, interest-free, for that purpose. Kiva in turn lends the money to the MFI, also interest-free. The MFI lends funds to the entrepreneur at the usual rate of interest for that MFI—usually without waiting to receive funds from Kiva; collects payments from the entrepreneur; and remits the repaid principal to Kiva. The online lender’s account with Kiva is credited as Kiva is repaid by the MFI.


10. See http://www.kiva.org/about/how (last visited Apr. 2, 2010). For an example of a for-profit firm—which has, however, pledged to operate as a ‘social enterprise’—offering similar services, see Babyloan, http://www.babyloan.org/Default.aspx?lng=EN (last visited Apr. 2, 2010).
• MYC4 is a Danish for-profit company that operates an online lending platform matching lenders with small and medium-sized business borrowers in Africa. The prospective borrowers are identified by a local organization with which MYC4 has a relationship. Prospective borrowers provide information on their projects, the size of the loan requested, and the maximum interest rate they are willing to pay. Prospective lenders first transfer money to an account with MYC4, then bid in a Dutch auction to lend to specific borrowers. The winning bids demand the lowest interest rates, provided that their combined loan amount satisfies the borrower’s request and their average interest rate is below the maximum specified by the borrower. MYC4 disburses the loan in local currency via a local intermediary (which may or may not be the entity that identified the borrower). The borrower repays the loan at an interest rate equal to a weighted average of the interest rates specified in the winning bids, plus fees for MYC4 and its partners. Each winning bidder is repaid principal plus interest at the rate it had bid; investors bear any currency risk.11

• DhanaX is an Indian for-profit company that operates an online lending platform matching lenders, who must be either resident or non-resident Indians, with prospective individual borrowers in India. The borrowers must organize themselves into “self-help groups” that guarantee their members’ obligations to DhanaX. DhanaX collects repayments monthly “from their [borrowers’] doorsteps” and remits them to the lenders’ accounts. Unlike Kiva and MYC4, DhanaX guarantees the borrowers’ obligations. The borrowers pay an interest rate of 24 percent; DhanaX pays the lenders an interest rate of 14 percent.12

The Calvert Foundation is a U.S. charity that issues fixed-interest-rate unsecured notes to individuals and institutional investors. The notes are sold directly by the Foundation, through registered brokers, and online through MicroPlace, Inc. (an eBay affiliate). Calvert applies the proceeds to below-market loans to nonprofits engaged in community development and other social enterprises in and outside the United States. Noteholders who purchase online must designate a particular enterprise as their investment target. Interest rates on the notes vary depending on the enterprise designated, but, according to Calvert, they range substantially below the rates investors could obtain on purely commercial investments.13

Acumen Fund is a U.S. charity that uses the proceeds from donations to make investments in enterprises, both for-profit and nonprofit, that have the potential for “significant social impact.” The investments take a variety of forms, including both debt and equity, and range in size from $300,000 to $2,500,000. Investment targets are enterprises in developing countries and firms in the United States and the United Kingdom that work in developing countries.14

In each of these examples, the intermediary explicitly styles itself as a provider of financial services, stressing its efforts to reach the millions of “unbanked” and otherwise underserved by mainstream finance, one recipient at a time. All promise the psychic returns of doing good. But in no case is the bundle of products and services offered by the intermediaries limited to psychic returns alone. All of them also emphasize their capacity to generate financial returns; all except Acumen undertake to repay their funders at least their initial advance. Such promises of repayment are in addition to and distinct from the promise to do good.

So far the amount of money flowing through peer-to-peer intermediaries is relatively small. In November 2008, Kiva, perhaps the highest profile of the intermediaries listed above, had lent a total of just $50 million over three years of operation. But the sector is also growing rapidly—by November 2009 Kiva’s cumulative lending topped $100 million. The sector is also evolving rapidly; it is not far-fetched to expect intermediaries to offer peer-to-peer products with redemption rights that make them as liquid as mutual funds, or guaranteed returns that make them look like certificates of deposit. On the current trajectory, the $100 million trickle of funds flowing through Kiva in $25 increments soon may become a multi-billion-dollar stream flowing through the new intermediaries. The trend holds immense promise. To the general public, the new investment options could look like development-friendly alternatives to mutual fund investing—a diversification opportunity. For recipients and policy makers, there is the possibility of new sources and more funding for development, and potential for mobilizing entrepreneurial innovation to achieve better development outcomes.

Governments should encourage peer-to-peer development finance for its far-reaching potential. But this very reach has regulatory consequences: new actors and products emerge in a thicket of overlapping private and public interests implicated in economic development, foreign assistance, charity, and consumer finance. Each of these fields is heavily regulated, but in very different ways. Grouping peer-to-peer finance with one field or another could subject it to radically different kinds of regulation, potentially affecting the policy outcomes. For as long as the aggregate amounts involved are small and the impact is limited, this may not matter. But if the objective is to mainstream peer-to-peer transfers in foreign assistance and consumer finance, the question of regulation is unavoidable—even if the ultimate choice is to exempt them altogether.

Regulating peer-to-peer intermediaries poses important new challenges for government authorities, the financial in-

dustry, and the broader civil society. The emergence of new vehicles for delivering financing to inhabitants of developing countries is part of the fragmentation and realignment of the institutional landscape of foreign aid. Accordingly, regulating the intermediaries is part of the ongoing challenge of devising governance structures that will “make aid work.” At the same time, the emergence of new actors should be seen as part of ongoing changes in the international financial system, which themselves demand regulatory adjustment. Regulating peer-to-peer intermediaries involves all of the challenges inherent in regulating other forms of international finance, namely, promoting financial inclusion through innovation while simultaneously ensuring the safety and soundness of financial institutions, protecting consumers of financial services, and minimizing systemic risk, all the while taking into account the economic and foreign policy concerns of investors’ home states as well as the macro-economic and development objectives of investment host states. Devising an appropriate regulatory framework is particularly difficult once we have taken into account the sector’s tremendous potential for growth. Optimal regulation for today’s small peer-to-peer vehicles may be ill-suited for the development-friendly mainstream money-market fund of the future.

In this article we offer a critical examination of the regime that governs peer-to-peer intermediaries located in the United States. The U.S. regime merits particular attention because of the relative size of the industry it governs: in 2008 the United States accounted for $37.3 billion of private foreign aid flows, compared to $14.6 billion in private foreign aid from other OECD countries and $26.8 billion in U.S. ODA.

The U.S. regime comprises both charities law and the law governing financial institutions and markets, sometimes operating in conjunction with one another, other times as alternatives. We find that neither body of law is up to the challenge of regulating the new peer-to-peer intermediaries. U.S. chari-


19. Metcalf, supra note 5, at 1093, 1098.
ties law is unsuitable for both substantive and structural reasons. The regime that governs cross-border activities of conventional financial institutions can be burdensome even as it falls short of core policy goals. At best, applying traditional regulatory tools to these new actors produces disjointed regulation that keys off formal commonalities with traditional charitable giving or securities investment, but not the substance of their combination, nor the social and economic goals of development assistance. Perhaps more importantly, we find no principled arguments and very little information to support classifying peer-to-peer vehicles either as charities or conventional financial institutions. Choosing one over the other requires assuming away either charitable intent or the promise to repay.

And yet we do not argue for a distinct regulatory regime to govern the activities of peer-to-peer intermediaries. This position stems from our belief that the challenge these intermediaries present to policymakers is part of the broader challenge of making complex and global finance serve the needs of individuals, including the most vulnerable; of earning and keeping popular trust in finance;20 and safeguarding national and global financial systems from massmeltdowns. It is of a piece with regulating mortgages, credit cards, securitization, and derivative products—but also shares the welfare goals of consumer protection regulation and development aid coordination. The task of mainstreaming the new intermediaries proceeds in tandem with adapting financial regulation. We therefore situate the new arrivals in the broader financial regulatory framework, and propose ways to reconcile the needs of their multiple constituents: donors, recipients, governments, and national and global financial systems.21

The next Part of this article describes the new forms of international finance in functional terms and by way of com-

20. See, e.g., Robert Shiller, In Defence of Financial Innovation, FT.COM, Sep. 27, 2009, http://www.ft.com/cms/s/0/c4a74ba2-ab83-11de-9be4-00144feabdc0.html?SID=google (arguing that individuals can benefit from complex financial products, but (reasonably) do not trust the financial system enough to use them).

21. For a general argument in favor of treating all international financial flows aimed at developing countries as a single object of study, see Kevin E. Davis, ‘Financing Development’ as a Field of Practice, Study and Innovation, in Acta Juridica 168 (2009).
parison to traditional charities and financial institutions. Part III sets out the concerns that typically justify regulation of peer-to-peer intermediaries. Part IV describes the regulatory frameworks that govern charities and financial institutions. Part V sets out our recommendations.

II. OLD AND NEW CATEGORIES OF INTERNATIONAL FINANCE

A. What Do Charities Do?

First, a definitional point. When we refer to charities we are referring to entities described in § 501(c)(3) of the Internal Revenue Code in the United States, and which enjoy special tax privileges because their activities advance one or more charitable purposes. Those privileges take several forms. Like many other nonprofit organizations, charities are exempt from federal taxation on their income and receive preferential treatment under other provisions of federal, state, and local tax laws. Perhaps even more importantly, contributions of cash or property to certain charities are deductible for the purposes of calculating the donor’s income, estate, and gift taxes. Charities that are eligible to receive tax-deductible donations have a great advantage over other kinds of organizations in attracting funds.

Traditionally, charities serve as intermediaries between donors and beneficiaries. Donors transfer money or other assets to the charity, which in turn transfers them to or for the benefit of needy individuals or socially useful causes. The charity typically assumes only minimal financial obligations to donors and is owed only minimal financial obligations by beneficiaries. In other words, so long as the charity disburses the funds more or less as specified by the donor, it owes the donor no financial obligation. Similarly, so long as the recipient uses the funds as specified by the charity, it owes no financial obligations to the charity.

There are multiple benefits of using charitable organizations as intermediaries, as opposed to relying exclusively upon either direct giving by individuals or intermediation by government agencies—which is essentially what happens when tax receipts are used to support government-sponsored social programs. These benefits run both to the private donors and beneficiaries, as well as to the governments. First, an intermediary can aggregate donations from a number of donors, thereby achieving economies of scale and scope, and a level of coordination unattainable to most individual donors. Second, it is easier to monitor the use and any abuse of any tax subsidy by a small number of intermediaries than by scores of individual donors. To facilitate such monitoring, governments may prescribe the manner of charitable organization, activities, and reporting requirements. Third, as compared to its donors, and perhaps a government agency as well, the charity has superior information, expertise, and administrative capacity.25 Fourth, competition between governments and charitable organizations encourages experimentation and helps foster altruism.26

B. What Do Financial Institutions Do?

Financial institutions can also function as intermediaries, but of a different sort. Two basic forms are key to our discussion: banks and investment companies.27 A traditional bank


26. See, e.g., Bruce R. Hopkins, The Law of Tax-Exempt Organizations §1.4 (9th ed. 2007) (describing a “political philosophy rationale” for exempting charities from taxation in the United States, with roots in the writings of John Stuart Mill and Alexis de Tocqueville, among others); Atkinson, supra note 25, at 600-38 (describing alternative justifications for the tax exempt treatment of charities and emphasizing the benefits of promoting altruism).

27. Two other forms of intermediation are beyond the scope of this article: insurance and dealing in derivatives. Peer-to-peer intermediaries could conceivably offer versions of either of these financial products. Imagine an intermediary that allows individual investors an opportunity to provide business interruption insurance—or any other kind of insurance for that matter—to entrepreneurs of their choosing. Alternatively, imagine a firm that offers investors opportunities to collect fixed returns in exchange for taking on obligations to make payouts to selected farmers in the event that grain prices in a region—or rainfall levels—fall below a preset level. Under a long-standing political compromise embodied in the McCarran-Ferguson
receives funds from individual and business depositors, and in return assumes obligations to repay those funds on demand or at the end of a specified term. Depositors may or may not earn a competitive market return, since regulations may constrain banks’ capacity to pay interest on deposits. In most cases, having an account entitles depositors to a bundle of transactional services, such as check-writing and money transfers, in addition to getting their money back. When it receives a deposit, the bank turns around and lends the funds to other individuals or firms, who in return assume various obligations to the bank, chief among them the obligation to repay. A bank thus combines features of a pooled investment vehicle with the basic utility of giving its depositors a secure means to hold and transfer money. Unlike charities and most other financial institutions, banks intermediate credit risk, and transform liquid deposits into long-term loans.

Investment companies, such as mutual funds, facilitate pooled investment in securities under third-party management. Such vehicles originated in Great Britain in the 19th century, partly in response to the scale and information challenges inherent in private financing of colonial enterprises. Investment companies issue common stock, and occasionally other securities, to investors. They use the proceeds to buy diversified portfolios of securities, and contract with investment advisers to manage their assets in line with the investment goals approved by their shareholders. Depending on how a fund is organized, an investor may redeem her shares either on demand, or at the end of a specified term, and receive the net asset value represented by her holdings. Unlike banks, which bear the credit risk of their loan portfolios, in-
vestment funds do not guarantee the value of their investors’ claims. Thus if a bank loan defaults, the bank’s obligation to its depositor is unchanged. If a bond held by an investment fund defaults, the total value of fund assets goes down, and so does the value of the investor’s claim against the fund. Some investment funds, notably money market mutual funds, offer transactional services such as check-writing.

A third category of financial institutions—comprising brokers (agents who buy and sell securities for their customers’ accounts), dealers (who buy and sell securities for their own account), and investment advisers (who advise clients on securities investing)—is less relevant to our discussion. Broker-dealers offer expertise and have corresponding duties to their customers, but do not pool customer funds; instead of intermediating, they facilitate direct investing. Most of the new peer-to-peer intermediaries we discuss do not enable providers of funds to obtain direct claims against the ultimate recipients of funds and so do not play roles analogous to those of broker-dealers or investment advisers.28

In at least two respects, individuals derive benefits from using banks and investment funds that are comparable to the benefits of using charities as intermediaries for donations. First, the financial institution aggregates funds from a large number of depositors or investors. This allows people to access larger and more diversified investments than they would without pooling. Second, financial institutions match providers and recipients of funds. Not many depositors or investors can access the information required to identify the full range of potential targets, the expertise to evaluate the risks associated with lending to them, or the capacity to administer a portfolio that may include claims against large numbers of funding recipients.29 Apart from such pooling and information ser-

28. Some of the intermediaries may issue securities through broker-dealers or be recommended by investment advisers. See, e.g., Microplace.com, supra note 9. Intermediaries like Kiva and MYC4 perform functions similar to those of investment advisers to the extent that they screen or provide ratings for local financial institutions with whom they deal on behalf of their clients.

29. Individuals can invest in securities directly in the United States if the issuer has complied with the registration and reporting requirements under the Securities Act of 1933 and the Exchange Act of 1934. Most do not enjoy the liquidity and information advantages of institutional investors. Here and
vices, traditional financial institutions and traditional charities offer different benefits. Where banks and investment funds offer financial returns, transactional services, and varying measures of liquidity, charities promise social benefits and psychic satisfaction.

C. The New Peer-to-Peer Intermediaries

Some of the new peer-to-peer intermediaries perform some of the same functions as banks or investment funds. Take, for example, Kiva. It receives funds from investors, and in return assumes a conditional obligation to repay those funds (albeit without interest). Kiva then turns around and lends the funds it receives to a microfinance institution—typically in a low-income country, but sometimes in the United States—which in turn lends the money to a local borrower. To the extent it identifies potential recipients and aggregates loans from multiple funders to meet recipients’ needs, Kiva performs the information and pooling functions of traditional intermediaries. Investors bear the full risk of default. As with investment funds, investors’ returns depend on recipients’ or guarantors’ payment performance. However, unlike a traditional investment fund Kiva does not automatically provide diversification for investors. Unlike banks, Kiva does not intermediate credit risk (although some of its partner MFIs choose to guarantee their clients’ repayment) and it does not transform maturities: generally, investors fund the full term of the recipients’ loans (an average of just over ten months).30 On the other hand, by holding accounts for their lenders, from elsewhere in this article we refrain from discussing securities and related laws and regulations of U.S. states. E.g., Cal. Code Regs. tit. 10, § 260.140.01 (2010), Release No. 8-C, California Commissioner of Corporations (Feb. 27, 1969) available at http://www.corp.ca.gov/Commissioner/Releases/pdf/8C.pdf (limiting California residents’ eligibility to invest in securities based on their income, net worth, and other criteria). Although such requirements affect peer-to-peer lenders in the United States, elaborating another layer of regulation would complicate our discussion, even as it would not change our analysis. E.g., Galloway, supra note 7 at 3; Prosper Marketplace, Inc., Prospectus Supplement Dated August 18, 2009 to Prospectus Dated July 13, 2009 at 2 (describing state financial suitability requirements applicable to peer-to-peer lending).

which those lenders can either withdraw money using Paypal or fund new Kiva loans, Kiva provides limited transactional services.\textsuperscript{31}

In addition to such distinctions, there are two fundamental differences between peer-to-peer intermediaries and conventional banks or investment funds. First, the obligations the intermediary assumes to its investors need not involve paying a market rate of return or serving as a full-blown transactional services utility. Second, the ultimate recipients of funding from these intermediaries are, in the first instance, selected because funding them is deemed to serve some socially useful purpose that presumably also yields psychic satisfaction for the provider of funds. Creditworthiness alone, in the traditional sense, may be necessary but is not sufficient. Both these features are, of course, more characteristic of organized charity than traditional financial institutions. Thus the new intermediaries combine aspects of charity, banking, and investment fund operation.

There are no authoritative studies establishing why this mix of financial and non-financial returns appeals to providers of funds. The peer-to-peer model may satisfy visceral desires to establish a direct connection with beneficiaries and to exert a measure of control over the use of one’s money. But peer-to-peer intermediaries may offer only the illusion of a direct connection and control because in many cases the entrepreneurs whose pictures they use to solicit funds have already received financing, and do not know its ultimate source.\textsuperscript{32} It also remains unclear why funders prefer to receive a below-market rate of return on their investment over making a pure grant or insisting on a market rate of return. Some donors may believe that lending—even lending with a large effective grant element (very long-term and interest-free)—instills discipline in the borrowers with the obligation to repay, or is more dignified and less condescending to the beneficiaries. Other donors may choose to lend rather than give away their money


because they cannot afford to give away the marginal dollar, but can muster a smaller subsidy inherent in an interest-free or low-interest loan. Yet others may either not understand the terms of their financing, or may not care about them. In June 2008 Matt Flannery, one of Kiva’s co-founders, observed that many Kiva lenders were carrying balances in their Kiva accounts. Flannery is reported as saying, “We have a challenge right now, because the people who are getting paid back aren’t relending. . . . They are just keeping the money in their [Kiva] account. Maybe they didn’t know it was a loan. Maybe they thought it was a donation. So we have about $3 million right now in the bank just getting float.”33

III. REGULATORY CONCERNS

Financial intermediation is a socially valuable activity. The potential benefits flow not only to the providers and recipients of funds, but also to the communities in which they live and the larger economies of which they are part. International peer-to-peer intermediaries are a case in point. Their business models enhance the appeal of development finance to both funders and recipients and so have the potential to increase the aggregate amount of money flowing to socially valuable projects in developing countries. Moreover, innovations introduced by peer-to-peer intermediaries, such as market-based selection and community feedback mechanisms, may improve the quality of existing projects, or even inspire new projects, and thus lead to better development outcomes.34 For all these reasons, encouraging new forms of intermediation is a legitimate policy objective.

At the same time, as the recent financial crisis has amply demonstrated, financial intermediation is an inherently risky activity—especially when it crosses national borders—and innovative forms of intermediation can have hidden dangers. From the perspective of the person providing the funds, there are concerns that the intermediary may misuse their funds or misrepresent the riskiness of their investment, resulting in un-

33. Knowledge@Wharton, supra note 30.
expected loss.\textsuperscript{35} Similarly, at the other end of the transactional chain, recipients may worry that the intermediaries will abscond with the funds and, in the worst case scenario, leave them with the repayment obligation. Recipients may also worry about being subject to unduly onerous obligations imposed on them by the intermediaries.\textsuperscript{36} Because cross-border financial flows can have significant impacts on constituencies apart from the contracting parties, the jurisdictions in which all of the funders (the home state), the recipients (the host state), and the intermediaries (the intermediary’s state) are located, or, in the extreme, any jurisdiction with an interest in the security and stability of the international financial system, have an interest in regulating international financial intermediation. Regulators’ failures to respond to innovative ways of connecting savers and users of funds such as, most recently, large-scale asset securitization, can lead to misallocation of finance, credit and asset price bubbles, and eventually, financial crises. In the remainder of this section we take up each of these regulatory concerns in turn.

Our overarching contention is that the new intermediaries are financial institutions offering financial services and products to the retail public, often in multiple jurisdictions, and, given the risks inherent in such transactions, should be presumptively regulated as such.\textsuperscript{37} The funders of some of these intermediaries may have altruistic motivations, and some of the intermediaries may also be appropriately classified as charities. In such cases, charities regulation may fill in gaps left by financial regulation. But the presence of charitable motives alone should not preclude financial regulation.

\textsuperscript{35} For sobering stories of funds channeled through peer-to-peer intermediaries that were misappropriated by home country intermediaries, see Matt Flannery, \textit{Kiva at Four}, INNOVATIONS (Special Edition for Skoll World Forum 2009), at 29, 32-36 (2009).

\textsuperscript{36} Brokers, dealers, and advisers can have a similar impact indirectly, when they condition their willingness to buy or recommend investments.

\textsuperscript{37} \textit{Cf. In re Prosper Marketplace, Inc.}, Securities Act Release No. 8984, 2008 SEC LEXIS 2791 (Nov. 24, 2008). In this Cease and Desist Order entered against an online peer-to-peer loan broker, the SEC observed that “\textit{w}hile some Prosper lenders may be motivated, in part, by altruism, altruistic and profit motives are not mutually exclusive.” \textit{Ibid.} at 11.
A. Interests of Donors, Depositors, and Investors

A central regulatory concern is with protecting the expectations of people who provide funds to financial intermediaries. Those expectations pertain to how their funds will be used, financial returns and services provided by the intermediary, and the risk that such expectations will be disappointed. Naturally, providers’ expectations can vary considerably. Some people want their funds deployed to support very specific projects, which they expect to have very specific financial and social outcomes. Others are less interested in precisely how their funds will be used than in what the intermediary will provide in return, such as a particular level of liquidity, particular social outcomes, or a particular financial rate of return. Finally, providers of funds can have widely varying levels of tolerance for risk that their expectations, financial or otherwise, will be disappointed.

The threshold concern, then, is that providers of funds understand the terms of their financing and the risks they are taking on. For example, do they have a direct claim on the ultimate borrower, the MFI, or the intermediary? What are the legal and financial relationships among the three, and how does the creditworthiness of each determine the funders’ chances of getting their money back? These are hard questions. Because so many of the peer-to-peer funders are middle-income individuals who are not necessarily sophisticated investors, regulators cannot take for granted their capacity to manage the risks inherent in their foray into development finance. They also cannot take it for granted that intermediaries will voluntarily provide accurate, comprehensive, and comprehensible answers to these questions in the absence of regulation.


The regulatory challenge is most significant when intermediaries are given broad discretion over the use of funds. This is a rational response to the combined effects of imperfect information and transaction costs—it is often difficult to predict the future course of events and prohibitively costly either to specify in advance how funds should be used in every possible contingency or to seek the provider’s consent each time a decision has to be made about the use of funds. But the broader the discretion the intermediary has, the greater the need for regulation to ensure that its managers behave in a manner consistent with the interests and expectations of those who have provided capital. In practical terms, this means that the case for intrusive regulation of true intermediaries, such as deposit-taking banks and money market funds, is stronger than the case for regulating brokers with limited authority to invest on clients’ behalf or “middlemen” such as wire transfer services.

Some of the risks associated with giving a financial intermediary broad discretion are inherent in principal-agent relationships. There is always the danger that the intermediary—or at least critical agents or employees—either will be incompetent or will have interests that conflict with those of the providers of capital. These kinds of “managerial agency costs” can lead to either waste, in the case of incompetence, misappropriation of funds, or “mission drift,” where the funds may be used productively but not in the manner intended by the providers.

The risks associated with financial intermediaries are also affected to some extent by their capital structure, and the roles that holders of various sorts of claims against the intermediaries’ assets play in its governance. A critical issue is the role of residual claimants, such as equity holders. On the one hand, residual claimants, by definition, have a financial interest in maximizing the economic value of the firm. On the other hand, where the firm’s assets are insufficient to pay residual claimants, they have nothing to lose and much to gain from risky ventures—or gambling at the expense of more senior fixed claimants.40 Residual claimants are the object of

40. For instance, when the firm is on the borderline of being able to satisfy the fixed claims against its assets, residual claimants bear a relatively small share of the downside risk associated with risky assets (the remaining
regulation in both charities and financial institutions: charities are defined by their prohibition on residual claims, eliminating the potential conflict of interest with donors. In banks by contrast, residual claimants provide capital on terms narrowly specified by regulators to discourage excessive risk taking at the expense of depositors or the deposit insurance fund. These tensions between the advantages and disadvantages of residual claimants are reflected in ongoing debates about whether microfinance institutions should be organized as for-profits or nonprofits—i.e., with or without residual claimants.

Funders should also care about the levels of fragmentation or complexity of the intermediary’s capital structure. The benefits of fragmentation and complexity are the benefits of aggregating capital from a large number or disparate set of sources. The potential costs are the collective action problems that might inhibit coordinated monitoring of the intermediary’s operations or collective decision-making at critical junctures, such as when some sort of financial restructuring is required. Thus large banks with many small depositors, or

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43. See Hansmann, *supra* note 39, at 39-45 (discussing the costs associated with collective decision making).
charities with many small donors perform very valuable services, but they also pose distinctive regulatory challenges.

B. Interests of the Public in the Home State

Peer-to-peer international financing is not a wholly private affair, even if all the immediate parties to the transaction chain are private actors. There are several reasons to believe that broader public interests are affected by these sorts of transactions. We begin with the interests of the general population in the funders’ home country.

At the most basic level, private funds deployed in line with the home country’s foreign assistance goals increase the total resources available to advance such goals. For this reason the home country has an interest in documenting and publicizing cross-border financial assistance provided by its residents. Countries earn reputational benefits from being recognized for their generosity, and public shame for being stingy with aid. It seems plausible to assume that the generosity of individual residents of a country reflects well on the country as a whole, and enhances the moral stature of that country by providing evidence that it is bearing its fair share of global redistribution. Generosity can engender goodwill abroad, and is a valuable part of the “soft power” arsenal. These considerations probably go a long way toward explaining why the United States takes great pains to point out that when individ-


45. This is the premise behind initiatives such as the Commitment to Development Index, which “rates 22 rich countries on how much they help poor countries build prosperity, good government, and security.” Ctr. for Global Development, Commitment to Development Index 2009, http://www.cgdev.org/section/initiatives/_active/cdi/ (last visited Apr. 4, 2010).

46. The term describes “the ability to get what you want by attracting and persuading others to adopt your goals. It differs from hard power, the ability to use the carrots and sticks of economic and military might to make others follow your will.” Joseph S. Nye, Propaganda Isn’t the Way: Soft Power, INT’L HERALD TRIB., Jan. 10, 2003, at 6, 6.
ual and corporate philanthropy are taken into account, Americans are much more generous to the developing world than is suggested by official development assistance statistics.47

For similar policy reasons, the home country can have an interest in controlling the destinations of private actors’ cross-border financial transfers. This is especially true when those private transfers are subsidized by public funds, as is the case when taxpayers are permitted to deduct charitable donations from their taxable income. Democratic principles suggest that the public may agree to subsidize some cross-border transfers but not others. A democratic state might legitimately conclude that the public interest lies in insisting that public funds be used to support projects that would otherwise have to be funded by the government, that generate public benefits, or are distributed in an efficient, fair, and transparent fashion (although such a state may also have an interest in sponsoring dissenting views).48

To be sure, the public interest in controlling the allocation of private funds across borders does not arise only when there is a public subsidy. A country clearly has an interest in discouraging private actors from providing financial support to its enemies and in encouraging the provision of financial support to its friends, whether or not that support is being publicly subsidized. There is a public interest in restricting financial support to terrorists. Similarly, there is a public interest in encouraging financial transfers to people who will reciprocate by helping to fight its wars, combating threats to the global environment, or—perhaps more controversially—upholding its values.49 All of these concerns are manifest in ongoing debates about the circumstances in which economic sanctions ought to be imposed,50 the extent to which subsi-

47. Metcalf, supra note 5, at 1092-93; see also Carol Adelman, Global Philanthropy and Remittances: Reinventing Foreign Aid, BROWN J. WORLD AFF., Spring/Summer 2009, at 23.


49. Natsios, supra note 43 (indicating that NGOs should give preference to working with governments that espouse democratic values).

dized credit should be provided to exporters,\textsuperscript{51} whether or not tax deductions ought to be provided for donations to foreign charity,\textsuperscript{52} and the conditions upon which bilateral aid ought to be provided.

C. Interests of Recipients of Funds

Recipients of funding in international peer-to-peer transfers—which are often, at least in the first instance, financial intermediaries themselves—are exposed to significant risks. Some are due to agency and information problems similar to those summarized earlier in the discussion of funding providers: before the money is disbursed, would-be recipients are just another set of claimants on the intermediary. Until they have the money in hand, recipients ought to be concerned about whether intermediaries will live up to commitments to provide funding, whether those commitments are explicit or implicit. The more credible the commitments, the more prospective recipients are justified in relying on them to make productive investments. Conversely, the absence of credible commitments of this sort can be destabilizing. The absence of credible commitments to specific levels of funding is the fundamental source of complaints about the volatility of foreign aid flows.\textsuperscript{53} Similarly, host country intermediaries—such as the MFIs that work with Kiva—and the ultimate recipients of funding are vulnerable to sudden fluctuations in the supply of capital from peer-to-peer intermediaries.\textsuperscript{54}

\begin{footnotesize}
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  \item[54.] Deborah Burand, \textit{Microfinance Managers Consider Online Funding: Is It Finance, Marketing, or Something Else Entirely?} (CGAP, Focus Note No. 54, 2009); Flannery, \textit{supra} note 34, at 31-32 ("MFIs come to expect a certain level of funding and plan their portfolio growth around it. If the funding they actually get differs significantly from their projections, they run the risk of having a liquidity crisis. Although this hasn’t yet happened to any of our partners, it is a real risk."). Flannery went on to explain that Kiva attempts to
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Additional concerns arise when the intermediary attaches conditions and obligations to the funding. The purpose of these conditions is generally to advance the goals of the funders and to prevent misuse of the funds by recipients; however, they may overreach, or pursue legitimate goals in problematic ways. In that case a host of policy concerns, ranging from bounded rationality and asymmetric information to due process and protection of basic human rights, come into play. For instance, do recipients understand the obligations they are assuming, particularly complex obligations, such as those involving foreign exchange risk? Are those obligations fair and reasonable? Are the obligations of the ultimate recipients of funding being enforced by threats of violence or other forms of abuse? These kinds of concerns are more or less the same ones that have traditionally arisen in wholly domestic debates about predatory lending, loan-sharking, and abusive debt collection, as well as in more recent debates about whether borrowers lose privacy when their lenders raise funds from peer-to-peer intermediaries.

D. Interests of the Host State

The public in the recipient’s country is affected by international peer-to-peer financing in ways that may not be apparent to the funders and their governments. Transfers that look minuscule from the donor perspective ($25 for an individual, $25 million for a government) can transform the policy landscape in a $4 billion economy where most people live on $1 a day. Whether they displace or add to foreign assistance, private flows replicate, and occasionally exacerbate, the challenges of aid allocation and coordination, well-rehearsed in the government-to-government context. There is no guarantee that funders and host states will agree on policy priorities or the relative social benefits of alternative projects. Nor is there any guarantee that the uncoordinated choices of dispa-

mitigate this risk by barring any partner MFI from funding more than 30 percent of its portfolio through Kiva.
56. Id. at 9.
rate public and private actors will result in the socially optimal allocation of funds in a host economy where basic human needs go unmet.

One clearly public interest in regulating inflows of capital stems from their macroeconomic effects. For example, a spike in foreign exchange inflows may push up the value of the local currency and make local industries uncompetitive; more broadly, it can dramatically affect resource allocation among different sectors in the economy.\textsuperscript{58} Moreover, where funding recipients take on unsustainable debt burdens,\textsuperscript{59} the resulting financial distress can have social costs, including broader economic decline in the recipient’s locality, family breakdown, ill-health, and even suicide epidemics.\textsuperscript{60} Default brings on social ostracism. And, if the benefits of external financing flow only

\textsuperscript{58} For an overview of the policy debate on the macroeconomic impact of foreign aid flows and potential policy responses, see, for example, Alessandro Prati & Thierry Tressel, \textit{What is the Most Effective Monetary Policy for Aid-Receiving Countries?} (U.N. Dept of Econ. & Soc. Affairs, Working Paper No. 12, 2006), available at http://www.un.org/esa/desa/papers/2006/wp12-2006.pdf (considering the macroeconomic implications of radically increasing donor country commitments for HIV/AIDS funding); see also Raghuram Rajan & Arvind Subramanian, \textit{What Undermines Aid’s Impact on Growth?} (Int’l Monetary Fund, Working Paper No. 05/126, 2005) (arguing that aid inflows can depress growth by making recipient country’s exports uncompetitive). Because aid flows are highly volatile (often varying 10 to 30 percent of the recipient country’s output from year to year), fluctuations in aid flows can bring highly destabilizing exchange rate fluctuations. Prati & Tressel, supra, at 1. The traditional policy response is sterilization, where the central bank effectively absorbs the foreign currency inflows on its balance sheet. Id. at 3.

\textsuperscript{59} See, e.g., Ketaki Gokhale, \textit{A Global Surge in Tiny Loans Spurs Credit Bubble in the Slum}, \textit{Wall St. J.}, Aug. 13, 2009, at A1 (“[A]verage Indian household debt from microfinance lenders almost quintupled between 2004 and 2009, to about $135” per household). While this sum is small by global standards, “in rural India, the poorest often subsist on just a few dollars a week.” Id.

to certain segments of the society, the resulting increase in inequality may cause social tensions and conflict.

Yet another host state concern is specific to the financial sector. To the extent that foreign intermediaries purport to fill the gap left by under-provision of financial services in the recipient’s country, they may do so in ways that either spur or displace the development of a local financial services industry.61 Thus the manner in which the foreign aid intermediary interfaces with the individual or small business recipient and the extent and manner of the intermediary’s recourse to local financial institutions, can be of great policy interest to host country authorities.

When foreign funders or intermediaries attempt to take host state public interests into account, members of the host state may disagree with their assessment of where the public interest lies. Conflicts of this sort are reflected in the long-standing policy debate and academic literature on country “ownership” in development assistance,62 as well as studies on foreign aid allocation.63 For example, foreign actors may be more interested in funding projects evidenced by visible short-term outcomes such as buildings or dams, rather than intangible or long-range outcomes such as training teachers; or they may be interested in helping people with whom the donors

Especially when the sector is growing fast, it can be hard to tell the difference.

61. See, e.g., Todd Johnson, *OPIC Equity Funds, in FOREIGN AID AND PRIVATE SECTOR DEVELOPMENT* 57, 63 (Carol Lancaster, Kwaku Nuamah, Matthew Lieber & Todd Johnson, eds., 2006) (describing private equity investment by the International Finance Corporation with the goal of capacity building—“to modernize the financial sectors” in recipient countries—rather than just funding the recipient firms).


share a language, culture, religion, or gender, rather than the most impoverished. This is not a problem if other private or public funding is available for more pressing needs: money is fungible, and having someone else pay for a dam can free up budget resources for teacher training. But where there are no other sources of funds, host states can find the allocation of foreign funding wasteful and damaging.64

Finally, there is the simple lack of coordination. In a wealthy or even middle-income country, private resource allocation may be the norm, with the government filling in the gaps. But where the society relies on outside, largely public, funding to provide for basic human needs, there is a prima facie case for coordination by officials from the host country.65 For example, providers of funds with limited information may rationally stampede to fashionable projects—such as ones most recently shown to be most effective. The result may be an over-supply of capital for popular projects and neglect of others in dire need. Capital inflows from private as opposed to public sources are particularly difficult to coordinate because their sources are often relatively diffuse. It is one thing for the government of a developing country to sit down with five or ten official-sector donors to coordinate funding for a coherent national development strategy; it is another thing to do the same with thousands of private online funders, or even their intermediaries.

It bears emphasis that even if protecting the interests of inhabitants of the host state is accepted as a valid regulatory concern, it remains an open question whether in any given context private funders and their intermediaries or host country officials are best placed to safeguard those interests. Pri-


65. Severino & Ray, supra note 17, at 6.
vate actors may be ill-informed or disorganized, but host country officials may be corrupt or inept, or simply overwhelmed. We believe that host states have legitimate interests in regulating peer-to-peer international finance, but we do not presume that they will always regulate effectively.

E. Systemic Concerns

The possibility of adverse systemic consequences from small-scale peer-to-peer loans initially seems far-fetched. Such consequences arise when the failure of one or more financial institutions threatens to bring on a cascade of failures throughout the financial sector, with dire effects for the real economy. Institutions that are capable of bringing on systemic collapse are usually large (for example, a dominant state-owned bank); interconnected with other parts of the financial system (for example, some investment funds and broker-dealers that serve as counterparties in complex webs of financial contracts); serve as a principal source of finance in a key sector of the economy, such as housing; or are likely to spur imitative runs. Thus traditional banks, with their structural mismatch between long-term lending and demand deposits, links with all other parts of the financial system and the real economy, and central role in the payment system, have been historically prone to panics and contagion that threaten the broader financial system.

There are three reasons why the risk of system-wide repercussions from the failure or rapid withdrawal of an international peer-to-peer intermediary may not be as remote as it seems at first blush. The first has to do with defining the relevant "system." As noted earlier, private peer-to-peer financ-

66. The issue becomes even more complicated if one takes into account the possibility that assigning responsibility to host country governments will, over time, enhance their institutional capacity.

67. The definition of what constitutes the "system" in "systemic risk" varies considerably in the literature. See e.g., Adam J. Levitin, In Defense of Bailouts, 99 Geo. L. J. __ (forthcoming 2011) [at 11], available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1548787 (a current summary of the literature). Systemic risk and systemic crises can be regional, national or international. A localized crisis with macroeconomic effects could be systemic. Thus the U.S. savings and loan crisis of the 1980s, which was limited to thrift institutions and disproportionately affected the Southwest, may be fairly described as systemic.
ing may be concentrated in certain geographical areas or sectors, where it would trigger macroeconomic effects, including a significant impact on asset prices, inflation, and employment, which may reverberate far beyond the area of concentration. Recent high-profile debates surrounding shantytowns “carpet-bombed” with microloans, and the limits on the microcredit absorptive capacity in parts of Latin America and South Asia, have prompted comparisons with the U.S. subprime crisis. Second, many peer-to-peer intermediaries are deeply connected with other parts of the financial system. For example, intermediaries that mobilize ‘peer-to-peer’ funding for loans extended by host country financial institutions effectively serve as sources of asset-backed financing for such institutions, which in turn specialize in loan origination and servicing (identifying borrowers, providing initial advances, billing and collection). Third, flows of new funds into peer-to-peer intermediaries are potentially volatile. It is not difficult to imagine investors rapidly deserting an intermediary in the event of a scandal or the emergence of a new competitor. A run in this context could be a wave of investors refusing to roll over their ten-month commitments into new loans. Connecting the dots, all of this suggests that there is a meaningful risk that a peer-to-peer intermediary will suddenly stop funding financial institutions that play significant roles in key regions or sectors.

of host country economies. At the same time, intermediaries and host country MFIs are susceptible to regulation while neither their ultimate funders, nor the ultimate recipients, may be accessible to regulators, or susceptible to traditional regulatory tools.\textsuperscript{69} This raises the question whether the intermediary should be subject to minimum capital or liquidity buffers adequate to absorb distress at either side of the transaction chain that either threatens the intermediary’s network or has systemic consequences in the home or (more likely) host states. Applied counter-cyclically—when new intermediation is growing fastest—such buffers may also help prevent bubbles from forming.\textsuperscript{70}

Such concerns parallel well-worn policy debates about systemic risk and institutions that are too big (or too important, or too interconnected) to fail. While the traditional debate has played out among private domestic for-profit institutions, the fact that it may reprise among new peer-to-peer intermediaries reflects the current state of global financial integration, and particularly the incorporation of individuals in what had previously been the domain of large firms.

\section*{IV. Regulatory Responses: Where the Existing Frameworks Fall Short}

In the U.S. context peer-to-peer intermediaries that channel funds to developing countries are regulated in at least three distinct ways: under the regime that governs charities, the regime that governs financial institutions, and through what we call ‘private ordering’. In the sections that follow we examine each of these forms of regulation in turn.

\subsection*{A. Regulation of Charities}

The legal privileges U.S. charities enjoy are conditioned upon their compliance with a set of special requirements, designed mainly to ensure that charities’ resources are dedicated

\textsuperscript{69} Recipient MFIs in host countries are generally subject to some form of traditional regulation, but also may seek to preempt systemic problems through self-regulation. \textit{See Bubbles and Self-Regulation, supra} note 66.

\textsuperscript{70} See Avinash Persaud, \textit{Macro-prudential Regulation}, \textsc{World Bank Group Crisis Response Note} 6 (July 2009), available at \url{http://pubdocs.worldbank.org/irad/12350488445606.pdf} (advocating countercyclical regulation and liquidity buffers).
primarily to activities that generate fairly widely distributed social benefits. Those requirements serve the interests of donors in preventing their donations from being used for non-charitable purposes. It also serves the interests of the U.S. government in ensuring that the indirect subsidy it provides for charitable donations—in the form of the tax deduction—is used appropriately. However, the requirements imposed on charities are not particularly suited to the broader regulatory needs of international financial intermediaries, which, as we have seen, also encompass protection of the financial interests of providers of funding, the interests of recipients of funding, the interests of host states, and general interests in mitigating systemic risks. The substance of charities law is inadequate for these purposes in large part because it subjects the financial performance of charities to limited scrutiny, significantly less than managers of traditional financial institutions. Meanwhile, the institutional structure of the U.S. charities regime is unsatisfactory because it relies primarily on the Internal Revenue Service and state attorneys general, institutions that are not well suited to the task of regulating international financial intermediation. In particular, as they are currently organized, those institutions do not have the right incentives either to compete or cooperate with their foreign counterparts.

The most salient feature of charities law in these respects is that it exempts managers of charities from oversight by residual claimants. As we have already noted, although residual claimants may sometimes encourage excessive risk-taking, they also have a unique interest in encouraging an organization to maximize its financial returns. The Internal Revenue Code’s “non-distribution constraint” effectively bars charities from issuing residual claims to providers of capital.\textsuperscript{71} The constraint also serves to limit informal distributions of benefits to insiders of a charity, whether or not they are characterized as distributions to equity holders. Charities’ managers are, however, legally accountable to regulators, such as state attorneys general, and the Internal Revenue Service.\textsuperscript{72} 

\textsuperscript{71} To qualify as a charitable organization it must be the case that “no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual.” 26 U.S.C. § 501(c) (3).

\textsuperscript{72} See generally Marion Fremont Smith, Governing Nonprofit Organizations (2004).
costs in charities are also controlled by factors such as managers’ altruism, pride, and careerism, as well as competition from other intermediaries. The need to attract continued support from donors also serves to control agency costs, although donor funding can simultaneously blunt the impact of competition. It is unclear whether those factors will be sufficient to motivate peer-to-peer intermediaries organized as charities to maximize financial returns. We suspect that regulators, donors, and managers are, relative to residual claimants, more likely to be concerned about social outcomes. Moreover, they may be relatively uninterested in maximizing financial performance, even when it can be accomplished without compromising performance along other dimensions.

U.S. law also imposes distinct disclosure obligations on charities; and those obligations are not designed primarily to facilitate oversight of their financial performance. On the one hand, securities issued by charities—the non-distribution constraint does not preclude a charity from issuing securities in

73. The internal governance structure of nonprofits typically provides no formal role for donors. The charities that concern us here are typically organized as nonprofit corporations. Directors of nonprofit corporations are generally governed by the same fiduciary duties as directors of for-profit corporations (although some jurisdictions afford special protection to directors or officers who serve without compensation). See Harvey J. Goldschmid, The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms, 23 J. Corp. L. 631, 632 (1998) (“Nonprofit directors and officers generally operate under the same legal standards under state law in terms of managerial obligations and the duties of loyalty and care as their for-profit peers.”). For examples of state laws regulating internal governance, see Cal. Corp. Code § 5047.5 and N.Y. Not-For-Profit Corp. L. § 720-a, both of which shield uncompensated directors of 501(c)(3) organizations from liability, subject to a number of important exceptions, unless they acted intentionally, in bad faith, or in a grossly negligent fashion. However, in many jurisdictions donors have no ability to sue the directors of a nonprofit corporation for breach of fiduciary duty. See, e.g., Carl J. Herzog Foundation, Inc. v. University of Bridgeport, 699 A.2d 995, 997, 1001 (1997) (donor has no standing to sue either at common law or under the Connecticut Uniform Management of Institutional Funds Act). For a critique of this norm, see Kenneth L. Karst, The Efficiency of the Charitable Dollar, 73 Harv. L. Rev. 433 (1960). See also Henry Hansmann, The Role of Nonprofit Enterprise, 89 Yale L.J. 835 (1980) (discussing the economic role played by nonprofit organizations); Rob Atkinson, Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?, 23 J. Corp. L. 655 (1998) (discussing the question of who should have standing to sue nonprofit organizations). On the other hand, larger donors may bargain for a role in the governance of charities.
the nature of debt—are exempt from some of the requirements imposed by federal and state securities laws. In particular, offerings of securities by charitable nonprofits are exempt from the registration requirements imposed by the federal securities laws. They are not exempt from the anti-fraud provisions of those laws (or from other legal prohibitions on fraud), which effectively require issuers to disclose all material information to purchasers of securities. But instruments that do not offer their holders anything more than a promise to repay their investment, such as Kiva’s zero interest commitments to its online lenders, do not appear to be considered securities, implying that they are not subject even to the anti-fraud provisions of the securities laws. On the other hand, charities and, in some cases, those who solicit funds on their behalf, are typically subject to registration and annual report-


76. Kiva decided not to offer interest to its online lenders on the basis of this interpretation of the securities laws. See Flannery, supra note 34, at 37. In deciding whether an investment arrangement is a security fully subject to the disclosure and liability regime of the Securities Act of 1933 and the Securities Exchange Act of 1934, U.S. courts have interpreted the phrase “investment contract” in the statutes 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. . .” SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (interpreting §2(a)(1) of the Securities Act of 1933). The expectation of profits element of the Howey test has been critical in the case of the new intermediaries. (The Supreme Court’s leading interpretation of this element is in United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975) (analyzing shares in a housing co-operative, where the shareholders’ interest is in living in the housing development rather than earning financial returns)). See also Jenna Holtzmann, How Should Americans’ Investments in International Micro Finance be Regulated in the United States? (unpublished manuscript on file with authors) (reviewing case law on definition of a security). U.S. securities regulators are not the only ones who draw a sharp distinction between zero interest loans and those which entail a higher interest rate. Babyloan, a French online lending platform, reports that it initially wanted to set an interest of 1 to 2 percent, but eventually decided to offer lenders zero interest in order to avoid French laws prohibiting any entity other than a registered bank from lending at a positive interest rate. See Babyloan.org. Pourquoi un prêt solidaire à 0%?, http://www.babyloan.org/fr/FAQ.html#div1 (last visited Apr. 8, 2010).
The disclosure requirements imposed by the Internal Revenue Code and state law are less rigorous than those imposed by the securities laws, if only because they require less frequent disclosure: the securities laws require issuers of registered securities to disclose various sorts of information quarterly, and also require almost immediate disclosure of material information concerning changes in the company's financial condition or operations.

Charities law does not impose any special regulatory requirements on charities that engage in financial intermediation that might offset adverse effects on financial performance of either the non-distribution constraint or charities' reduced disclosure obligations. For instance, charities generally are subject to significant restrictions on their commercial activities, but for a variety of reasons these do not necessarily impose meaningful constraints on financial intermediation. A bedrock principle of the regulatory scheme established by the Internal Revenue Code is that charities must be operated primarily for charitable purposes, a restriction that one might think would preclude inherently commercial activities such as issuing or distributing securities, making potentially risky investments, or holding deposits. In fact, however, charitable purposes have been deemed to include the provision of financial services to poor or disadvantaged individuals, or even to businesses located in neighborhoods inhabited mainly by poor or disadvantaged people. Consequently, peer-to-peer financial intermediaries organized as charities have solid grounds for arguing that provision of financial services to inhabitants of developing countries qualifies as ordinary charitable activity. Similarly, charities are typically subject to restrictions on their investment activities that are generally designed to limit the

77. See, e.g., IRS, Form 990, Return of Organization Exempt from Income Tax (2008).
amount of risk they assume.81 Significantly, however, these restrictions do not apply to assets whose primary purpose is to accomplish the organization’s charitable purposes—so-called “program-related” assets.82 So, for example, charities’ investments in securities or notes issued by organizations whose operations tend to benefit poor or disadvantaged people qualify as program-related investments and are not subject to the same kind of scrutiny as other investments.

The institutional features of the U.S. charities regime are also poorly suited to the regulation of international financial intermediation. As we have already discussed, the institutions principally responsible for administering the U.S. regime are the Internal Revenue Service and state attorneys general. Those actors are reasonably well-suited to administering annual reporting requirements, pursuing allegations of fraud, and sanctioning the use of charitable donations for non-charitable purposes. However, they often lack the resources or the institutional capacity to pursue even those mandates.83 Moreover, they do not have the expertise to conduct ongoing monitoring of the risk posed by financial intermediaries to other parts of the financial system in home and host countries. They also are not particularly well suited to account for any interests that foreign actors might have in the administration and oversight of U.S. financial intermediaries.

81. Under state law, charities are not only required to exercise care and prudence in the management of their assets, but are also subject to more specific directives, such as to incur “only costs that are appropriate and reasonable in relation to the assets” or to “consider the charitable purposes of the institution” in managing and investing the assets. See Uniform Management of Institutional Funds Act [hereinafter, UPMIFA] §§ 3(a), 3(c)(1). They are also encouraged to diversify their investments. Id. § 3(e)(4).

82. See id. § 2(7) (“Program-related asset means an asset held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment”).

More generally, the institutional framework that governs U.S. charities is less than ideal because it creates a regulatory oligopoly. According to the Internal Revenue Code, to qualify as a charity an organization must be "created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States" and recognized as a charity by the IRS. Limited exceptions to this rule have been made pursuant to bilateral treaties for charities recognized by authorities in Canada, Israel, and Mexico. The general rule, however, effectively gives U.S. lawmakers (collectively) a monopoly on formulating the organizational laws of charities, even where the object of charity and the bulk of charitable activity are outside the United States. In other words, charities competing for U.S. taxpayers’ donations do not face competition from entities other than those overseen by the IRS and governed by U.S. organizational laws.

The immediate consequence of this state of affairs is that donors do not have the opportunity to channel their donations through intermediaries subject to potentially superior regulatory frameworks. The absence of regulatory competition also has dynamic effects. For one thing, at the margins, U.S. charities face less competition for charitable donations from U.S. taxpayers than they would in a more competitive system, thus reducing their managers’ incentives to improve their performance. Finally, to the extent regulatory competition encourages regulators to make their regimes more appealing to donors, the absence of regulatory competition means that U.S. lawmakers lack the incentives to alter the U.S. regime in response to developments overseas.


85. I.R.C. § 508(a). See generally Pozen, supra note 47, (describing theories of applying charitable deductions to internationally targeted donations); Chang et al., supra note 51, 601-12 (1997) (surveying tax deductions established by international tax treaties); Dale, supra note 51 (describing tax treatment of foreign charities).

B. Regulation of Financial Institutions

The preoccupations of financial institutions regulation are a mirror image of those that drive charities regulation. While charities law focuses primarily on ensuring that intermediaries generate adequate social returns, bank and securities regulators tend to focus on whether banks and investment funds satisfy the risk-taking and repayment expectations of their depositors and investors, especially retail depositors and small investors. Governments also put a high priority on protecting the financial system as a whole from the effects of firm failure, and seek to protect recipients of funds from fraud and exploitation. Compared to the regime that governs charities, the regime that governs financial institutions has muscular disclosure requirements, a consensus on core regulatory parameters such as capital adequacy, an elaborate supervision infrastructure, and channels for cross-border communication and coordination among regulators, all of which are likely to be fortified in the aftermath of the crisis. However, with very few exceptions, it purports to be essentially blind to the development impact of investment, which is of course central to many of those interested in financing development using the new peer-to-peer intermediaries.

The U.S. regime for regulating financial institutions keys off the nature of their funders’ expectations, the amount of discretion granted to the intermediary, its vulnerability to systemic risk and the extent to which unsophisticated individuals are at risk. The most stringent regulation is imposed on banks, which both commit to pay depositors a specific financial rate of return, and enjoy broad discretion over the use of depositors’ funds. The inherent maturity mismatch on their balance sheets and their central role in macroeconomic, payments and credit systems puts banks at the center of systemic risk concerns. Depositors have virtually no role in the governance of the bank. Bank regulation addresses the resulting con-

87. See Community Reinvestment Act, 12 U.S.C. §§ 2901-08 (2006). The Act was designed to counteract discriminatory lending practices, also known as “red-lining,” and to increase the level of development in lower-income neighborhoods. See id. § 2901 (“It is the purpose of this title to require each appropriate Federal financial supervisory agency . . . to encourage [financial] institutions to help meet the credit needs of the local communities in which they are chartered”).
cerns about agency costs and collective action problems through mechanisms such as minimum capital requirements, chartering rules, activities restrictions, supervision, and insurance.88

Unlike banks, investment companies do not, and cannot by law, guarantee their investors a specific rate of return. In-

88. First, to secure a federal bank charter in the United States, the organizers must demonstrate the “experience, competence, willingness, and ability” to run a safe and sound institution; have the capacity to supply or obtain capital when the bank needs it; and have a business plan that passes regulatory muster. See generally 12 C.F.R. § 5.20; Office of the Comptroller of the Currency, Comptroller’s Licensing Manual: Charters (2009). State chartering requirements are broadly similar. Further specific restrictions on bank affiliation advance a range of policy goals, from protecting deposits to guarding against conflicts and political power concentration. Thus the United States insisted on the separation of commercial and investment banking for much of the 20th century, and still bars commercial firms from acquiring banks. See 12 U.S.C. §§ 1841(c)(1), 1843(a), (c), (k); Arthur E. Wilmarth, Jr., Wal-Mart and the Separation of Banking and Commerce, 39 Conn. L. Rev. 1539 (2007). Second, somewhat like charities, banks are permitted a limited range of activities and investments. Bank powers are restricted to those specifically enumerated by law (for example, taking deposits, making loans, leasing, foreign exchange), and those incidental to “the business of banking.” 12 U.S.C. § 24 (2006). Banks are also affirmatively required to engage in some activities by, for example, the Community Reinvestment Act, 12 U.S.C. §§ 2901-08. In some cases, the “business of banking” has been interpreted broadly by the regulators. Saule Omarova, The Quiet Metamorphosis: How Derivatives Changed the ‘Business of Banking’, 63 U. Miami L. Rev. 1041 (2009). Some activities are expressly prohibited, such as owning real estate and underwriting corporate securities. 12 U.S.C. §§ 24, 29. In addition, bank transactions with affiliates are restricted to guard against conflicts and self-dealing. §§ 371c, 371c-1. Third, banks must maintain internationally agreed minimum levels of capital, calculated as a ratio of capital to risk-weighted assets, as well as a minimum leverage ratio of capital to assets. §§ 1831o(c)(1), 3907. Note that securities broker-dealers are also subject to minimum capital requirements. Fourth, the supervision process is a critical feature of bank oversight. Each bank must file quarterly reports of its financial condition, providing extensive balance sheet data to their regulators. Banks also must file periodic income reports and submit to on-site examinations. § 1820(d). Fifth, the government insures depositors against bank failure up to a relatively generous amount that captures most retail and some small business deposits. § 1821(a). In the United States, the insurance limit was recently raised to $250,000. The insurance fund, administered by the Federal Deposit Insurance Corporation, is financed with industry premiums, but also backed by the full faith and credit of the United States in the event the premiums run short. Insurance is central to bank regulation: one may conceive of the regime as protecting the taxpayer, rather than the insured depositor.
vestment companies enjoy limited discretion over the deployment of investors’ funds, consistent with stated investment objectives, and are subject to a less intrusive regulatory regime. Nearly all investment companies in the United States are organized as “management companies” under the Investment Company Act of 1940, which effectively mandates their corporate form. Investment companies are required to register with the SEC, and to furnish the SEC with extensive disclosure of their investment policies and financial condition, both upon initial registration, and thereafter as part of annual and semiannual reporting. Most relevant for our purposes, the initial registration statement must disclose whether the intermediary’s investment strategy includes concentration in a particular industry or economic sector, and must identify any policies that are so “fundamental” that changing them would require shareholder approval. Fund names are regulated so as to avoid misleading investors about the mission and investment strategy of their intermediary. The Investment Company Act prohibits intermediaries from entering into transactions with a broadly defined range of affiliated persons. In addition, the Investment Advisers Act contains a range of substantive requirements designed to guard against fraud and conflicts of interest. Recent enforcement actions have emphasized the advisers’ position of trust with respect to investors.

Unlike banks and investment funds, brokers, dealers and investment advisers do not intermediate between funders and their targets; rather, they facilitate direct investment. The reg-

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90. The Investment Company Act requires that at least 40 percent of the company’s board be independent, and subjects key decisions to the approval of independent directors. §§ 80a-10(b)(1), 80a-15(c). A key function of the board under the law is to oversee the investment adviser (typically, the firm that established the investment company), who manages the company’s portfolio.
91. § 80a-8(a)-(b).
92. § 80a-29(a), (c)-(g).
93. § 80a-8(b)(2).
94. A hypothetical “Long-Term Income Fund” may not pursue a short-term growth investment strategy.
96. State prosecutors have accused investment advisers of breaching their duty of loyalty through “late-trading” and “market-timing” practices favoring some investors over others.
ulatory regime consequently focuses on optimizing the flow of information to the investors through disclosure and fiduciary duties for agents and advisers. Such securities firms are regulated in the United States by the SEC, under the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940, as well as by self-regulatory organizations such as major stock exchanges and the Financial Industry Regulatory Authority (FINRA). And although they are subject to capital requirements and a measure of supervision, by far the bulk of regulatory emphasis in securities issuance and trading is on disclosure.

Regulatory reform in the wake of the latest financial crisis has sought to elevate the profile of consumer financial protection. Initiatives respond to criticism of U.S. regulators for neglecting consumers in the run up to the crisis, leading to dismal social and systemic consequences. Congress moved to consolidate consumer protection functions dispersed among financial regulatory agencies. Bills passed by the U.S. House of Representatives and the U.S. Senate each provided for a new consumer financial protection body with primary jurisdiction over consumer financial products and services. Both versions of the legislation vested the new body with broad rulemaking and enforcement powers under existing and new consumer financial protection laws to prevent and sanction “unfair, deceptive, or abusive acts or practices.”

99. For a discussion of the trend to declining protection in the run up to the crisis, see Patricia A. McCoy & Elizabeth Renuart, The Legal Infrastructure of Subprime and Nontraditional Home Mortgages, in Borrowing to Live: Consumer and Mortgage Credit Revisited 110 (Nicolas Paul Retsinas & Eric S. Belsky eds., 2008).
The House of Representatives bill granted the consumer protection agency primary authority to regulate “person-to-person lending” and “person-to-person lending platforms” and exempts the sale of loans or notes in connection with person-to-person lending transactions from the securities laws.\(^{101}\) The definition of person-to-person lending was limited to transactions that involved individual borrowing for family, personal, educational, household, or business purposes.\(^{102}\) These provisions would not affect intermediaries that sell either interests in loans extended to organizations as opposed to individuals or interests in bundled consumer loans. The legislation also did not distinguish between charitable and non-charitable person-to-person lending platforms. As a result it is unclear whether intermediaries that are exempt from the S.E.C.’s prospectus filing requirements because they are charities would remain exempt on the same grounds, or would be regulated more actively by the new consumer protection body. At this writing, the version of the bill under consideration by the House-Senate conference contains no similar provision. Senate conferees rejected House proposals to include it; instead, the bill commissions a study of person-to-person lending, presumably with a view to regulation.\(^{103}\)

The regime that governs U.S. financial institutions has a track record of taking concerns about cross-border effects into account. International regulatory cooperation was reasonably robust in financial services even before the crisis, and has re-

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\(^{101}\) H.R. 4173, § 4315, Regulation of Person-to-Person Lending. Securities laws disclosure requirements are to apply until new ones are formulated.

\(^{102}\) Elsewhere in the bill the term “Consumer Financial Product or Service” is defined to mean financial activities used by consumers “primarily for personal, family or household purposes.” See H.R. 4173, § 4002(8); S. 3217, § 1002(5).

ceived a boost from the recognition of the global reach of the crisis. The Basel Capital Accords have promulgated a voluntary minimum standard for capital adequacy since the late 1980s; the Basel I standard was universally adopted by national regulators, effectively becoming a core norm of bank regulation worldwide. The Basel Committee on Bank Supervision promulgates common principles for bank supervision, which are also widely followed. Securities regulators coordinate through the International Organization of Securities Commissions (IOSCO), however, they have not achieved their bank counterparts’ level of substantive regulatory harmonization.

In the wake of the financial crises of the late 1990s, governments in leading financial centers established the Financial Stability Forum (FSF) to coordinate their regulatory and standard-setting efforts. The FSF was, from the start, an informal and hybrid body, comprising both government regulators and private standard-setters, with no enforcement powers. Following the financial crisis of 2008 and the emergence of the Group of Twenty wealthy and developing states as the leading forum for coordinating economic and financial policies, the FSF was expanded, renamed as the Financial Stability Board (FSB), and given broad responsibilities for regulatory coordination and peer review. However, it still has no formal institutional charter or direct enforcement authority.

This history of coordination reflects in part the intractable challenge of allocating responsibility for transnational financial activities among national regulators. For instance, internationally active institutions must be supervised on a consolidated basis—which in effect puts the bulk of regulatory and supervisory responsibility on home country authorities—although home and host regulators are expected to share information and cooperate. The original impetus behind worldwide consolidated supervision came from the implosion

108. Id.
of the Bank of Credit and Commerce International (BCCI) in the late 1980s, which defrauded customers and depositors in host countries throughout Europe, Asia, and North America. By the late 1990s, the regulatory paradigm shifted to embrace the expansion of European and North American financial institutions throughout the developing world. Home and host roles switched. Giving home regulators more authority was deemed sensible because the major financial centers were thought to be closer to best regulatory practices. In effect, poor and middle-income states were importing good regulation.

The crises of the 1990s and even more so the crises of this decade revealed problems with this regime: home regulators rarely, if ever, targeted the economic and financial conditions in host states. Thus consolidated home regulation and supervision has in some cases allowed foreign institutions to fuel asset bubbles and exacerbated contractions in the host states.109 For example, Swedish and Austrian banks were at the forefront of the recent lending boom in Eastern Europe, yet Swedish and Austrian regulators had no mandate to target the macroeconomic stability of Latvia or Hungary, nor the capacity to regulate their own banking systems for the sake of capital recipients. Bubbles, crises, and painful contractions followed in the host countries. In response, the pendulum appears to be swinging in the direction of more host regulation.110 Post-crisis regulation is also likely to seek smaller and safer finance—an approach that may make sense for the multitrillion dollar derivatives industry, but one that could cut off badly needed and already scarce funds for development.

Regulatory competition is another perennial feature of the financial regulatory discourse, more so than in charities regulation. Competition is in part a function of the inherent mobility of capital; however, governments have historically sought to restrict their citizens’ capacity to invest abroad and


foreigners’ entry into their financial markets.\textsuperscript{111} Academics have long criticized U.S. barriers to cross-border investing.\textsuperscript{112} More recently, as more countries removed restrictions on capital flows, competitive concerns have moved to the U.S. policy forefront.\textsuperscript{113} In the peer-to-peer context, restrictions on direct cross-border investing arguably distort the market in favor of home-country intermediaries, especially where foreign intermediaries and MFIs are not organized with an eye to regulatory exemptions under U.S. law. At the extreme, U.S.-based intermediaries may be creatures of residual capital controls. This concern is in addition to the broader point that home regulation does not account for host country policy needs.

Explicit social policy, even purely domestic, has been a relatively small and heavily criticized element of for-profit financial services. Governments have subtle ways of encouraging lending for favored policy goals, but explicit requirements have been rare in the United States, with the prominent exception of state-sponsored housing finance vehicles. The ongoing controversy over community reinvestment is a case in

\textsuperscript{111} Such efforts have often backfired, famously in the case of the U.S. Interest Equalization Tax on U.S. residents’ income from foreign securities, in effect between 1963 and 1974. It was meant to dissuade U.S. investors from sending money abroad, but is now credited with spurring the vast offshore Eurodollar market based in London.


 Critics have argued that requiring banks to lend in poor neighborhoods—in effect, domestic financing for development—conflicts with safety and soundness objectives of bank regulation, and have recently blamed the financial crisis on a mix of community reinvestment and housing policy lending.\footnote{See e.g., Michael Barr, Credit Where It Counts: The Community Reinvestment Act and Its Critics 80 N.Y.U. L. Rev. 513 (2005)} Redistribution and social responsibility have yet to be assimilated in mainstream finance; they sit uneasily on its margins.

Failure to account for host country policy concerns and a strained relationship with social policy are among the several ways in which existing financial regulation is a poor fit for the international peer-to-peer intermediaries. The current regime also has a discontinuous structure that is prone both to over- and under-regulating hybrids. At the extreme, if a “peer funder” collects just 1 percent interest, it may be entitled to the full range of costly disclosure, registration, and anti-fraud protections of the U.S. securities laws; in contrast, collecting no interest would make the transaction exempt. This is so even if, in both cases, the ultimate “peer borrower” pays interest to its intermediary at 20 percent, and each funder gets a legal and binding promise to repay the principal and a glossy brochure touting a history of over 95 percent repayment rates.

The existing elaborate and costly financial regulatory regime justifies itself primarily in terms of protecting small investors and depositors. Such a regime should, in theory, be concerned with potential for fraud and manipulation involving $25 loans to pooling vehicles for the benefit of high-risk borrowers with no foreign exchange earning capacity in high-risk countries. This should not change just because the $25 is interest-free, the investor is partly motivated by charity, and the pooling vehicle is not organized as either a bank or an investment fund. The $25 could be lent in irrational exuberance through an undercapitalized intermediary, based on false disclosure that the principal is “safe.”

This is a case for functional regulation, rather than a regime that keys off institutional formalities.\textsuperscript{116} To be sure, if the funders really meant to give their money away—a 100 percent grant in the form of a loan—regulation geared to default risk and risk monitoring is beside the point. But if the funders do (or will as the sector matures) take the repayment promise seriously, they should have access to a threshold quantity of information of such quality and presented in such form that helps them decide whether the repayment expectation is in fact justified. Put differently, the grant element in a peer-to-peer loan can vary drastically depending on the riskiness of the ultimate loan, the character and credit of the intermediaries, and the resulting discount. The only way to know that the funder had consented to make a grant in the effective amount is to provide her with adequate disclosure.

On the other hand, there is risk of over-regulation: charities are exempt from disclosure and registration aspects of securities laws in part because the cost of compliance is out of proportion with nonprofit finances. Bank oversight is so strict in part out of concern about bank runs arising out of structural maturity mismatches (absent in peer-to-peer finance to date) and misbehavior by equity holders in a highly leveraged firm (a model that does not apply to nonprofits that have no residual claimants). The challenge, then, is to scale financial regulation to the functions of the new intermediaries, without compromising their development policy objectives.

Shifting regulatory authority over peer-to-peer lending from the SEC to a specialized consumer protection body has the potential—depending on how that body exercises its authority—to address some of the problems in the current regime, such as expensive disclosure requirements that could be especially burdensome for small transactions. However, such initiatives risk creating new regulatory discontinuities. For example, provisions supported by the U.S. House of Representatives would only grant the Consumer Financial Protection Agency authority over transactions involving isolated loans

made to individuals, suggesting that peer-to-peer transactions involving bundled loans or loans to organizations would be regulated differently.

C. Private Ordering

The legal regimes that govern both charities and financial institutions are often supplemented by norms formulated by private actors. Sometimes the relevant actors are individuals. For instance, the background legal constraints on charities’ use of funds are often supplemented by more specific constraints imposed by donors who insist that their donations be held in trust for specific charitable purposes. In other situations, industry-wide organizations play an important role in supplementing the legal regime.117

Private ordering plays a particularly significant role in the governance of microfinance institutions. The explosive growth of the microfinance industry in recent decades posed a legal and regulatory dilemma. MFIs sprung up—and had the greatest impact—in jurisdictions whose financial regulatory infrastructure was widely understood to fall short of the state of the art, in Africa, Asia, Eastern Europe, and Latin America. In fact, microfinance was partly a response to the shortcomings of the local financial systems, which in turn were closely related to regulatory shortcomings. Host states had widely divergent regimes for chartering and regulating the new institutions, and often inadvertently erected insurmountable barriers to their operation through chartering rules, licensing, and interest rate ceilings, among others.118 In response, the budding microfinance community—including nonprofit and for-profit actors, bilateral development agencies, and multilateral organizations such as the World Bank—established clearing houses, consultation procedures, and processes for distilling and publishing research and best practices. The most prominent clearing house of this sort is the Consultative Group to Assist the Poor (CGAP), an organization housed at the World Bank and sponsored by the World Bank and a number of other international financial institutions, bilateral aid agencies, and private foundations. Taken as a whole, the best prac-

117. Id.
118. See Microfinance Consensus Guidelines, supra note 66, at 6-12 (describing regulations imposed by host states).
tices developed by CGAP and other bodies represent a remarkably sophisticated example of private regulation.

Private regulation is now being extended to some of the intermediaries that channel funds to MFIs. In response to the rapid growth of for-profit private investment in microfinance, especially in the wholesale capital markets, CGAP recently ventured beyond MFI regulation into guidelines for Microfinance Investment Vehicles (MIVs). The initial round of guidelines was produced in 2007, prompted by a request from the International Finance Corporation (the private sector arm of the World Bank), in consultation with a diverse group of industry experts and market participants. Although most of the disclosure variables address financial reporting, the draft product explicitly contemplates the development of social performance indicators. The model is promising because it aspires to create a template for consistent and comparable reporting across a range of regulatory systems, and reflects the existing reporting standards under securities and accounting rules in major financial centers. Perhaps more importantly, it builds on the existing private ordering infrastructure for MFIs, and promises to create a transnational regime that is focused on the information needs of cross-border investors in microfinance.

A comparable regime for peer-to-peer intermediaries might diffuse, build on, and reinforce existing voluntary disclosure norms. However, the mechanism for coordinating any new standards matters for its efficacy and legitimacy. The fact that the CGAP and its collaborators currently dominate the market for this sort of private regulation may raise concerns in some quarters about whether private regulation is likely to produce optimal results. Competition among private regulators has the same potential advantages (and disadvantages) as regulatory competition among public actors.

The MIV Guidelines appear as an example of very promising private regulation. It is difficult, however, to generalize about the advantages and disadvantages of private ordering.

Much depends on the particularities of the ordering in question, including whether all affected parties are represented and the level of competition across regimes.

V. Policy Implications

So how should the new peer-to-peer intermediaries be regulated? For starters, we do not believe that they ought to be regulated exclusively as either charities or financial intermediaries; nor should they be regulated solely by the jurisdiction in which providers of funds are located. As we have argued above, the regime that governs charities is not well-suited to regulating organizations that take on meaningful financial commitments to members of the general public. At the same time, the regime that governs traditional financial intermediaries is not well-suited to protecting the private and public interests in achieving social as well as financial outcomes. It focuses entirely on repayment, and is also essentially blind to the central policy objective of foreign assistance: improving development outcomes, which requires a significant increase in funding as well as accountability. The U.S. regime in particular still largely keys off legal formalities (for example, chartering), rather than the economic substance of financial activities, which makes it poorly suited to regulate actors active in multiple fields. More generally, regulatory institutions in the jurisdiction of the provider of funds are ill-suited to protecting either the interests of recipients of funds or the broader interests of inhabitants of host countries, nor can they single-handedly ensure the smooth operation of the financial systems that transcend national borders.

In response to these concerns we offer the following recommendations for reform of the regulatory framework that governs international peer-to-peer financial intermediaries:

- Presumptively apply financial regulation—including any new consumer protection regulation—to all actors that promise to return some portion of the provider’s funds, regardless of charitable status or level of returns.
- Reform charities laws to permit international regulatory competition.
• Enhance monitoring of financial flows through international peer-to-peer intermediaries on concessional terms.
• Promote regulation by host states.
• Promote private ordering as a supplement to state regulation.

A. Subject All Actors that Promise Financial Returns, Regardless of Charitable Status or Level of Returns, to Regulation as Financial Institutions

Intermediaries that make financial commitments to providers of funds raise distinct regulatory concerns from those that do not. As illustrated by current U.S. law, the nature of the regulatory regime can and should vary depending on the expectations the intermediary creates and the amount of discretion it enjoys. We do not prescribe a specific mode of regulation or fix regulatory authority in a single institution, since we believe that these decisions ought to be made on functional grounds, based on the nature of the services being offered by the intermediary in question.121 In some cases, disclosure on the securities law model may be appropriate; in others, supervision and even insurance on the banking law model may be suitable.122 We also believe that the appropriate regulatory regime will need to adapt over time as the peer-to-peer financing industry continues to change and evolve. However, we accept the fundamental idea that regulation is required to protect the interests of people who run the risk of not receiving the financial returns they have been promised by an intermediary. These concerns are particularly salient when the intermediary offers relatively a variegated set of products to the general public and consequently has a fragmented and complex capital structure.

We believe that these risks are present regardless of whether the intermediary qualifies as a charity and regardless of whether it offers to return more or less than 100 percent of

121. Cf. Holtzman, supra note 73 (recommending creation of a less rigorous version of existing securities regulation for electronic intermediaries that solicit investments in microfinance in the United States).
122. We leave to another day the question of whether any elements of the regulatory scheme that governs transactions in derivatives ought to be applied to peer-to-peer intermediaries.
the funds advanced to it. In these respects our position is inconsistent with the regulatory status quo. Under current law, if a charity solicits funds from unsophisticated members of the general public in exchange for a promise to invest in a charitable venture and repay the money in due course, the transaction is not likely to be subject to either securities laws or the laws applicable to banks or investment companies, so long as there is no promise to pay interest. In effect, the promise to repay principal falls through the cracks of the regulatory regime—more easily so when bundled with the promise to do good. But as we have discussed, the fact that an entity is subject to the disclosure obligations and organizational requirements of charities law does not substitute for regulation geared to credit risk assessment, of the kind (if not necessarily to the full extent) imposed on banks or registered investment companies. An intermediary that offers providers of funds a zero percent interest rate (or less) can still expose to them to the risk of substantial or total losses. For example, many of the new international peer-to-peer intermediaries channel their funding through local microfinance institutions and expose their online lenders to the credit risk of those entities. That credit risk can be substantial, because investors are likely to recover very little when microfinance institutions become insolvent.

There is no reason to presume that providers of funds are willing to accept such a risk of loss simply because charitable motivations led them to accept a below-market rate of return. Moreover, although some intermediaries voluntarily disclose these risks, we are not prepared to assume that all intermediaries will do so in the absence of regulation. We believe that filling this regulatory gap is essential to safeguard the integrity and foster sustainable growth of peer-to-peer financing for development.

We also recognize that under current law some of the services currently offered by peer-to-peer international intermediaries might be exempt from regulation because of the

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124. See, e.g., ROZAS, supra note 37, at 3.
small size of the transactions and parties involved. Such exemptions will be appropriate in many cases, but we are reluctant to presume that peer-to-peer financial intermediaries deserve a blanket exemption from regulation simply because they are small, or their transactions involve small amounts of money. The danger is that such an exemption would give a free pass to intermediaries who serve the least wary providers of funds and the most vulnerable beneficiaries—in other words, the intermediaries most in need of regulation.

A recent securities enforcement action illustrates both our substantive concerns and the limits of the existing regulatory regime when facing hybrid products and institutions. In 2008, the SEC sued Prosper Marketplace, a peer-to-peer platform where small lenders funded bank loans of $1,000 to $25,000 for anonymous borrowers. Although the Commission acknowledged the possibility of charitable motives among Prosper investors, it deemed these motives unimportant. The Commission also made no mention of the idea that the relatively small amounts at stake might weigh against regulatory intervention. At the same time the Prosper case reaffirmed the limits of the current regime. Following existing law, the Commission made it clear that its decision to assert jurisdiction over Prosper turned in part on the fact that, in addition to any good feelings, “lenders expect a profit . . . at a rate generally higher than that available from depository accounts at financial institutions.”

125. Cf. Advisory Comm. on Smaller Pub. Companies, Final Report to the United States Securities and Exchange Commission 20-21 (2006) (discussing the history of “scaling” securities regulation to reflect the size of the issuers and transactions, and to achieve regulatory efficiencies). Such regulatory economy may be particularly important in host states where regulatory personnel and expertise are scarce.


127. Id. at 3; see also id. at 5 (“While some Prosper lenders may be motivated, in part, by altruism, altruistic and profit motives are not mutually exclusive.”). An earlier case cited in the Prosper order teaches a similar lesson: customers who lent money to a wayward broker testified that they were “not primarily motivated by desire for profit, but instead by a desire to help a friend in need,” though some saw helping a friend also as an opportunity to diversify their investments and limit losses from other investment strategies. But the high interest rates on the loans made it easy to impute the profit motive, which in turn subjected otherwise unregulated consumer financial
higher than zero (full grant), representing any expectation of repayment, should be presumptively sufficient to prompt oversight.\textsuperscript{128}

Regulating peer-to-peer lending under the consumer protection umbrella rather than the securities laws, as proposed by the House of Representatives, could limit the effect of the Prosper enforcement action.\textsuperscript{129} However, to be effective, any new regulatory scheme must go beyond the securities disclosure model to reflect prudential concerns as appropriate, cover intermediaries that are charitable entities, govern a broad range of transactions (including loans to organizations rather than individuals, and pooled loans), and have the capacity to coordinate internationally to reflect recipient and host state concerns.

B. \textit{Reform Charities Laws to Permit International Regulatory Competition}

The preferential tax treatment afforded to charities creates strong incentives to establish these intermediaries as charities. Consequently, one way to enhance regulation of these entities is to enhance the regime that governs charities. A comprehensive review of possible reforms to charities law is beyond the scope of this article. However, one potential reform merits particular attention: U.S. lawmakers could grant U.S. taxpayers deductions for donations to charitable organizations that are overseen by foreign regulators and organized under foreign laws and whose activities are intended to benefit inhabitants of designated poor or middle-income countries.\textsuperscript{130} These privileges could be extended either to specific
countries to elements of securities regulation. \textit{In re McNabb}, 54 S.E.C. 917, 921-23 (2000), \textit{aff’d}, 298 F.3d 1126 (9th Cir. 2002).

\textsuperscript{128} We recognize that this recommendation implies a significant departure from the way in which courts have traditionally viewed mixed-motive investment. \textit{See}, \textit{e.g.}, United Housing Foundation, Inc. \textit{v. Forman}, 421 U.S. 837, 853-57 (1975) (shares in a housing development are not securities because their primary purpose is to give the owner a place to live, not a financial return).

\textsuperscript{129} \textit{Supra} note 103 and accompanying text.

\textsuperscript{130} \textit{Cf.} Dale, \textit{supra} note 51, at 659-61, 696 (recommending abandonment of ban on deduction of donations to foreign charities); Pozen, \textit{supra} note 47, at 594-601 (same). Recall that current law already permits deductions for donations to charities organized under U.S. law whose activities benefit inhabitants of foreign countries.
tries’ regimes on a case-by-case basis, as the U.S. has already done through its bilateral treaties with Canada, Israel, and Mexico, or in a blanket fashion to all regimes that meet prescribed standards. The list of countries in which the eligible organizations would operate could be formulated in consultation with the U.S. State Department so as to ensure that U.S. foreign policy interests are taken into account.

Abandoning the “water’s edge” approach to the tax treatment of charitable donations would have a number of potential benefits. To begin with, it would expand the range of choices open to donors who care about U.S. tax deductions. Those donors might appreciate being able to direct their donations to charities that are subject to more effective oversight than is offered by U.S. regulators. For example, if the U.K.’s Charity Commission offers more vigorous oversight of charities than any U.S. state’s attorney general, then U.S. donors would benefit from being able to donate to a U.K. charity. Donors might also benefit from receiving tax benefits for supporting charities that are subject to different substantive norms. For example, donors may prefer to donate to charities whose regulators require more detailed disclosure about the social impact of their work.

Abrogating the water’s edge rule would also expose U.S. charities to greater competition—from charities governed by foreign law—for U.S. taxpayers’ donations, thereby encouraging both groups of charities to make their offerings more appealing to potential U.S. donors. So for example, Kiva and the Calvert Foundation would face competition for U.S. taxpayers’


132. Cf. Pozen, supra note 47, at 595-96 (discussing potential of rescinding geographic restrictions on deductions with respect to countries whose regulators are “trust[ed]” by the U.S. government).

133. The benefits of regulatory competition in the organizational law of charities should parallel the benefits of regulatory competition in corporate and securities law. See Romano, supra note 104; Choi & Guzman, supra note 104; Coates, supra note 104; Ellig & Shadab, supra note 104.
donations from similar entities incorporated in Europe and Asia.\textsuperscript{134}

Finally, abandoning the water’s edge rule might also encourage lawmakers to compete. For instance, if lawmakers measure their success by the popularity of their jurisdiction among charities then they will have an incentive to pass laws that are relatively appealing to charities and, to the extent they influence charities’ decisions on how to regulate themselves, donors. So, for example, the prospect of ‘losing’ charities to the U.K. might prompt U.S. lawmakers to enhance the perceived quality of the U.S. charities regime. We acknowledge, however, that there are reasons to doubt that lawmakers will compete in this fashion.\textsuperscript{135}

\textbf{C. Enhance Public Monitoring of Financial Flows Through International Peer-to-Peer Intermediaries on Concessional Terms}

Neither charities law nor securities law is designed to give effect to the foreign policy concerns of the home states of the providers of funds—a stark contrast to the regime that governs Official Development Assistance. Under the status quo, peer-to-peer intermediaries are subject to generally applicable legislation designed to control money laundering and terrorist financing, thus addressing home states’ concerns about barring private funds from flowing to enemies of the state. By contrast, the status quo regime does relatively little to help home states monitor and control the flow of funds to their friends. In particular, there is no reliable mechanism to allow states to monitor private flows of funds to developing countries and

\textsuperscript{134} We have not been able to find data on the magnitude of donations to non-U.S. organizations operating in developing countries. However, we presume that such competition is minimal under the current regime because of the substantial tax advantages of donating to U.S. organizations and evidence suggesting that U.S. donors are quite sensitive to tax incentives. See Pozen, supra note 47, at 568; David Roodman & Scott Standlee, Tax Policies to Promote Private Charitable Giving in DAC Countries, 9, 11, 18-20 (Ctr. for Global Dev., Working Paper No. 82, 2006) (citing evidence that IRS deduction data captures the bulk of U.S. private giving and discussing the sensitivity of giving to tax incentives).

change the allocation of state-controlled flows in response.\textsuperscript{136} This in turn exacerbates the problems of aid coordination and accountability.\textsuperscript{137} To this end, we recommend requiring intermediaries engaged in international financing to report the magnitude of flows to various countries and, roughly, the extent to which their terms deviate from those of purely commercial transactions in the relevant market.

D. Promote Regulation by Host States

The financial crisis has led many to lose faith in the ability of states such as the United States and the United Kingdom to serve as the sole regulators of financial institutions operating on a global scale. At the same time increasingly forceful concerns have been raised about how effectively these and other wealthy countries have allocated foreign aid to developing countries in the post-war era. Similar skepticism about the willingness or ability of wealthy countries to protect the interests of developing countries undermines the notion that international peer-to-peer intermediaries should be regulated exclusively by their home states, and points to a bigger role for host regulation.

In the particular case of peer-to-peer intermediaries, concerns about consumer protection, developing the capacity of local financial intermediaries, and mitigating systemic risk, support host state regulation. So for example, regulators of microfinance institutions in developing countries that receive funds from peer-to-peer intermediaries ought to be concerned about factors such as: whether online intermediaries sufficiently protect the privacy of local borrowers; whether any part of the financing chain is exposed to excessive currency risk; and whether foreign online intermediaries are displacing local intermediaries.\textsuperscript{138} For these and other reasons, we recom-

\textsuperscript{136} How ODA should be adjusted to reflect peer-to-peer financing is beyond the scope of this Article. We believe it ought to depend on the answers to empirical questions such as whether the respective flows serve as substitutes or complements. \textit{See} Kevin E. Davis & Sarah Dadush, \textit{The Privatization of Development Assistance: Overview of a Symposium} [in this volume].


\textsuperscript{138} Cf. Burand, \textit{supra} note 53, at 3-4 (pointing to some of these factors).
mend that host states reserve the authority to regulate the activities of foreign peer-to-peer intermediaries operating within their boundaries.139

E. Promote Private Ordering as a Supplement to State Regulation

Designing a legal regime that accommodates the varied interests of providers of funds, recipients of funds, home states and host states is a challenging task. It is particularly challenging to craft a single legal regime that accommodates the significant amount of heterogeneity that appears to characterize providers of funds. Different providers place different amounts of weight on financial and social returns, and when it comes to social returns, their priorities can be infinitely varied. Some people care about improving the lot of women, others about the rural poor, still others focus on particular countries or regions. It is difficult to imagine how any single set of disclosure requirements could suit the needs of funders with such diverse motivations.

Under the circumstances we believe that gaps in state regulation of peer-to-peer intermediaries are inevitable and that private ordering has a significant role to play in filling those gaps. A good example of the kind of private ordering we have in mind is the set of advisories and best practices for microfinance institutions that have emerged through CGAP, the World Bank-sponsored microfinance clearinghouse discussed in Part IV.C. Without taking any position on the substance of those norms, we note that they possess several distinctive structural features that make them valuable models for private efforts to regulate peer-to-peer intermediaries:

• They are emphatically transnational and directed at a broad range of legal systems and levels of regulatory development. They contemplate sourcing funds for microfinance both abroad and at home, and consider the interaction of different legal systems in the process.

They start from the premise that social impact—at policy, community, and individual recipient levels—and financial sustainability are both necessary objectives of microfinance.

They bring together public, private, and non-profit actors in designing a regulatory regime that affects them all.

Partly owing to their transnational aspirations, but also reflecting the need for popular and regulatory legitimacy in a new field, the guidelines and advisories emerging out of the microfinance industry are not tied to rigid and static regulatory categories. They explicitly contemplate both regulatory pluralism and continuing change in the industry.

The result is an open and flexible self-regulatory paradigm designed to operate in widely different legal regimes, and mindful of the need for interaction among different regimes. Thus, for example, the consensus guidelines for regulating MFIs do not take a firm position on optimal corporate organization or specific chartering rules, but instead set forth substantive and institutional considerations for prudential and business-conduct regulation of financing for the poor. Moreover, since diffusion of best practices has been a key objective of the recent efforts, the microfinance industry has developed increasingly sophisticated web-based technologies and networks for disseminating the knowledge they produce. While we endorse private ordering, we also note that competition among private regimes, and with public regimes, is more likely to achieve better financial and development outcomes.

VI. CONCLUSION

The past decade has seen rapid financial innovation, growing pluralism, and fragmentation in development assistance. This trend has proceeded in tandem with similar trends elsewhere in international finance. In practice, what used to be distinct fields of foreign aid and private international finance are rapidly merging. We have argued that these

140. We take no position on whether it would be desirable to have greater regulatory competition among private actors, in relation either to MFIs or peer-to-peer intermediaries. For discussion of the potential advantages and disadvantages of regulatory competition in this context, see Snyder, supra note 112, at 437-42.
changes demand a new look at the regulatory regime governing development finance. In particular, the rise of peer-to-peer intermediaries has meant that a growing number of unsophisticated funders and recipients have become involved in some of the riskiest activities in international finance. The risks arise primarily because these transactions occur across jurisdictions with vastly different legal regimes and financial infrastructure, involve illiquid currencies, and are guided by what are often inexperienced and unregulated financial institutions that are themselves feeling their way in uncharted financial territory through trial and error. The absence of agreed-upon uniform accountability standards for social performance in this field is at least as important as the lack of uniform criteria for financial disclosure.

Against this background, we face a choice: either to refine the regime for charities regulation in the funders’ home country to address the shortcomings in financial reporting, or to integrate the new aid intermediaries in the evolving regime for regulating international finance. We suggest doing both, for the following reasons. First, when intermediaries promise repayment, they subject new aid funders to risks that are indistinguishable from those faced by traditional depositors and investors, even where they seek a social as well as a financial return on their investment. This promise makes it appropriate to regulate intermediaries as financial institutions. Second, so long as these intermediaries continue to rely, even in part, on tax-deductible donations, it makes sense to enhance the regime that aims primarily at protecting the public and private interests in ensuring that tax-deductible donations are used effectively. Third, the regime for cross-border regulatory cooperation is relatively robust in international finance, and virtually absent in charities regulation. We believe that such cooperation—particularly in the areas of aid coordination, and negotiation of home and host country policy priorities—is essential to the success of the new mechanisms for mobilizing and delivering development finance. Fourth, international finance is replete with examples of reasonably successful private and hybrid ordering regimes, which are especially important for establishing accountability for the social outcomes of peer-to-peer development assistance.

Our core argument, then, is that regulating peer-to-peer intermediaries must become part of an increasingly seamless
web of regulating cross-border financial transactions to protect not only the interests of private market participants, but also the public interest in the fund-providing and fund-receiving states, as well as local, national and global financial stability. The resulting regime must be transnational in scope and capable of adapting to continuous innovation, including the evolving mix of demands for financial and social returns. If it works, the new regime will help mobilize more durable funds for development and instill confidence in the financial system among its many diverse stakeholders, including those who have been traditionally excluded from it and are most vulnerable to its failures—yet who also need it the most.