[Fordham Journal of Corporate & Financial Law](https://ir.lawnet.fordham.edu/jcfl)

Volume 22 | Issue 2 Article 1

2017

The Right Deed for the Wrong Reason: A Critical Examination of Regulation A+ and its Rationales

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THE RIGHT DEED FOR THE WRONG REASON: A CRITICAL EXAMINATION OF REGULATION A+ AND ITS RATIONALES

Louis Anthony Steiner[*]

The recent enactment of Regulation A+ makes it possible for the first time for companies to conduct retail equity crowdfunding (i.e., equity crowdfunding campaigns involving general solicitation of unaccredited investors). On its surface, Regulation A+ seems poised to provide dual benefits to start-ups by both democratizing access to capital and easing the transition into public company status. However, Regulation A+ is largely a solution in search of a problem. There is little empirical evidence of an equity gap for early stage companies, nor is there evidence that the recent dip in small-company IPOs has anything to do with regulatory burdens. While Regulation A+'s two main raisons d'etre are likely misguided, the regulation may still provide modest, but important, social benefits. Close enforcement is needed, however, to ensure these benefits do not come at the cost of market integrity and potential losses to ordinary investors.

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INTRODUCTION

It is estimated that over $5.1 billion in funds were raised via crowdfunding in 2013.[1] Prosper and Lending Club, the two largest peer-to-peer lenders, made $1.7 billion in loans in 2014, up from a mere $26 million in 2009.[2] Meanwhile, crowdfunding in real estate grew by 156% in 2014 to a total of over $1 billion.[3] A recent World Bank study found that "[b]y 2025, the global crowdfunding market could reach between $90 billion and $96 billion—roughly 1.8 times the size of the global venture capital industry today."[4] Crowdfunding in its various forms has taken the world by storm, and the Securities and Exchange Commission's ("SEC") recent enactment of Regulation A+ could open the floodgates even wider by enabling companies to conduct retail equity crowdfunding raises of up to $50 million at a time.[5]

Whether equity crowdfunding holds the potential to spur economic development is still up for debate, but early signs have been promising. A study of Kickstarter campaigns found that "over 90% of successful projects remained as ongoing ventures for 1–4 years after their campaign, almost a third reported annual revenues of over $100,000 a year since the campaign, and successful projects increased their staffing by 2.2 employees on average."[6] Another, more recent survey found that "[o]f the fifty highest funded projects on Kickstarter, . . . [forty-five] have turned

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1. MASSOLUTION, 2013CF THE CROWDFUNDING INDUSTRY REPORT (2013). This figure includes reward-based, donation-based, debt-based, and equity-based crowdfunding.

2. Michael S. Fischer, *Crowdfunding Makes Rapid Gains with Accredited Investors*, THINKADVISOR (Mar. 30, 2015), https://www.thinkadvisor.com/2015/03/30/crowdfunding-makes-rapid-gains-with-accredited-inv [https://perma.cc/HKP7-2W6J].

3. Zachary Zagger, *Real Estate Crowdfunding to Top $2.5B in 2015, Report Says*, LAW360 (Mar. 3, 2015, 10:00 AM), https://www.law360.com/articles/624658/real-estate-crowdfunding-to-top-2-5b-in-2015-report-says [https://perma.cc/J77G-7E6B].

4. Katherine Noyes, *Why Investors Are Pouring Millions into Crowdfunding*, FORTUNE (Apr. 17, 2014, 6:47 PM), https://fortune.com/2014/04/17/why-investors-are-pouring-millions-into-crowdfunding [https://perma.cc/3KY6-RWHG].

5. *See infra* Section I.C.

6. Gary Bruton et al., *New Financial Alternatives in Seeding Entrepreneurship: Microfinance, Crowdfunding, and Peer-to-Peer Innovations*, 39 ENTREPRENEURSHIP THEORY & PRAC. 9, 15 (2015) (citing Mollick, *After the Campaign: Outcomes of Crowdfunding* (UNC Kenan-Flagler, Research Paper No. 2376997, 2014), https://ssrn.com/abstract=2376997 [https://perma.cc/Q4AN-BKT2]).

into ongoing entrepreneurial firms."[7] Thus, the early evidence seems to suggest that crowdfunding platforms are indeed capable of spawning viable businesses. Even more promising is a recent success story from the United Kingdom's equity crowdfunding scene[8]:

> In October of 2012, a pharmaceutical development company called Antabio, which had raised early stage funding on WiSeed, became the first company to reach an important milestone in the development of equity crowdfunding—over two hundred crowd investors received a profitable return in an exit event. In fact, not only did the investors make a return, some made as much as 70% on their initial investment when a larger pharmaceutical development company bought out all of Antabio's existing shares.[9]

Current experience with crowdfunding indicates that those seeking funds are, for the most part, serious about what they are doing: roughly 25% of hardware projects on Kickstarter deliver on time, which is in line with the on-time performance rates of projects backed by more traditional funding sources.[10] Experiments with allowing intrastate equity crowdfunding in several Midwestern states also seem to indicate that fraud is not rampant.[11]

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7. Ethan Mollick, *Swept Away by the Crowd? Crowdfunding, Venture Capital, and the Selection of Entrepreneurs* 10 (Wharton School of the University of Pennsylvania, Working Paper, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239204 [https://perma.cc/T5H9-REJU].

8. Note that the United Kingdom's market is a dramatically different market from that of the United States, and thus may not be a perfect indicator of how United States crowdfunding campaigns will fare. Note also that given the nascency of the crowdfunding market, one should be hesitant to generalize too readily from the small number of samples we have to work with at the current time.

9. Ross S. Weinstein, *Crowdfunding in the U.S. and Abroad: What to Expect When You're Expecting*, 46 CORNELL INT'L L.J. 427, 446 (2013).

10. *Can Crowdfunding Democratize Access to Capital?*, INNOVATION@WORK BLOG (Jun. 2, 2014), https://executive.mit.edu/blog/can-crowdfunding-democratize-access-to-capital [https://perma.cc/H3ND-BATC].

11. Steven Davidoff Solomon, *S.E.C.'s Delay on Crowdfunding May Just Save It*, N.Y. TIMES: DEALBOOK (Nov. 18, 2014), https://dealbook.nytimes.com/2014/11/18/s-e-c-s-delay-on-crowdfunding-may-just-save-it-2/ [https://perma.cc/KX6M-43PP]. These early experiments are being somewhat contradicted by recent developments under the JOBS Act. *See, e.g.*, Martin O'Sullivan, *FINRA Bars Crowdfunding Portal in 1st JOBS Act Settlement*, LAW360 (Dec. 9, 2016), https://www.law360.com/articles/870969/finra-bars-crowdfunding-portal-in-1st-jobs-act-settlement [https://perma.cc/BV68-CCYT].

With this in mind, many prominent voices have called for relaxed regulations on capital gathering by start-ups. Steve Case, for example, has famously called for giving unaccredited investors greater ability to invest by noting that "[i]t seems a little crazy to me that you have to be an accredited investor to invest in a company, but you can go to Las Vegas and lose $10,000 at the table in an hour and you don't have to be an accredited gambler to do that."[12] Others note that regulators' natural aversion to letting start-ups freely raise capital has often worked to the detriment of investors. Sam Guzik, an attorney practitioner who frequently writes on issues in this field, is fond of pointing out that the state of Massachusetts blocked its residents from participating in Apple's 1980 initial public offering ("IPO") because the investment opportunity failed merit review, thereby preventing those residents from holding a piece of what later became the most valuable public company in the world.[13]

But for all its promise, opening up the largely unexplored frontier of equity crowdfunding brings some massive risks. Several prominent commentators question whether the general public can properly vet investment opportunities and screen out fraudulent company listings,[14] and it is far from clear that unaccredited investors will be able to diversify sufficiently to avoid devastating losses. Despite these very real risks, Regulation A+ has been placed in the Code of Federal Regulations and is now in effect. This Article examines the potential consequences of its adoption, critiques the two primary rationales for the regulation in light of those consequences, and offers a normative framework that ought to guide the SEC's enforcement going forward.[15] Analysis will proceed in four parts. Part I discusses the history of and impetus for Regulation A+. Part II discusses the merits of the "democratizing access to capital"

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12. Scott Edward Walker, *Crowdfunding Bill Stuck in the Senate*, FORBES (Jan. 13, 2012), https://www.forbes.com/sites/scottedwardwalker/2012/01/13/crowdfunding-bill-stuck-in-the-senate/2 [https://perma.cc/6S6W-EA4H].

13. Sam Guzik, *Regulation A+ Offerings—A New Era at the SEC*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 15, 2014), https://corpgov.law.harvard.edu/2014/01/15/regulation-a-offerings-a-new-era-at-the-sec [https://perma.cc/5U8V-XPUJ].

14. *See, e.g.*, 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).

15. While the scope of this Article is limited to discussing Regulation A+, to the extent Regulation Crowdfunding (issued under Title III of the JOBS Act) has similar aims, the same critiques can be leveled against it and the same prescriptions apply.

rationale for Regulation A+. Part III examines the merits of the "IPO facilitation" rationale for Regulation A+. Part IV evaluates Regulation A+ holistically in light of its dual goals and makes certain suggestions in terms of enforcement.

I. HISTORY AND IMPETUS FOR REGULATION A+

A. THE ECONOMIC IMPORTANCE OF SMALL FIRMS

In 2011, at least three bills were introduced that sought to increase access to capital for entrepreneurs.[16] All three bills were motivated (ostensibly) by a desire to spur economic growth, and were influenced by the pervasive notion that start-ups hold the key to such growth.[17] And indeed, there is ample evidence (approaching the problem from multiple perspectives) to support the idea that start-ups are key drivers of economic prosperity.

Consider the issue of reducing unemployment. Despite their small size, new businesses are responsible for the bulk of job creation. According to a report by the Kauffman Foundation, "existing firms are net job destroyers, losing 1 million jobs net combined per year. By contrast, in their first year, new firms add an average of 3 million jobs."[18] And this job creation seems to be subject to a multiplier effect: each new high-tech job is estimated to create 4.3 additional non-high-tech jobs in a given region.[19] The employment boost provided by start-ups seems to be relatively resilient compared to other job sources: "during recessionary years, job creation at startups remains stable, while net job losses at

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16. Walker, *supra* note 12.
17. *Id.*
18. TIM KANE, EWING MARION KAUFFMAN FOUND., THE IMPORTANCE OF STARTUPS IN JOB CREATION AND JOB DESTRUCTION (2010), https://www.kauffman.org/what-we-do/research/firm-formation-and-growth-series/the-importance-of-startups-in-job-creation-and-job-destruction [https://perma.cc/FLE3-3S9U].
19. IAN HATHAWAY, Bay Area Council Econ. Inst., TECHNOLOGY WORKS: HIGH-TECH EMPLOYMENT AND WAGES IN THE UNITED STATES (2012). *See generally* Enrico Moretti, *Local Multipliers*, 100 AM. ECON. REV: PAPERS & PROC. 1 (2010). For a similar analysis reaching similar results in Europe, see Marten Goos et al., *High Technology Employment in the European Union* (Vives, Discussion Paper, 2013), https://feb.kuleuven.be/VIVES/Onderzoek/discussionpapers/DP/dp2013/final-20131223-3rd.pdf [https://perma.cc/96UV-EGWX].

existing firms are highly sensitive to the business cycle."[20] Similarly, "[p]atterns of job growth at startups and existing firms are both pro-cyclical, although existing firms have much more cyclical variance."[21]

New firms backed by venture capitalists are especially adept at producing jobs. In fact, in 2010, there were 11.9 million venture-backed jobs in the United States, comprising 11% of jobs in the private sector[22]—this, despite annual venture capital investment amounting to less than 0.2% of GDP.[23] These jobs are also slightly more resilient than average: while the 2008 financial crisis caused a drop in private-sector employment of 2.6% from 2008 to 2010, "venture-backed company employment fell by only 2.0 percent—23 percent less than the overall decline."[24] Statistics on angel investments paint a similar picture: "by one estimate, in the first half of 2013 alone, angels invested approximately $9.7 billion in over 28,000 ventures, with over 111,000 new jobs created as a result of these investments."[25]

Interestingly, research suggests that "92% of job growth for young companies occurs after an initial public offering."[26] The Kauffman Foundation estimates that if companies had gone public in the first decade of the twenty-first century at the same rate they did between 1980 and 2000, an additional 1.881 million jobs would have been created over that

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20. KANE, *supra* note 18.

21. *Id.*

22. NAT'L VENTURE CAPITAL ASS'N, VENTURE IMPACT: THE ECONOMIC IMPORTANCE OF VENTURE CAPITAL-BACKED COMPANIES TO THE U.S. ECONOMY 3 (6th ed. 2011), https://www.jumpstartnetwork.org/sitecore/content/jumpstartinc/home/results/dl/~/media/JumpStartInc/Images/Results-Page/2011-NVCA-VentureImpactReport.ashx [https://perma.cc/L3UT-HJUN].

23. *Id.* at 2.

24. *Id.* at 8.

25. Keith Higgins, *The Changing Regulatory Landscape for Angel Investing*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Apr. 21, 2014), https://blogs.law.harvard.edu/corpgov/2014/04/21/the-changing-regulatory-landscape-for-angel-investing/ [https://perma.cc/7JR2-FJR2] (citing JEFFREY SOHL, CTR. FOR VENTURE RESEARCH, THE ANGEL INVESTOR MARKET IN Q1Q2 2013: A SUSTAINABLE GROWTH CONTINUES (2013), https://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/Q1Q2%202013%20Analysis%20Report.pdf [https://perma.cc/4UKV-W3W4]).

26. NAT'L VENTURE CAPITAL ASS'N, *supra* note 22, at 4. This figure is questioned in MARTIN KENNEY, DONALD PATTON & JAY R. RITTER, EWING MARION KAUFFMAN FOUND., POST-IPO EMPLOYMENT AND REVENUE GROWTH FOR U.S. IPOS, JUNE 1996-2010 (2012), https://www.kauffman.org/what-we-do/research/2012/05/postipo-employment-and-revenue-growth-for-us-ipos-june-19962010 [https://perma.cc/DB69-NTGW], which considers the actual number to be something closer to 62%.

decade.[27] Given those staggering figures, it is easy to understand why Congress and the SEC have made it a priority to create a smoother "on-ramp" for emerging growth companies,[28] attempting to offer start-ups a cheaper, easier "mini-IPO" under Regulation A.[29]

GDP figures paint a similar picture regarding the importance of new firms. According to the National Venture Capital Association, "for every dollar of venture capital invested from 1970 to 2010, $6.27 of revenue was generated in 2010."[30] In fact, revenue from venture capital-backed companies currently comprises roughly 21% of U.S. GDP.[31] Similarly, a report from Deutsche Bank finds that "[a]n increase in VC investments of 0.1% of GDP is statistically associated with an increase in real GDP growth of .30pp. A similar increase in seed and startup investments is associated with an increase of as much as .96pp."[32]

On a more qualitative level, start-ups seem to improve the flow of tacit information among firms in a given region, thereby contributing greatly to a region's competitiveness.[33] Small firms lead to more knowledge dissemination and thus are more impactful to the local economy, while "[l]arge firms incorporate many of the services within their own operations because they can achieve scale economies within the

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27. KENNEY ET AL., *supra* note 26. Query, however, whether the drop in IPOs has a direct causal effect on employment figures, or whether employment figures and IPO figures are both driven by some third, common cause.

28. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, Title I, 126 Stat. 306, 307-13 (codified in scattered sections of 15 U.S.C. (2012)).

29. *See, e.g.*, Victoria Silchenko, *Fifty Shades of White: Raising Equity from the Public by Start-ups*, HUFFINGTON POST (Mar. 31, 2015), https://www.huffingtonpost.com/victoria-silchenko/fifty-shades-of-white-rai_b_6966268.html [https://perma.cc/88WN-GEH5] (characterizing the regulation as creating a "mini-IPO" mechanism).

30. NAT'L VENTURE CAPITAL ASS'N, *supra* note 22, at 2.

31. *Id.*

32. THOMAS MEYER, Deutsche Bank Research, VENTURE CAPITAL ADDS ECONOMIC SPICE 5 (2010), https://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000262487.PDF [https://perma.cc/EHC4-FY8P]. The report cautions, however, that causality likely runs both ways. *Id.* at 5. The author does find that a Granger-causality test of the U.S. data indicated that U.S. venture capital investment does, in fact, cause real-GDP growth. *Id.* at 4.

33. Matthew A. Zook, *The Knowledge Brokers: Venture Capitalists, Tacit Knowledge and Regional Development*, 28 INT'L J. URB. & REGIONAL RES. 621, 624 (2004)).

firm."[34] In other words, large firms are more fully integrated and less reliant on outside suppliers, such that "dollar for dollar, their business is less of a stimulus" because it generates less local knowledge dissemination than that of smaller firms.[35]

Thus, it is clear that new firms are integral to the success of the U.S. economy, regardless of whether success is measured in terms of employment rate, GDP, or other less easily quantifiable measures, such as the rate of knowledge dissemination.

B. Regulation A and Its Shortcomings

Regulation A+ updates Regulation A, an exemption that was meant to be attractive for small issuers. Compared to full SEC registration, the Regulation A exemption offered numerous benefits including (but not limited to) the following:

> (i) reduced disclosures to investors . . . including the ability to use "reviewed" financial statements instead of audited financial statements, . . . [(ii)] the ability to "test the waters" prior to incurring significant upfront costs such as filing an offering memorandum with the SEC, [(iii)] the ability of an investor to receive free trading shares upon their issuance, and (iv) the absence of post-offering reporting requirements unless and until a company meets the threshold reporting requirements applicable to all companies under the Securities Exchange Act of 1934.[36]

However, Regulation A proved to be highly unpopular. From 1997 to 2011, the number of filings per year began at a mere 116 and fell to 19.[37] Actual use of the exemption is even lower; in fact, in 2011, only one of the nineteen filings ultimately resulted in an offering qualified by Regulation A.[38] As a result, Regulation A filings are currently dwarfed by both Regulation D offerings (8194 in 2011) and registered IPOs (312 in 2011).[39] This low utilization is generally attributed to the high cost of

34. *Id.* at 624 (citing Chinitz, *Contrasts in Agglomeration: New York and Pittsburgh*, 51 AM. ECON. REV. 279, 288 (1961)).

35. *Id.*

36. Guzik, *supra* note 13.

37. U.S GOV'T ACCOUNTABILITY OFF., GAO-12-839, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS 8-9 (2012).

38. *Id.*

39. *Id.* at 10-11.

conducting a Regulation A offering compared to the amount that can be raised.[40] The bulk of the cost arises from the need to comply with blue sky laws of each state where the offering is conducted,[41] which can require substantial time and money.[42] The most troublesome blue sky laws are those involving "merit review,"[43] which can lead to incidents like Massachusetts' infamous decision to pull the plug on Apple's 1980 IPO.

C. REGULATION A+ TO THE RESCUE

Recognizing the failure of Regulation A to offer meaningful support to small issuers, Congress elected to update the regulation in Title IV of the JOBS Act.[44] This enhanced form of Regulation A is commonly referred to as "Regulation A+." The SEC, working under the mandate of Congress, proposed rules for Regulation A+ on December 18, 2013.[45] The final Regulation A+ rules were announced on March 25, 2015 with slight variations from their proposed form. Under the final rules, the exemption is available in two tiers, which work as follows:

- The Tier 1 exemption is available only to those who raise $20 million or less.[46] It requires both SEC and state-level review, along with the associated fees.[47] Issuers are, by default, required only to have their financials reviewed for registration, not audited,

40. Guzik, *supra* note 13.
41. *Id.* (citing U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 37).
42. *Id.*; *see also* David Drake, *Crowdfunding Industry Set to Explode as SEC Approves Regulation A+*, HUFFINGTON POST (Mar. 27, 2015), https://www.huffingtonpost.com/david-drake/crowdfunding-industry-set_b_6953600.html [https://perma.cc/3A5L-USWR].
43. Guzik, *supra* note 13.
44. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, Title IV, 126 Stat. 306, 323-25 (codified at 15 U.S.C. §§ 77c-77d, 77r (2012)).
45. Press Release, Sec. & Exch. Comm'n, SEC Proposed Rules to Increase Access to Capital for Smaller Companies (Dec. 18, 2013), https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540518165 [https://perma.cc/QWQ3-RK25].
46. David Drake, *Why the New Regulation A+ Rules Will Rock the Crowdfunding World*, HEDGECO.NET (Mar. 29, 2015), https://www.hedgeco.net/blogs/2015/03/29/why-the-new-regulation-a-rules-will-rock-the-crowdfunding-world-by-david-drake/ [https://perma.cc/KH4N-6WLV].
47. *Id.*

although audited financials are required to be disclosed if they are already in existence.[48]

- The Tier 2 exemption, in contrast, is available for raises of up to $50 million.[49] Tier 2 requires SEC review but no state blue-sky review, in essence pre-empting state-level review.[50] Issuers must disclose audited financials[51] and must submit to an annual audit on a going-forward basis. This exemption also requires the use of a registered transfer agent.[52]

Both tiers create unrestricted securities,[53] allow participation by unaccredited investors, and are not available for certain "bad actors" or for reporting companies.[54] In certain circumstances, Tier 2 offerings are exempt from the registration requirements of Section 12(g) of the Securities Exchange Act.[55]

Practitioners have argued that compared to Rule 506(c) offerings,[56] Regulation A+ has both pros and cons that are, on balance, likely to make it a somewhat attractive option for issuers. On the plus side, Regulation A+ allows for solicitation of unaccredited investors, creates a tradable

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48. *Id.*; *see also* KATHERINE K. DELUCA ET AL., A GUIDE TO REGULATION A+ 11 (2015), https://media.mcguirewoods.com/publications/2015/White-Paper-on-Regulation-Aplus.pdf [https://perma.cc/35Y6-BM4W].

49. Drake, *supra* note 46.

50. *Id.*

51. *Id.*

52. *Id.*

53. Alon Y. Kapen, *SEC Adopts Final Reg A+ Rules for Mini Public Offerings of up to $50 Million Without Registration*, N.Y. VENTURE HUB (Mar. 26, 2015), https://www.nyventurehub.com/2015/03/26/sec-adopts-final-reg-a-rules-for-mini-public-offerings-of-up-to-50-million-without-registration/ [https://perma.cc/L3UH-YUFJ].

54. Press Release, Sec. & Exch. Comm'n, SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital (Mar. 25, 2015), https://www.sec.gov/news/pressrelease/2015-49.html [https://perma.cc/4BUH-YAY8].

55. Dorothee Fisher-Appelt and Godric C. Shoesmith, Greenberg Traurig, LLP, *SEC Adopts Regulation A+: Two New Alternatives for Exempt Capital Raises* 4 (2015).

56. By way of background, Rule 506(c) is an exemption from the registration requirements of the Securities Act of 1933, which allows an issuer to engage in a general solicitation without having to register the securities being sold, so long as the issuer limits participation to accredited investors only and takes certain concrete steps to verify the accredited status of each participant. *See generally* U.S. Sec. & Exch. Comm'n, *Fast Answers: Rule 506 of Regulation D*, SEC (Oct. 6, 2014), https://www.sec.gov/fast-answers/answers-rule506htm.html [https://perma.cc/3U6G-AXDY]. Rule 506(c), unlike some of the other exemptions from the '33 Act, does not place a limit on the size of the offering. *Id.*

security, and has relatively high offering limits (especially under Tier 2).[57] Its downsides include the considerable time it can take to launch a Regulation A+ offering (SEC review being a bottleneck) and the increased legal fees and accounting costs compared to Regulation D private placements (because of the fees associated with both the initial registration and the ongoing reporting obligations).[58]

On its face, Regulation A+ promises to change the risk capital landscape in two ways: (1) by addressing inequitable distributions of risk capital, thereby "democratizing" access to capital, and (2) by creating a "mini-IPO" process less burdensome than full IPOs, thereby affording increased access to public markets for companies too small to afford the expense of the extensive registration and disclosure involved in conducting a full IPO. Viewed critically, however, both rationales contain serious flaws which largely undermine the arguments for adopting Regulation A+. The two rationales will be discussed in turn.

II. THE "DEMOCRATIZING ACCESS TO CAPITAL" RATIONALE—DOES IT HOLD UP?

A. IS THERE A GENERAL UNDERSUPPLY OF RISK CAPITAL?

Many entrepreneurs will argue that a huge barrier to their success is the fact that too few investors are willing to invest in risky, early-stage ventures. For example, a 2014 survey found that the second most common perceived reason for failure among unsuccessful start-ups was that they "[r]an out of cash."[59] Similarly, there is no shortage of news articles from various regions claiming that a severe lack of capital in the area is holding back the local start-up community (and, by extension, the local economy).[60]

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57. Drake, *supra* note 46.

58. *Id.*

59. Erin Griffin, *Why Startups Fail, According to Their Founders*, FORTUNE (Sept. 25, 2014, 3:00 PM), https://fortune.com/2014/09/25/why-startups-fail-according-to-their-founders/ [https://perma.cc/VSB5-9LLR]. The most commonly perceived reason was "the lack of a market need." *Id.*

60. *See, e.g.*, Chuck Soder, *Local Startups Are Stalled by Lack of Capital*, CRAIN'S CLEVELAND BUS. (Apr. 20, 2014), https://www.crainscleveland.com/article/20140420/SUB1/140419790/local-startups-are-stalled-by-lack-of-capital [https://perma.cc/5688-9B67].

However, those on the other side of the table paint a very different picture. A common refrain among venture capitalists is that "[t]here's still too much money . . . chasing too few deals."[61] The consensus seems to be that the existing private placement market is already a deep source of funding, and those entrepreneurs who feel that there is an undersupply of capital are probably overestimating the number of viable ventures.[62] Venture capitalists also contend that while funding levels have remained relatively constant over time (albeit with some cyclical variance), the amount of capital needed to launch a company has decreased dramatically in recent years due to cloud computing, lower software development costs, and a variety of other advancements.[63]

While the literature is somewhat conflicting, the bulk of the empirical evidence gathered so far seems to indicate that venture capital is not, in general, undersupplied. Perhaps the starkest indicator of this is the fact that venture capital returns during the 2000s were abysmal. If venture capital, as an asset class, were undersupplied, one would expect the "price" of acquiring venture capital to be artificially high and returns on venture capital investments to be artificially high as a result (on a risk-adjusted basis). Yet an infamous Kauffman Foundation report from 2009 suggests that, on average, venture capital funds failed to outperform the Russell 2000 Index from 1997 to 2009.[64] In fact, more than half of the

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61. *E.g.*, Carmel DeAmicis, *Bill Draper: Why Venture Returns Have Fallen Dramatically and Will Likely Stay That Way*, PANDODAILY (June 24, 2013), https://pando.com/2013/06/24/venture-capitalist-bill-draper-takes-the-long-view-of-history-2/ [https://perma.cc/FAK8-FMMS].

62. *See, e.g.*, *id.*; Sarah Max, *Venture Capital Is Looking for Ways to Outrun the Herd*, N.Y. TIMES: DEALBOOK (Dec. 10, 2014, 12:31 PM), https://dealbook.nytimes.com/2014/12/10/venture-capital-is-looking-for-ways-to-outrun-the-herd/ [https://perma.cc/GVF6-NVZN].

63. *See, e.g.*, Deborah Gage, *Which Start-Ups Should Not Raise Venture Capital?*, WALL ST. J.: VENTURE CAP. DISPATCH (Apr. 3, 2012, 4:34 PM), https://blogs.wsj.com/venturecapital/2012/04/03/which-start-ups-should-not-raise-venture-capital/ [https://perma.cc/HYG5-TCBL] (recapping a discussion among a panel of investors and entrepreneurs who felt that "[w]ith Amazon Web Services and a myriad of other free or low-cost technologies, start-ups are cheaper than ever to start"). This may be more true for the software industry than other industries, but even for non-software companies a robust ecosystem has developed, which lowers costs appreciably.

64. DIANE MULCAHY ET AL., EWING MARION KAUFFMAN FOUND., WE HAVE MET THE ENEMY, AND HE IS US 3 (2012), https://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2012/05/we_have_met_the_enemy_and_he_is_us.pdf [https://perma.cc/ZB4A-HKQU].

venture capital firms surveyed in the report *failed to even return investor capital* (*after fees*) during the period from 1989 to 2003—suggesting that, if anything, venture capital is probably being *oversupplied* at the moment, not undersupplied.[65]

Evidence from European markets conflicts with this picture somewhat, but not entirely. A survey conducted of small enterprise financing data in the United Kingdom found that "small business growth is constrained by a lack of working capital,"[66] even after controlling for a number of variables related to business and owner characteristics. Another study found that "European [technology companies] finance new investments by relying primarily on internal funds. There seems to be a wedge between the cost of internal and outside finance, including debt and external equity. Such a wedge is likely due to capital market failures induced by asymmetric information."[67] It is important to note, however, that two factors limit the applicability of these studies. First, the United Kingdom does not have as robust a private capital market as the United States, so one must be careful about generalizing too much from data from the United Kingdom. Second, given the evidence that the observed market failure is rooted in information asymmetry, the correct way to address it would be by facilitating quality disclosures, rather than trying to increase the supply of capital.

In short, the evidence is not entirely consistent, but the most convincing signs indicate that there is probably not a nationwide—or global—shortage of startup capital.

B. IS THERE A REGIONAL EQUITY GAP?

Even if there is no nationwide undersupply of capital, it is possible that capital might be undersupplied in some regions and overabundant in others, creating a "regional equity gap" to the detriment of entrepreneurs in the underserved regions. Indeed, there is evidence that venture capital

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65. *Id.* at 4.

66. Stuart Fraser et al., *What Do We Know About Entrepreneurial Finance and Its Relationship with Growth?*, 33 INT'L SMALL BUS. J. 70, 78 (2015) (citing STUART FRASER, ACCESS TO FINANCE FOR CREATIVE INDUSTRY BUSINESSES (2011), https://www.bis.gov.uk/assets/biscore/enterprise/docs/a/11-898-access-to-finance-for-creative-industry-businesses [https://perma.cc/AX5X-8AFY]).

67. Valérie Revest & Alessandro Sapio, *Financing Technology-Based Small Firms in Europe: What Do We Know?*, 39 SMALL BUS. ECON. 179, 198 (2012).

investments tend to flow disproportionately to a small number of tech "clusters."[68] If there is a regional equity gap, crowdfunding seems to hold great promise to remedy it, since "80% of [crowd]funding comes from people more than 3,000 miles away from the startup's/fund seeker's physical location."[69] But to understand whether there is a regional equity gap at all, we must first understand why venture capital investments are so heavily clustered.

1. Venture Capitalist and Angel Investment Criteria

Both venture capitalists and angel investors exhibit a tendency to invest disproportionately high amounts of capital in certain key regions.[70] A series of papers by Florida and Kenney in the early 1990s, for example, found that venture capital investments primarily flowed into established high-tech centers such as Silicon Valley and Boston's Route 128.[71] They further found that technology hubs attract venture capitalists not only from the surrounding, local regions, but also from financial centers like New York and Chicago.[72] While it might be expected that the clustering of venture capital investment would decline over time, subsequent studies have found just the opposite.[73] This effect has become so pronounced that today, despite talk of globalization, "the average distance between a lead VC and their investment is 70 miles."[74] This is very much a conscious decision on the part of investors—surveys find that somewhere between 25% and 72% of angel investors will intentionally limit their investing to within fifty miles of home.[75]

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68. *See, e.g.*, Richard L. Florida & Martin Kenney, *Venture Capital, High-Technology and Regional Development*, 22 REGIONAL STUD. 33, 33 (1988).

69. *Can Crowdfunding Democratize Access to Capital?*, *supra* note 10.

70. Richard Florida & Donald F. Smith, Jr., *Venture Capital Formation, Investment, and Regional Industrialization*, 83 ANNALS ASS'N AM. GEOGRAPHERS 434, 436 (1991) (citations omitted).

71. *Id.*

72. *Id.*

73. Colin Mason, *VC: A Geographical Perspective*, *in* HANDBOOK OF RESEARCH ON VENTURE CAPITAL 86, 102 (Hans Landstrom ed., 2007).

74. Olav Sorenson & Toby E. Stuart, *Bringing the Context Back In: Settings and the Search for Syndicate Partners in Venture Capital Investment Networks*, 53 ADMIN. SCI. Q. 266 (2008); Mollick, *supra* note 7, at 8 (citation omitted).

75. Mason, *supra* note 73, at 90–91 (citing PATRICK COVENEY & KARL MOORE, BUSINESS ANGELS: SECURING START-UP FINANCE (1997); ROBERT J. GASTON, FINDING PRIVATE VENTURE CAPITAL FOR YOUR FIRM: A COMPLETE GUIDE (1989); Stuart Paul et

One commonly cited reason for this is a practical one: investors prefer to invest in companies that are physically close so that they do not have to travel far to work with their portfolio companies.[76] Yet a preference for avoiding long travel surely does not tell the whole story. A study of Germany's venture capital industry found that the distance of the portfolio company was only a minor consideration in deciding when to invest, and that the interviewed investors generally agreed that the acute undersupply of good deals required them to be relatively geography agnostic.[77]

A more nuanced view suggests that this effect arises, in part, because of the "absence of publicly available information on new and young businesses."[78] This view posits that their "unproven business models, untested management teams, new technologies and inchoate markets" are all significant sources of risk and uncertainty for investors.[79] Venture capitalists attempt to minimize this risk by sharing information with "other investors, consultants, accountants and a wide range of other actors"[80]—but information sharing does not come easily. For proper information sharing, participants need mutual trust, which can only be established over time and through ongoing communication; thus, the "nature of this information flow tends to [be] personal and informal and

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al., *The Operation of the Informal Venture Capital Market in Scotland*, 5 VENTURE CAP. 313 (2003); Dominique M. Short & Allan L. Riding, *Informal Investors in the Ottawa-Carleton Region: Experiences and Expectations*, 1 ENTREPRENEURSHIP & REGIONAL DEV. 99 (1989)). Note that one 1989 survey of U.S. angels found that 72% wished to invest within fifty miles of home and only 7% had no geographic preferences. GASTON, *supra*.

76. *See, e.g.*, *Can Crowdfunding Democratize Access to Capital?*, *supra* note 10 ("According to Professor Ajay Agrawal of the University of Toronto, 'The angel level of finance is traditionally very local and liquid. The various [crowdfunding] platforms make it more impactful for both investors and founders.'").

77. Michael Fritsch & Dirk Schilder, *Does Venture Capital Investment Really Require Spatial Proximity? An Empirical Investigation* (Freiberg, Working Paper No. 07/2006, 2006), https://tu-freiberg.de/sites/default/files/media/fakultaet-6-3307/fileadmin/Arbeitspapiere/2006/fritsch_7_2006.pdf [https://perma.cc/Q24U-MDC6]. The authors note that Germany may be a unique case because most cities in Europe are accessible from every other city by a two-hour flight. *Id.*

78. Mason, *supra* note 73, at 103.

79. *Id.* (citing Olav Sorenson & Toby E. Stuart, *Syndication Networks and the Spatial Distribution of Venture Capital Investments*, 106 AM. J. SOC. 1546 (2001)).

80. *Id.*

therefore hard to conduct over distance."[81] Sticking to local investments is thus one way venture capitalists can "reduce uncertainty, compensate for ambiguous information and thereby [minimize] risk."[82]

This reliance on personal and professional relationships continues throughout every stage of the investment—from the initial investment decisions to the post-investment monitoring stage.[83] Post-investment, venture capitalists monitor their portfolio companies by "taking a seat on the board of directors, setting goals and metrics for the companies to meet and . . . [providing] advice and mentoring."[84] In some cases, they may directly manage the company (e.g., if the business is led by a young scientist).[85] The proximity of the venture capitalist to the company influences the efficacy of these post-investment activities in three ways: (1) venture capitalists can work more closely with local companies, (2) venture capitalists can provide more relevant referrals and contacts to nearby companies, and (3) "unplanned encounters" and informal informational flow is stronger if the venture capitalist and company are physically closer.[86] Thus, venture capitalists who take seriously the goal of maximizing investment returns will naturally prefer to invest in start-ups that are closer to them.

To be sure, there are likely some factors that encourage localized venture capital-funding and that are not associated with greater returns. For example, "behavioral reasons may also contribute to [investors'] preference for local investments because [local investments] can potentially allow them to maintain and strengthen local social and family ties more effectively than distant transactions."[87] To the extent that such considerations drive investment decisions, crowdfunding may be able to offer an improvement by routing money to the most meritorious companies, rather than to companies that happen to offer potential personal benefits for local venture capitalists. However, there is little

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81. *Id.*

82. *Id.* (citing Florida & Kenney, *supra* note 68; Florida & Smith, Jr., *supra* note 70).

83. *Id.*

84. *Id.* at 105.

85. *Id.* (citing MATTHEW ZOOK, THE GEOGRAPHY OF THE INTERNET INDUSTRY (2005); Walter W. Powell et al., *The Spatial Clustering of Science and Capital: Accounting for Biotech Firm-Venture Capital Relationships*, 36 REGIONAL STUD. 291 (2002)).

86. *Id.* (citing Powell et al., *supra* note 85).

87. Christos Kolympirisa & Nicholas Kalaitzandonakes, *The Geographic Extent of Venture Capital Externalities on Innovation*, 15 VENTURE CAP. 199, 200 (2013).

evidence to suggest that personal perquisites play anything more than a minor role in venture capitalists' decision-making.

The above should not be taken to mean that the supply of venture capital necessarily constrains the flow of venture capital. To the contrary, the supply of venture capital is more than capable of flowing to the best opportunities through the mechanism of investment syndication. As long as there is at least one investor geographically close to the opportunity and willing to serve as the "lead investor" (i.e., the investor responsible for monitoring the investment), other investors from distant locales can participate without losing the benefit of local monitoring and mentorship. This process of syndication has led to the somewhat paradoxical situation that "[o]n the one hand, VC is highly mobile and on the other, it is very concentrated"[88]: regardless of the source of the capital, investments tend to occur near "concentrations of high-technology businesses and employment and VC coinvestment."[89] Thus, the supply and demand of venture capital appear to be largely geographically decoupled, which "contradicts the underlying premise upon which much public policy in this area rests, viz., that 'gaps' in the [venture capital] supply are a major reason for the lack of high-technology development in certain places."[90]

In short, as long as a given market has enough local venture capitalists to enable a pipeline of incoming syndicated investments, policy makers should not worry about the absolute supply of local venture capital (in dollar terms). Accordingly, initiatives that attempt to spur local growth and development by providing funds for venture capital investment have historically been unsuccessful. Historical data from cities as varied as Silicon Valley, Ottawa, Washington, D.C., and Cambridge all indicate that "venture capital lags rather than leads the emergence of entrepreneurial activity."[91] In the case of Ottawa, "[a] survey of high tech start-ups founded since 1965 . . . found that few had raised external

88. Florida & Smith, Jr., *supra* note 70, at 438.

89. *Id.* at 448.

90. *Id.*

91. Mason, *supra* note 73, at 109. The author notes that while venture capital is not needed to create a center of entrepreneurial activity, "venture capital is needed for the sustained growth and development of a cluster: without venture capital a cluster is likely to stagnate or decline." *Id.*

finance, none had raised venture capital and the most important source of funding was the personal savings of their founders."[92]

Thus, it is far from clear that there is a true regional equity gap. The perceived regional gap is likely just a result of certain regions being better or worse for entrepreneurs. Pouring money into traditionally underserved regions may be a waste—especially if that money does not come with monitoring, mentorship, advice, new networks of contacts, and all the other myriad benefits that good venture capitalists offer. Section II.B.ii below provides further support for that reading of the data by examining various explanations for why Silicon Valley has outperformed other similar regions.

2. Regional Differences that May Explain Venture Capital Clustering

Given the theoretical potential for venture capital to flow to wherever it will earn the greatest returns, the obvious implication is that venture capital clustering occurs because certain regions simply offer better prospects for entrepreneurial ventures. And indeed, there is good evidence that this is the case. This section will explore that notion by first examining Silicon Valley as a region and then comparing it to other regions.

The modern Silicon Valley emerged sometime in the second half of the twentieth century. In the view of Jerome Engel, "three components—universities, government, and entrepreneurs—played key historic roles in the transformation of this small agricultural valley into the powerhouse of invention and business creation" that it is today.[93] For example, the Stanford Industrial Park (now Stanford Research Park), which was created in 1951 on university-owned land, now hosts more than 150 companies with over 23,000 employees.[94] Government involvement began in earnest immediately prior to World War II and continued through the Cold War, with "military research fund[ing] engineering efforts in universities . . . , national government laboratories . . . , and private firms in Silicon Valley."[95] As one researcher notes, "[t]his long-

92. *Id.* at 111 (citing G.P.F. Steed & L.J. Nichol, Entrepreneurs, Incubators and Indigenous Regional Development: Ottawa's Experience (1985) (unpublished manuscript)).

93. Jerome S. Engel, *Global Clusters of Innovation: Lessons from Silicon Valley*, 57 CAL. MGMT. REV. 36, 39 (2015).

94. *Id.*

95. *Id.* Hewlett Packard, for example, grew out of military contracts.

term governmental spending on military weapons and aerospace R&D in the Valley can be considered as a crucial catalyst for the subsequent emergence of this techno-centric innovation cluster."[96]

Silicon Valley also houses a uniquely robust class of "professional entrepreneurs,"[97] which some speculate has its origins in the California Gold Rush.[98] Regardless of the origin of the class, it is clear that those professionals are now "core actors that drive Silicon Valley's continuous self-reinvention with new industries and technologies."[99]

In terms of concrete resources, Silicon Valley has numerous venture capital funds, mature corporations (i.e., potential partners), industrial research centers, and professional service providers (including lawyers, accountants, design professionals, recruiting firms, investment bankers, incubators, and accelerators) "who not only provide[] tailored professional services, but also are willing to discount or defer fees, often in exchange for a small share in the venture's eventual returns."[100] On a more qualitative level, Silicon Valley has mobility of resources, respect for entrepreneurial process, global strategic perspective, and an alignment of interests that permits companies to incentivize employees properly and allows innovators to collaborate with establishments together in a "win-win challenge to displace incumbents."[101] Finally, a comparison of Silicon Valley with other regions suggests that yet another key differentiator is Silicon Valley's large talent pool and high labor velocity.[102]

In contrast to those in Silicon Valley, small firms in peripheral areas are characterized by lower levels of innovation.[103] Within those regions, the level of innovation is closely related to "the degree to which firms are

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96. *Id.* at 40.
97. *Id.*
98. *Id.*
99. *Id.*
100. *Id.* at 41.
101. *Id.* at 43-45.
102. Alan Hyde, *Silicon Valley's High-Velocity Labor Market*, 11 J. APPLIED CORP. FIN. 28 (1998).
103. Edward J. Malecki, *Entrepreneurship in Regional and Local Development*, 16 INT'L REGIONAL SCI. REV. 119, 131 (1993) (citing E.J. Malecki & P. Nijekamp, *Technology and Regional Development: Some Thoughts on Policy*, 6 ENV'T & PLAN. C: GOV'T & POL'Y 383 (1988)).

tied to local networks of suppliers and to external markets."[104] These regions are generally poor environments for entrepreneurship because they lack a critical mass of entrepreneurs. Without this critical mass, innovators have fewer role models and must rely on "nonlocal sources of information and technology," which leads to less meaningful business relationships.[105] The lack of successful role models can, in particular, cause small firms to have "weak market and product development, a particular problem of older industrial regions such as Pittsburgh."[106] Similarly, since "[e]ducation levels appear strongly related to entrepreneurial success and [are] associated with a greater range of information sources and a wider set of customers and markets,"[107] regions that do not contain top-flight universities are at a natural disadvantage compared to those that do.

Although a good location can certainly help, ultimately the success or failure of a given enterprise is determined not by its location, but by how well it is run. In the words of Edward Malecki, "[c]apital is actually less critical to small business success than simpler, but less easily supplied, inputs. Capital is secondary to information, business knowledge, and management expertise."[108] Thus, every region has the potential to be a Silicon Valley; what is required to achieve that potential is not a large stable of local venture capitalists but rather a thriving local economy with rapid information transfer between firms, receptiveness to innovation, and a labor pool of talented managers.

3. What the Lack of a Regional Equity Gap Means for Regulation A+

Two interviews with prominent venture capitalists succinctly summarize the reasons why venture capital flows primarily to a small number of locales. As one notes:

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104. *Id.* at 131 (citing I. Turok & P. Richardson, *New Firms and Local Development: Evidence from West Lothian*, 25 REGIONAL STUD. 71 (1991)).

105. *Id.* at 132.

106. *Id.* at 132 (citing R.S. Ahlbrandt, *Adjusting to Changes in Traditional Markets: The Problems of Small Manufacturers in Older Industrial Regions*, 2 ECON. DEV. Q. 252 (1988)).

107. *Id.* at 134 (citing H. M. Miller et al., *Southern Appalachian Handicrafts Industry: Implications for Regional Economic Development*, 17 REV. REGIONAL STUD. 50 (1987)).

108. *Id.* at 139 (citation omitted).

> [a]ll other things being equal, you want your venture capital to be local. I can see it in my own work. I sit on the boards of two companies in Virginia and four in California and the California firms see me ten times more [than] the ones in Virginia. Whether it is just stopping by, or brain-storming around a specific problem, they just get a lot more of my attention because they're right here. And entrepreneurs do get it. If they are trying to build a successful company they know VCs can help. We're a sounding board, market research company, headhunter, and we can connect them up with partners and suppliers. Plus, since we review so many business plans in the course of our work and know so many people in the business, we know what the larger movements in the market are.[109]

Rounding out that point is this summary from the second interviewee: "[w]hat we're really selling is time. When you have a start-up, time is your most precious commodity so you want to do anything that saves it."[110] In an environment where droves of companies are all competing to "quickly establish dominant brands and market share" (often in nascent, rapidly changing markets), it is only natural for entrepreneurial firms to cluster around the richest sources of funding and assistance, in order to access that funding and assistance as rapidly, efficiently, and continuously as possible.[111] Both venture capitalists and entrepreneurs benefit from being physically located at the center of a system of tacit knowledge—it provides them with a great deal of know-how and "know-who" (i.e., contacts) that they otherwise would not have access to.[112]

Given this reality, simply throwing money at the problem will not work. To the extent that Regulation A+ is an attempt to empower communities currently underserved by venture capital firms by flooding them with a new supply of capital, the results are likely to be lackluster. It is not money itself that leads to prosperous ventures, but rather the mentorship, monitoring, and connections that come with that money—benefits that unaccredited investors are generally unable to provide. This intuition was borne out in the early twenty-first century in experiments conducted in the United Kingdom, which were intended to reduce a perceived regional equity gap. The Hunter Center for Entrepreneurship in Glasgow found that despite significant government efforts to increase the

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109. Zook, *supra* note 33, at 638.
110. *Id.* at 639.
111. *Id.*
112. *Id.*

supply of capital and reduce the perceived equity gap, the gap between London and other regions of the United Kingdom has not been reduced significantly and may have actually widened in the years after 2001.[113] In the United States, the experience of state-run venture capital funds in the 1980s tells a similar story. As one industry observer put it,

> [d]uring the '80s state governments got into venture capital as part of a failed strategy to develop high-technology enclaves. Within a few years those states saw most of their locally subsidized venture capital get exported to Silicon Valley, Route 128, or other places with promising high-tech start-ups; either that, or they saw their money go to local companies that failed to generate any profits. Now many of the states are reducing their commitment to venture capital or are pulling out altogether.[114]

These failed attempts to remedy perceived regional equity gaps suggest that the underlying problem is not a lack of capital but rather a lack of talented entrepreneurs with the skills and knowledge needed to commercialize technological breakthroughs. Entrepreneurial expertise is hard to come by, and artificially inflating the supply of capital alone is unlikely to change that.

This sentiment is echoed in the Kauffman Foundation's educational policy briefs, which encourage state and local governments to focus on efforts to facilitate knowledge transfer rather than attempting to increase the supply of capital[115]: "there must be a long-term focus on entrepreneurs as individuals distinct from small businesses, who learn by doing and interacting with others. These connections are locally embedded even if entrepreneurs reach broad markets. The entrepreneurial experience is personal, and it is local."[116] In short, the Foundation suggests cultivating

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113. Colin Mason & Yannis Pierrakis, *Venture Capital, the Regions, and Public Policy: The United Kingdom Since the Post-2000 Technology Crash*, 47 REGIONAL STUD. 1156, 1166, 1169 (2013). This analysis presumes that the relevant measure of the gap is amount invested per region. If number of investments is the relevant measure, the gap was reduced to a mild extent, but not dramatically.

114. Richard Florida, *What Start-ups Don't Need is Money*, INC. (Apr. 1, 1994), https://www.inc.com/magazine/19940401/2859.html [https://perma.cc/E35Q-DWD8].

115. *See, e.g.*, Ewing Marion Kauffman Found., *The Dos and Don'ts of Local Entrepreneurship Promotion*, ENTREPRENEURSHIP POL'Y DIG. (Mar. 24, 2014), https://www.kauffman.org/~/media/kauffman_org/resources/2014/entrepreneurship%20policy%20digest/april%202014/entrepreneurship_policy_digest_april2014.pdf [https://perma.cc/82RY-GS2M].

116. *Id.* at 21.

networks and providing emotional support for entrepreneurs. The Foundation discourages public investment funds, and for those states where a public fund already exists, it suggests awarding many small prizes rather than a single large one in order to create a large cohort of entrepreneurs who can learn from each other.[117] The Foundation prefers other, more effective policy measures though, such as relaxing professional licensing requirements, welcoming immigrants, streamlining tax codes and payment systems, and ending the enforcement of non-compete agreements.[118]

The Kauffman Foundation likely understates the appeal of public investing for a couple of important reasons. First, private investors (absent government intervention) generally conduct less research and development than would be socially optimal because they are unable to financially capture the social benefits of their research.[119] Once social impacts are taken into consideration, by some estimates, "the social rate of return [to research and development] is between 150 and 200% of the private rate of return; according to that, government's intervention is justified by means of market failure theories in order to . . . achieve a socially optimal situation."[120] Second, while bureaucrats generally cannot be trusted to "pick winners" when it comes to individual companies, expert agencies such as the Department of Defense or the National Institutes of Health have a fairly impressive track record of backing technologies that have ultimately become world-changing.[121] So there is certainly solid theoretical foundation for using government funds to encourage early-stage research, and some support for the idea of using public funds to encourage socially beneficial ventures—although there is

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117. *Id.*

118. *Id.* at 2.

119. Itxaso del-Palacio, Francesc Sole & Xiaotian Tina Zhang, *The Capital Gap for Small Companies: Public Venture Capital to the Rescue?*, 38 SMALL BUS. ECON. 283, 285 (2012) (citing J. Lerner, *The Government as Venture Capitalist: The Long-Run Impact of the SBIR Program*, 72 J. BUS. 285 (1999)).

120. *Id.* at 285 (citing Z. Griliches, *The Search for R&D Spillovers*, 94 SCANDINAVIAN J. ECON. S29 (1992); S. Lall, *Technological Capabilities and Industrialization*, 20 WORLD DEV. 165 (1992)).

121. *See, e.g.*, MARIANA MAZZUCATO, THE ENTREPRENEURIAL STATE: DEBUNKING PUBLIC VS. PRIVATE SECTOR MYTHS (2013) (discussing, among other things, the government's involvement in developing the Internet, GPS, touch-screen displays, and Siri).

no doubt that when it comes to providing funds to companies hoping to commercialize already extant technology, private investment firms have shown themselves to be much more adept than their government counterparts.[122]

To the extent that crowdfunding participants play a role similar to that of public investors and solely provide money without performing any monitoring or advising, one can expect their investments to produce relatively lackluster results. Thus, the "opening the floodgates" aspect of Regulation A+ is unlikely to have a significant positive effect on the vitality of early-stage companies. There are unique benefits that come from taking "smart money," and those benefits are not unlocked solely by enabling startups to look to the public for funding.

C. Social Reasons to Encourage Crowdfunding

1. Gender/Race Issues

While there is little evidence of an overarching need for more capital (either locally or nationally), there may still be some other, more pernicious systematic failings of the venture capital industry that are in need of remedy. For example, it is well known that women receive less venture capital funding than men: "less than 6% of venture capital funding has historically gone to companies with female CEOs, and only 1.3% of VC-backed companies have female founders."[123] Minority-founded companies also receive disproportionately low amounts of venture capital funding.[124] A recent Pepperdine University study confirms this disparity, finding that "[m]inority-, female- and foreign-owned companies are 22.2%, 18.7% and 17.9% less likely [respectively] to successfully raise a venture round than companies run by American-born white males."[125]

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122. *See supra* text accompanying note 114 (discussing the failure of various state-run venture capital funds).

123. Mollick, *supra* note 7, at 8 (citations omitted).

124. *See, e.g.*, *Venture Capital Demographics—87% of VC-Backed Founders Are White; All-Asian Teams Raise Largest Funding Rounds*, CB INSIGHTS (Aug. 3, 2010), https://www.cbinsights.com/blog/venture-capital-demographics-87-percent-vc-backed-founders-white-asian-teams-raise-largest-funding/ [https://perma.cc/8553-827Z] (reporting that less than 1% of founders of VC-backed companies are African-American).

125. Timothy Hay, *Female-, Minority-Run Startups Have Tougher Fundraising Road, Study Says*, WALL ST. J.: VENTURE CAP. DISPATCH (Oct. 30, 2014, 8:00 AM), https:

Many believe that these shocking numbers are attributable to the low number of female and minority investors at major venture capital funds (which is borne out in the data—a 2011 survey found, for example, that 89% of venture capital partners were male and 76% were white males).[126] In light of these disparities, there is a strong case to be made that "gender and geographic biases . . . distort VC assessments."[127]

If this disparity in funding stems not from economically rational factors but rather from biases against women and minorities, we might expect market forces to remedy the problem, since those spurned businesses represent untapped opportunities and potential above-market returns. And indeed, several venture capital funds targeting female-founded companies have cropped up in recent years,[128] such as Isabella Capital,[129] Women's Venture Capital Fund,[130] Texas Women's Ventures,[131] Cowboy Ventures,[132] Aspect Ventures,[133] Broadway

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//blogs.wsj.com/venturecapital/2014/10/30/female-minority-run-startups-have-tougher-fundraising-road-study-says/ [https://perma.cc/D2EL-AM8U] (citing John Paglia & Maretno Agus Harjoto, *The Effects of Private Equity and Venture Capital on Sales and Employment Growth in Small and Medium Sized Businesses*, 47 J. BANKING & FIN. 177 (2014)).

126. Scott Austin, *White Men Still Dominate the Venture Industry*, WALL ST. J.: VENTURE CAPITAL DISPATCH (Nov. 21, 2011, 12:55 PM), https://blogs.wsj.com/venture capital/2011/11/21/venture-industry-still-dominated-by-white-males-survey/ [https://per ma.cc/5QCE-B5XZ].

127. Mollick, *supra* note 7, at 3 (citing P. Greene & C. Brush, *Patterns of Venture Capital Funding: Is Gender a Factor?*, 3 VENTURE CAP. 63 (2001); R. Harrison & C. Mason, *Does Gender Matter? Women Business Angels and the Supply of Entrepreneurial Finance*, 31 ENTREPRENEURSHIP THEORY AND PRAC. 445 (2007); T. Stuart & O. Sorenson, *Liquidity Events and the Geographic Distribution of Entrepreneurial Activity*, 48 ADMIN. SCI. Q. 175 (2003)).

128. Claire Cain Miller, *Female-Run Venture Capital Funds Alter the Status Quo*, N.Y. TIMES: DEALBOOK (Apr. 1, 2015), https://www.nytimes.com/2015/04/02/business /dealbook/female-run-venture-funds-alter-the-status-quo.html?_r=0 [https://perma.cc/ Y628-935A].

129. *Isabella Capital*, CRUNCHBASE, https://www.crunchbase.com/organization/isa bella-capital [https://perma.cc/5EPU-FENG].

130. *Investment Focus*, WOMEN'S VENTURE CAP. FUND, https://www.womensvcfund .com/investment-focus/ [https://perma.cc/LRM4-CPHH].

131. TEX. WOMEN VENTURES, https://www.texaswomenventures.com/ [https://perma .cc/3SD7-LGZQ].

132. COWBOY VENTURES, https://cowboy.vc/ [https://perma.cc/9533-QTRM].

133. ASPECT VENTURES, https://aspectventures.com/ [https://perma.cc/2NLE-KM AC].

Angels,[134] Illuminate Ventures,[135] Forerunner Ventures,[136] and Aligned Partners,[137] to name a few. Minority-focused funds are harder to find, but a few do exist.[138] As promising as these funds are, the fact that they have begun to crop up only recently despite the funding disparities having existed for decades suggests that there are significant barriers to remedying this problem.

To the extent that this is an issue, equity crowdfunding might help to eliminate the disparity and address the market failure. If equity crowdfunding allows entrepreneurs to appeal to a wider, more diverse set of investors, it might alleviate this bias and help ensure that female- and minority-led startups are not underserved by capital markets. At least one study of traditional (non-equity) crowdfunding has found that "entrepreneurial quality is assessed in similar ways by both VCs and crowdfunders, but . . . crowdfunding alleviates some of the geographic and gender biases associated with the way that VCs look for signals of quality."[139] The study found weak evidence that crowdfunders exhibit less geographic bias than venture capitalists and strong evidence that crowdfunders exhibit less gender bias than venture capitalists.[140] Notably, while only 1.3% of venture capital-backed companies have female founders, over 21.1% of venture capital-eligible crowdfunded projects studied had female founders.[141] Yet broadly, the same signals used by venture capitalists to assess viability of new ventures (e.g., past success, third-party endorsements, preparedness, etc.) were also used by

134. BROADWAY ANGELS, https://www.broadway-angels.com/ [https://perma.cc/AP8R-WUW7].

135. ILLUMINATE VENTURES, https://www.illuminate.com/ [https://perma.cc/6XAL-TGM9].

136. FORERUNNER VENTURES, https://forerunnerventures.com/ [https://perma.cc/WH83-BQWA].

137. ALIGNED PARTNERS, https://www.alignedvc.com/ [https://perma.cc/7QXB-CG4C].

138. *See, e.g.*, NAT'L ANGEL MINORITY NETWORK, https://www.nmanetwork.com/ [https://perma.cc/QG5X-VDBB]; Wayne Sutton, *The Search for Minority Entrepreneurs Is Over—Now They Need to Be Ready for Investors*, TECHCRUNCH (Sept. 29, 2012), https://techcrunch.com/2012/09/29/the-search-for-minority-entrepreneurs-is-over-now-they-need-to-be-ready-for-investors/ [https://perma.cc/9MQA-4CB5] (referencing the Minority Angel Investor Network and Mexican.VC, both of which primarily invest in companies with minority founders).

139. Mollick, *supra* note 7, at 1.

140. *Id.* at 23-24.

141. *Id.* at 8, 24.

crowdfunders, suggesting that the crowdfunders are making rational investment decisions.[142]

However, crowdfunding is not panacea here; crowdfunders are likely to be biased too, only in a different manner. Crowdfunding projects tend to pick up steam with time since people prefer to invest in projects that have already received significant funding.[143] Friends and family are likely to be the first investors in a crowdfunding project, so "[t]o the extent that distant investors disproportionately rely on information revealed in the investment decisions of others, friends and family might play an important role in making early investments that generate that information."[144] The upshot is that those with the largest and wealthiest network of friends and family might achieve disproportionate success, regardless of the actual merits of their projects.[145] In other words, while advances in technology in theory enable all modern-day entrepreneurs to draw from the same global pool of capital, in practice that pool of capital may only be accessible to those with a "sufficient base of offline support."[146]

2. Community Building

Another social reason to welcome equity crowdfunding is its potential for community building. Consider the example of a community that uses crowdfunding to revitalize its downtown area—perhaps by

142. *Id.* at 25.

143. Ajay K. Agrawal, *The Geography of Crowdfunding* 16 (Nat'l Bureau of Econ. Research, Working Paper No. 16820, Feb. 2011).

144. *Id.* at 3-4.

145. This is in line with Matthew J. Salganik et al., *Experimental Study of Inequality and Unpredictability in an Artificial Cultural Market*, 311 SCIENCE 854-56 (2006), which finds a high level of path dependency in the popularity of songs on music downloading sites. Specifically, Salganik finds that individuals were far more likely to download songs that had been previously downloaded in significant numbers, and far less likely to download songs that had not been popular. *Id.* When Salganik segregated the site into different "worlds" with different download counters, the download rates in various "worlds" varied wildly. *Id.* No world matched download rates of songs that were downloaded anonymously. *Id.*

146. Agrawal, *supra* note 143, at 4.

creating a public park or funding an "open lab."[147] Crowdfunding could be a way for the community to both finance projects and gauge their demand, while simultaneously getting "buy-in" from the community (thereby increasing the chances that the users of the project are "sticky" and highly engaged). If done correctly, equity crowdfunding could usher a new era in local governance, empowering citizens to more directly participate in the selection of public projects and assessment of local expenditures. Of course, this goal could likely be served by purely intrastate equity raises, so Regulation A+ does more than needed to secure this benefit. But to the extent Regulation A+ facilitates such raises, it constitutes a laudable advance.

D. FINAL REMARKS ON "DEMOCRATIZING ACCESS TO CAPITAL" RATIONALE

In short, although Regulation A+ seems poised to address inequities faced by female and minority entrepreneurs and also to facilitate community projects, it offers limited promise of democratizing access to early-stage capital in a way that spurs major economic development. This would not be worrisome if the weak economics of the "democratizing access to capital" rationale for the regulation were complemented by a strong IPO facilitation rationale. Unfortunately, upon close scrutiny, the IPO facilitation rationale appears to be highly tenuous as well.

III. EXAMINING THE IPO FACILITATION RATIONALE

A. THE NEED FOR IPOS

It is well known that IPOs are "broken," and have been for some time. As Steven Davidoff puts it, "[t]he small company initial public offering (IPO) is dead. In 1997, there were 168 exchange-listed IPOs for companies with an initial market capitalization of less than $75 million. In 2012, there were seven such IPOs, the same number as in 2003."[148] The

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147. Indeed, these are precisely the types of projects currently being funded on the UK-based crowdfunding platform "Spacehive." *See* Kevin Gray, *Built by the Crowd: The Changing World of Public Infrastructure*, WIRED (Nov. 4, 2013), https://www.wired.co.uk/magazine/archive/2013/11/features/built-by-the-crowd [https://perma.cc/3JPN-H35D].

148. Steven Davidoff, *Disappearing Small IPOs and Lifecycle of Small Firms*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 6, 2014), https://blogs.law.harvard

average time to IPO statistics tell a similar story: in 2000, the average age of a company at its IPO was ten years; in 2005, it was twenty-one.[149]

Multiple explanations for the decline have been put forth, perhaps the most popular being that "increased federal regulation and market structure changes also driven by federal regulation" led to the falling number of IPOs.[150] Whatever the cause, the decline is particularly worrisome for venture capitalists, since they are highly dependent on IPOs as a source of "exit" that allows them to cash out. However, the lack of IPOs is problematic for consumers and the general public as well, since there is empirical evidence that IPOs are good for the consumer, given that (1) they herald "an era of reduced profits and greater consumer mobility within an industry,"[151] and (2) most of the employment produced by new companies comes *after* the IPO stage.[152] In fact, by one estimate, "[u]p to 22 million jobs may have been lost because of our broken IPO market."[153] Thus, Andrew W. Lo (the director of the MIT Laboratory for Financial Engineering) was right to state that "[w]e should be very concerned about this trend . . . . Capital markets are central to business formation and economic growth, and if [public] listings are falling, that is a sign there is not the same level of capital formation as there was in the past."[154]

Regulation A+, along with other provisions of the JOBS Act, promises to address this problem by lowering the regulatory hurdles involved in achieving liquidity for early-stage investors. In addition to providing liquidity for early investors, the mini-IPO market will offer businesses "many of the traditional benefits of the public offering process,

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.edu/corpgov/2014/03/06/disappearing-small-ipo-and-lifecycle-of-small-firm/ [https://perma.cc/DJ7Y-ZZ53].

149. Darren Dahl, *Facing the Capital Gap*, INC. (Feb. 1, 2006), https://www.inc.com/magazine/20060201/priority-finance.html [https://perma.cc/585J-LV9B].

150. Davidoff, *supra* note 148.

151. R. Christopher Small, *An IPO's Impact on Rival Firms*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Sept. 15, 2014), https://blogs.law.harvard.edu/corpgov/2014/09/15/an-ipos-impact-on-rival-firms/ [https://perma.cc/9VU9-AEK2].

152. NAT'L VENTURE CAPITAL ASS'N, *supra* note 22.

153. David Weild & Edward Kim, A WAKE-UP CALL FOR AMERICA, GRANT THORNTON: CAPITAL MARKET SERIES 2 (2009). Note that this estimate is dramatically higher than the 1.881 million figure listed in KENNEY ET AL., *supra* note 26.

154. Graham Bowley, *Wall Street, the Home of the Vanishing I.P.O.*, N.Y. TIMES (Nov. 17, 2010), https://www.nytimes.com/2010/11/18/business/18place.html?_r=0 [https://perma.cc/T8LN-RKYG].

including improved valuations relative to traditional private offerings (due to the unrestricted nature of the securities) with scaled down regulatory costs."[155] This cost reduction can be easily quantified: traditional IPO registration takes 1200 hours[156] and can cost hundreds of thousands of dollars.[157] The SEC estimates that a Regulation A+ Tier 2 registration will cost $75,000,[158] with some industry experts predicting that this price will come down even further as practitioners adjust to market needs (possibly by accepting equity as payment in lieu of cash).[159] The annual reports required by Regulation A+ will take another 600 hours and are estimated by the SEC to cost $60,000 a year.[160] In contrast, the annual cost of being a public company is estimated by PricewaterhouseCoopers to be upwards of $1.5 million a year.[161]

Yet not all are convinced that Regulation A+ will have the promised effect. For example, certain prominent Silicon Valley lawyers have gone on record stating that the effects of the new rules will be negligible for

155. Josh Kalish, *Regulation A+: A Practical Perspective*, CROWDFUND INSIDER (Apr. 1, 2015), https://www.crowdfundinsider.com/2015/04/65360-regulation-a-a-practical-perspective/ [https://perma.cc/7SGW-2CEP].

156. Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493, 501 (2014) (citing Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1468-70 (2013)).

157. *Id.* at 501 (citing C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 27-28 (2012); Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. 281, 292 (2014). PwC estimates the cost of going public to be north of $1 million. PWC, CONSIDERING AN IPO? THE COSTS OF GOING AND BEING PUBLIC MAY SURPRISE YOU (2012), https://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf [https://perma.cc/7266-NC8G].

158. Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 9741, Exchange Act Release No. 74,578, 2015 WL 1788375 (Mar. 25, 2015). Note that this estimate may well understate the costs.

159. Devin Thorpe, *Crowdfunding Experts Address New Regulation A+ Rules Live*, FORBES (Apr. 9, 2015, 12:10 AM), https://www.forbes.com/sites/devinthorpe/2015/04/09/crowdfunding-experts-address-new-regulation-a-rules-live/ [https://perma.cc/975X-CC2X]. Note that this sentiment is not universal, and others expect costs to be significantly higher than those estimated by the SEC.

160. Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 9741, Exchange Act Release No. 74,578, 2015 WL 1788375 (Mar. 25, 2015).

161. PWC, *supra* note 157.

technology firms, especially those in Silicon Valley.[162] Among other things, these experts question the "value of a mini-IPO market relative to the existing private placement market, which is already a deep source of funding that is unrestrained by the disclosure, audit and filing requirements that will accompany Regulation A+ capital."[163] Similarly, there is good reason to suggest that the root cause of the recent downtick in IPO frequency is not regulation but rather decreased investor demand for these securities. This section will address the controversy and ultimately conclude that Regulation A+ will do little to fix the IPO market.

B. SMALL COMPANY IPOS—DEAD FOR GOOD REASON?

A popular argument is that the decrease in IPOs can be traced to increased regulation of public companies, with the enactment of the Sarbanes-Oxley Act of 2002 ("SOX") often singled out as the main culprit.[164] In support of this argument, many point to the increase in listings in other, less-regulated countries since the passage of SOX in the United States.[165] And indeed, studies show that after the passage of Title I of the JOBS Act, the value of public companies eligible for "Emerging

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162. David Ruiz, *New Mini-IPO Will Have Few Takers in the Valley*, RECORDER (Mar. 25, 2015), https://www.therecorder.com/id=1202721669638/New-MiniIPO-Will-Have-Few-Takers-in-the-Valley?slreturn=20150301111550 [https://perma.cc/8XVN-S7MD].

163. Kalish, *supra* note 155.

164. *See, e.g.*, Bowley, *supra* note 154 (partially blaming regulations); Amy Feldman, *What Does Sarbanes-Oxley Mean for Companies That Want to Go Public?*, INC. (Sept. 1, 2005), https://www.inc.com/magazine/20050901/surviving-so-sidebar.html [https://perma.cc/UF8F-DAY2]; Wade Roush, *Who's Afraid of an IPO? Everybody, at the Moment*, XCONOMY (July 1, 2008), https://www.xconomy.com/national/2008/07/01/whos-afraid-of-an-ipo-everybody-at-the-moment/ [https://perma.cc/Z47S-WFX4] ("In a survey last week, the NVCA asked its own members to name the three biggest reasons for the current IPO drought. . . . 77 percent named 'skittish investors' as a reason, while 64 percent pointed to the credit crunch resulting from the subprime-mortgage debacle, and 57 percent blamed the high cost of complying with Sarbanes-Oxley accounting rules for companies preparing to go public. A few other interesting reasons came up as well: lack of analyst coverage of smaller companies (18 percent), a generally poor selection of IPO candidates recently (15 percent), and the disappearance of investment banks willing to invest in early-stage companies (14 percent).").

165. *See, e.g.*, Erika Brown, *London Calling*, FORBES (Apr. 21, 2006, 2:30 PM), https://www.forbes.com/forbes/2006/0508/051.html [https://perma.cc/7XGP-A8ZX].

Growth Company" status (and the commensurate reduced regulatory compliance costs) jumped nearly 3.6%, suggesting that domestic public company regulations exact a very real (and quantifiable) cost.[166] But there is good reason to think that the cost of regulatory compliance is only a small part of the reason for the downswing in IPO activity. A new consensus appears to be emerging that the decline in IPOs is attributable to market factors rather than regulatory changes.

For example, a 2014 study by Steven Davidoff found as follows:

> the evidence derived from the lifecycle of small IPOs points to supply side changes, rather than regulatory changes, as the reason for the vanished small IPO. In short, we believe that investors simply tired of investing in these small IPOs due to their inability to survive and grow in the public markets. In the absence of investor demand, supply side forces [initially] still pushed these IPOs into the market . . . [but] have [now] disappeared in light of technological and market structure changes.[167]

In that same study, Davidoff found that the enactment of the JOBS Act had little to no effect on small-company IPOs.[168] Ultimately, Davidoff suggests that relaxing IPO regulations "may only bring back companies that are ill-suited to the public markets."[169]

This is consonant with the picture painted by David Weild, former Vice Chairman of NASDAQ. He argues that large brokerage firms have lower profitability as a result of advancements in technology and changes in regulation that increased competition and lowered trading costs.[170] As a result, such firms have shifted their focus from smaller companies' stocks to those of larger companies.[171] He sees this as a cause for alarm: "[t]he whole ecosystem to support small-cap companies has shrunk . . . . This infrastructure is every bit as important as bridges, roads and tunnels. Without it, you undermine growth."[172]

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166. Dhammika Dharmapala & Vikramaditya S. Khanna, *The Costs and Benefits of Mandatory Securities Regulation: Evidence from Market Reaction to the JOBS Act of 2012*, 1 J. L. FIN. & ACCT. 139 (2016).

167. Davidoff, *supra* note 148.

168. *Id.*

169. *Id.*

170. Bowley, *supra* note 154.

171. *Id.*

172. *Id.*

Another recent paper makes similar findings, arguing that (in essence) "firms are being acquired rather than going public because in many industries a small firm is worth more as part of a larger organization than as an independent firm, whether it is public or private."[173] In other words, the decrease in small company IPOs can be attributed to the perception that most companies would fetch a lower valuation in a public offering than they would in the context of a trade sale.[174] Crucially, though, the authors find that these depressed public market prices are not due to lack of analyst coverage or increased regulatory costs.[175] Rather, they find that trade sales offer better valuations simply because "earnings are higher as part of a larger organization," generally because of economies of scope that allow larger companies to "speed new technologies to market."[176] They conclude that "regulatory reforms aimed at restoring the IPO 'ecosystem' will have only a modest ability to affect IPO volume."[177] In sum, "while SOX . . . may have had some effect on small company IPOs, the more fundamental problems are the lack of profitable small company IPOs and the lack of small company IPOs that grow and become highly profitable, earning high returns for investors."[178]

Thus, there is ample reason to think a relaxed IPO regulatory regime (i.e., the provision of "mini-IPOs") will do little to stimulate the anemic IPO market.

IV. POTENTIAL PITFALLS AND SUGGESTIONS FOR ENFORCEMENT

The benefits of Regulation A+ are expected to be modest and largely hard to quantify. With that in mind, for the regulation to be a sensible measure, it must not increase harm to investors appreciably. Unfortunately, there are myriad ways in which Regulation A+ in its current form might expose investors to new harms, the most salient of which are discussed below, along with some suggestions for reform.

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173. R. Christopher Small, *Where Have All the IPOs Gone?*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 30, 2011), https://corpgov.law.harvard.edu/2011/12/30/where-have-all-the-ipos-gone/ [https://perma.cc/PV8D-55C2].

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.*

178. *Id.*

A. POTENTIAL PITFALLS

1. Behavioral Economics

Humans exhibit a systematic bias towards overvaluing long-shot bets, due to the so called "optimism bias."[179] This effect likely stems from irrationalities regarding the extent of human involvement in fundamentally uncertain activities: "we act as though we can control purely random events like lotteries and dice rolls when[ever] there is a veneer—no matter how thin—of individual action involved."[180] Given the boom-or-bust nature of early-stage investing, equity crowdfunding is uniquely poised to activate this bias, to ill effect.

To illustrate the potential magnitude of the problem, consider that the average American family has $3800 in savings.[181] Each year, Regulation A+ allows that family to risk up to 10% of its net worth or 10% of its income—whichever is higher—on Tier 2 equity crowdfunding raises.[182] Given that the median U.S. household income was roughly $54,000 in 2014,[183] in practice, this means the average American family has the potential to wipe out the entirety of its savings by participating in Regulation A+ offerings in any given year. Based on data predating the adoption of Regulation A+, even among angel investors—a sophisticated group of investors who are able to carefully vet each investment—over half of the individual investments made result in a loss.[184] The top 10% of

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179. Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STANFORD L. REV. 1471 (1998); Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 806 (1980).

180. Dorff, *supra* note 156, at 522 (citing ELLEN J. LANGER, THE PSYCHOLOGY OF CONTROL 59-90 (1983)).

181. Michael Maiello, *47% of Americans Can't Save Any Money*, DAILY BEAST (Apr. 14, 2015, 4:05 PM), https://www.thedailybeast.com/articles/2015/04/14/47-of-americans-can-t-save-any-money.html [https://perma.cc/HJG9-LS5Q].

182. Under Tier 1, they can risk as much money as they want. *See* Sec. & Exch. Comm'n, *supra* note 45.

183. CARMEN DENAVAS-WALT & BERNADETTE D. PROCTOR, U.S. CENSUS BUREAU, NO. P60-252, INCOME AND POVERTY IN THE UNITED STATES: 2014 (2015), https://www.census.gov/content/dam/Census/library/publications/2015/demo/p60-252.pdf [https://perma.cc/SZ2D-V79V].

184. ROBERT WILTBANK & WARREN BOEKER, RETURNS TO ANGEL INVESTORS IN GROUPS (Nov. 2007), https://sites.kauffman.org/pdf/angel_groups_111207.pdf [https://perma.cc/K5UT-TDD8].

the investors take home 50% of the total gains, with a mere 10% of the investments garnering 75% of the total returns.[185] If this distribution holds true in the crowdfunding context, then there will be a small number of investors with huge wins and a much larger number that experience losses they are ill-equipped to bear.[186] When combined with the human propensity to overvalue long-shot bets referenced above, the results could be devastating.

2. The Lemons Problem

One lesser concern is that if equity crowdfunding is perceived by entrepreneurs as a funding-route-of-last-resort, then the companies engaging in crowdfunding will generally be those with low potential for success, and those who invest in such companies will be "virtually certain to lose their money."[187] While the prospect of losing money is not foreign to early-stage investors, in this context it could be disastrous because, as Michael Dorff describes,

> the losses most issuers inflict will not be offset by a few huge winners. Investors will not find tomorrow's Googles on crowdfunding portals because they will not be there; instead, start-ups with real potential will continue to use other programs, such as the newly expanded Rule 506 exemption. This outcome is the inevitable result of the nature of start-up investing and crowdfunding.[188]

Rory Eakin, Chief Operating Officer of the crowdfunding platform CircleUp, makes a similar prediction: "[i]f issuers can fundraise using Regulation D—no blue sky, audited financial, or ongoing reporting requirements—why will they raise under Reg A+? Similar to Title III, I only see Reg A+ working in edge cases."[189]

185. *Id.*
186. This effect is only further exacerbated by the investment caps of Regulation A+, which limit the ability of the average investor to diversify appreciably.
187. Dorff, *supra* note 156, at 493.
188. *Id.*
189. Rory Eakin, *The JOBS Act Is Progress but Much Remains to Be Done*, TECHCRUNCH (Mar. 29, 2015), https://techcrunch.com/2015/03/29/the-jobs-act-is-progress-but-much-remains-to-be-done/ [https://perma.cc/7BYG-EDPP]. Note that CircleUp is a platform designed for accredited investors only—so Mr. Caldbeck is probably a

While only time will tell if these predictions have merit, there are at least some reasons to think legitimate start-ups might prefer retail crowdfunding instead. For example, worthwhile start-ups might be drawn to retail crowdfunding over other options (such as venture capital) because retail crowdfunding might offer more attractive valuations and less intrusive investors. Similarly, retail crowdfunding might be a better source of funding for companies with long, slow growth trajectories that have been traditionally spurned by venture capitalists seeking rapid exits. In addition, private financings done under Regulation D generally produce restricted shares[190] subject to a "liquidity discount" which constrains the company's valuation;[191] Regulation A+ shares are freely tradable,[192] which should result in higher valuations. Finally, consumer-facing companies might prefer crowdfunding for the increased visibility it brings and its capacity for creating a built-in class of brand/product evangelists. In all likelihood, retail crowdfunding probably will not attract the most pedigreed of high growth companies, but that does not mean it does not have an important role to play in the early-stage capital ecosystem.

3. Dilution

The problem of dilution, wherein a founder or a seed-level investor sees his equity stake in the company—and thus the value of his

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biased source on this topic. Note also that Regulation D offerings require audited financials generally and at least an audited balance sheet.

190. U.S. Sec. & Exch. Comm'n, *Investor Bulletin: Private Placements Under Regulation D*, SEC (Sept. 24, 2014), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html [https://perma.cc/5WWK-W65A] ("Generally, most securities that you acquire in a private placement will be restricted securities.").

191. Peter H. Ehrenberg, *Raising Capital for the Emerging Private Company: An Introduction to the Inherent Legal Risks and Opportunities of the Capital Raising Process*, LOWENSTEIN SANDLER (Mar. 2001), https://www.lowenstein.com/publications/articles/detail.aspx?PubID=624 ("The restrictions on resale that typically apply in the context of private placements significantly impact the substantive arrangements negotiated between emerging companies and their new investors. Since such investors may be required to hold their shares indefinitely, and since often there can be no assurance that an active public trading market will ever develop, purchasers in private placements who are precluded from reselling their shares promptly will pay less than they would pay for freely tradeable securities in a comparably positioned company. This discount (called an illiquidity discount) may approach 50%.").

192. *See supra* note 53.

investment—drastically reduced in later rounds of financing, is a very real issue for early-stage startup participants. This problem has historically been a big concern with the CROWDFUND Act,[193] and it applies with equal force in the Regulation A+ context.[194] The concern is so prominent that one United Kingdom equity crowdfunding site, Crowdcube, explicitly mentions dilution in the investment disclaimer on its homepage.[195] While dilution is a concern for any investor, this concern is particularly dangerous for crowdfunding investors given that (1) they generally lack the expertise needed to recognize this as a risk and negotiate contractual provisions protecting against it, and (2) even crowdfunders savvy enough to know this is a risk still face a "collective action problem" in that if the pool of investors is massive and widely dispersed (with each individual contributing only a small slice of the overall investment), then no one individual has a proper economic incentive to expend significant time and effort negotiating specific contractual protections against dilution (or enforcing those protections post-investment).

One way to address this risk would be for the SEC to require that all shares distributed in Regulation A+ raises include certain anti-dilution provisions. However, this would probably be an unnecessary overreach and further deter businesses from raising capital via Regulation A+. At most, the SEC should require prominent disclosure of the anti-dilution protections attached to the shares being offered (if any). It is likely that with adequate disclosure and anti-fraud protection (backstopped by the limitations imposed by fiduciary duty law), the market will determine the

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193. *See, e.g.*, Jack Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583 (2013). The specific concern is that early investors might be robbed of the benefit of their investment if the company later issues additional shares (either to new investors or company executives) in exchange for little to no consideration, effectively diluting the early investors' stake in the company and reducing their payout upon an exit event. A famous example of this was Mark Zuckerberg's attempt to dilute Eduardo Saverin's holdings in Facebook from 30% to 0.03%. *Id.*

194. *See, e.g.*, Cherly Connor, *'Do You Really Want Dumb Money?' Barry Schuler, On Crowdfund Equity's Dark Sides*, FORBES (Nov. 3, 2011), https://www.forbes.com/sites/cherylsnappconner/2013/11/03/do-you-really-want-dumb-money-barry-schuler-on-crowdfund-equitys-dark-sides/ [https://perma.cc/V5AD-Q29X] (discussing the dangers of dilution in the equity crowdfunding context and referencing Facebook's infamous decision to dilute Eduardo Saverin's stock in the company).

195. CROWDCUBE, https://www.crowdcube.com/ [https://perma.cc/758N-EBJT].

proper level of anti-dilution protection on its own (especially if the collective action problem is addressed through the encouragement of syndication, as discussed in Section IV.B.4 below).

4. Fraud

Perhaps the most widely discussed risk of allowing general solicitation is the risk of fraud, which reared its head once already in recent memory in the context of Rule 504.[196] The episode in question began in 1992, when the SEC amended Rule 504 so that it no longer banned general solicitations.[197] At the time, it was thought that for such small offerings, a hands-off approach was justified and state securities regulators could be relied upon to prevent fraud;[198] however, this reliance proved to be misplaced. Almost immediately after the rule was amended, many issuers and traders began using the exemption to sell and trade worthless securities in microcap "pump-and-dump" schemes, often over the (then-new) internet.[199] The incidence of fraud was so widespread that the SEC ultimately opted to amend Rule 504 to ban general solicitations.[200] While fraud in the Regulation A+ context will likely take a different form, this historical vignette illustrates the ingenuity and prevalence of unscrupulous securities market participants. Early signs seem to indicate that outright fraud is not rampant in the crowdfunding space,[201] but this will have to be closely policed going forward.

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196. 17 C.F.R. § 230.504 (2016).

197. C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 14 (2001).

198. SEC. & EXCH. COMM'N, ADOPTION OF AMENDMENTS TO RULE 504: FACT SHEET (1999), https://www.sec.gov/news/extra/micro504.txt [https://perma.cc/5R5N-CQ42].

199. *Id.*

200. Dorff, *supra* note 156, at 507 (citing Hazen, *supra* note 14, at 1763-64).

201. *Can Crowdfunding Democratize Access to Capital?*, *supra* note 10 (finding that Kickstarter-funded projects' on-time delivery rates are comparable to those of other funding sources); Solomon, *supra* note 11 (suggesting that intrastate equity crowdfunding is primarily being used by legitimate companies such as craft brewers and butcher shops); John Tozzi, *Crowdfunding's on Hold. So Is Crowdfunding Fraud*, BLOOMBERG BUS. (Apr. 4, 2013), https://www.bloomberg.com/bw/articles/2013-04-04/crowdfundings-on-hold-dot-so-is-crowdfunding-fraud [https://perma.cc/AS9R-GJR3] (stating that regulator fears have not been justified so far, and that regulators have so far only found one case of crowdfunding fraud to point to). *But see* Shelly Banjo, *Once Idealistic, Crowdfunding Is Now an Unholy Hybrid of Retail, Investment, and Risk*, QUARTZ, https://qz.com/389001/once-idealistic-crowdfunding-is-now-an-unholy-hybrid

5. Decreased Protection from State Regulators

An additional concern specific to the Tier 2 exemption under Regulation A+ is that by preempting state securities regulators, the regulation removes one of the traditional sources of protection for investors and thus puts them in harm's way. State regulators, in contrast to the SEC, "are closer, more accessible, and more in touch with the local and regional economic issues," making them (in theory) well suited to referee small, local securities transactions.[202] This unique position explains why "states have historically been the primary 'cops on the beat' in the regulation of all areas of small business capital formation."[203] Despite the historical prominence of state securities regulators, in practice they have proven to be significantly less active than the SEC in commenting on filings, and even in cases when they do take action, their record is far from perfect (as alluded to in the Introduction above).[204] To the extent state regulators are doing more harm than good, this particular concern with Regulation A+ may be unfounded, and pre-emption may well be a sensible policy.

-of-retail-investment-and-risk/ [https://perma.cc/AT92-DEC5] (arguing that crowdfunded companies often take advantage of a lack of accountability); Dave Johnson, *With Crowdfunding, Odd Often Competes with Fraud*, CBS MONEYWATCH (July 14, 2014), https://www.cbsnews.com/news/with-crowdfunding-odd-often-competes-with-fraud/ [https://perma.cc/BBA7-4BWB] (discussing Healbe GoBe, a crowdfunding campaign that raised over $1 million for a wristband claiming to implement an impossible technology, and "Home Quantum Energy Generator," a crowdfunding campaign that raised over $18,000 by claiming to have created free energy).

202. Noam Noked, *The JOBS Act: An Investor Protection Disaster Waiting to Happen*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 26, 2012), https://blogs.law.harvard.edu/corpgov/2012/03/26/the-jobs-act-an-investor-protection-disaster-waiting-to-happen/ [https://perma.cc/S2X2-TW7U]; O'Sullivan, *supra* note 11 (discussing action by FINRA shutting down Virginia-based crowdfunding portal over allegations that it overlooked various red flags, include failure of certain participating companies to file required paperwork with the SEC).

203. Noked, *supra* note 202.

204. *See supra* Introduction; *see also* Leslie Scism & Mark Maremon, *Regulators Missed Chance to Block Bad Deals*, WALL ST. J. (Mar. 22, 2015) (describing the failure of state regulators to prevent 25-year old Alexander Chatfield Burns from buying two large insurance companies with fraudulent securities and siphoning hundreds of millions of dollars from the companies).

6. The Risks of Distant Ownership

One final concern is that enabling general solicitation encourages distant ownership, which is harmful in and of itself. There is research indicating that firms with a higher degree of local ownership are "more profitable and have more independent boards,"[205] and are less likely to be named in class action lawsuits than their distantly owned counterparts.[206] The theoretical underpinning of this effect is that managers of firms with more local ownership are subject to more close and meaningful monitoring, making them less likely to engage in various undesirable (and unprofitable) activities such as "empire building,"[207] "leading the quiet life,"[208] aggressively managing earnings,[209] and backdating options.[210] This close monitoring often takes the form of shareholders that are "more likely to introduce shareholder proposals, increase CEO turnover, and reduce excess CEO compensation"[211]—in effect, putting direct and continuous pressure on the company's management to perform. The implication, of course, is that to the extent that Regulation A+ facilitates the raising of money from distant, widely dispersed investors, we can expect an increase in empire building and other undesirable corporate activities.

B. SUGGESTIONS FOR REFORM

Given these issues, Regulation A+ could be improved in a number of ways. Four of the most pressing needs are addressed below.

1. Anti-fraud Measures

Fraud must be closely policed. Regulation A+ exposes an unsophisticated class of investors to an entirely new asset class. Given the

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205. Vidhi Chhaochharia et al., *Local Investors and Corporate Governance*, 54 J. ACCT. & ECON. 42, 43 (2012).
206. *Id.*
207. *Id.*
208. *Id.*
209. *Id.*
210. *Id.*
211. R. Christopher Small, *Local Investors and Corporate Governance*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 6, 2012), https://blogs.law.harvard.edu/corpgov/2012/06/06/local-investors-and-corporate-governance/ [https://perma.cc/P8TS-SKFA].

collective action problem involved in monitoring a retail crowdfunded investment coupled with the relative lack of sophistication of retail crowdfunding investors, the potential for fraud here is enormous. And indeed, our brief experiment with allowing general solicitation under Rule 504 in the 1990s confirmed that there is no shortage of fraudsters willing to sell sham securities to the public.[212]

To combat this, the SEC might consider heightened antifraud liability in this context, perhaps in the form of treble damages or strict liability. Of course, this is a bit of a balancing act—too much liability will result in no one using this financing mechanism, but too little liability will allow fraudsters to run free. The bad actor provisions that have been included in the rules[213] should also help to guard against fraud. These, coupled with fiduciary duty law, should go a long way towards discouraging fraudsters from making use of Regulation A+ for their deviant schemes.

Another novel technique that may help is the use of a "public shaming service"—i.e., a publicly available central database of bad actors maintained by the SEC. This database could include additional information such as the type of company the bad actor was pitching, the crowdfunding platform the bad actor used, etc. This measure would have the dual benefits of alerting investors to trends in fraudulent activity and of pressuring crowdfunding platforms into self-policing for fraud. Interestingly, private services providing a similar function have cropped up already;[214] given their existence, it would be wise for the SEC to work with these services and to adjust disclosure requirements to aid them in their efforts.

2. Diversification

Investors must be encouraged to diversify appreciably. It has been shown that U.S. investors already hold under-diversified portfolios and are especially likely to under-diversify if they are young, low-income, less

212. *See* Hazen, *supra* note 14, at 1763-64.
213. Sec. & Exch. Comm'n, *supra* note 45.
214. Rebecca Burn-Callander, *Crowdfunding Charlatans to Be Named and Shamed by New Rating Start-up*, TELEGRAPH (Sept. 17, 2015), https://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11868437/Crowdfunding-charlatans-to-be-named-and-shamed-by-new-rating-start-up.html [https://perma.cc/49VX-VBY5].

educated, or less sophisticated.[215] Diversification is likely to be a problem in the crowdfunding context because the relatively small annual caps on investments contained in Regulation A+ could easily push unaccredited investors into preferring to place one large bet over multiple small bets. Given how time consuming it is to vet an early-stage investment and how little money will be at play (generally), it will be far too tempting for the average investor to place all his eggs in one basket rather than exerting the immense time and effort it would take to build up a diversified portfolio.

Two solutions might help. First, investors should receive a notice (in plain English) before investing, explaining the importance of diversification.[216] Taking a page out of Thaler's book, it might be further required that these notices show how retirement income flows would differ in different scenarios—some involving diversified portfolios, others with portfolios highly concentrated in a few key stocks.[217] Investors might be required to certify that they understand that "projected . . . income typically doubles as an employee switches from a concentrated portfolio with a single stock to a diversified portfolio."[218] The SEC could even require the potential investor to take a quiz on finance theory, although this last requirement is likely to be too onerous to help. A second, more intrusive and paternalistic option is to impose a second layer of capping targeted at individual investment sizes. While each investor would remain limited to investing the greater of 10% of his net worth or income per year, he will also be limited from investing more than 20% of this overall cap *on any one company*. This would encourage investors to diversify at least modestly; however, it might also encourage investors to put money in less-than-ideal companies simply to ensure that they have the maximum possible amount of capital deployed. This may also limit certain investors to investments too small to be worthwhile.

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215. William N. Goetzmann & Alok Kumar, *Equity Portfolio Diversification*, 12 REV. FIN. 433 (2008).

216. This idea is borrowed from Shlomo Benartzi & Richard H. Thaler, Sell More Tomorrow: Using Behavioral Economics to Increase Diversification in 401(k) Accounts 3 (2003) (unpublished manuscript), https://www.researchgate.net/profile/Richard_Thaler/publication/228805997_Using_behavioral_economics_to_improve_diversification_in_401_(k)_plans_Solving_the_company_stock_problem/links/0912f50eb073313d16000000.pdf [https://perma.cc/S8FP-DUZ9].

217. *Id.*

218. *Id.*

3. Intrastate Emphasis

Intrastate offerings should be encouraged to the extent possible. This runs somewhat counter to the "democratizing access to capital" rationale, but given that the case for a regional equity gap is weak and that firms with local investors engage in less undesirable activity, intrastate fundraising offers a clear advantage over more dispersed fundraising campaigns. Intrastate offerings could be directly encouraged through a number of mechanisms, such as tax breaks, decreased disclosure and reporting requirements, and expedited review. These mechanisms could be used individually or in tandem.

However, we need not place undue focus on encouraging purely intrastate offerings. Syndicated offerings involving at least one local lead investor capture many of the same benefits of intrastate offerings without unduly limiting the pool of available capital. Thus, the most elegant solution (and likely the most cost-effective one) is to focus on syndication. This task—the encouragement of syndication—is taken up below.

4. Syndication

Encouraging (or requiring) syndication with one large "lead" investor is likely the most powerful measure available to the SEC to minimize the risks of crowdfunding to retail investors. This is, after all, the mechanism venture capitalists and angel investors use to make prudent long-distance investments, and while it is not a perfect fit for the retail crowdfunding context it could certainly ameliorate the collective action problems described above. And in fact, in the United Kingdom at least one crowdfunding platform explicitly endorses this model by encouraging large angel investors to partner with a crowd of small retail investors.[219] Unfortunately, it is far from obvious how syndication can be best encouraged by regulators.

One forceful way to encourage syndication would be to require that each Regulation A+ raise have at least one investor who monitors the company and attends all company board meetings. This measure,

219. Freddie Dawson, *The Crowdfunding Site That Lets You Play with Sharks or Dragons*, FORBES (June 27, 2014), https://www.forbes.com/sites/freddiedawson/2014/06/27/the-crowd-funding-site-that-lets-you-play-with-sharks-or-dragons/ [https://perma.cc/R5JF-CTSF] (describing the crowdfunding platform "Syndicate Room").

however, would be highly paternalistic and difficult to enforce in practice. A less forceful method might provide reduced fraud liability or disclosure requirements for companies who do a Regulation A+ raise involving at least one "lead investor." Yet this solution has problems of its own—namely, that it would be difficult to define "lead investor" in a way that ensures the person acting as lead investor provides meaningful monitoring, oversight, and mentoring to the company.

Luckily, coercive measures may prove to be entirely unnecessary. There is at least some reason to think that market forces are capable of addressing the problem without the need for government intervention. In a recent working paper, MIT Sloan Professor Christian Catalini suggests that syndication may be the "killer app" of equity crowdfunding and observes that syndication has already arisen naturally as a method for division of labor between geographically dispersed angel investors.[220] To illustrate his point, Catalini explores AngelList's syndication system in depth. Under AngelList's system, lead investors perform in-person due diligence and deal sourcing in exchange for receiving a share of the profits earned by geographically dispersed "backer" investors who simply supply additional capital for the syndicated deal.[221] In this way, the lead investor is able to leverage his reputation and diligence efforts while the passive investors are able to outsource the task of vetting and monitoring the investment.[222] This division of labor arrangement has proven so compelling that syndicated deals are now vastly more common than non-syndicated deals on AngelList, despite the syndication option having only become available in July 2013.[223] Importantly, the median investment amount in these syndicated deals is a mere $2500,[224] which implies that transaction costs will not be a barrier to bringing syndication to retail equity crowdfunders (who generally only have small sums of money to invest).

Of course, a trade-off is inherent here: the more syndication with professional investors is encouraged, the less we can expect equity crowdfunding to ameliorate the well-documented biases of that powerful group. So, syndication is a double-edged sword: it is probably the only way to ensure that crowdfunders have a decent chance of evaluating

220. Ajay Agrawal, Christian Catalini & Avi Goldfarb, *Are Syndicates the Killer App of Equity Crowdfunding?*, 58 CALIF. MGMT. REV. 111 (2016).

221. *Id.*

222. *Id.* at 3-4.

223. *Id.* at 2.

224. *Id.* at 4.

human factors like the cohesiveness of the founding team, yet it has the unfortunate effect of fixing in place systemic biases against female- and minority-owned companies. Given that market-based syndication facilitators have already emerged and that overemphasizing syndication risks undermining the social positives of Regulation A+, policymakers would do well to use a light touch when implementing reforms designed to encourage syndication.

C. LIMITS OF SECURITIES LAW

Ultimately, the root of the problem goes much deeper than securities law. As the Silicon Valley examination suggests, the birth of a high-tech center comes not from a rush of private capital backing commercialization efforts, but rather through decades of grants and initiatives aimed at enabling early-stage research. This makes sense—given the difficulty of capturing the full extent of the social benefits from early-stage research (e.g., due to imperfect intellectual property protection), we cannot expect private markets to properly fund this public good, no matter how large we make the pool of market participants. Thus, to best encourage technological advances, this Article proposes increasing grants for early stage research and increasing preferential tax treatment for expenditures on research and development. Additionally, as the Kauffman Foundation suggests, the cultivation of a professional class of entrepreneurial managers is best done not by increasing access to capital but rather through programs which facilitate the formation of relationships and the transmission of knowledge among entrepreneurs. While federal securities law is ill-suited to make this happen, local initiatives (both public and private) hold the potential to appreciably further this goal.

One innovative solution, proposed by Darden professor Saras Sarasvathy, is to focus federal funds and initiatives on the task of educating investors.[225] Ideally, the principles of investing would be taught in public schools of all levels, with more advanced courses available on a community-by-community basis at community colleges and the like. Funding and resources could be provided to support the formation of local investment clubs. Even relatively sophisticated parties, such as executives in manufacturing companies, could benefit from educational programs tailored towards explaining how to evaluate potential equity-based

225. This suggestion was derived from personal conversations between the author and Prof. Sarasvathy.

partnerships and joint ventures with up-and-coming startup companies. If well designed, such programs could constitute a powerful "carrot" to complement the "stick" of SEC sanctions and review. Indeed, a comprehensive program of this type would address nearly every pitfall described in Section IV.A above: it would minimize irrationalities exhibited by naïve investors (by explaining away myths and introducing rational investment practices); it would increase the proportion of intrastate investment (thereby increasing the level of active monitoring); it would encourage diversification (by allowing small groups to share in the work of vetting investments, thereby making placing several small bets a more economically viable choice); and it would help investors guard against fraud (since investors could draw on their instructors and fellow club members to help spot fraudulent investment opportunities).

CONCLUSION

Regulation A+ holds some promise, but also much danger. Two prominent rationales for the measure—democratizing access to capital and reinvigorating the IPO market—appear to be largely baseless. However, Regulation A+ has the potential to ameliorate much of the systematic bias observed in the venture capital industry regarding female- and minority-founded companies. Additionally, Regulation A+ may well develop a niche within the early-stage capital ecosystem as a source of funds for community projects. As laudable as these advances are, we must remember that Regulation A+'s promise to change the status quo necessarily implicates new risks. In particular, Regulation A+ invites fraud, risks bankrupting ordinary investors, and is likely to have a negative impact on corporate governance. While its ultimate impact is impossible to determine ex ante, certain amendments and supplements would undoubtedly help ensure that its ultimate goal—economic development—is achieved with only minimal harmful side effects. These include heightened anti-fraud liability, measures designed to encourage diversification, and increased incentives to syndicate. A more comprehensive plan would go beyond securities law by instituting educational programs combined with seeding the formation of local investment clubs, thereby ensuring that retail equity crowdfunders have the tools they need to properly navigate the choppy waters of this new asset class.