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PLAYING TO A NEW CROWD: HOW CONGRESS COULD BREAK THE STARTUP STATUS QUO BY RAISING THE CAP ON THE JOBS ACT'S CROWDFUNDING EXEMPTION

Abstract: On October 30, 2015, the Securities and Exchange Commission voted to implement the Jumpstart Our Business Startups ("JOBS") Act's exemption for crowdfunded securities, which became effective on May 16, 2016. Crowdfunding technology allows any entrepreneur with an Internet connection the opportunity to pitch an idea to a community of investors, which could revolutionize the market for early-stage startup financing. That market has largely adhered to a status quo in which the strength of an entrepreneur's network is nearly as important as his or her idea—a dynamic that is especially difficult for female and minority entrepreneurs who have been largely excluded from traditional sources of early-stage funding. Crowdfunding may offer a solution. The JOBS Act, however, caps the amount that an entrepreneur can raise with the crowdfunding exemption at $1 million annually. Given how much capital it takes to launch a successful startup, this cap could prevent crowdfunding from truly benefitting entrepreneurs. This Note examines the startup financing landscape, crowdfunding's revolutionary potential, and securities regulation laws. Further, this Note argues that Congress should raise the cap on the JOBS Act's crowdfunding exemption to $5 million annually so that entrepreneurs relying on it can more likely compete with their peers who have easier access to traditional startup financing.

INTRODUCTION

In 2013, actor and director Zach Braff launched a campaign on the website Kickstarter to crowdfund his second major film, *Wish I Was Here*.[1] He raised over $3 million on the website's portal, which allows individuals to tap into a community of online investors interested in helping to fund a project.[2]

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[1] *See* Kathryn Shattuck, *The Roar Over the Funds of the Crowd*, N.Y. TIMES (July 9, 2014), http://www.nytimes.com/2014/07/13/movies/the-roar-over-the-funds-of-the-crowd.html?_r=0 [https://perma.cc/6QWG-9EJQ] (providing a background of Braff's Kickstarter campaign, and explaining that Braff launched the crowdfunding campaign because he wanted a degree of creative control over the film that traditional film financers generally do not allow).

[2] *WISH I WAS HERE by Zach Braff*, KICKSTARTER, https://www.kickstarter.com/projects/1869987317/wish-i-was-here-1 [https://perma.cc/2ADQ-BBT8]; *see also About*, KICKSTARTER, https://www.kickstarter.com/about [https://perma.cc/DW3E-XBGK] (describing the Kickstarter platform). Those who participated in Braff's campaign by donating received some sort of gift in return, including copies of the film's soundtrack and set visits. *See WISH I WAS HERE by Zach Braff*, *supra*.

Although the resulting film was not itself groundbreaking,[3] Braff's project did shift national attention toward crowdfunding, the innovative way to raise capital that some argue could soon surpass traditional venture capital financing for startups.[4]

The Jumpstart Our Business Startups ("JOBS") Act's crowdfunding exemption was implemented on May 16, 2016, and since then entrepreneurs have been able to engage with communities of online investors, comprised of everyday Americans, to issue securities through crowdfunding portals.[5] Title III of the JOBS Act, known as the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act ("CROWDFUND Act" or the "Act"), creates a new exemption to the Securities Act of 1933 ("Securities Act") that allows startup companies to issue securities through a crowdfunding portal without having to comply with the Securities and Exchange Commission's ("SEC") registration requirements.[6] Specifically, under the Act, startups can issue up to $1 million in crowdfunding securities annually, and individuals are allowed to

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[3] *Wish I Was Here*, ROTTEN TOMATOES, http://www.rottentomatoes.com/m/wish_i_was_here/ [https://perma.cc/7TNN-UY6Q] (aggregating reviews from professional film critics, with the overall critique being that the film "covers narrative ground that has already been well trod").

[4] *See, e.g.*, Chance Barnett, *Trends Show Crowdfunding to Surpass VC in 2016*, FORBES (June 9, 2015), http://www.forbes.com/sites/chancebarnett/2015/06/09/trends-show-crowdfunding-to-surpass-vc-in-2016/ [http://web.archive.org/web/20161214204235/http://www.forbes.com/sites/chancebarnett/2015/06/09/trends-show-crowdfunding-to-surpass-vc-in-2016/#7d2c034538c0] (estimating that crowdfunding could exceed $34 billion in 2015, and noting that traditional venture capital funds invest an average of $30 billion a year); *see also* Chuck Klosterman, *Was It Ethical for Zach Braff to Take to Kickstarter?*, N.Y. TIMES (May 24, 2013), http://www.nytimes.com/2013/05/26/magazine/was-it-ethical-for-zach-braff-to-take-to-kickstarter.html [https://perma.cc/LD49-9LMF] (discussing Zach Braff's crowdfunding campaign).

[5] *See* Jumpstart Our Business Startups Act, 15 U.S.C. §§ 77d, 77d-1, 77r, 78c, 78l, 78o (2012); Press Release, SEC, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015), http://www.sec.gov/news/pressrelease/2015-249.html [https://perma.cc/ES5X-6D6Z] (announcing that the SEC had voted on October 30, 2015 to implement Title III of the Jumpstart Our Business Startups ("JOBS") Act starting in mid-2016). The SEC announced that the JOBS Act's crowdfunding rules would be effective 180 days after they were published in the Federal Register. Press Release, SEC, *supra*. The rules were published in the Federal Register on November 16, 2015, which makes their effective date May 16, 2016. *See* Title III of the JOBS Act, 80 Fed. Reg. 71,387, 71,388 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, 274).

[6] *See* 15 U.S.C. § 77d(a)(6); *see also* Richard A. Epstein, *The Political Economy of Crowdsourcing: Markets for Labor, Rewards, and Securities*, 82 U. CHI. L. REV. DIALOGUE 35, 47 (2015), https://lawreview.uchicago.edu/sites/lawreview.uchicago.edu/files/uploads/Epstein_Dialogue_2.pdf [https://perma.cc/9NS6-D2RT] (noting that it is "quite clear" that the regulatory scheme for securities offerings is too burdensome to be operable for small ventures); Andrew Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1469 (2013) (estimating that compliance with securities registration requirements can require over 1200 hours of work from attorneys, underwriters, and accountants). A "startup" is a company that is formed by one or several entrepreneurs with the hope that the company will experience rapid growth and eventually become a much larger company. *See* John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 ARIZ. ST. L.J. 861, 864 (2005) (discussing "rapid-growth" start-up companies).

purchase those securities.[7] The Act also includes protections for investors who could potentially fall victim to fraudulent crowdfunding campaigns.[8] Congress's concerns about fraud were legitimate considering the Internet-based nature of crowdfunding under the Act, as is illustrated by past examples of deceptive crowdfunding campaigns.[9]

The purpose of the JOBS Act is to encourage innovation and economic growth in the United States by giving entrepreneurs easier access to capital.[10] This is a worthwhile goal considering that an active entrepreneurial environment has long been considered by economists to be vital to a well-functioning economy.[11] Entrepreneurs contribute to "creative destruction," a phrase coined

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[7] *See* 15 U.S.C. § 77d(a)(6)(A)–(B).

[8] *See id.* § 77d-1(c) (providing a remedy to investors who have been subject to a fraudulent offering); David Mashburn, *The Anti-Crowd Pleaser: Fixing the Crowdfund Act's Hidden Risks and Inadequate Remedies*, 63 EMORY L.J. 127, 151, 155–57 (providing an overview of the liability provisions of the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act ("CROWDFUND Act" or the "Act")).

[9] *See* 158 CONG. REC. S1,766 (daily ed. Mar. 19, 2012) (statement of Sen. Harry Reid) (expressing concern for investor protection during debate regarding the crowdfunding exemption); 158 CONG. REC. S1,781 (daily ed. Mar. 19, 2012) (statement of Sen. Carl Levin) (expressing investor protection concerns in response to the crowdfund exemption); *see also* Press Release, FTC, Crowdfunding Project Creator Settles FTC Charges of Deception (June 11, 2015), https://www.ftc.gov/news-events/press-releases/2015/06/crowdfunding-project-creator-settles-ftc-charges-deception [https://perma.cc/NGJ2-VQAU] (providing an overview of a recent settlement between the Federal Trade Commission ("FTC") and an entrepreneur who allegedly used an online crowdfunding platform to engage in deceptive practices). Although the risk of fraud in crowdfunding is not the focus of this Note, it is an issue that has attracted scholarly attention. *See generally, e.g.*, Jacques F. Baritot, *Increasing Protection for Crowdfunding Investors Under the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 259 (2013) (focusing on the risks of fraud in crowdfunding and how the Securities and Exchange Commission ("SEC") can best protect investors); Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735 (2012) (discussing the risk of fraud on Internet crowdfunding campaigns and arguing that meaningful disclosures are necessary to protect investors); Thomas G. James, *Far From the Maddening Crowd: Does the JOBS Act Provide Meaningful Redress to Small Investors for Securities Fraud in Connection with Crowdfunding Offerings?*, 54 B.C. L. REV. 1767 (2013) (discussing the investor risk introduced by the JOBS Act).

[10] *See* 158 CONG. REC. S2,230 (daily ed. Mar. 29, 2012) (statement of Sen. Pat Toomey) (stating that the JOBS Act "sets the framework for developing a new market in which entrepreneurs can raise capital and ordinary investors can invest in new ideas"); 158 CONG. REC. H1,277 (daily ed. Mar. 8, 2012) (statement of Rep. Patrick McHenry) ("[E]entrepreneurship is at a 17-year low in the United States . . . so what [the crowdfunding provision of the JOBS Act] does is it enables investors to connect with start-ups."); *see also Remarks by the President at JOBS Act Bill Signing*, WHITEHOUSE.GOV (Apr. 5, 2012), https://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing [https://perma.cc/VAS7-628L] ("[N]o matter how good their ideas are, if an entrepreneur can't get a loan from a bank or backing from investors, it's almost impossible to get their businesses off the ground.").

[11] *See* David M. Hart, *Entrepreneurship Policy: What It Is and Where It Came From*, *in* THE EMERGENCE OF ENTREPRENEURIAL POLICY 3, 3–6 (David M. Hart ed., 2003) (explaining a connection between entrepreneurial policy and a healthy capitalist economy); Ronald J. Gilson & Reiner Kraakman, *Takeovers in the Boardroom: Burke Versus Schumpeter*, 60 BUS. L. 1419, 1431 (2005) (describing the "creative destruction" economic concept and how innovation contributes to economic

to describe the positive effect that innovation has on a capitalist economy.[12] The concept is illustrated by startups that continue to shake up industries perpetuating an atmosphere of innovation and creating jobs in the process.[13]

Launching and growing a successful startup is extremely capital-intensive, however, which is why Congress identified that legislation like the JOBS Act was necessary.[14] Entrepreneurs need easier access to early-stage financing in order to bridge the "capital gap"—the disparity between the amount of capital required by a startup in its infancy and the amount that investors are willing to extend to startups at that point.[15] Startups are especially vulnerable to failure during the capital gap, prompting some to refer to it as the "valley of death."[16]

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progress); Orcutt, *supra* note 6, at 861 (citing JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 83 (3d ed. 1950)) (providing an overview of economist Joseph Schumpeter's theory of "creative destruction" and its relation to entrepreneurship).

[12] *See* Hart, *supra* note 11, at 5–6; Gilson & Kraakman, *supra* note 11, at 1431.

[13] *See, e.g.*, Steve Lohr, *Lessons from ZocDoc, a Health Tech Start-Up That Works*, N.Y. TIMES (Jan. 30, 2012, 2:28 PM), http://bits.blogs.nytimes.com/2012/01/30/lessons-from-zocdoc-a-health-tech-start-up-that-works/?_r=0 [https://perma.cc/3S4H-GSNF] (discussing a startup revolutionizing the process of booking doctor appointments); Vanessa O'Connell, *Warby Parker Co-Founder Says Initial Vision Was All About Price*, WALL ST. J. (July 18, 2012, 8:00 PM), http://www.wsj.com/articles/SB10000872396390444097904577535111565440718 [https://perma.cc/F4NE-7ZSR] (discussing a startup revolutionizing the eyewear market); Jessica Salter, *Airbnb: The Story Behind the $1.3bn Room-Letting Website*, THE TELEGRAPH (Sept. 7, 2012, 7:00 AM), http://www.telegraph.co.uk/technology/news/9525267/Airbnb-The-story-behind-the-1.3bn-room-letting-website.html [https://perma.cc/C3QU-25V8] (discussing a startup revolutionizing the market for travel lodging); *see also* Matthew Diebel, *Warby Parker: A Visionary Approach to Selling Eyewear*, USA TODAY (Dec. 1, 2014), http://www.usatoday.com/story/money/business/2014/11/30/warby-parker-selling-stylish-eyewear-cheaper/70060670/ [http://web.archive.org/web/20160614194714/http://www.usatoday.com/story/money/business/2014/11/30/warby-parker-selling-stylish-eyewear-cheaper/70060670/] (stating that startup company Warby Parker employs 400 people in its New York City office).

[14] *See* 158 CONG. REC. H1,277 (daily ed. Mar. 8, 2012) (statement of Rep. Patrick McHenry) (referring to the burdensome "red tape" that the SEC creates for startups that practically hinders their efforts to raise capital); *see also* Mark Lennon, *CrunchBase Reveals: The Average Successful Startup Raises $41M, Exits at $242.9M*, TECHCRUNCH (Dec. 14, 2013), http://techcrunch.com/2013/12/14/crunchbase-reveals-the-average-successful-startup-raises-41m-exits-at-242-9m/ [https://perma.cc/6SZT-ZT4N] (stating that the average successful startup has raised $41 million).

[15] Jeffrey E. Sohl, *The U.S. Angel and Venture Capital Market: Recent Trends and Developments*, 6 J. PRIVATE EQUITY 7, 14 (2003); Sramana Mitra, *Can Crowdfunding Solve the Startup Capital Gap?*, HARV. BUS. REV. (July 24, 2013), https://hbr.org/2013/07/can-crowdfunding-solve-the-sta/ [https://perma.cc/5BHP-3PML]; *see* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1416–17 (2008) (providing an overview of angel investors); Falon Donohue, *Understanding the "Capital Gap,"* VENTURE OHIO (Nov. 15, 2015), http://www.ventureohio.org/uncategorized/understanding-the-capital-gap/ [https://perma.cc/W7SJ-FRMG] (describing the capital gap in the startup context).

[16] *E.g.*, Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 60 (1998) (discussing that a primary reason for business failure is a lack of capital); Ibrahim, *supra* note 15, at 1417; Mitra, *supra* note 15; Martin Zwilling, *10 Ways for Startups to Survive the Valley of Death*, FORBES (Feb. 18, 2013, 11:30 PM), http://www.forbes.com/sites/martinzwilling/2013/02/18/10-ways-for-startups-to-survive-the-valley-of-death/#68ae93185e40 [http://web.archive.org/web/20160428155732/http://www.forbes.com/sites/martinzwilling/2013/02/

Further, the lack of gender and racial diversity in the entrepreneurial landscape in the United States makes survival even more difficult for entrepreneurs who do not fit the startup financing status quo of primarily white men from elite universities.[17] Traditional sources of capital for entrepreneurs have historically been effectively unavailable to women and minorities.[18] This problem is exacerbated by the exclusive social dynamics in the venture capital market, where the strength of an entrepreneur's network is often as important as the strength of his or her idea.[19] Although there are financing alternatives to venture capital and angel investors—the two methods traditionally used by entrepreneurs to launch new businesses—one study shows that, on average, suc-

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18/10-ways-for-startups-to-survive-the-valley-of-death/#1c30b55f5d68] (referring to the capital gap as the "valley of death").

[17] *See* CANDIDA BRUSH, DIANA PROJECT, WOMEN ENTREPRENEURS 2014: BRIDGING THE GENDER GAP IN VENTURE CAPITAL 7 (2014) (presenting empirical data on gender inequality in startup financing); KEVIN LAWTON & DAN MAROM, THE CROWDFUNDING REVOLUTION 65 (2012) (noting that 8% of startups that receive venture capital funding are run by women); BARBARA ORSER & CATHERINE ELLIOTT, FEMININE CAPITAL: UNLOCKING THE POWER OF WOMEN ENTREPRENEURS 1 (2015) (discussing how being female can be viewed as an "entrepreneurial handicap"); Jessica Guynn & Elizabeth Weise, *Lack of Diversity Could Undercut Silicon Valley*, USA TODAY (Aug. 15, 2014), http://www.usatoday.com/story/tech/2014/06/26/silicon-valley-tech-diversity-white-asian-black-hispanic-google-facebook-yahoo/11372421/ [http://web.archive.org/web/20161215051334/http://www.usatoday.com/story/tech/2014/06/26/silicon-valley-tech-diversity-white-asian-black-hispanic-google-facebook-yahoo/11372421/] (presenting empirical evidence of the underrepresentation of black and Hispanic employees in the technology industry); Timothy Hay, *Female-, Minority-Run Startups Have Tougher Fundraising Road, Study Says*, WALL ST. J. TECH. (Oct. 30, 2014, 8:00 AM), http://blogs.wsj.com/venturecapital/2014/10/30/female-minority-run-startups-have-tougher-fundraising-road-study-says/ [https://perma.cc/87W6-QFEX] (discussing racial inequality in startup financing); Michelle Leder, *Main Street VCs*, INC. (Dec. 1, 2004), http://www.inc.com/magazine/20041201/finance.html [https://perma.cc/T3LA-5PP4] (discussing venture capitalists preference to be within an hour drive of the startups in which they invest); Claire Cain Miller, *Female-Run Venture Capital Funds Alter the Status Quo*, N.Y. TIMES (Apr. 1, 2015), http://www.nytimes.com/2015/04/02/business/dealbook/female-run-venture-funds-alter-the-status-quo.html?_r=0 [https://perma.cc/QJC5-9V52] (discussing the status quo in venture capital that leaves women underrepresented); *see also* TrueBridge Capital, *The Education of Venture Capitalists: Midas List 2013 Edition*, FORBES (May 9, 2013, 9:02 AM), http://www.forbes.com/sites/truebridge/2013/05/09/the-education-of-venture-capitalists-midas-list-2013-edition/#25a355c24684 [http://web.archive.org/web/20150910042424/http://www.forbes.com/sites/truebridge/2013/05/09/the-education-of-venture-capitalists-midas-list-2013-edition/] (listing the colleges with the most venture capitalist alumni, with Stanford, Harvard, Brown, Dartmouth, and MIT making up the top five).

[18] LAWTON & MAROM, *supra* note 17, at 65; Hay, *supra* note 17.

[19] *See* Candida Brush et al., *Venture Capital Access: Is Gender an Issue?*, *in* THE EMERGENCE OF ENTREPRENEURSHIP POLICY, *supra* note 11, at 141, 150–51 (discussing how venture capitalists tend to deal with entrepreneurs who are like them, meaning that it is harder to get a venture capitalist's attention without some connection); Alex Iskold, *8 Things You Need to Know About Raising Venture Capital*, ENTREPRENEUR (July 15, 2015), http://www.entrepreneur.com/article/248377 [https://perma.cc/C7RA-MCSG] (explaining how venture capitalists view an entrepreneur's ability to utilize his or her network as evidence of the entrepreneur's "hustle," and that venture capitalists also feel more comfortable considering investing in someone who is somehow connected to them); *see also* TrueBridge Capital, *supra* note 17 (showing the prevalence of alumni from elite universities in the venture capital field).

cessful startups raise $41 million from those two sources.[20] This places entrepreneurs ignored by venture capitalists and angel investors at a significant comparative disadvantage.[21]

Crowdfunding has the potential to mitigate this problem.[22] Crowdfunding combines the far-reaching access of social networking with finance, and therefore provides all entrepreneurs, regardless of background, the opportunity to pitch their idea to a community of investors.[23] The crowdfunding exemption under the JOBS Act, however, limits entrepreneurs to raising $1 million annually, which is an insufficient amount to allow crowdfunding to realize its potential to break the startup financing status quo.[24]

This Note argues that the JOBS Act should be amended to raise the annual cap on crowdfunded securities from $1 million to $5 million—the highest the SEC is authorized to raise the cap under Section 3(b) of the Securities Act—so that entrepreneurs can more easily access capital.[25] Such an amendment would help entrepreneurs bridge the capital gap and would further democratize the market for startup financing by giving all entrepreneurs equal opportunity to raise more capital regardless of background.[26] Part I provides an

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[20] Lennon, *supra* note 14.

[21] *See id.*

[22] *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5 (discussing the revolutionary nature of crowdfunding); John S. Wroldsen, The Social Network *and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 594, 601 (2013) (discussing the transformative power of crowdfunding, and arguing that the JOBS Act wrongly forces the innovative technology of crowdfunding into a traditional regulatory scheme); Zachary J. Gubler, *Inventive Funding Deserves Creative Regulation*, WALL ST. J. (Jan. 31, 2013, 6:50 PM), http://www.wsj.com/articles/SB10001424127887323468604578251913868617572 [https://perma.cc/822T-6ENH] ("Crowdfunding has the potential to revolutionize the financing of small business, transforming millions of users of social media . . . into venture capitalists, and giving life to valuable business ideas that might otherwise go unfunded."); Mitra, *supra* note 15 (discussing crowdfunding as a potential solution to the startup capital gap). *See generally* LAWTON & MAROM, *supra* note 17 (providing an overview of how crowdfunding is a significant technological leap forward in the evolution of how startups fund themselves).

[23] *See* LAWTON & MAROM, *supra* note 17, at ix, xiii (describing how crowdfunding is similar to social networking and gives affinity groups the ability to financially support its members). *See generally* Kristen Dell, *Crowdfunding*, TIME (Sept. 4, 2008), http://content.time.com/time/magazine/article/0,9171,1838768,00.html [https://perma.cc/6H9L-XT74] (describing crowdfunding as "one part social networking and one part capital accumulation"); Gubler, *supra* note 22 (arguing that crowdfunding's social media characteristics could help fund quality business ideas that may have gone unnoticed without crowdfunding).

[24] *See* JD Alois, *Doug Ellenoff Reflects on 2015. Sees Opportunity in Reg CF/Title III Crowdfunding*, CROWDFUND INSIDER (Dec. 22, 2015), http://www.crowdfundinsider.com/2015/12/79190-doug-ellenoff-reflects-on-2015-sees-opportunity-in-reg-cf-title-iii-crowdfunding/ [https://perma.cc/EEF7-VZLY] (quoting Doug Ellenoff, an investor advocating for the JOBS Act's cap be raised from $1 million to $5 million so that the legislation can be useful to entrepreneurs); *see also* Lennon, *supra* note 14 (showing that the average successful startup raised $41 million before either being acquired by a larger corporation or launching an initial public offering).

[25] *See infra* notes 211–235 and accompanying text.

[26] *See infra* notes 211–235 and accompanying text.

overview startup financing.[27] Part II discusses some of the problems with the market for startup financing, including its diversity problem.[28] Part III introduces the concept of crowdfunding and how it worked leading up to the JOBS Act.[29] Part IV provides an overview of the crowdfunding exemption under the JOBS Act.[30] Finally, Part V argues that if Congress were to raise the JOBS Act's annual cap on crowdfunding securities to $5 million it could mitigate the lack of diversity in the startup market.[31]

I. THE MARKET FOR STARTUP FINANCING

One study shows that the average successful startup has raised an average of $41 million.[32] It is therefore crucial that an entrepreneur has access to the various sources of capital available for startups.[33] Entrepreneurs have several options when considering how to finance their startup.[34] The common options include debt financing, equity financing, financing through a venture capital fund or angel investor, or several alternative forms of startup financing.[35] This Part provides an overview of each.[36]

Debt financing includes traditional bank loans, and is more often used to fund small businesses rather than startups.[37] Small businesses, in general, differ from startups by not focusing on innovation or high-growth, and are there-

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[27] *See infra* notes 32–70 and accompanying text.

[28] *See infra* notes 71–103 and accompanying text.

[29] *See infra* notes 104–166 and accompanying text.

[30] *See infra* notes 167–210 and accompanying text (arguing for an increased crowdfunding exemption).

[31] *See infra* notes 211–235 and accompanying text.

[32] Lennon, *supra* note 14. There are two ideal "exits" for a startup: an initial public offering ("IPO") and acquisition. *Id.* This study defined "successful startup" as one that achieved one of those exits. *Id.* It found that startups that exited through acquisition raised $29.4 million on average, and startups that exited with an IPO raised $162 million. *Id.* Overall, it found that of the startups that have reached an exit between 2007 and 2013, the average amount raised by those startups was $41 million. *Id.*

[33] *See id.*; *see also* Fisch, *supra* note 16, at 60 (noting that "lack of capital" is a primary reason why businesses fail).

[34] *See infra* notes 37–70 and accompanying text.

[35] *See infra* notes 37–70 and accompanying text.

[36] *See infra* notes 37–70 (describing the current structure of the startup financing market).

[37] *See* Fisch, *supra* note 16, at 60–61 (citing Rebel Cole et al., *Bank and Nonbank Competition for Small Business Credit: Evidence from the 1987 and 1993 National Survey of Small Business Finances*, 82 FED. RES. BULL. 983, 988 tbl. 4 (1996) (explaining a 1993 survey determining that banks supply more than 60% of small business credit)); *see also* Orcutt, *supra* note 6, at 869–70 (discussing why loan financing is generally not appropriate for a startup). An important distinction between a "small business" and a "startup" is that startups are innovative in nature and have ambitions for high-growth. Orcutt, *supra* note 6, at 862–23. Small businesses generally include businesses like local convenience stores and barber shops, without much innovation or intentions for rapid growth. *Id.*

fore safer investments than startups for banks.[38] Thus, private loans are difficult for entrepreneurs to secure because they generally lack the stability or reliability that banks prefer when making lending decisions.[39] Even if an entrepreneur is able to secure a bank loan, however, the cash flow demands on a business financed by standard loans generally makes it an impractical financing strategy for startups.[40]

Another option for financing a startup is equity financing, which involves an offer of securities in a company that investors will purchase in the hope of seeing a return on the investment.[41] Equity financing provides a startup with capital without the cash flow demands of debt financing.[42] There are, however, a number of barriers that typically keep equity financing out of reach for startups.[43] An initial public offering ("IPO"), for example, involves substantial transaction costs.[44] These include the costs of registering with the SEC pursuant to federal securities laws, which requires the services of attorneys and underwriters.[45] Further, a successful equity issuance depends on investors believing that they will see a return on their purchase of equity in a business; early-stage startups may therefore struggle to generate enough confidence among investors in an offering to make the high cost economically reasonable.[46] Not until a startup has been able to prove itself as a viable long-term investment, generally with the help of venture capital or angel investor financing, does equity financing become a practical source of capital for a startup.[47]

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[38] *See* Orcutt, *supra* note 6, at 862–23 (explaining differences between "small businesses" and "startups").

[39] *See* Fisch, *supra* note 16, at 61; Orcutt, *supra* note 6, at 869–70.

[40] Fisch, *supra* note 16, at 61. Financing a small business through bank loans is a form of debt financing, which means that it will require the business to make payments to the bank, including interest, to repay the loan. *Id.* In order to make payments to a bank, a business will need a source of cash flow coming into the business. *Id.* Startups often do not generate cash flow in their early stages, and therefore the cash flow-dependent nature of bank loans is generally not a practical source of capital for startups. *Id.*

[41] *Id.* Investors will see a return on their investment if the company does well, because when a company does well the value of its equity will increase. *Id.*

[42] *Id.* Unlike loans, equity financing does not require an entrepreneur to make repayments to the investor who holds equity in the company. *Id.* Some companies that issue equity may make cash payments to equity holders in the form of dividends, but companies are not required to do this. *Id.*

[43] *See id.* ("The transaction and regulatory costs associated with an initial public offering (IPO) are substantial."); Schwartz, *supra* note 6, at 1468–70 (explaining the regulatory costs to a registered offering).

[44] Fisch, *supra* note 16, at 61; Schwartz, *supra* note 6, at 1468–70.

[45] Fisch, *supra* note 16, at 61; Schwartz, *supra* note 6, at 1468–70.

[46] *See* Fisch, *supra* note 16, at 61 ("A small business without a proven track record may . . . have difficulty obtaining the services of a reputable underwriter and, without those services, may be unable to market its securities adequately.").

[47] *See* Eugene Choo, *Going Dutch: The Google IPO*, 20 BERKLEY TECH. L.J. 405, 408–13 (2005) (providing an overview of the venture capital and IPO process for startups). *See generally* Conner Forrest, *Startups: How to Know When It's Time to IPO*, TECHREPUBLIC (Feb. 24, 2014), http://www.techrepublic.com/article/startups-how-to-know-when-its-time-to-ipo/ [https://perma.cc/ZC9P-73ZK]

Venture capital financing, one of the most traditional forms of startup financing, involves a venture capital fund extending financing to a startup, generally through several rounds.[48] Venture capital funds are a popular source of capital for startups because they offer financing before a startup can afford to launch an IPO.[49] Venture capital financing is a form of equity financing because in return for investing in the startup, venture capitalists generally receive preferred stock in the company.[50]

The sophisticated investors who operate venture capital funds take large ownership stakes in early-stage startups, hoping to see a return on their investments when the startups go public or are acquired by or merge with another company.[51] Venture capitalists, therefore, will often take an active role in the

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(explaining the factors that are important to a startup's decision to go public, including the importance of demonstrating long-term investment viability).

[48] *See* Fisch, *supra* note 16, at 61–62 (discussing venture capital and how venture capitalists invest in a business in its early stages, before an IPO is possible); Chad Brooks, *What Is Venture Capital?*, BUS. NEWS DAILY (Apr. 1, 2013, 12:16 PM), http://www.businessnewsdaily.com/4252-venture-capital.html [https://perma.cc/7P85-942K] (explaining that entrepreneurs, whose businesses are "new, unproven, and risky" turn to venture capitalists because traditional forms of financing, like banks, are generally unwilling to incur the risk). Venture capital financing rounds generally start with a "Series A" financing, with follow-up financing rounds (if the venture capital fund decides to continue extending capital to the startup) referred to as "Series B" financing, and so on. *See* DEVLYN TEDESCO, ALBANY LAW SCH. GOV'T LAW CTR., AN OVERVIEW OF THE VENTURE CAPITAL PROCESS FOR ENTREPRENEURS 1–3 (2013) (providing an overview of the procedure venture capitalists go through when investing in a startup); *see also* Wroldsen, *supra* note 22, at 585 (pointing out venture capital's place in popular culture after the movie *The Social Network* based on Facebook's early growth was released).

[49] *See* Fisch, *supra* note 16, at 61.

[50] *See* Barry J. Kramer & Michael J. Patrick, *Explanations of Certain Terms Used in Venture Financing Terms Survey*, FENWICK & WEST LLP (Feb. 23, 2012), https://www.fenwick.com/publications/pages/explanation-of-certain-terms-used-in-venture-financing-terms-survey.aspx [https://perma.cc/AY4Q-3BS3]. Preferred stock differs from common stock by granting its holder some additional rights and protections, like liquidation preferences, dividend rights, redemption rights, conversion rights, and voting rights. *See id.* Venture capitalists use preferred stock because those rights and protections allow them to maintain control of the startups in which they invest, and there also may be tax benefits to using preferred stock. *See id. See generally* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874 (2003) (examining the complex tax incentives that are partially responsible for the predominance of preferred stock in venture capital financing contracts).

[51] *See* Kramer & Patrick, *supra* note 50. Venture capitalists are able to take large equity stakes in a startup before the startup goes public because the startup will make small, private offerings of equity to the venture capitalist. *See id.* (discussing the preferred stock rights that venture capitalist generally take in the startups in which they invest). *See generally* George Deeb, *Comparing Equity, Debt, and Convertibles for Startup Financing*, FORBES (Mar. 19, 2014), http://www.forbes.com/sites/georgedeeb/2014/03/19/comparing-equity-vs-debt-vs-convertibles-for-startup-financings/#36ad9fbb6aa3 [http://web.archive.org/web/20170204135443/http://www.forbes.com/sites/georgedeeb/2014/03/19/comparing-equity-vs-debt-vs-convertibles-for-startup-financings/#6ae78fbb5d78] (providing an overview of a standard "Series A" round of venture capital financing).

management and development of a startup in which they invest to increase the likelihood of success.[52]

Venture capital financing is hard to come by, however, with some estimating that venture capitalists decline to invest in all but a very small number of startups.[53] A venture capitalist's decision to extend financing to an entrepreneur is informed by intensive due diligence about the entrepreneur and his or her business, including calculating potential rates of return on the investment and reaching out to the entrepreneur's references.[54] In most cases, an entrepreneur will need to network his or her way into an introduction with a venture capitalist before their startup will be seriously considered for venture financing.[55] Further, venture capitalists generally do not make their funds available for the initial growth needs of a startup, which means that an entrepreneur will likely have to turn to other sources of capital to operate at least until he or she is established enough to be considered by a venture capitalist.[56]

Angel investors provide another financing option and have much in common with venture capital investors.[57] Similar to venture capitalists, angel investors take a strong personal interest in the entrepreneurs in whom they invest.[58] Unlike venture capitalist, however, angel investors tend to have more entrepreneurial experience of their own, and often invest with the intention of being more closely involved in the management of the startup.[59] Another important distinction between angel investors and venture capitalists is that angel

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[52] *See* TEDESCO, *supra* note 48, at 2–3 (discussing the managerial benefits that venture capitalists, who often sit on the board of directors of the companies in which they invest, provide); Dana M. Warren, *Venture Capital Investment: Status and Trends*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 1, 12 (2012) (discussing the oversight that venture capitalists like to keep over the startups in which they invest).

[53] *See, e.g.*, TEDESCO, *supra* note 48, at 6; Bradford, *supra* note 22, at 103; Fisch, *supra* note 16, at 62; *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-00-190, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 3, 13, 19 (2000) (measuring venture capital activity and noting a trend showing that it has become harder for early-stage startups to secure financing).

[54] *See* TEDESCO, *supra* note 48, at 3–4 (describing venture capitalists' due diligence process); Richard Sudek, *Angel Investment Criteria*, 17 J. SMALL BUS. STRATEGY 89, 89–90 (2007) (explaining some of the steps that venture capitalists take as they make investment decisions).

[55] *See* Brush et al., *supra* note 19, at 150–51 (discussing how venture capitalists tend to deal with entrepreneurs who are like them, meaning that it is harder to get a venture capitalist's attention without some connection); Iskold, *supra* note 19 (explaining how venture capitalists view an entrepreneur's ability to utilize his or her network as evidence of the entrepreneur's "hustle," and that venture capitalists also feel more comfortable considering investing in someone who is somehow connected to them).

[56] Fisch, *supra* note 16, at 62. The period of time between a startup is formed and the time that it has established a potential success is known as the "seed stage." *Id.* At this point startups are especially high-risk investments, which is why venture capitalists will generally prefer to wait for a startup to at least somewhat establish itself before investing. *Id.*

[57] Orcutt, *supra* note 6, at 876.

[58] Fisch, *supra* note 16, at 62; Sudek, *supra* note 54, at 90.

[59] Sudek, *supra* note 54, at 90.

investors invest their own money, rather than drawing money from a venture capital fund.[60]

In addition, when making investment decisions, angel investors rely less on formal due diligence than do venture capitalists.[61] Venture capitalists inform their investing decisions with hours of financial due diligence, whereas angel investors are more likely to rely on instincts accumulated through their own entrepreneurial experiences.[62] Further, although venture capitalists have recently demonstrated a preference against investing in early stage startups, angel investors are more likely to invest in a startup during its infancy.[63]

Finally, entrepreneurs unable to attract the attention of venture capitalists or angel investors, and who cannot rely on bank loans or afford an equity offering, may seek funding through several different innovative financing instruments that combine the characteristics of debt and equity.[64] These financial instruments are referred to as "convertible debt," and include bridge notes, simple agreements for future equity ("SAFEs") and the Keep It Simple Security ("KISS").[65] Each of these instruments begin as a debt instrument, meaning that an investor will extend money to a startup similar to a bank extending a loan.[66] Unlike traditional loan financing, however, investors holding convertible debt will generally not require the startup to make periodic repayments on the loan, which means that startups can rely on convertible debt without facing the cash flow demands of bank loans.[67] In place of repayments on the loan, the investor will hold convertible debt on the promise that when the startup issues

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[60] Orcutt, *supra* note 6, at 877.

[61] Fisch, *supra* note 16, at 62 (noting that angel investors are more "informal" than venture capitalists); Sudek, *supra* note 54, at 89.

[62] *See* Sudek, *supra* note 54, at 90 (comparing and contrasting the approaches that venture capitalists and angel investors take when making investing decisions).

[63] *See* Orcutt, *supra* note 6, at 876 (noting that angel investors typically invest in startups in their early stages); Sudek, *supra* note 54, at 89.

[64] *See* David Sorin & Matthew Uretsky, *KISS the SAFE Goodbye? Another Alternative for Start-up Financing*, ABOVE LAW (May 22, 2015, 10:02 AM), http://abovethelaw.com/2015/05/kiss-the-safe-goodbye-another-alternative-for-start-up-financing/ [https://perma.cc/7M2U-DSC8] (describing "KISS" securities as a "hybrid" that seeks to "embody the simplicity and ease of use of SAFEs with some of the investor protections associated with convertible notes"); Yoichiro Taku, *What Is Convertible Equity (Or a Convertible Security)?*, STARTUP COMPANY LAW (Aug. 13, 2012), http://www.startupcompanylawyer.com/category/convertible-note-bridge-financing/ [https://perma.cc/EAH7-5BVV] (providing an overview of convertible debt as an alternative to traditional equity for startups); Scott E. Walker, *Everything You Ever Wanted to Know About Convertible Note Seed Financings (But Were Afraid to Ask)*, TECHCRUNCH (Apr. 7, 2012), http://techcrunch.com/2012/04/07/convertible-note-seed-financings/ [https://perma.cc/W7UZ-QHZU] (providing an overview of convertible debt in the context of startup financing).

[65] *See* Sorin & Uretsky, *supra* note 64 (discussing SAFEs and KISSs instruments); Walker, *supra* note 64.

[66] Sorin & Uretsky, *supra* note 64; Walker, *supra* note 64.

[67] Sorin & Uretsky, *supra* note 64; Walker, *supra* note 64.

equity, including a private equity offering as part of a venture capital financing round, the debt instrument will convert to equity.[68]

Convertible debt may be more palatable to investors in early-stage startups because they offer investors the promise of repayment if the startup does not live to see an equity issuance.[69] Convertible debt can therefore be an attractive choice for early stage startups trying to survive, but it is not suitable as a standalone form of long-term financing.[70]

II. ISSUES FACING THE STARTUP FINANCING MARKET, INCLUDING THE DIVERSITY PROBLEM

The demand for startup financing far exceeds its supply, a fact that has had an especially negative impact on minority entrepreneurs.[71] Section A of this Part explores how this dynamic contributes to a "valley of death" problem for new startups.[72] Section B discusses the diversity problem in the startup financing market.[73]

A. The "Valley of Death"

A capital gap exists when a startup requires cash to operate and grow, but is still too immature to generate interest from investors.[74] Although venture capitalists often do invest in early-stage startups, the startup will nonetheless need some source of capital to sustain itself from formation until the point that it strikes a deal with a venture capitalist (or some other type of financier); the

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[68] *See* Scott E. Walker, *Convertible Note Seed Financings: Econ 101 for Founders*, TECHCRUNCH (Apr. 21, 2012), http://techcrunch.com/2012/04/21/convertible-note-seed-financings-econ-101/ [https://perma.cc/CDW5-YXV5] (providing an overview of the convertible debt conversion process).

[69] *See* Scott E. Walker, *Convertible Note Seed Financings: Founders Beware!*, TECHCRUNCH (May 13, 2012), http://techcrunch.com/2012/05/13/convertible-note-seed-financings-part-3/ [https://perma.cc/969Z-F8QA] (discussing what happens to convertible debt if it does not convert).

[70] *Id.*; *see* Adam Levine-Weinberg, *Why Convertible Bonds Can Be Very Expensive*, MOTLEY FOOL (Nov. 11, 2014), http://www.fool.com/investing/general/2014/11/11/why-convertible-bonds-can-be-very-expensive.aspx [https://perma.cc/GY5H-6PWX] (describing the hidden costs and risks of convertible debt, including the risk of diluting the upside for other investors in a startup, to explain why startups should not rely heavily on convertible debt).

[71] *See infra* notes 74–103 and accompanying text.

[72] *See infra* notes 74–78 and accompanying text.

[73] *See infra* notes 79–103 and accompanying text.

[74] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 53, at 3, 13 (discussing the unmet need for financing among entrepreneurs seeking between $250,000 and $5 million); Ibrahim, *supra* note 15, at 1416–17 (discussing how the capital gap is a problem that especially affects startups in their earliest stages); Sohl, *supra* note 15, at 14–15 (providing background information regarding the capital gap problem); Donohue, *supra* note 15 (providing an overview of the capital gap); Mitra, *supra* note 15 (discussing how 99% of entrepreneurs find themselves rejected by venture capitalists and angel investors).

capital gap exists in that window.[75] Angel investors are the most likely type of startup investor to fill this gap, but their involvement is insufficient to address the overall capital gap felt by startups across the country.[76] The capital gap for startups generally affects entrepreneurs who are looking for up to $2 million.[77] A startup stuck in the capital gap is extremely vulnerable to failure, which is why some refer to it as the "valley of death."[78]

B. The Diversity Problem

With evidence suggesting that venture capitalists and angel investors reject nearly all the entrepreneurs who apply for financing, and evidence that all entrepreneurs are vulnerable to the threats posed by the capital gap, there is clearly an unmet need in the market for startup financing.[79] Evidence further suggests that women and minorities are disproportionately ignored by traditional forms of startup financing.[80] This is a problem because successful startups need significant amounts of capital, and therefore those entrepreneurs who are overlooked by traditional sources of startup financing are at a serious disadvantage.[81]

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[75] *See* Ibrahim, *supra* note 15, at 1417. Venture capitalists want to invest in early-stage startups because it maximizes their chances of significant returns if they get involved on the ground floor. *See id.* Nevertheless, early-stage startups are risky investments, so a venture capitalist will also want to wait to invest money in a startup for as long as possible to still also enjoy the ground floor returns, and that is why a capital gap forms. *See id.*

[76] *See id.* at 1420 (discussing how angels can be beneficial to startups who need operating capital until they can attract venture capital); Mitra, *supra* note 15 (pointing out that 99% of startups are "outside the realm" of angel investors' networks).

[77] U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 53, at 3, 13; Ibrahim, *supra* note 15, at 1417; Mitra, *supra* note 15.

[78] *See* Zwilling, *supra* note 16 (discussing the "valley of death"); *Definition of Death Valley Curve*, INVESTOPEDIA, http://www.investopedia.com/terms/d/death-valley-curve.asp [https://perma.cc/NN4D-HJ9B]; *see also* Fisch, *supra* note 16, at 60 (pointing out that lack of capital is second only to management error as the major cause for business failure).

[79] *See* ORSER & ELLIOTT, *supra* note 17, at 134 ("Angels typically reject 97 percent of proposals, three out of four at first sight."); TEDESCO, *supra* note 48, at 3 (citing THEODORE M. HAGELIN, TECHNOLOGY INNOVATION LAW AND PRACTICE: CASES AND MATERIALS 1257 (2011)) (stating that only 1% of entrepreneurs who apply for venture capital financing are accepted); Fisch, *supra* note 16, at 63 ("[F]unding availability for small business is often viewed as inadequate"); *see also* Ibrahim, *supra* note 15, at 1417 (explaining the "capital gap"); Mitra, *supra* note 15 (discussing crowdfunding as a potential solution to the capital gap); Zwilling, *supra* note 16 (referring to the capital gap as the "valley of death").

[80] *See* BRUSH, *supra* note 17, at 7–8 (providing statistics that highlight how little funding women receive from venture capitalists); LAWTON & MAROM, *supra* note 17, at 65 (noting the gender inequality in venture capital financing and citing a study that showed that only 8% of startups that receive venture capital funding are run by women); ORSER & ELLIOTT, *supra* note 17, at 1 ("[B]eing female is too often deemed an entrepreneurial handicap."); Hay, *supra* note 17; Leder, *supra* note 17 (noting that venture capitalists prefer to be within an hour drive of the startups in which they invest).

[81] *See* Fisch, *supra* note 16, at 59–64 (discussing how a lot of sources of capital are not practical for startups); Lennon, *supra* note 14 (referring to a study that showed that startups that achieve successful exits raise $41 million on average).

1. Women

The gender inequality in the startup financing ecosystem is apparent both in the lack of women entrepreneurs receiving financing and in the lack of women representing the firms that extend financing.[82] Although forty-five percent of venture capital employees are women, most of those jobs are administrative, and only eleven percent of those in decision-making, partner-level positions at venture capital firms are women.[83] This disparity made headlines in 2012, when Ellen Pao filed a lawsuit against a prominent Silicon Valley venture capital firm, Kleiner Perkins Caufield & Byers, for gender discrimination.[84] Although Pao's suit was ultimately unsuccessful, it did shed light on and elicit discussion about the "entrepreneurial handicap" that some women face in the startup financing market.[85]

From the entrepreneur side, women have a harder time securing venture capital to finance their startups.[86] One study shows that between 1991 and 1996 only 2% out of the $33 billion invested by venture capitalists was used to

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[82] *See* Davey Alba, *The Gender Problem in Venture Capital Is Really, Really Bad*, WIRED (Mar. 20, 2015, 2:39 PM), http://www.wired.com/2015/03/gender-problem-venture-capital-really-really-bad/ [https://perma.cc/PCF4-3MCH] (noting that 77% to 79% of venture capital firms have never included in their portfolios a company with a woman serving on the board); Monica Leas & Julie Oberweis, *Venture Capital's Next Venture? Women*, TECHCRUNCH (June 3, 2015), http://techcrunch.com/2015/06/03/venture-capitals-next-venture/ [https://perma.cc/SM6Q-WTXJ] ("The reality is that women make up as little as 4 percent of deal-making venture capitalists in [Silicon Valley].").

[83] Jessica Guynn, *Small Venture Firm, Big Mission: Diversity*, USA TODAY (Jan. 11, 2017), http://www.usatoday.com/story/tech/news/2017/01/11/charles-hudson-precursor-ventures-diversity/96446316/ [http://web.archive.org/web/20170202035446/http://www.usatoday.com/story/tech/news/2017/01/11/charles-hudson-precursor-ventures-diversity/96446316/].

[84] *See* David Streitfeld, *Ellen Pao Loses Silicon Valley Bias Case Against Kleiner Perkins*, N.Y. TIMES (Mar. 27, 2015), http://www.nytimes.com/2015/03/28/technology/ellen-pao-kleiner-perkins-case-decision.html?_r=0 [https://perma.cc/WKB7-YVRX].

[85] *See* ORSER & ELLIOTT, *supra* note 17, at 1 (noting the "entrepreneurial handicap" faced by women); Vikas Bajaj, *Venture Capital's Boys' Club on Trial*, N.Y. TIMES (Mar. 17, 2015), http://www.nytimes.com/2015/03/17/opinion/venture-capitals-boys-club-on-trial.html [https://perma.cc/B9L5-Y35Q] (using Ellen Pao's lawsuit as an opportunity to discuss the gender disparity in venture capital, and arguing that it makes it harder for diverse entrepreneurs to get noticed, to the detriment of venture capital fund returns); Frederic Paul, *What the Kleiner Perkins Lawsuit Decision Says About Gender Discrimination in Silicon Valley*, NETWORKWORLD (Mar. 30, 2015, 7:31 AM), http://www.networkworld.com/article/2903327/careers/what-the-kleiner-perkins-lawsuit-decision-says-about-gender-discrimination-in-silicon-valley.html [https://perma.cc/396Y-BCJQ] (discussing how Pao's gender discrimination lawsuit, which was unsuccessful, nonetheless raised valid concerns about how women are treated in the venture capital industry).

[86] *See* BRUSH, *supra* note 17, at 3 (quoting a female venture capitalist discussing what she perceives as an unspoken bias in the male-centric venture capital community); Brush et al., *supra* note 19, at 144 (citing the "Diana Project," a study that uses data from the National Venture Capital Association to examine gender disparity in startup financing); Jonathan Sherry, *A Data-Driven Look at Diversity in Venture Capital and Startups*, CB INSIGHTS (June 15, 2015), https://www.cbinsights.com/blog/venture-capital-diversity-data/ [https://perma.cc/EJL8-Z4RY] (collecting statistics regarding the lack of diversity in the market for startup financing).

finance startups led by women.[87] Another study shows that from 2011 to 2013 only 15% of all startups funded by venture capital had a woman on the executive team, and only 2.7% of them had a female CEO.[88]

Some economic psychologists have proposed that this disparity can be attributed in part to female entrepreneurs being more risk-averse than male entrepreneurs, but more recent studies have shown that such a theory is outdated and untrue.[89] Even if venture capitalists are not explicitly discriminating against female entrepreneurs, there is clearly evidence of a bias toward male-run startups that has perpetuated this disparity.[90]

Another counterargument may be that the science, technology, and engineering, and mathematics ("STEM") fields, where many technology and life sciences entrepreneurs are bred, are dominated by men.[91] Statistics show, however, that the STEM field is closer to gender equality than many believe, which would therefore not explain the stark difference between the attention that male and female entrepreneurs receive from financiers.[92]

2. Minorities

Racial minorities have had limited access to capital necessary to start businesses for generations.[93] It is therefore unsurprising that racial minorities are largely underrepresented in the venture capital world.[94] CB Insights, a firm that compiles and analyzes data on venture capital and startup activity, released a study that revealed that from January 2010 to June 2010, only 1% of founders who received seed or Series A financing from venture capitalists were black.[95] 12% were Asian, 7% were listed as "other race," and 87% of founders were white.[96]

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[87] Brush et al., *supra* note 19, at 144.

[88] BRUSH, *supra* note 17, at 7.

[89] *See* ORSER & ELLIOTT, *supra* note 17, at 129.

[90] *See* BRUSH, *supra* note 17, at 2–3, 5.

[91] *See* Denise Cummins, *Why the STEM Gender Gap Is Overblown*, PBS (Apr. 17, 2015, 1:45 PM), http://www.pbs.org/newshour/making-sense/truth-women-stem-careers/ [https://perma.cc/6LPC-P8CF] (providing statistics to show that the STEM field is closer to gender equality than many believe it to be).

[92] *See id.*

[93] *See* Timothy Bates, *Minority Business Assistance Programs Are Not Designed to Produce Minority Business Development*, *in* THE EMERGENCE OF ENTREPRENEURSHIP POLICY, *supra* note 11, at 155, 156–57 (proving a brief history of minorities limited access to business capital in the United States).

[94] *See* Sherry, *supra* note 86 (analyzing racial diversity in the venture capital and startup industries, and finding that of the startup founders included in the study, 87% were white); Marty Zwilling, *Who Is Getting Venture Capital Money This Year?*, HUFFINGTON POST (Aug. 3, 2011), http://www.huffingtonpost.com/marty-zwilling/who-is-getting-venture-ca_b_668826.html [https://perma.cc/B27E-74SB] (explaining and providing commentary on the CB Insights presentation on the lack of diversity in the startup world).

[95] Sherry, *supra* note 86.

[96] *Id.*

Minorities are also underrepresented on the investor side.[97] Only 3% of those working in venture capital are black, and only 4% are Latino.[98] One survey found that of the 217 venture capital firms with over 2500 employees, none of them had a black partner.[99]

Racial disparity is as stark in the broader technology industry as it is in startup financing.[100] In 2014, data released by some of the most prominent and powerful technology companies in the United States revealed that black and Hispanic employees are significantly outnumbered by their white peers.[101] Black employees made up 3% of Google's staff, 2% of Facebook and Yahoo!'s staff, and 7% of Apple's staff.[102] Hispanic employees made up 2% of Google's staff, 4% of Facebook and Yahoo!'s staff, and 11% of Apple's staff.[103]

III. Crowdfunding Before the JOBS Act

In 2012, Congress passed the JOBS Act into law with the hope that it would make it easier for entrepreneurs to raise the capital they need to launch new businesses.[104] Title III of the JOBS Act, the CROWDFUND Act, creates a new exemption to the securities registration laws for entrepreneurs who use an Internet crowdfunding portal to sell equity in their companies, subject to limitations.[105] Section A of this Part provides an overview of crowdfunding.[106] Section B describes the five major models of crowdfunding campaigns.[107] Section C describes some of the events and legislative history that lead to the JOBS Act.[108]

A. What Is Crowdfunding?

Crowdfunding is the process through which an individual or organization raises funds for a business or project by initiating an open campaign to reach a large number of investors, with each contributing a small amount of capital to

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97 *See* Guynn, *supra* note 83 (discussing racial diversity in the venture capital market).

98 *Id.*

99 *Id.* One new venture capital firm, Precursor Ventures, has gained attention for making diversity its mission. *See id.* Charles Hudson, who runs the firm, has made over fifty investments; 31% of the companies receiving funding from his firm have at least one female founder, 16% have a black founder, and 7% have a self-identified Hispanic founder. *Id.*

100 *See* Guynn & Weise, *supra* note 17.

101 *Id.*

102 *Id.*

103 *Id.*

104 *See* 15 U.S.C. § 77d(a)(6) (2012); 158 Cong. Rec. S2,230 (daily ed. Mar. 29, 2012) (statement of Sen. Pat Toomey) (advocating for the JOBS Act as a way to make it easier for innovators to raise capital); 158 Cong. Rec. H1,277 (daily ed. Mar. 8, 2012) (statement of Rep. Patrick McHenry) (advocating for the JOBS Act as a way to make it easier for investors to connect with startups).

105 *See* 15 U.S.C. §§ 77d(a)(6), § 77d-1.

106 *See infra* noes 109–116 and accompanying text.

107 *See infra* notes 117–136 and accompanying text.

108 *See infra* notes 137–166 and accompanying text.

support the goal.[109] As a concept, Crowdfunding projects is not new, but the term as it is now used can be traced back to 2006.[110] Modern crowdfunding largely happens through Internet portals, blending social networking with capital raising.[111] Popular online crowdfunding portals include Kickstarter, Indigogo, and GoFundMe.[112]

Crowdfunding has become more popular among entrepreneurs in the last five years.[113] In 2010, $880 million was reportedly raised online through crowdfunding.[114] In 2014, $16 billion was crowdfunded online, and its estimated total for 2015 is $34 billion.[115] That means that future reports may show that 2016 was the first year that crowdfunding surpassed traditional venture capital financing.[116]

B. Five Types of Crowdfunding

There are five basic models of crowdfunding: the donation model, the reward model, the pre-purchase model, the lending model, and the equity mod-

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[109] *See Crowdfunding: Connecting Investors and Job Creators: Hearing Before the Subcomm. on TARP, Financial Services and Bailout of Public and Private Programs of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 3 (2011) [hereinafter *Crowdfunding Hearing*] (statement of Rep. Patrick McHenry) (defining crowdfunding as "essentially the ability of individuals to pool their money in support of a common cause" during a hearing about crowdfunding); LAWTON & MAROM, *supra* note 17, at ix (defining crowdfunding as raising capital through a network of people, generally through the Internet); Paul Belleflamme et al., *Crowdfunding: Tapping the Right Crowd*, 29 J. BUS. VENTURING 585, 586 (2014) (defining crowdfunding).

[110] *See Crowdfunding Hearing*, *supra* note 109, at 2 (noting that crowdfunding has existed for generations in the form of political fundraising); Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TRANSACTIONS: TENN. J. BUS. L. 63, 70–71 (2011) (explaining how modern crowdfunding derives from charitable giving but did not come into its current level of popularity until after 2008, and citing Michael Sullivan as coining the term "crowdfunding" in 2006); Daniela Castrataro, *A Social History of Crowdfunding*, SOC. MEDIA WK. (Dec. 12, 2011), http://socialmediaweek.org/blog/2011/12/a-social-history-of-crowdfunding/ [https://perma.cc/5TV6-VGET] (providing a history of crowdfunding).

[111] *See* LAWTON & MAROM, *supra* note 17, at ix, xiii (discussing how crowdfunding "shares a lot of social networking's energy" and is "in the most simplistic terms, social networking meets venture financing"); *see also* Dell, *supra* note 23 (defining crowdfunding as being "one part social networking and one part capital accumulation"); Gubler, *supra* note 22 (discussing crowdfunding's connection to social media).

[112] *See About*, *supra* note 2; *About Us*, GOFUNDME, https://www.gofundme.com/about-us/ [https://perma.cc/8LTF-D3PG]; *About Us*, INDIEGOGO, https://www.indiegogo.com/about/our-story [https://perma.cc/2RU7-LLLS].

[113] *See* Barnett, *supra* note 4 (predicting 2016 as the first year that the amount of money raised by crowdfunding may surpass the amount raised through venture capitalists).

[114] *Id.* (citing MASSOLUTION, 2015CF: THE CROWDFUNDING INDUSTRY REPORT (2015)).

[115] *Id.*

[116] *See id.* "Traditional" venture capital financing consists of professional investors, working at venture capital funds, giving money to startup companies with high-growth potential. Brooks, *supra* note 48.

el.[117] They are distinguishable by what the investors receive in return for contributing to the crowdfunding campaign.[118]

Investors in a donation model do not receive anything in return for their contributions.[119] It involves investors making charitable donations, but the recipient need not be a non-profit charitable organization.[120]

The reward and pre-purchase crowdfunding models are similar because participants in either type of campaign receive something in return for their contribution.[121] Zach Braff's Kickstarter campaign for his film *Wish I Was Here* used the reward model of crowdfunding.[122] Investors in that project were rewarded with a variety of gifts from Braff while he was making the film, including journals from the set and casting calls to appear in the film that were only open to contributors.[123]

Pre-purchase crowdfunding is the most popular type of campaign for entrepreneurs.[124] Entrepreneurs generally launch this type of campaign to raise funds to develop a product, and then promise to send the finished product to contributors.[125] One of crowdfunding's greatest success stories was a pre-purchase campaign.[126] Pebble Technology Corp., a wearable technology startup based in Silicon Valley that beat Apple to the smart watch market, got

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[117] *See* Bradford, *supra* note 22, at 14–15 (providing an overview of what investors receive in return for investing in each crowdfunding model).

[118] *See id.* at 14–24.

[119] *Id.* at 15.

[120] *See id.* Many donation model crowdfunding campaigns are not organized by formal non-profit organizations, but are instead launched by individuals who are crowdfunding for a charitable cause. Larry Kim, *Most Successful Feel-Good Crowdfunding Campaigns of the Year*, INC. (Jan. 2, 2015), http://www.inc.com/larry-kim/most-successful-feel-good-crowdfunding-campaigns-of-the-year.html [https://perma.cc/3P8N-NREU]. For example, after four-year-old Eliza O'Neil was diagnosed with a rare neurological disorder, her parents found a potential gene therapy trial that could help Eliza, but the researchers would need $2.5 million to get started. *Id.* They turned to crowdfunding portal GoFundMe.com and raised $380,000 in six months. *Id.* Now, 26 months since launching the campaign, Eliza's parents have raised over $2 million. *Id.*; *Saving Eliza GoFundMe.com Campaign*, GOFUNDME, https://www.gofundme.com/ElizaONeill [https://perma.cc/JQB3-SCUC].

[121] Bradford, *supra* note 22, at 16; *see also* Epstein, *supra* note 6, at 43–47 (discussing the reward-based crowdfunding model).

[122] *See WISH YOU WERE HERE by Zach Braff*, *supra* note 2.

[123] *Id.* Those who invested in the crowdfunding campaign for *Wish I Was Here* received access to journals from the set, t-shirts, opportunities to audition for roles in the film, and early screenings. *Id.*

[124] Bradford, *supra* note 22, at 16.

[125] *Id.*

[126] *See Pebble E-Paper Watch for iPhone and Android Kickstarter Campaign*, KICKSTARTER, https://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android?ref=sidebar [https://perma.cc/EBA7-GJEK]; Wil Schroter, *Top 10 Business Crowdfunding Campaigns of All Time*, FORBES (April 16, 2014), http://www.forbes.com/sites/wilschroter/2014/04/16/top-10-business-crowdfunding-campaigns-of-all-time/ [http://web.archive.org/web/20170102040220/http://www.forbes.com/sites/wilschroter/2014/04/16/top-10-business-crowdfunding-campaigns-of-all-time/#3b9465113218].

its start on Kickstarter in 2012.[127] Investors who pledged $99 to the company were promised a Pebble smart watch in return.[128] The campaign raised $10 million.[129] The company was ultimately unable to maintain its early success in the long term and was purchased by another wearable technology company, but its campaign is still considered a breakout crowdfunding success.[130]

Lending crowdfund campaigns are also known as "peer-to-peer" lending.[131] Participants in a lending crowdfund campaign loan money to the organizer, and eventually receive repayment.[132]

Finally, in an equity crowdfunding campaign, an entrepreneur launches the campaign and participants receive an ownership interest in the entrepreneur's company in return for their contributions.[133] Of all the crowdfunding models, this one most closely resembles a securities offering, and is thus subject to regulation by the SEC.[134] Until recently, every equity crowdfunding campaign had to comply with the Securities Act's registration requirements.[135] As of May 16, 2016 and passage of the JOBS Act, however, equity crowdfunding has enjoyed a $1 million exemption from compliance with the Securities Act, subject to certain limitations.[136]

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[127] *See* Philip Elmer-DeWitt, *Pebble Has a New Face and a New Pitch: I'm Not an Apple Watch*, FORTUNE (Sept. 24, 2015), http://fortune.com/2015/09/24/apple-pebble-round/ [https://perma.cc/ER2H-5VZX] (noting that Pebble beat Apple to the smart watch market by two years); Jenna Wortham, *Start-Ups Look to the Crowd*, N.Y. TIMES (Apr. 29, 2012), http://www.nytimes.com/2012/04/30/technology/kickstarter-sets-off-financing-rush-for-a-watch-not-yet-made.html?pagewanted=all [https://perma.cc/HSU8-37YD] (providing background on the Pebble crowdfunding campaign).

[128] Wortham, *supra* note 127.

[129] *See Pebble E-Paper Watch for iPhone and Android Kickstarter Campaign*, *supra* note 126; Schroter, *supra* note 126; Wortham, *supra* note 127.

[130] *See* Steve Kovach, *Fitbit Discloses That It Bought Smartwatch Startup Pebble for $23 Million*, BUS. INSIDER (Feb. 22, 2017), http://www.businessinsider.com/fitbit-bought-pebble-for-23-million-2017-2 [https://perma.cc/X9DL-ZR5Y] (discussing some of the details surrounding Pebble's dissolution and sale to Fitbit); *see also* Trent Moore, *Now That Pebble Is Dead, What Does That Mean for the World of Wearables?*, PASTE (Feb. 22, 2017), https://www.pastemagazine.com/articles/2017/02/now-that-pebble-is-dead-what-does-that-mean-for-th.html [https://perma.cc/D2EZ-E7VM] (recognizing the success of Pebble's "rock solid" crowdfunding efforts despite the company's failure to achieve long-term success).

[131] Bradford, *supra* note 22, at 20.

[132] *See id.* The most popular online portal for the lending crowdfunding model is Kiva.org. *See id.*; *About Us*, KIVA, http://www.kiva.org/about [https://perma.cc/9KDJ-GRC3]. Sometimes the lender will receive interest on his or her contribution to a lending crowdfunding campaign, and sometimes the lender will simply recoup the principal. Bradford, *supra* note 22, at 20.

[133] Bradford, *supra* note 22, at 24.

[134] *See id.*

[135] *See* 15 U.S.C. § 77d(a)(1)–(5) (2012) (listing exemptions to the Securities Act of 1933 ("Securities Act") rules before the JOBS Act); *see also* Wroldsen, *supra* note 22, at 596–97 (discussing a crowdfunding campaign in 2011 that the SEC decided involved a securities offering and therefore shut down for not registering the offering in compliance with the Securities Act).

[136] *See* 15 U.S.C. § 77d(a)(6); Title III of the JOBS Act, 80 Fed. Reg. 71,387, 71,388 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, 274).

C. The Demand for a Securities Crowdfunding Exemption and the Congressional Response

Entrepreneurs could crowdfund securities before passage of the JOBS Act, but they had to do so without an exemption from the securities registration requirements.[137] This meant that crowdfunding securities was not a practical option for startups because registration entails prohibitively high compliance costs.[138]

The crowdfunding campaign launched to purchase Pabst Brewing Company ("Pabst") in 2011 illustrates why many felt that regulatory reform for equity crowdfunding was necessary, and helped propel the issue to the floor of Congress.[139] The Pabst campaign was launched because the beer company was actively seeking a buyer.[140] The campaign's leaders, Michael Migliozzi and Brian Flatow, created a website, BuyaBeerCompany.com, with the hope of crowdfunding the $300 million needed to purchase Pabst.[141] They promised to repay investors with beer in the amount of their investments and offered investors certificates of ownership in Pabst.[142] They successfully raised $200 million from more than five million participants in the campaign's first six months, which is when the SEC served them with a cease-and-desist letter.[143]

Certificates of ownership fall within the Securities Act's broad definition of a security, which means that because Migliozzi and Flatow failed to register their offering, they violated the Securities Act's requirements.[144] The Pabst

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[137] *See* 15 U.S.C. § 77e(c).

[138] *See id.* (stating that a non-exempt offering of securities cannot be made until its registered with the SEC); *see also* Schwartz, *supra* note 6, at 1468–70 (discussing the costs of a registered securities offering). A registered offering of securities is so burdensome because it demands hours of work from expensive professionals, including attorneys, underwriters, and accountants. *See* Schwartz, *supra* note 6, at 1469.

[139] *See Crowdfunding Hearing*, *supra* note 109, at 3; Wroldsen, *supra* note 22, at 596–97 (providing an overview of the Pabst Brewing Company ("Pabst") crowdfunding campaign).

[140] *See* Uriel S. Carni, *Protecting the Crowd Through Escrow: Three Ways That the SEC Can Protect Crowdfunding Investors*, 19 FORDHAM J. CORP. & FIN. L. 681, 692 (2014).

[141] *See id.*

[142] *See* Wroldsen, *supra* note 22, at 596.

[143] Michael Migliozzi II & Brian Flatow, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, Securities Act Release No. 9216, at 1–2 (June 8, 2011), https://www.sec.gov/litigation/admin/2011/33-9216.pdf [https://perma.cc/2NJQ-4TV5] [hereinafter Cease-and-Desist Order]; Wroldsen, *supra* note 22, at 596.

[144] *See* Cease-and-Desist Order, *supra* note 143, at 3–4; Wroldsen, *supra* note 22, at 596. The term "security" is broadly defined in the Securities Act. *See* 15 U.S.C. § 77b(a)(1) (2012). It is defined so broadly so that the Securities Act's regulatory scheme can adapt to the "countless and variable schemes devised by those who seek the use of money of others on the promise of profits . . . ." *See* Marine Bank v. Weaver, 455 U.S. 551, 555–56 (1982) (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946)); *see also W.J. Howey Co.*, 328 U.S. at 298–99 (defining investment contract as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party").

campaign likely would have escaped SEC scrutiny if Migliozzi and Flatow simply offered contributors beer rather than any type of ownership in the company.[145] The Pabst campaign did, however, draw attention to the power of crowdfunding, including, notably, the attention of North Carolina Representative Patrick McHenry, a Congressional leader in the crowdfunding movement.[146]

Beginning in 2010, several proposals were brought to the SEC to create a crowdfunding exemption to the Securities Act.[147] Each proposal included annual limits for how much an entrepreneur could raise with a crowdfunding exemption, and how much an individual could invest.[148] The Sustainable Economies Law Center, in July 2010, was the first organization to formally propose a crowdfunding exemption with its petition to the SEC.[149] Its petition recognized the difficulties that entrepreneurs face when raising capital, and proposed that a crowdfunding exemption could be a "powerful source of grassroots and local funding."[150] The proposal was to exempt up to $100,000 in crowdfunded securities a year for entrepreneurs, with a $100 annual limit on how much individuals could invest.[151]

In December 2010, the Small Business & Entrepreneurship Council ("SBEC") made a proposal to the SEC for a crowdfunding exemption.[152] It advocated for a crowdfunding exemption to help entrepreneurs "turn ideas into viable companies."[153] The proposal included a $1,000,000 annual cap on

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[145] *See* Wroldsen, *supra* note 22, at 596.

[146] *See Crowdfunding Hearing*, *supra* note 109, at 3 (citing to the Pabst crowdfunding campaign in his remarks in support of a crowdfunding exemption); *see also Pabst Blue Ribbon Beer Almost Gets Bought via Crowd Funding Investing*, STARTUP EXEMPTION (June 23, 2011), http://www.startupexemption.com/archives/110#axzz44s3OcTJo [https://perma.cc/ZV3Q-FJGB] (pointing to the Pabst crowdfunding campaign in support of the Startup Exemption's online petition calling for a crowdfunding exemption).

[147] *See* Letter from Woodie Neiss, Member, SBE Council Advisory Comm., to Gerald J. Laporte, Chief, Office of Small Bus. Policy, Div. of Corp. Fin., SEC 1 (Dec. 21, 2010), https://www.sec.gov/info/smallbus/2010gbforum/2010gbforum-sbe.pdf [https://perma.cc/49ZM-7ZLE] [hereinafter SBE to SEC]; Sustainable Econ. Law Ctr., Request for Rulemaking to Exempt Securities Offerings up to $100,000 with $100 Maximum per Investor from Registration, SEC File No. 4-605, at 2 (July 1, 2010), https://www.sec.gov/rules/petitions/2010/petn4-605.pdf [https://perma.cc/K89E-3HM5] [hereinafter Sustainable Econ. Law Ctr. to SEC]; *About Us*, STARTUP EXEMPTION, http://www.startupexemption.com/about-us#axzz44s3OcTJo [https://perma.cc/UC2Q-W4T3] (petition created in 2012 by a team of entrepreneurs to encourage the SEC to create a crowdfunding exemption); *see also* Bradford, *supra* note 22, at 81–84 (providing an overview of the different proposals to the SEC).

[148] Bradford, *supra* note 22, at 81–84.

[149] *See* Sustainable Econ. Law Ctr. to SEC, *supra* note 147, at 1.

[150] *Id.* at 2.

[151] *Id.*

[152] SBE to SEC, *supra* note 147, at 1.

[153] *Id.*

crowdfunded securities for entrepreneurs, and a limit on individual investor's involvement set at 10% of their yearly income, with a maximum of $10,000.[154]

Entrepreneur Sherwood "Woodie" Neiss, who authored the SBEC's proposal, worked with a team of entrepreneurs to co-found Startup Exemption, an online petition to Congress to promote a crowdfunding exemption that would be available only to startups.[155] Like the SBEC proposal, the Startup Exemption's petition capped the exemption at $1,000,000 a year, and limited individuals to investing up to 10% of their yearly income, or to $10,000.[156]

Congress recognized the demand for a crowdfunding exemption in 2011 when Representative McHenry introduced the Entrepreneur Access to Capital Act.[157] The bill included an exemption for crowdfunded securities with an annual cap set at $2 million.[158] The House of Representatives passed the law.[159] It was criticized in the Senate, however, for its lack of investor protections, with some referring to the bill as the "Boiler Room Legalization Act," referring to a time in history when investors were pressured into making unsound investment decisions while gathered in "boiler rooms."[160]

In response to the "boiler room" criticisms, the Senate's versions of the crowdfunding exemption were heavier on investor protections, including requirements that crowdfunded securities be sold only through funding portals registered with the SEC, increased disclosure and investor education requirements, and restrictions on resale of crowdfunded securities.[161] The Senate's

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[154] *Id.* at 4.

[155] *See Exemption Framework*, STARTUP EXEMPTION, http://www.startupexemption.com/exemption-framework#axzz44s3OcTJo [https://perma.cc/V9Z3-A7ZR]. It defined "startup" as businesses with annual gross revenue below $5 million in the last three years. *Id.*

[156] *See id.*

[157] *See* H.R. REP. NO. 112-262, at 3–4 (2011) (recognizing the increasing popularity of crowdfunding and arguing that the SEC's regulatory scheme without a crowdfunding exemption has a detrimental impact on innovation and entrepreneurship).

[158] 157 CONG. REC. H7,314 (daily ed. Nov. 3, 2011).

[159] *See* Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. (2011).

[160] *See* 158 CONG. REC. S1,766 (daily ed. Mar. 19, 2012) (statement of Sen. Harry Reid) (comparing the lack of investor protections found in the House version of the crowdfunding exemption bill to the "bad old days when people gathered in [boiler rooms] and made cold calls to try to elicit unwary investors into dubious schemes"); 158 CONG. REC. S1,781 (daily ed. Mar. 19, 2012) (statement of Sen. Carl Levin) (arguing that the House bill would essentially be a legalization of "the business model of unscrupulous boiler rooms"); *see also* Wroldsen, *supra* note 22, at 598 (discussing the "boiler room" criticisms of the House's crowdfunding exemption bill); *What Is a Boiler Room Operation?*, INVESTOPEDIA, http://www.investopedia.com/ask/answers/04/080604.asp [https://perma.cc/J386-8DM6] (defining "boiler room" investing as "the use of high pressure sales tactics to sell stock to clients" who are randomly selected).

[161] *See* Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011 ("CROWDFUND Act"), S. 1970, 112th Cong. (2011); Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. (2011); *see also* Bradford, *supra* note 22, at 91–98 (providing an overview of the investor protections that the Senate introduced into the crowdfunding exemption legislation); Wroldsen, *supra* note 22, at 598–99 (discussing the negotiations in Congress that ultimately resulted in the current version of the JOBS Act's crowdfunding exemption).

first version was the Democratizing Access to Capital Act of 2011, and its second was the CROWDFUND Act.[162] Ultimately, the CROWDFUND Act became the version of the crowdfunding exemption that was incorporated into the JOBS Act, which was passed by the House and the Senate in March 2012 and signed into law by President Obama on April 5, 2012.[163]

After the JOBS Act was signed into law, in 2014, Representative McHenry, still an advocate for crowdfunding, introduced the Equity Crowdfunding Improvement Act to amend the JOBS Act.[164] One of the proposed amendments would have increased the annual cap on crowdfunded securities for an entrepreneur from $1 million to $3 million, with the option for an entrepreneur to raise as much as $5 million a year if he or she provided investors audited financial statements.[165] The bill was introduced in the 113th Congress but never received a vote.[166]

IV. CROWDFUNDING UNDER THE JOBS ACT

Prior to the JOBS Act, startups could use the "private placement" exemption from the Securities Act's registration requirements, which allows them to privately issue equity to the founder's friends, family, or unrelated wealthy investors.[167] Compliance with the Securities Act's regulations for a non-exempt securities offering, including an IPO, is generally cost prohibitive for a startup.[168] Consequently, startup financing has traditionally been dominated by angel investors and venture capitalists, both of which fall under the existing Securities Act exemptions and have enough capital to support a growing startup.[169] Congress therefore passed the JOBS Act in the hope that it would allow entrepreneurs to raise capital more easily.[170] Section A reviews the new

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[162] *See* S. 1970; S. 1791.

[163] 158 CONG. REC. S1,977 (daily ed. Mar. 22, 2012) (noting that the bill passed in the Senate by a vote of 73 to 26); 158 CONG. REC. H1,289 (daily ed. Mar. 8, 2012); *Remarks by the President at JOBS Act Bill Signing*, *supra* note 10.

[164] Equity Crowdfunding Improvement Act of 2014, H.R. 4564, 113th Cong. (2014).

[165] *Id.* § 301(a).

[166] *See id.*; Actions Overview, *H.R. 4564- Equity Crowdfunding Improvement Act of 2014*, CONGRESS.GOV, https://www.congress.gov/bill/113th-congress/house-bill/4564/actions [https://perma.cc/4QTH-DD5R] (showing that no vote was held on the bill after its introduction on May 6, 2014).

[167] 15 U.S.C. § 77d(a)(2), (5) (2012).

[168] *See* Schwartz, *supra* note 6, at 1468–70 (discussing the costs of a registered securities offering, which can include over 1200 hours of work from attorneys, underwriters, and accountants).

[169] *See* Fisch, *supra* note 16, at 61–62; Schwartz, *supra* note 6, at 1473.

[170] *See* 158 CONG. REC. S2,230 (daily ed. Mar. 29, 2012) (statement of Sen. Pat Toomey) (stating that the JOBS Act "sets the framework for developing a new market in which entrepreneurs can raise capital and ordinary investors can invest in new ideas"); 158 CONG. REC. H1,277 (daily ed. Mar. 8, 2012) (statement of Rep. Patrick McHenry) ("[E]entrepreneurship is at a 17-year low in the United States . . . . So what [the crowdfunding provision of the JOBS Act] does is it enables investors to connect with start-ups.").

rules introduced by the JOBS Act.[171] Section B discusses a company that has taken advantage of the JOBS Act to illustrate how the rules work in practice.[172]

A. A Look at the New Rules

On October 30, 2015, the SEC voted to implement the rules proposed in the JOBS Act.[173] Since May 16, 2016, entrepreneurs have been able to take advantage of the Act's new exemption to raise $1 million annually through crowdfunding securities sold to investors online.[174]

Investors are limited in how many securities they purchase through equity crowdfunding in a year depending on their net worth or annual income.[175] Investors with a net worth or annual income under $100,000 may invest up to the greater of $2000 or 5% of their annual income in crowdfunded securities annually.[176] Investors with a net worth or annual income greater than $100,000 may invest up to the greater of 10% of their annual salary or $100,000 annually.[177]

1. Limitations and Protections

The Act requires that entrepreneurs crowdfund their securities through an intermediary registered with the SEC rather than dealing directly with any investors.[178] Issuers of crowdfunded securities are not allowed to advertise the offering themselves, so they must rely on the intermediary to promote the offering.[179] The Act creates a new classification of intermediary, called "funding portals," which are subject to a new regulatory scheme established by the SEC.[180] The funding portals are limited to connecting entrepreneurs and buyers of their crowdfunded securities, and may not offer any investment recommen-

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[171] *See infra* notes 173–202 and accompanying text.

[172] *See infra* notes 203–210 and accompanying text.

[173] *See* Title III of the JOBS Act, 80 Fed. Reg. 71,387, 71,388 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, 274); Press Release, SEC, *supra* note 5 (announcing the SEC's vote to implement the crowdfunding exemption under the JOBS Act).

[174] 15 U.S.C. § 77d(a)(6)(A) (2012); Press Release, SEC, *supra* note 5 (announcing that the JOBS Act's crowdfunding provisions will be implemented and available to entrepreneurs and investors on May 16, 2016).

[175] 15 U.S.C. § 77d(a)(6)(B)(i)–(ii) (providing the limits that individual investors may contribute to a crowdfunding campaign based on their annual income or net worth).

[176] *Id.* § 77d(a)(6)(B)(i)

[177] *Id.* § 77d(a)(6)(B)(ii).

[178] *See id.* § 77d(a)(6)(C) (requiring that crowdfunded securities under the § 77d(a)(6) exemption be sold through a broker or funding portal that complies with the § 77d-1(a) rules for small intermediaries).

[179] *See id.* § 77d-1(b)(2).

[180] *Id.* § 77d(a)(6)(C); *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, SEC (May 13, 2016), https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm [https://perma.cc/9YDU-G64X] [hereinafter *Regulation Crowdfunding*] (providing an overview of the requirements for crowdfunding portals).

dations or advice.[181] The Financial Industry Regulatory Authority ("FINRA") is tasked with ensuring that only crowdfunding portals compliant with federal securities laws and FINRA regulations are registered.[182] Since the JOBS Act's crowdfunding rules went into effect in May 2016, there are already over twenty FINRA-approved crowdfunding portals in operation.[183]

The intermediary has the obligation of ensuring that investors do not exceed the amount that the Act allows them to invest in a year.[184] Additionally, the SEC requires that the directors, officers, and other management at an intermediary do not have any financial interest in a crowdfunding campaign launched on that intermediary.[185] Startup businesses that take advantage of securities crowdfunding are also required to set a target amount for the campaign to raise, and the intermediary cannot disburse the proceeds of the offering until the target is met.[186]

The Act restricts a secondary market for the securities that are issued in a crowdfunding campaign from forming.[187] Investors holding securities offered in an exempt crowdfunding campaign are not able to transfer or sell those securities for the first year after purchase, unless the sale is to a family member of the purchaser, an accredited investor, or as otherwise part of an offering registered with the SEC.[188]

2. Disclosure Requirements Under the CROWDFUND Act

To enjoy the new exemption, the Act requires disclosures that include the name of the business crowdfunding securities, its physical address and website address, its legal status, a description of the business and any anticipated business plans, and the names of the directors, officers, and substantial investors.[189] The Act also requires a disclosure regarding the financial condition of the issu-

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[181] *See* 15 U.S.C. § 77d-1(a)–(b).

[182] *Crowdfunding and the JOBS Act: What Investors Should Know*, FINRA, http://www.finra.org/investors/alerts/crowdfunding-and-jobs-act-what-investors-should-know [https://perma.cc/F54S-CQFB]; *see also Funding Portals*, FINRA, http://www.finra.org/industry/funding-portals [https://perma.cc/67GY-WQUS] (providing an overview of FINRA's process for registering crowdfunding portals).

[183] *See* JD Alois, *There Are Now 21 FINRA Approved Reg CF Crowdfunding Portals*, CROWDFUND INSIDER (Nov. 21, 2016), http://www.crowdfundinsider.com/2016/11/92810-now-21-finra-approved-reg-cf-crowdfunding-portals/ [https://perma.cc/A4SR-VDBG] (providing updates on the progress of registered crowdfunding portals since the rules went into effect in May 2016).

[184] *See* 15 U.S.C. § 77d-1(a)(8); *see also Regulation Crowdfunding*, *supra* note 180 (summarizing the SEC's requirements for crowdfunding portals).

[185] 15 U.S.C. § 77d-1(a)(11).

[186] *Id.* § 77d-1(a)(7).

[187] *Id.* § 77d-1(e).

[188] *Id.*

[189] *Id.* § 77d-1(b)(1)(A)–(H).

er.[190] The terms of the financial condition disclosure depend on the size of the offering; income tax forms and unaudited financial statements are required from businesses offering less than $100,000, and audited financial statements are required from businesses raising between $500,000 and the Act's cap of $1 million.[191] Businesses must also disclose how they plan to use the proceeds from the offering, the amount that they are hoping to raise, their deadline for raising that amount, the offering price for the securities, and a description of its capital structure.[192] It must also provide updates to the SEC on the progress of the offering.[193]

3. Protecting Investors from Fraud

Consistent with the SEC's fundamental policies, the limitations found in the Act are meant to protect investors from fraud while advancing the Act's mission to make it easier for startups to raise capital.[194] The exemption puts investors at risk because it marks the first time that a company can offer securities to the general public without complying with the SEC's registration requirements.[195] The Internet-based nature of crowdfunding offerings further increases the potential that investors could be defrauded.[196] This risk was illustrated by a complaint filed by the Federal Trade Commission ("FTC") against Erik Chevalier, an entrepreneur who engaged in deceptive practices while raising money through a Kickstarter campaign to produce a board game.[197] Chevalier raised $122,000 from 1246 participants in his campaign, but the FTC al-

[190] *Id.* § 77d-1(b)(1)(D).

[191] *Id.*

[192] *Id.* § 77d-1(b)(1)(D)–(H).

[193] *Id.* § 77d-1(b)(1)(F).

[194] *See* 158 CONG. REC. S2,230 (daily ed. Mar. 29, 2012) (statement of Sen. Pat Toomey) (advocating for the crowdfunding exemption as a way to encourage entrepreneurial ventures); 158 CONG. REC. H1,277 (daily ed. Mar. 8, 2012) (statement of Rep. Patrick McHenry) (identifying that entrepreneurship had slowed down in the United States and advocating for the crowdfunding exemption as a potential solution); *Remarks by the President at JOBS Act Bill Signing*, *supra* note 10 (explaining that the purpose of the JOBS Act is to make capital more accessible to entrepreneurs); *see also* Schwartz, *supra* note 6, at 1465 (explaining that the disclosure requirements included in the JOBS Act are meant to mitigate the risk of fraud in crowdfunding); *What We Do*, SEC, https://www.sec.gov/about/whatwedo.shtml [https://perma.cc/HCR3-UDF5] (explaining that investor protection is a policy driving the SEC's actions).

[195] *See* 15 U.S.C. § 77d(a)(6); *see also* Hazen, *supra* note 9, at 1736–38 (discussing how online securities offerings marks a departure from standard securities regulation, and the new risks that it introduces).

[196] *See generally* Hazen, *supra* note 9 (examining the JOBS Act crowdfunding exemption and arguing that its fraud protections will rely on the disclosure requirements involving meaningful disclosures).

[197] Complaint at 2–3, FTC v. Chevalier, No. 3:15-cv-01029-AC (D. Or. June 10, 2015), 2015 WL 3776613.

leged that he used that money for personal purposes and the participants never saw any reward or refund.[198]

The JOBS Act addresses the increased risk of fraud by imposing liability on any issuer of crowdfunded securities who engages in fraudulent or deceptive disclosures.[199] The liability provision of the Act provides investors in a securities crowdfunding campaign a remedy, either at law or in equity, to recover the consideration paid for securities purchased from an issuer engaged in fraudulent activity.[200] FINRA also uses its authority to police funding portals as a way to address some of the risks inherent to Internet-based securities sales.[201] In November 2016, FINRA, for the first time, terminated the registration of a securities crowdfunding portal for failing to comply with the JOBS Act's investor protection requirements.[202]

B. JOBS Act Crowdfunding Illustrated

In November 2016, Hopsters LLC, a startup craft brewery that offers a brew-your-own-beer experience, launched an equity crowdfunding campaign under the JOBS Act's new rules.[203] Hopsters used Wefunder, a FINRA-

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[198] *Id.* Chevalier announced that he was cancelling his campaign fourteen months after launching it, and promised that he would provide refunds to the investors. *Id.* at 1, 8–9. The FTC ultimately filed a complaint when investors did not see any refund, alleging that Chevalier had used the funds he raised with his crowdfunding campaign for personal reasons unrelated to his board game project. *Id.* at 8–9. Chevalier and the FTC ultimately reached a settlement that prohibited Chevalier from benefitting from anything related to his Kickstarter campaign, and also imposed on Chevalier a $111,793.71 penalty. Proposed Stipulated Order for Permanent Injunction and Monetary Judgment at 4–5, FTC v. Chevalier, No. 3:15-cv-01029-AC (D. Or. 2015), 2015 WL 4270382.

[199] *See* 15 U.S.C. § 77d-1(c); Mashburn, *supra* note 8, at 151–57 (providing an overview of the JOBS Act's liability provision, including an overview of Section 12(a)(2) in the Securities Act, from which the JOBS Act's provision borrows language).

[200] 15 U.S.C. § 77d-1(c)(1)(A). The heightened risk of investor fraud presented by Internet crowdfunding, and the adequacy of the JOBS Act's liability provisions, has attracted scholarly attention, but it is not the focus of this note. *See generally, e.g.*, Baritot, *supra* note 9 (focusing on the risks of fraud in crowdfunding and how the SEC can best protect investors); Hazen, *supra* note 9 (discussing the risk of fraud presented by the Internet-based nature of the JOBS Act's crowdfunding exemption, and arguing that adequate investor-protection will hinge on meaningful disclosure); Mashburn, *supra* note 8 (arguing that the liability provisions of the JOBS Act do not provide adequate protection for investors participating in crowdfunding campaigns).

[201] *See* Ali Perry, *FINRA Action Against Crowdfunding Platform*, MOFO JUMPSTARTER (Dec. 16, 2016), http://www.mofojumpstarter.com/finra/ [https://perma.cc/8WRN-5FVY] (discussing FINRA's decision to terminate the registration of UFP, LLC, which was the first crowdfunding portal to be subject to termination).

[202] *See id.*

[203] *See* HOPSTERS, http://www.hopstersbrew.com/ [https://perma.cc/ACM8-P833] (home page for the Hopsters company website, inviting customers to "come try [their hand] at brewing"); Jessica Pham, *Hopsters Brewery: The Fastest Reg CF Crowdfunding Ever*, CROWDFUND INSIDER (Dec. 8, 2016, 1:40 AM), http://www.crowdfundinsider.com/2016/12/93457-hopsters-brewery-fastest-reg-cf-raise-crowdfunding-ever/ [https://perma.cc/KR7Y-CSKC] (providing an overview of the launch of the campaign, including the fact that it raised $615,000 in the first two weeks).

approved registered funding portal, to host its campaign.[204] Under the campaign, online investors could purchase preferred equity in the company for $500/unit, which entitles investors to a pro-rata distribution of 20% of Hopsters' profits in perpetuity.[205] The campaign webpage provided thorough details about the company, including its financial history, projections for future growth, and management structure.[206] It also included a risk factor section and a feature that allowed potential investors to submit questions to the company's management team.[207] Further, the campaign webpage provided a link to the filing that the company submitted to the SEC in order to launch the campaign.[208] The form, called a Form C, provides a clear illustration of how the JOBS Act's crowdfunding rules are executed in practice.[209] The campaign hit its target, the maximum amount allowed under the JOBS Act, of $1 million and will use the funds to expand the business from its original Newton, Massachusetts location into a new location in downtown Boston.[210]

V. AMENDING THE JOBS ACT TO HELP DIVERSIFY THE STARTUP LANDSCAPE

The crowdfunding provisions of the JOBS Act should be amended to increase the annual amount that an entrepreneur can raise from crowdfunded securities from $1 million to $5 million.[211] Crowdfunding is a revolutionary technol-

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[204] *See Funding Portals We Regulate*, FINRA, http://www.finra.org/about/funding-portals-we-regulate [https://perma.cc/6WUS-3VSM] (listing the registered funding portals); *see also Invest in Hopsters*, WEFUNDER, https://wefunder.com/hopsters [https://perma.cc/BDT3-WA2Z] (the Hopsters LLC equity crowdfunding campaign page).

[205] *See Invest in Hopsters*, *supra* note 204. For an explanation of preferred stock see *supra* note 50 and accompanying text.

[206] *Invest in Hopsters*, *supra* note 204.

[207] *Id.*

[208] *Id.*; *see also Hopster's LLC Form C*, SEC, https://www.sec.gov/Archives/edgar/data/1689082/000167025417000007/documents_list.htm [https://perma.cc/RNL7-HQDV] (the Form C filing for Hopsters LLC equity crowdfunding campaign under the JOBS Act).

[209] *See Hopster's LLC Form C*, *supra* note 208 (providing the SEC with all of the disclosures mandated by Title III of the JOBS Act).

[210] *See Invest in Hopsters*, *supra* note 204; *see also* Jessica Bartlett, *Brew-Your-Own-Beer Startup Hopsters Pops Off New Crowdfunding Campaign*, BOS. BUS. J. (Nov. 17, 2016), http://www.bizjournals.com/boston/news/2016/11/17/brew-your-own-beer-startup-hopsters-pops-off-new.html [http://web.archive.org/web/20161123221732/http://www.bizjournals.com/boston/news/2016/11/17/brew-your-own-beer-startup-hopsters-pops-off-new.html] (providing an overview of Hopsters' expansion plans).

[211] *See* Equity Crowdfunding Improvement Act of 2014, H.R. 4564, 113th Cong. (2014) (proposal to amend the JOBS Act that includes raising the annual cap on crowdfunded securities); Alois, *supra* note 24 (quoting Doug Ellenoff, a renowned investor, saying that the annual cap in Title III of the JOBS Act needs to be raised from $1 million to $5 million for the legislation to be useful for entrepreneurs).

ogy with the potential to disrupt the startup financing status quo, but entrepreneurs will need more than $1 million a year for that potential to be realized.[212]

The capital gap in startup financing leaves early-stage entrepreneurs seeking up to $2 million especially vulnerable to failure, but allowing entrepreneurs to raise up to $5 million a year through crowdfunded securities may mitigate that problem.[213] Section A argues that crowdfunding technology has the potential to level the playing field within the startup financing ecosystem.[214] Section B argues that the SEC can and should raise the annual cap on the crowdfunding exemption from $1 million to $5 million because it is in the public interest to encourage entrepreneurship by making more capital available to the entrepreneurs disadvantaged by the traditional startup financing status quo.[215]

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[212] *See* Bradford, *supra* note 22, at 5 (discussing the revolutionary nature of crowdfunding); Schwartz, *supra* note 6, at 1473 ("[C]rowdfunding enhances the possibility that an aspiring entrepreneur from a modest background and/or geographically remote region (for example, far from Silicon Valley) would find financial backers for her vision."); Wroldsen, *supra* note 22, at 601 (discussing the transformative power of crowdfunding, and arguing that the JOBS Act wrongly forces the innovative technology of crowdfunding into a traditional regulatory scheme); Gubler, *supra* note 22 ("Crowdfunding has the potential to revolutionize the financing of small business, transforming millions of users of social media . . . into venture capitalists, and giving life to valuable business ideas that might otherwise go unfunded."). *See generally* LAWTON & MAROM, *supra* note 17 (providing an overview of how crowdfunding is a significant technological leap forward in the evolution of how startups fund themselves). The lack of diversity in startup financing illustrates the need to level the playing field. *See* BRUSH, *supra* note 17, at 7–8 (showing the disparity with which venture capital is distributed between female and male entrepreneurs); LAWTON & MAROM, *supra* note 17, at 65 (discussing gender inequality in venture capital); ORSER & ELLIOTT, *supra* note 17, at 1 ("[B]eing female is too often deemed an entrepreneurial handicap."); Hay, *supra* note 17 (providing statistics that show how female and minority entrepreneurs are far less likely to receive traditional forms of startup financing); Leder, *supra* note 17 (discussing venture capitalists' preference to be within an hour drive from the startups in which they invest); Sherry, *supra* note 86 (noting the stark racial inequality among entrepreneurs who received venture capital); *see also* Lennon, *supra* note 14 (noting that the average successful startup raises $41 million).

[213] *See* Ibrahim, *supra* note 15, at 1417, 1445 n.209 (noting that the capital gap exists for entrepreneurs looking to raise between $2 million and $5 million); Alois, *supra* note 24 (quoting a prominent investor who believes that the JOBS Act needs to allow entrepreneurs to raise $5 million a year for the act to be useful); Mitra, *supra* note 15 (presenting the argument that crowdfunding may be able to help entrepreneurs bridge the startup gap); Zwilling, *supra* note 16 (estimating that the amount of capital that a startup will need to survive the capital gap is around $1 million, if not slightly more); *see also* Fisch, *supra* note 16, at 60, 63 (noting the unmet need for financing for new businesses, and stating that lack of capital is a top reason for failure among new businesses).

[214] *See infra* notes 216–227 and accompanying text (arguing that crowdfunding has the potential to break the startup financing status quo).

[215] *See infra* notes 228–235 and accompanying text (arguing that the SEC has the authority to raise the annual cap on the JOBS Act's crowdfunding exemption).

A. Crowdfunding Technology Has the Potential to Mitigate Diversity Problems in Startup Financing

Crowdfunding brings the power of social networking into the capital raising process.[216] It therefore has the potential to mitigate the lack of diversity in startup financing by supporting affinity groups.[217] An affinity group is a group of people who are linked by a common interest or purpose.[218] Affinity groups have long been forming to support the kinds of entrepreneurs who have been left out of traditional startup financing systems, including women and minorities.[219] Examples include the Female Entrepreneur Association and Code2040 (a support network for black and Hispanic entrepreneurs).[220] The crowdfunding exemption in the JOBS Act has the potential to capitalize on the phenomena of affinity groups by giving those and similar groups the power to provide serious amounts of capital, in addition to social support, to underrepresented entrepreneurs.[221]

Having some connection to a venture capitalist or being able to network your way into a meeting with a venture capitalist has become an unwritten requirement to securing venture capital financing.[222] Entrepreneurs seeking venture capital, therefore, have to devote time, money, and energy toward getting

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[216] *See* LAWTON & MAROM, *supra* note 17, at ix, xiii (discussing how crowdfunding "shares a lot of social networking's energy" and is "in the most simplistic terms, social networking meets venture financing"); Dell, *supra* note 23 (defining crowdfunding as being "one part social networking and one part capital accumulation"); Gubler, *supra* note 22 (discussing crowdfunding's connection to social media).

[217] *See* YOCHAI BENKLER, THE WEALTH OF NETWORKS 242 (2006) (discussing affinity groups); LAWTON & MAROM, *supra* note 17, at 10–14 (discussing the power of affinity groups).

[218] *See Affinity Group*, OXFORD DICTIONARIES, http://www.oxforddictionaries.com/us/definition/american_english/affinity-group?q=affinity+group [https://perma.cc/ZFE2-RC3C].

[219] *See* Bates, *supra* note 93, at 155–56, 162–65 (describing groups and initiatives formed to support businesses founded by black entrepreneurs); Brush et al., *supra* note 19, at 141–44 (providing an overview of groups formed to support female entrepreneurs); Guynn, *supra* note 83 (discussing a new venture capital firm aimed at representing a more diverse pool of entrepreneurs). *See generally* CODE2040, http://www.code2040.org/ [https://perma.cc/TL5J-YY89] (providing a support network for Black and Hispanic entrepreneurs); FEMALE ENTREPRENEUR ASS'N, http://femaleentrepreneurassociation.com/ [https://perma.cc/F6WG-HAGU] (providing a support network for female entrepreneurs).

[220] *See generally* CODE2040, *supra* note 219; FEMALE ENTREPRENEUR ASS'N, *supra* note 219; MIDWESTERN ENTREPRENEURSHIP CONF., http://mwecomaha.com/ [https://perma.cc/9Z6P-YYBM] (providing a support network for entrepreneurs in the Midwestern United States).

[221] *See* 15 U.S.C. § 77d(a)(6) (2012) (exempting crowdfunded securities); *see also* LAWTON & MAROM, *supra* note 17, at 12–13 (discussing crowdfunding as a way to empower affinity groups).

[222] *See* Brush et al., *supra* note 19, at 150–51 (discussing how "social network theory" has created networks of similar people in which venture capitalists mainly operate); Guynn, *supra* note 83 (discussing the "clubby" nature of venture capital financing); Iskold, *supra* note 19 (discussing how venture capitalists often perceive an entrepreneur's ability to "hustle" his or her way into an introduction as a prerequisite for venture capital financing).

the attention of venture capitalists.[223] This creates a serious disadvantage for entrepreneurs who cannot easily get in front of a venture capitalist, either because they are not tapped into a network of established entrepreneurs, or because they did not graduate from elite schools like MIT and Stanford.[224]

Crowdfunding, because of its social networking roots, can mitigate that disadvantage by giving all entrepreneurs with an Internet connection equal access to a source of capital.[225] An entrepreneur, for example, who does not have a degree from Stanford and has had no opportunity to connect with a network of proven and elite entrepreneurs and venture capitalists can still have a great idea, but he or she is going to need more than $1 million a year to survive the capital gap and have a chance at competing with the entrepreneurs who do have those advantages.[226] With $5 million a year, that entrepreneur may be able to survive the "valley of death," and therefore have a better chance at attracting the attention of traditional forms of startup financing.[227]

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[223] *See* TEDESCO, *supra* note 48, at 3 (stating that the process through which an entrepreneur goes to attract venture capital can take from six to nine months of work with legal and financial professionals); Iskold, *supra* note 19 (providing insight into the time and effort that is generally required for an entrepreneur to attract venture capital financing); Jeremy Quittner, *4 Tips for Meeting with a Venture Capitalist*, INC. (June 3, 2014), http://www.inc.com/jeremy-quittner/advice-for-meeting-with-venture-capitalists.html [https://perma.cc/69MS-FX7M] (explaining the strategic considerations that entrepreneurs should think about if they are trying to attract venture capital financing).

[224] *See* Bobbie Gossage, *An Insider's Guide to Venture Capital Financing*, INC. (May 1, 2010), http://www.inc.com/magazine/20100501/an-insiders-guide-to-venture-capital-financing.html [https://perma.cc/FFJ5-NKVJ] (discussing how entrepreneurs can overcome barriers to securing venture capital, including the disadvantage that entrepreneurs face when competing against entrepreneurs from MIT or Stanford); TrueBridge Capital, *supra* note 17 (showing that the top five represented schools among venture capitalists are Stanford, Harvard, Brown, Dartmouth and MIT).

[225] *See* LAWTON & MAROM, *supra* note 17, at ix, xiii (discussing how crowdfunding "shares a lot of social networking's energy" and is "in the most simplistic terms, social networking meets venture financing"); Fisch, *supra* note 16, at 64 (discussing how Internet securities offerings can help connect more entrepreneurs with capital by reducing cost of connecting with traditional sources of capital); Schwartz, *supra* note 6, at 1473 (discussing how crowdfunding has the potential to give all entrepreneurs an equal chance at finding financing regardless of background or where they live in proximity to entrepreneurial hotspots like Silicon Valley); Dell, *supra* note 23 (defining crowdfunding as being "one part social networking and one part capital accumulation"); Gubler, *supra* note 22 (discussing crowdfunding's connection to social media).

[226] *See* Ibrahim, *supra* note 15, at 1417 (noting the capital gap that exists for entrepreneurs seeking up to $2 million); Gossage, *supra* note 224 (pointing out the additional work that entrepreneurs must do if they did not graduate from an elite university); Lennon, *supra* note 14 (stating that the average successful startups has raised $41 million); TrueBridge Capital, *supra* note 17 (discussing the large population of venture capitalists from elite universities).

[227] *See* Ibrahim, *supra* note 15, at 1417 (identifying the capital gap as existing for companies looking to raise up to $2 million); Mitra, *supra* note 15 (discussing the capital gap for entrepreneurs who are looking to raise $2 million or less); Zwilling, *supra* note 16 (citing crowdfunding as a way that entrepreneurs can survive the capital gap, or "valley or death"); *see also* Fisch, *supra* note 16, at 60 (pointing out that lack of capital is second only to management error as the major cause for business failure).

B. Raising the Annual Cap to $5 Million and Support for an Increased Cap

The SEC has the authority to increase the cap on what an entrepreneur can raise through equity crowdfunding to $5 million annually.[228] Section 3(b) of the Securities Act grants the SEC the authority to add new exemptions for offerings that do not exceed $5 million.[229] The SEC can exercise this authority as long as it finds that limiting the crowdfunding exemption to something less than $5 million is not "necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering."[230] Section 28 of the Securities Act further grants the SEC the authority to make any exemption, with no limit on the dollar amount, from any provisions or rules under the Securities Act if such an exemption is "necessary or appropriate in the public interest, and is consistent with the protection of investors."[231]

The SEC could appropriately raise the annual cap on crowdfunded securities to $5 million because, without changing the limits on how much each individual investor could invest in a year, investors' exposure to risk would not be affected.[232] Further, it would be in the public interest to raise the cap and allow more diverse entrepreneurs the opportunity to compete with their peers who are more likely to receive traditional forms of venture capital.[233] An annual cap of $5 million could lead to more of the "creative destruction" that bene-

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[228] *See* 15 U.S.C. §§ 77c(b), 77z-3 (2012).

[229] *Id.* § 77c(b).

[230] *See id.*; *see also* Bradford, *supra* note 22, at 87 (providing an overview of the SEC's authority to add new exemptions to its regulatory scheme).

[231] *See* 15 U.S.C. § 77z-3.

[232] *See id.* § 77d(a)(6)(B)(i)–(ii) (providing the limits that individual investors may contribute to a crowdfunding campaign based on their annual income or net worth). "While the SEC may have the authority to raise the cap higher than $5 million, the amount of risk inherent to Internet securities offerings likely disqualifies the crowdfunding exemption from being considered sufficiently 'necessary or appropriate in the public interest, and . . . consistent with the protection of investors.'" Bradford, *supra* note 22, at 87–88, 104–05 (discussing the standard that the SEC must meet to create an exemption greater than $5 million pursuant to § 28, and also recognizing that Internet crowdfunding is inherently risky).

[233] *See* 15 U.S.C. § 77d(a)(6)(A) (setting the cap on exempted crowdfunded securities at $1 million annually); Fisch, *supra* note 16, at 59–60 (discussing the importance of small business success to the economy, and noting the unmet need for capital to fund those businesses); Lennon, *supra* note 14 (presenting data showing that the average successful startup has raised $41 million through traditional startup financing methods). *See generally* Hart, *supra* note 11, at 3 (discussing the importance of strong entrepreneurial policy for a healthy economy).

fits our economy by spurring innovation and creating jobs.[234] For the Act to realize this potential, however, Congress must first empower it do so.[235]

CONCLUSION

Entrepreneurial activity is beneficial to the American economy. It is difficult, however, for entrepreneurs to secure the financing that they need to launch their businesses. The demand for startup financing significantly outweighs supply. Further, because of the "old boy's club" nature of the startup landscape, where the strength of an entrepreneur's network is effectively as important as the strength of his or her idea, female and minority entrepreneurs receive a disproportionately low amount of capital from venture capitalists and angel investors. Crowdfunding has the potential to help underrepresented entrepreneurs finance their startups by tapping into a community of online investors. As of May 16, 2016, entrepreneurs have been able to raise up to $1 million annually through crowdfunding securities pursuant to the crowdfunding exemption in Title III of the JOBS Act. This is good news for female and minority entrepreneurs, who may now be able to bypass the traditional sources of early-stage financing that have largely ignored them. Their businesses will need more than $1 million per year to survive, however, so Congress should amend the JOBS Act to raise the annual cap on the crowdfunding exemption to $5 million. Doing so may help empower a new crop of entrepreneurs to finally break the startup status quo.

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[234] *See* Hart, *supra* note 11, at 4–7 (explaining a connection between entrepreneurial policy and a healthy capitalist economy); Gilson & Kraakman, *supra* note 11, at 1431 (describing the "creative destruction" economic concept and how innovation contributes to economic progress); Orcutt, *supra* note 6, at 861 (citing SCHUMPETER, *supra* note 11, at 83 (providing an overview of economist Joseph Schumpeter's theory of "creative destruction" and its relation to entrepreneurship).

[235] *See* BENKLER, *supra* note 217, at 213 (discussing the power that social networks have to share and evaluate information more efficiently); Fisch, *supra* note 16, at 64 (recognizing that the Internet may have the potential to help some startups bridge the capital gap); Schwartz, *supra* note 6, at 1473 (discussing the "democratizing" effect of Internet crowdfunding, and how it could help entrepreneurs with no access to traditional forms of startup financing to launch their businesses); Dell, *supra* note 23 (highlighting the connection that crowdfunding makes between finance and social networking); Gubler, *supra* note 22 (discussing crowdfunding's connection to social media); Mitra, *supra* note 15 (proposing that crowdfunding may be able to "solve the startup capital gap"). *See generally* LAWTON & MAROM, *supra* note 17, at ix, xiii (discussing the power of crowdfunding to address the problems in the startup financing market).