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Bridgefunding: Crowdfunding and the Market for Entrepreneurial Finance

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BRIDGEFUNDING: CROWDFUNDING AND THE MARKET FOR ENTREPRENEURIAL FINANCE

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Title III of the Jumpstart Our Business Startups Act of 2012 (Regulation Crowdfunding) should encourage entrepreneurship by allowing startups and small businesses to sell stock online. Unfortunately, that law applied Depression-era securities law concepts to peer-to-peer financing in the Internet era; as a result, it implemented Internet-investor protection ineffectively. Using Regulation Crowdfunding requires startups to comply with costly and unnecessary antifraud requirements. Even after making disclosures, registering with a funding portal, and producing audited financial statements, startups still cannot raise enough money via Regulation Crowdfunding to deploy high-growth strategies without needing more funds from professional angel and venture investors.

This Article explores the business environment of entrepreneurial finance through the lens of securities regulations. It finds that regulators should be more concerned with protecting investors from startup failure than from crowdfunding fraud. It recommends an amendment to Regulation Crowdfunding that may enable startup success: the limit on fundraising should be raised from \$1 to \$5 million.

Bridgefunding theory begins with the observation that historically low percentages of startups are "bridging" from angel to venture financing; the rest often fail. Legal and economic analyses demonstrate that this growing gap is the result of regulations and market forces. Bridgefunding recognizes that peer-to-peer Internet financing is inherently different than securities issuances of yore. It posits that crowdfunding could bridge the funding gap and theorizes why bridgefunding may be safer for investors and better for startups.

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INTRODUCTION

Wittlebee was a successful startup that failed for surprising reasons. In 2011, former Myspace Vice President Sean Percival founded Wittlebee, a children's clothing club.[1] Subscription business models in technology companies like Netflix and Amazon Prime were booming.[2] Wittlebee extended that model to the retail clothing market in an exciting new way. Each month, busy parents would receive high-quality clothing

[1] *See* Sean Percival, *Introducing Wittlebee*, http://seanpercival.com/2012/02/13/introducing-wittlebee/ (last visited Dec. 21, 2014) (describing Wittlebee as "a new way to keep up with your kids' basic clothing needs.").

[2] *See* Dan Rayburn, *Amazon's Prime Streaming with Definitely Disrupt Netflix*, BUSINESS INSIDER (Feb. 23, 2011), http://www.businessinsider.com/amazon-prime-streaming-disrupt-netflix-2011-2.

for a low price.[3] At first it seemed like a runaway success. Initial investors contributed a shocking $2.5 million, five times what startups usually raise.[4] Wittlebee deployed the capital to grow quickly. It developed a user-friendly website, poached successful customer acquisition guru Chris Nella from ShoeDazzle, and even purchased another startup called Cottonseed Clothing.[5] Revenues grew quickly—but not quickly enough.

Like most early stage startups, Wittlebee was not designed to be self sufficient. Startups focus on growth, not profitability, and are dependent on raising outside funding to sustain that growth or even to continue operations. New money had usually been there for good startups like Wittlebee.[6] But in 2012, the money disappeared, and it has not returned. One thousand startups were "orphaned" that year,[7] including Wittlebee, which eventually sold its business to FabKids for pennies on the dollar in November 2013.[8] Wittlebee's business model succeeded when financed by its new parent company.[9] Its children's clothing subscription model was clearly a success, but its founders failed because the capital market for startup investment has a gap, where money is in short supply.[10] Other entrepreneurs, seeing that good startups like Wittlebee can be forced to liquidate even when employing a successful business model, may be discouraged from founding startups.

This Article is the first in legal literature to explore this gap as a market failure and whether that failure is an unintended consequence of certain legal regulations. Many assume that capital markets are free mar-

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3 *Id.* (explaining that Wittlebee is a new concept in the "subscription commerce" space).

4 *See Wittlebee*, CRUNCHBASE, http://www.crunchbase.com/organization/wittlebee (last visited Dec. 22, 2014).

5 Michael Carney, *Duck, Duck, Acquisition: Wittlebee Taps Kids Clothing Company Cottonseed*, PANDODAILY (Aug. 28, 2012), http://pando.com/2012/08/28/duck-duck-acquisition-wittlebee-taps-childrens-clothing-company-cottonseed/.

6 In 2008, 225 companies received seed funding from angels and 118 of angel-funded companies received additional financing from venture capital investors. PITCHBOOK, 2013 ANNUAL VENTURE CAPITAL RUNDOWN 9 (2013), http://files.pitchbook.com/pdf/PitchBook_VC_Rundown_Y2013.pdf. In 2012, angels funded 814 companies while venture capitalist invested in only 244 of them. *Id.* Therefore the ratio of seed-funded to VC-funded companies dropped from about 2:1 to about 4:1 in the period from 2008 to 2012.

7 Will Oremus, *Tech Startups Are About to Start Dropping Like Flies*, SLATE (Dec. 20, 2012), http://www.slate.com/blogs/future_tense/2012/12/20/series_a_crunch_tech_startups_are_about_to_start_dropping_like_flies.html ("One thousand startups will be orphaned; many will die. One billion dollars will have gone for naught. Bright young minds across the country will be out of work.").

8 Michael Carney, *Mother and Child Reunion: JustFabs Buys FabKids*, PANDO (Jan. 18, 2013), http://pando.com/2013/01/18/mother-and-child-reunion-justfab-buys-fabkids/.

9 *See* Sarah Perez, *FabKids Launches Subscription-based Kids Clothing Service, Actress Christina Applegate Partners*, TECHCRUNCH (Aug. 2, 2012), http://techcrunch.com/2012/08/02/fabkids-launches-subscription-based-kids-clothing-service-actress-christina-applegate-partners/.

10 *See, e.g.*, Ross S. Weinstein, *Crowdfunding in the U.S. and Abroad: What to Expect When You're Expecting*, 46 CORNELL INT'L L.J. 427, 452 (2013).

kets, but in fact they are heavily regulated. Only "accredited investors" can purchase large amounts of private equity.[11] The two types of accredited investors who participate in the private equity market, angels and venture capitalists, are driven by market dynamics to use different strategies. Most angel groups invest about $400,000 per company, while most venture capitalist firms invest about $7 million per company.[12] This leads to "lumpy" startup investment. It is well documented that startups have trouble raising between $1 and $5 million, a range that has become commonly known as the "Series A gap."[13] Many claim that this gap results from a liquidity problem, which is often referred to as the "Series A crunch."[14] This Article is the first to use game theory—in particular, concepts of hold-out and free rider problems—to show how this private equity gap may also result from a market failure.

In 2012, Congress amended securities law to enable a new way to finance startups. The Jumpstart Our Business Startups (JOBS) Act of 2012 is a law that creates a new exemption to securities laws.[15] It exempts "crowdfunding" from the Securities Act of 1933, allowing startups to sell $1 million of private equity to the general public.[16] Crowdfunding will introduce a new participant, "crowds," into the private equity market, which consist of members of the general public who do not necessarily have any particular accreditation or sophistication about investing. Crowds invest pursuant to a different set of dynamics than either angels or venture capitalists.[17] Crowds could provide the liquidity needed to avoid the Series A crunch.

Unfortunately, the JOBS Act only allows startups to raise $1 million per year through crowdfunding, which does not address the Series A gap.[18] Instead, it merely allows the general public to compete with professional angel investors to make the first investment in startup compa-

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[11] *See* 17 C.F.R. § 230.501(a) (2015) (defining "accredited investor" as that term is used in Regulation D).

[12] *Seed Investing Report—Startup Orphans and the Series A Crunch*, CB INSIGHTS (Dec. 19, 2012), https://www.cbinsights.com/blog/seed-investing-report/.

[13] *See, e.g.*, John Pletz, *Lightbank Looks to Plug the Series A Gap*, CRAIN'S CHICAGO BUS. (Mar. 26, 2013), http://www.chicagobusiness.com/article/20130326/BLOGS11/130329828/lightbank-looks-to-plug-the-series-a-gap ("There are a lot of quality seed-stage companies that have done well but not well enough to get over the hump.").

[14] *See* Rebecca Grant, *Watch Out for Bigfoot! 'Series A Crunch' Sighting Reported in Silicon Valley*, VENTUREBEAT (Mar. 25, 2013), http://venturebeat.com/2013/03/25/watch-out-for-bigfoot-series-a-crunch-sighting-reported-in-silicon-valley/ ("The Series A crunch has left the realm of Bigfoot and Nessie and is entering the realm of truth, at least according to Fenwick & West.").

[15] *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[16] *See id.*

[17] *See, e.g.*, Laura M. Hughes, *Crowdfunding: Putting a Cap on the Risks for Unsophisticated Investors*, 8 CHARLESTON L. REV. 483 (2014).

[18] *See id.*

nies.[19] 316,600 angels seed-funded 73,400 U.S. startup companies in 2014, when they invested $24.1 billion at an average of $328,300 per company.[20] There is already a substantial contributor to sub-million-dollar startup capitalization. The JOBS Act pits crowdfunding investors directly against the more established, sophisticated, and connected angels.

As designed by the drafters of the JOBS Act, the $1 million cap is intended to protect the general public from investment fraud or from simply making outright poor investment decisions.[21] Instead, it makes crowdfunding expensive, complicated, inefficient, and risky for unsophisticated investors. For example, the JOBS Act requires startups to spend up to $150,000 (e.g., to obtain independent audits, disclosure documents, filing fees, and legal fees) before selling equity via crowdfunding.[22] Raising money from angel investors is not only up to six times cheaper than crowdfunding, but angel investment costs are mostly incurred after financing is assured, whereas startups have to sink costs up front in order to try crowdfunding.[23] Under current regulations, therefore, it seems that only startups that are unable to get angel funding will seek crowdfunding.

This Article presents a new solution that uses crowdfunding to solve the Series A gap. The JOBS Act fundamentally misunderstood crowdfunding.[24] However, if existing crowdfunding limitations were inverted—such that startups had a $1 million floor and a $5 million ceiling—it would become rational for high-quality startups to seek crowdfunding for gap financing. This Article coins the term "bridgefunding" to describe such a regulatory regime. Bridgefunding accomplishes more than providing capital to fill a gap in the private equity market. Bridgefunding also leverages the ability of crowds to enhance the startup financing cycle.

Bridgefunding allows crowdfunding to become cost effective without reducing fraud protections such as disclosure requirements. It is harder to commit bridgefunding fraud because angels have already vetted

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[19] *See id.*

[20] Jeffrey Sohl, *The Angel Investor Market in 2014: A Market Correction in Deal Size*, CTR. FOR VENTURE RESEARCH (May 14, 2015), https://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/webform/2014%20Analysis%20Report.pdf.

[21] *See, e.g.*, Van S. Wiltz, *Will the JOBS Act Jump-Start the Video Game Industry? Crowdfunding Start-Up Capital*, 16 TUL. J. TECH. & INTELL. PROP. 141, 164 (2013).

[22] Sherwood Neiss, *It Might Cost You $39k to Crowdfund $100k Under the SEC's New Rules*, VENTUREBEAT (Jan. 2, 2014), http://venturebeat.com/2014/01/02/it-might-cost-you-39k-to-crowdfund-100k-under-the-secs-new-rules/ (explaining a recent SEC cost–benefit report that looked at success fees, compliance costs, and costs of CPA review or audit).

[23] As of the date of this publication, the SEC has not finalized and promulgated its crowdfunding regulations, so analysis here is based on the proposed final rules. For the proposed rule, see Crowdfunding, 78 Fed. Reg. 66,427 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240 & 249).

[24] *See infra* Part II.

and continue to monitor the startup when crowds invest. Portals could further reduce crowdfunding investor risk by encouraging individuals to diversify their investments; as the central nexus for investment, portals can make it easier to invest small amounts in multiple companies by aggregating, synthesizing, and analyzing information about investment opportunities. Additionally, bridgefunding introduces a valuable new signal to the private equity market. Bridgefunding could signal to venture capitalists that consumers are likely to desire a product. This may create a positive feedback loop where crowdfunded companies are more likely to obtain venture capital, thus making crowdfunding more successful.

Part I of this Article explains the startup funding lifecycle. It examines the investor dynamics that continue to perpetuate the Series A gap, examines data evidencing a private equity liquidity crunch, and introduces crowdfunding. Part II introduces "bridgefunding," a new way that securities regulation can solve the private equity gap and leverage the wisdom of crowds. Part II also addresses criticisms of crowdfunding, considers whether bridgefunding alleviates or aggravates those criticisms, and suggests some costs and benefits of bridgefunding that have not yet been addressed in the crowdfunding literature. Part III delves deeper into the theory of bridgefunding. This Part uses game theory to explain why there is a gap in the private equity market and also explores why alternative exemptions fail to fill the gap. This Article concludes by reviewing the competitive advantage of crowds to fund the gap.

I. STARTUP INVESTMENT

Equity is the financial fuel of the innovation economy. There are two main types of purchasers who fuel startup development through their investment in equity securities: angel investors and venture capitalists.[25] The differences between these two players in the private equity market have led to a gap in startup financing.[26] Section A of this Part reviews how startup private equity works by discussing both angel and venture investment in the private equity market, describing how private equity investments drive what is called the startup financing cycle, and explaining a gap in this cycle where fundraising is especially difficult. Section B introduces crowdfunding, a new regulatory regime that will allow a third type of investor, the general public, to invest in the private equity market by buying startup stock online.

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[25] Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 111 (2010).

[26] *See* Seth Oranburg, *The Law & Economics of the Series A Gap*, CLS BLUE SKY BLOG (Apr. 6, 2015), http://clsbluesky.law.columbia.edu/2015/04/06/the-law-economics-of-the-series-a-gap/.

A. *The Startup Private Equity Market*

Startups raise money from "angels" and "venture capitalists" (or "VCs") primarily by selling preferred stock to these two types of investors.[27] Startups are generally corporations,[28] which is one type of company that separates ownership and control. The stockholders technically own the corporation, but the board of directors (who are appointed by the stockholders) has authority and controls the corporation's actions.[29] Shareholders have limited rights under corporate law to control a corporation that they own, but shareholders can negotiate for contract rights of control. Contractual control rights (like the right of shareholders to prevent the company from issuing more stock, to obtain financial information about the corporation, to prevent other shareholders from selling the corporation's stock, or to have a representative on the board of directors) are often found in preferred stock purchase agreements.

The key point is that raising money by selling stock is different than taking out a loan because a startup gives up a percentage of the company along with some measure of control when it sells equity.[30] The relationship between the company and its equity investors can last the company's entire lifetime. Startup equity investment is often a long-term commitment. Central to understanding the startup private equity market is realizing that such investments are rarely passive. Angels and VCs compete for startups by providing guidance and services. They are "more than money,"[31] but they are also the only source of money. This creates the unique dynamic called the startup financing cycle.

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[27] *See, e.g.*, *What Are Some Basics to Know About Startup Investing?*, FUNDERSCLUB, https://fundersclub.com/learn/startup-investing/getting-started/basics-to-know-about-startup-investing/ (last visited Feb. 28, 2016) ("Individuals who invest in startups are called angel investors . . . whereas firms that are set up to invest in startups are called Venture Capital firms . . . ."). Stock is a type of equity, and equity reflects an ownership right in a company.

[28] *See* Kyle Hulten, *Why C Corporations Are the Preferred Entity for Tech Startups*, INVIGOR LAW (Feb. 24, 2014), https://www.invigorlaw.com/corporations-best-entities-tech-startups/ (explaining that the C corporation is ideal for startups because investors do not have to worry about pass-through tax or daily corporate decision-making, it is easy to grant equity to employees in the form of stock options, it is easy to grant preferential rights to investors as compared to founders and employees, investors pay capital gains rates on dividends instead of ordinary income rates on partnership distributions, and because the C corporation structure is familiar to founders, investors, employees and their counsel and accountants).

[29] *See, e.g.*, Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups,* 81 N.Y.U. L. REV. 967, 969 (2006).

[30] *Id.*

[31] *See* Joseph Menn, *Andreessen Expands Venture Capital Business*, FIN. TIMES (Nov. 3, 2010), http://www.ft.com/cms/s/0/af5c1a7c-e717-11df-880d-00144feab49a.html#axzz3MHe3lnjx.

1. Private Equity Market Participants

As discussed, there are two main types of investors in the private equity market: angels and VCs.[32] These investors are purchasers of private equity.[33] In 2014, 316,600 individual angels invested $24.1 billion in 73,400 startups[34]—an average of $328,300 per angel investment—while 803 VC firms invested $49.3 billion in 4,361 companies[35]—an average of $11.3 million per VC investment. In other words, despite investing a similar total amount, the average VC investment per round is thirty-five times that of the average angel investment. Accordingly, angel and VC investment strategies are quite different. Angels form groups to invest small amounts of their own money in brand new startups.[36] VCs form funds to invest large amounts of other people's money in more mature startups.[37] While the angels and VCs currently provide the vast majority of traditional startup investment, the JOBS Act may allow a new type of investor to enter the marketplace: the general public.

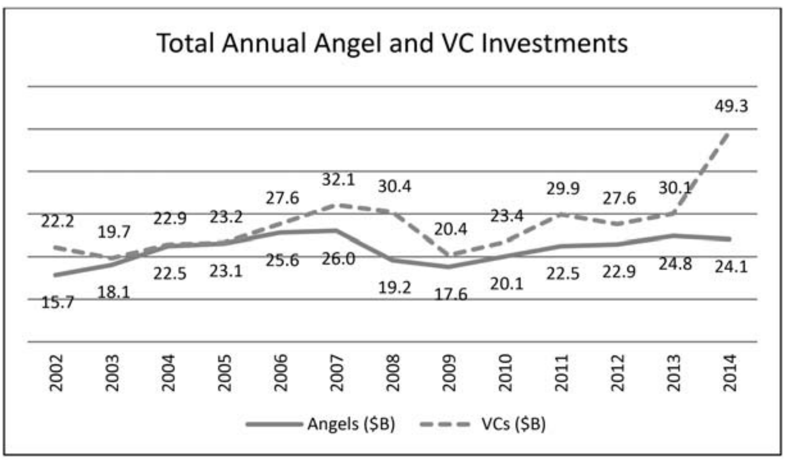

Figure 1: Angels and VCs historically invested a similar total amount per year (about $25B).[38]

[32] *See supra* Part I.A.

[33] *See Venture Capital*, U.S. SMALL BUS. ADMIN., https://www.sba.gov/content/venture-capital (last visited Oct. 7, 2015).

[34] Sohl, *supra* note 20.

[35] NAT'L VENTURE CAPITAL ASS'N, YEARBOOK 2015, at 38 figs.3.10 & 3.11 (2015), http://nvca.org/research/stats-studies/.

[36] *See* George Deeb, *How to Find Angel Investors for Your Startup*, FORBES (Sept. 19, 2014), http://www.forbes.com/sites/georgedeeb/2014/09/19/how-to-find-angel-investors-for-your-startup/.

[37] *See* Dan Primack, *VC Deals Are Down, but VC Deal Sizes Are WAY Up*, FORTUNE (July 3, 2014), http://fortune.com/2014/07/03/vc-deals-are-down-but-vc-deal-sizes-are-way-up/.

[38] Data aggregated from *CVR Analysis Reports*, UNIV. OF N.H., https://paulcollege.unh.edu/research/center-venture-research/cvr-analysis-reports (last visited Feb. 28, 2016); NAT'L VENTURE CAPITAL ASS'N, *supra* note 35, at 38 fig.3.10.

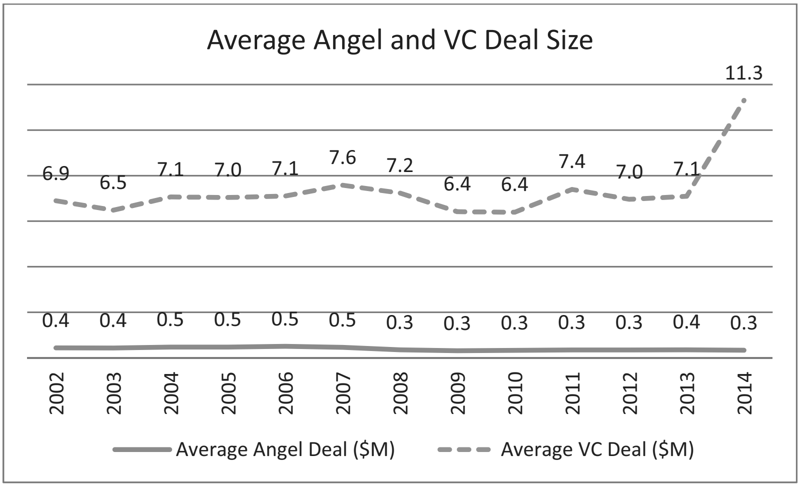

Figure 2: On average, angels invest three or four hundred thousand dollars in each startup, whereas VCs invest several million dollars in each round.[39]

a. Startups

The main seller of private equity in the startup private equity market is, unsurprisingly, the startup. But, it is important from the outset to distinguish startups from small business, as it is common to conflate these very different types of business entities.[40] Distinguishing between the two is important because private equity investment works for startups, not for small businesses.

The angel and venture capital investment model is to purchase restricted stock—which cannot be easily resold—to hold for a limited number of years.[41] This investment is very risky, so the objective is to obtain geometric returns when an investment is successful.[42] A startup is the sort of high-growth, high-risk enterprise that appeals to this investment model. Startups are designed to grow quickly.[43]

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39 Data aggregated from *CVR Analysis Reports*, *supra* note 38; NAT'L VENTURE CAPITAL ASS'N, *supra* note 35, at 38 figs.3.10 & 3.11.

40 *See, e.g.*, President Barack Obama, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012), http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing (describing President Barack Obama as proclaiming when he signed the JOBS Act into law, "startups and small business will now have access to a big, new pool of potential investors—namely, the American people").

41 JACK S. LEVIN ET AL., STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS ¶ 103 (2009).

42 *Id.*

43 *See Startups & High Growth Busineses*, U.S. SMALL BUS. ASS'N., https://www.sba.gov/content/startups-high-growth-businesses (last visited Jan. 30, 2015) ("In the world of business, the word 'startup' goes beyond a company just getting off the ground. The term startup is also associated with a business that is typically technology oriented and has high growth potential. Startups have some unique struggles, especially in regard to financing. That's because investors are looking for the highest potential return on investment, while balancing the

A small business, on the other hand—like a bike store, cobbler's shop, deli, espresso cafe, or food truck[44]—is designed to grow sustainably. Small businesses are wonderful and vital for the American economy. They provide employment opportunities for millions of Americans. But they generally make terrible equity investments.[45] Half of small businesses fail in their first five years.[46] Although this is similar to the 52% failure rate of startups,[47] small businesses do not grow exponentially as startups do, so equity investors who invest in small businesses would get the same risk as with investing in startups but with far lower returns. That is why small businesses are mostly financed with owner investment and an average of $80,000 a year in bank credit.[48] It is unrealistic, therefore, that private equity markets will provide a significant source of financing for small businesses.

While a small business might be able to use a small bank loan to become self sufficient, startups require millions of dollars to grow quickly before they are profitable as a stand-alone business. High-growth startups use money to scale quickly, which is important to win the race to register a patent or build a two-sided network.[49] For example, consider a famous startup story. Facebook was first funded on September 1, 2004 by two angels who invested $500,000, which Facebook used to build a basic web application that the founders deployed at Harvard University.[50] Less than a year later, Facebook received $12.7 million in a Series A financing from the venture firm, Accel Partners, in May 1, 2005, which it used to develop core social infrastructure and expand to more U.S. universities and international student networks.[51] Facebook

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associated risks."); *see also* Candice Landau, *What's the Difference Between a Small Business Venture and a Startup?*, BPLANS, http://articles.bplans.com/whats-difference-small-business-venture-startup/ (last visited Jan. 30, 2015).

44 All of these are examples from Inc. Magazine's article, *10 Inspiring Success Stories*, INC., http://www.inc.com/ss/10-inspiring-small-business-success-stories (last visited Jan. 30, 2015).

45 In future work, the author of this Article will discuss how *crowdlending* might be an excellent source of funding for small business.

46 *See Frequently Asked Questions*, U.S. SMALL BUS. ASS'N OFFICE OF ADVOCACY, https://www.sba.gov/sites/default/files/sbfaq.pdf (last visited Jan. 30, 2015).

47 *See generally* ROBERT WILTBANK & WARREN BOEKER, RETURNS TO ANGEL INVESTORS IN GROUPS (2007), http://sites.kauffman.org/pdf/angel_groups_111207.pdf.

48 *Id.*

49 *See* Thomas R. Eisenmann et al., *Strategies for Two-Sided Markets*, HARV. BUS. REV., Oct. 2006 (stating that competition lucrative for two-sided networks such as PC operating systems, credit card networks, and internet advertisements have a winner-take-all dynamic that requires operating on razor-thin margins or even giving subsidies to build the network).

50 *See* Brian Caulfield & Nicole Perlroth, *Life After Facebook*, FORBES (Jan. 26, 2011), http://www.forbes.com/forbes/2011/0214/features-peter-thiel-social-media-life-after-facebook.html.

51 *Facebook*, CRUNCHBASE, https://www.crunchbase.com/organization/facebook/funding-rounds (last visited Jan. 30, 2015).

needed a huge infusion of cash to expand rapidly, illustrating that $1 million is not a lot of money for a startup. Many startups raise millions of dollars throughout the startup financing cycle.[52] Accordingly, this Article focuses on the startups, not small business.

b. Angel Investors

Angels are professionals who invest their own money in startups.[53] Traditionally, angels were hard to find. Throughout the late 1980s, these wealthy gurus connected with startups through informal and even secretive channels.[54] In the early 1990s, angels began to form groups and publicize their activities.[55] The first prominent angel investment group formed in 1994.[56] Silicon Valley's "Band of Angels" began with twelve members and grew to 110 members by 1998.[57] From then on, angel groups sprouted up throughout the United States. The number of registered angel groups has tripled since 1999.[58] The Angel Capital Association estimates that there are between 10,000 and 15,000 angel groups operating in the United States today, with an average of 42 members per group.[59] Many of these angel groups now have a prominent website that contains a contract form, public membership list, and even a list of portfolio companies.[60]

Not all angels invest in groups. Some of the most popular angels continue to invest in the traditional, solitary, and secretive way. Many of these traditional angels—like Peter Thiel (who seeded Facebook) and Naval Ravikant (who funded Twitter and Uber)—are famous for building groundbreaking startups or investing early in hugely successful ventures.

Not everyone can be an angel. Legally, an angel must be an "accredited investor," someone with at least $1 million in net wealth or

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52 *See* Brian Solomon, *These 11 Startups Raised Over $1 Billion Before They Had a Product*, FORBES (June 11, 2015), http://www.forbes.com/sites/briansolomon/2015/06/11/these-11-startups-raised-over-1-billion-combined-before-launching/.

53 *What Is an Angel Investor?*, ANGEL CAPITAL ASS'N, http://www.angelcapitalassociation.org/faqs/#What_is_an_angel_investor_ (last visited Oct. 6, 2015).

54 Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1443 (2008) (explaining how the investment contract design of angel stock purchase agreements can be understood through a historical shift from informal modes of secretive operations to formal mechanisms and public group operations).

55 John May, *Structured Angel Groups in the USA: The Dinner Club Experience*, 4 VENTURE CAPITAL 337, 339 (2002).

56 *Id.*

57 *Id.*

58 *FAQs About Angel Groups*, ANGEL CAPITAL ASS'N, http://www.angelcapitalassociation.org/press-center/angel-group-faq/ (last visited Feb. 28, 2016).

59 *Id.*

60 *See, e.g.*, HYDE PARK ANGELS, http://www.hydeparkangels.com/ (last visited Feb. 28, 2016).

$200,000 in annual income.[61] The U.S. census counts household wealth, not individual wealth, so estimates for the number of potential angels varies, but 9.63 million American households had a net worth of $1 million or more in 2013,[62] which is about 3% of the U.S. population.[63] The Angel Capital Association estimates that about 4 million potential angels reside in the United States.[64]

Despite the large number of potential angels, only about 300,000 Americans made an angel investment in the past two years.[65] This is partially because an angel should have a solid understanding of business planning, corporate finance, preferred stock investment, and market conditions, plus a risk-seeking constitution.[66] Angel investment is not for everyone.

c. Venture Capital Investors

Venture capitalists are professional, institutional money managers of risk capital. VCs create funds in which large institutional investors (such as pension funds and university endowments) invest. VCs then "deploy" that capital primarily by purchasing startup equities. The nature of venture capital investment is quite different from angel investment because VCs manage other people's money, whereas angels invest their own money. Venture funds raise sums of money far in excess of most angels' personal net wealth,[67] and VCs have to deploy this money very quickly because the funds typically have eight to twelve year life spans.[68] When the fund's life is over, the capital must be returned.

Venture capital funds have grown dramatically since 1985, both in terms of the number of VC funds and the average amount that each VC fund manages. From 1985 to 2014, 2,054 VC firms were founded.[69] These firms raised 5,062 funds totaling over $599 billion.[70] While the number of VC funds has increased dramatically, the number of VC fund

61 17 C.F.R. § 230.501(a)(5)–(6) (2013).

62 *Number of U.S. Millionaires Hits New High*, CNN MONEY (Mar. 14, 2014), http://money.cnn.com/2014/03/14/news/economy/us-millionaires-households/.

63 Robert Schlesinger, *The 2014 U.S. and World Populations*, U.S. NEWS & WORLD REPORT (Dec. 31, 2013), http://www.usnews.com/opinion/blogs/robert-schlesinger/2013/12/31/us-population-2014-317-million-and-71-billion-in-the-world.

64 *See FAQs About Angel Groups*, *supra* note 58.

65 *Id.*

66 *See* WILTBANK & BOEKER, *supra* note 47 (asserting that due diligence, experience, and participation are the three largest factors impacting the outcome of angel investments).

67 *See, e.g.*, Dan Primack, *NEA Raising Largest VC Fund of All Time*, FORTUNE (Oct. 27, 2014), http://fortune.com/2014/10/27/exclusive-nea-raising-largest-vc-fund-of-all-time/. The VC firm NEA recently raised a fund with nearly $3 billion in capital.

68 Allen Wagner, *The Venture Capital Lifecycle*, PITCHBOOK (May 14, 2014), http://blog.pitchbook.com/the-venture-capital-lifecycle/.

69 *See* NAT'L VENTURE CAPITAL ASS'N, *supra* note 35, at 20 fig.1.04.

70 *Id.*

managers has not. In 1994, there were 3,735 VC professionals managing $33.2 billion—about $9 million per manager.[71] In 2014, there were 5,680 VC professionals managing $156.5 billion—about $28 million per manager, more than a three-fold increase in money under management per manager.[72] Put simply, there is a similar number of people managing a far larger amount of money, so they will tend to make larger investments.[73]

VC funds focus on high technology investments. These funds invested $5.2 billion in the information technology industry in 2014,[74] which accounted for 72% of total investments that year.[75] VCs increasingly focus on follow-on investment. In other words, VCs frequently fund the same company several different times throughout the startup financing lifecycle. In fact, over 85% of VC investments in 2014 were follow-on investments.[76] Despite making 4,361 investments in 2014, VCs only invested in 404 new non-high-technology companies that year.[77]

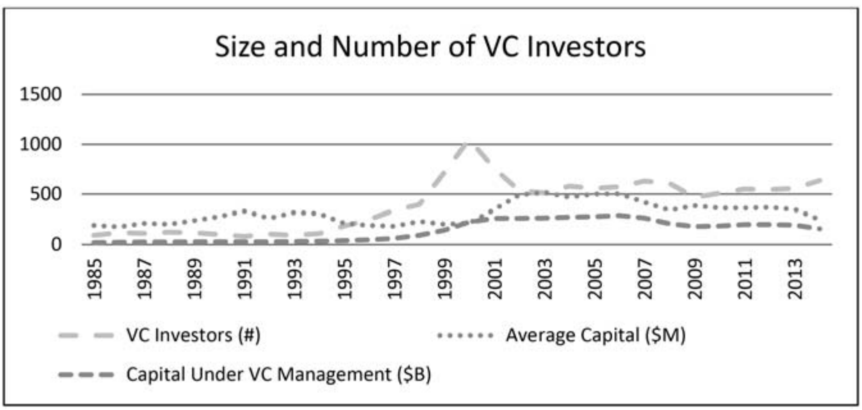

Figure 3: VC investors increased dramatically both in size and number around the year 2000, and the average capital managed by a single investor almost tripled, although there have been corrections since the Great Recession in the mid-2000s.[78]

Like angel investment, venture fund investment is not for everyone. Only "qualified purchasers"—those individuals who are natural persons owning $5 million or more in investments, or funds owning $25 million

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71 *Id.* at 9 fig.1.0.

72 *Id.*

73 *See id.*

74 *Id.* at 32 fig.3.02.

75 *See id.*

76 *See id.* at 56 fig.3.19.

77 *Id.* at 12 fig.5.0.

78 Data aggregated from NAT'L VENTURE CAPITAL ASS'N, *supra* note 35, at 19 fig.1.02 & 21 fig.1.05.

or more in investments[79]—can invest in venture capital funds. This means that many angels cannot invest in venture capital funds. The only way such angels can get involved in the startup private equity market is by making investments before VCs do. Accordingly, angels and venture capitalists play supporting roles by investing in different stages of startup development. This model of staged investment is called the startup financing cycle.

2. The Startup Private Equity Financing Cycle

Startups generally do not raise money only once, so it is very important to understand the entire startup fundraising cycle in order to understand the startup private equity market. The startup fundraising cycle is a multi-step process through which startups raise money at distinct periods.[80]

"Seedfunding" is the beginning of the startup financing cycle. Startups use seedfunding to research, assess, and develop an initial concept.[81] "[F]riends, family, and 'fools'" (fools referring to the high risk associated with investment in nascent startups) provide a small amount of seedfunding,[82] although angel investors provide most seedfunding capital.[83]

Once a startup receives seedfunding, the company begins operations and enters the "seed valley of death," where companies require significant capital inflows but have little or no revenue.[84] Startups begin to leave the perilous seed valley of death when their revenue increases enough to cover all monthly fixed and variable costs. This is called the "break even."[85]

After the break even, a startup enters an "early stage," where venture capital firms become substantially more interested in investing in that startup.[86] Startups decidedly exit the seed valley of death when a venture capital firm makes its first early stage investment, called "Series A."[87] After this point, venture capital investors frequently reinvest in the startup in Series B, C, D and so on, so the startup can afford to

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[79] 15 U.S.C. § 80a-2(51)(A) (2012).

[80] Oranburg, *supra* note 26.

[81] DOUGLAS J. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING: AN INTERNATIONAL PERSPECTIVE 5 (2d ed. 2014).

[82] *Id.* at 6.

[83] *Id.* (citing Andrew W. Wong, *Angel Finance: The 'Other' Venture Capital*, (University of Chicago, Working Paper, (2002)); *see also* Laura Entis, *Where Startup Funding Really Comes From*, ENTREPRENEUR (Nov. 20, 2013), http://www.entrepreneur.com/article/230011.

[84] CUMMING & JOHAN, *supra* note 81.

[85] *Id.* at 7.

[86] *Id.*

[87] *See id.*

invest in growth even if doing so causes net profits to become negative again.[88]

Small venture capital firms may only make early stage investments. Large venture capital firms make "later stage" investments all the way up to the end of the startup financing cycle, when a startup ceases to be a startup. The cycle ends badly when the startup goes broke and liquidates or sells the fledgling operations at a discount. The cycle ends well when the startup is sold to another company through a profitable acquisition or a merger. The ultimate conclusion to a startup is when the startup goes public and accesses the public capital markets through an initial public offering (IPO). The IPO is the preferred mode of exit—the ideal end of the startup financing cycle—for most investors to divest their investments.[89]

This Article examines newer data that indicates the Series A gap has become greater, meaning that more companies who receive seedfunding will not receive Series A funding, as illustrated by the chart below.

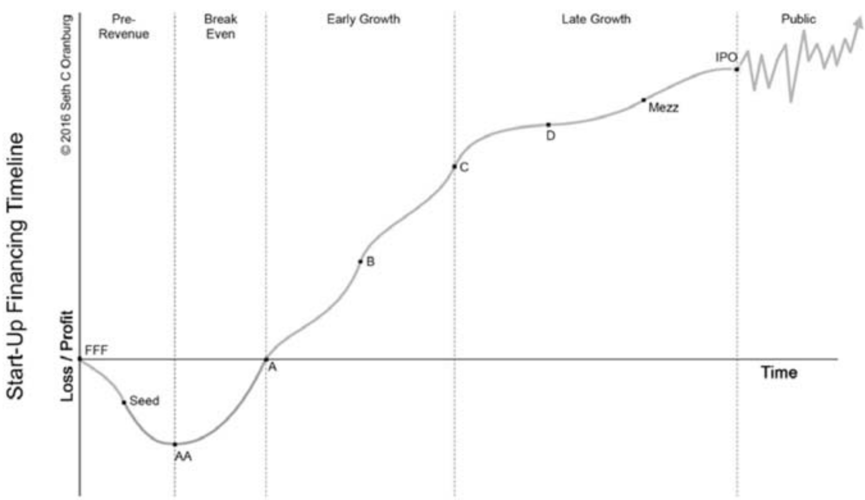

Figure 4: The Startup Financing Cycle

The above chart illustrates that, from 2008 to 2014, angel seed investment has increased while VC seed investment has decreased. This substantially contributes to the Series A gap and Series A crunch. During the relevant period, annual angel investment steadily rose from 55,480 deals to 73,400 deals.[90] Meanwhile, VC investments fell from 1966 to 740.[91]

88 *See id.*
89 *Id.* at 596.
90 *See CVR Analysis Reports*, *supra* note 38.
91 NAT'L VENTURE CAPITAL ASS'N, *supra* note 35, at 38 fig.3.10.

3. The Series A Gap in the Private Equity Market

Seedfunding is only the first step in the startup financing cycle, and startups rarely survive on seedfunding alone. As Professor Darian M. Ibrahim writes:

> Venture capital is crucial to a start-up's success, but it is not immediately available to most start-ups. Most venture capitalists fund start-ups that have survived their earliest stages and are expanding, for instance by delivering products and services to customers, or are preparing for an IPO or private sale. Nor is venture capital readily available in the smaller amounts that might be appropriate for very young companies. A typical venture round averages between $2 million and $10 million, although it can be much higher. Therefore, venture capitalists leave a critical funding gap that has both time and capital components. The time gap is present during the earliest stage of a start-up's life, which commonly lasts at least one year.[92]

In other words, between the seedfunding relative maxima of $350,801 and the Series A relative maxima of $4.87 million, there is a minimum of startup investment. Successful angel investor, Bill Payne, has studied these maxima and minima. In 2011, he produced what he termed the "Funding Gap":

> Let's look at some numbers: Hundreds of thousands of friends and family invest an estimated $50 billion or more in startup companies every year in the US. It is estimated that more than 200,000 angel investors fund 50,000 companies with $20 billion annually. And, the 1,000 or so VC firms also invest about $20 billion in 1,000 new companies every year. But, I estimate that less than 200 (and probably less than 100) investors provide funding in the gap between angels and VCs, that is, rounds of investment between $1 million and $4 million. Finding investors is always difficult, but finding capital in The Funding Gap is like seeking a needle in the proverbial haystack.[93]

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[92] Ibrahim, *supra* note 54, at 1416.

[93] *The Funding Gap*, BILL PAYNE & ASSOCIATES, (Jan. 20, 2011). http://billpayne.com/2011/01/20/the-funding-gap-2.html.

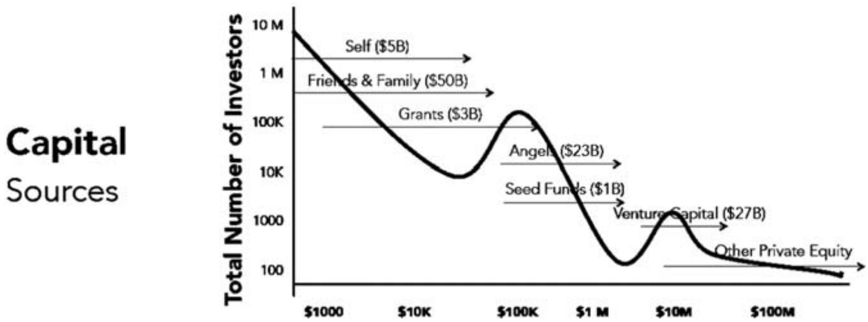

Figure 5: The Funding Gap © 2011 Bill Payne

The chart above shows that startup investment is lumpy. It tends to happen in specific times and in specific amounts. Angels typically invest less than $1 million at the Series Seed stage.[94] Venture firms typically invest more than $5 million at the Series A stage.[95] The result is that it is virtually impossible for an entrepreneur who needs $3.5 million to find investors.[96]

Since Professor Ibrahim's article from 2008 and Mr. Payne's article from 2011, the typical venture round has grown while the typical angel round has shrunk. As such, this Article argues that the gap has increased.

The leading venture law firm, Fenwick & West LLP, has empirically demonstrated that the gap is a persistent and growing phenomenon.[97] Fenwick's 2012 study of seedfunding found that there is an increasing institutionalization of seed financing.[98] In other words, there are fewer traditional (solo, secretive) angels out there. Angels are forming more visible groups that use technology to connect with potential investments.

In 2014, angels invested $24.1 billion in a total of 73,400 startups (an average of $328,300 per angel deal).[99] Venture capital firms—on whom angels and crowdfunding investors rely to provide additional funding from Series A to IPO—invested $49.3 billion in a total of 4,361 deals (an average of $11.3 million per venture deal).[100] Of these venture capital deals, venture capital firms invested $9.896 billion in 2,031 early stage deals (an average of $4.87 million per early stage deal).[101] Be-

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94 David H. Freedman, *The Great Funding Flameout*, 35 INC. 78, 82 (2013).

95 *Id.*

96 *The Funding Gap*, *supra* note 93.

97 Barry J. Kramer & Steven S. Levine, *Seed Finance Survey 2012*, FENWICK & WEST LLP (Mar. 25, 2013), http://www.fenwick.com/FenwickDocuments/2012_Seed_Survey_Report.pdf.

98 *Id.*

99 Sohl, *supra* note 20.

100 NAT'L VENTURE CAPITAL ASS'N, *supra* note 35, at figs.3.10 & 3.11.

101 *Id.*

tween these two peaks of investment at $0.3 million and $11.3 million is a valley where funding is increasingly hard to find.[102] The valley reaches a critical low point—a gap—between about $1 to $5 million, where startups fail because funds are in such short supply.

4. Gap Problems for Startups and Investors

The Series A gap causes problems for many startups. Angel investor Mason Myers of Greybull Stewardship has observed that "traditional Series A does not fit many companies."[103] Amar Bhidé,[104] in his article, *Bootstrap Finance: The Art of Start-ups*,[105] summarily explains, "belief in a 'big money' model of entrepreneurship . . . has little in common with the traditional low-budget start-up."[106] Venture capital investors look for high growth starters founded by successful entrepreneurship experience.[107] As a result, there are endless startups that build iPhone applications and similar products. But companies that design hardware or biotechnology—and the entire life science startup field in general—struggle to access capital.[108]

Lately there has been a remarkable increase in seedfunded startup failures. These failures have occurred as a result of a phenomenon known as the "Series A crunch."[109] Companies that obtain seedfunding but fail to receive Series A funding before they run out of capital get "crunched." The crunch threatens the success of the startup revolution. Slate Magazine reports, "[o]ne thousand startups will be orphaned; many will die. One billion dollars will have gone for naught. Bright young minds across the country will be out of work."[110] Startup-focused website, Launch, published a "Series A Crunch Survivor's Guide."[111] More pessimistic observers such as Richard Meyer of the Capital Formation Institute called this the "Start-Up Enterprise Valley of Death" and re-

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[102] *See FAQs About Angel Groups*, *supra* note 58 (noting that angel groups may invest in the gap between individual angels and venture capitalists).

[103] Mason Myers, *We're In Seed-Stage Boom, Not a Series A Crunch*, MASON MYERS BLOG (Apr. 6, 2014), http://masonmyers.com/seed-stage-boom-times-not-series-a-crunch/.

[104] Thomas Schmidheiny Professor of International Business, Tufts University.

[105] Amar Bhidé, *Bootstrap Finance: The Art of Start-ups*, 60 HARV. BUS. REV. 109 (1992).

[106] *Id.*

[107] *Id.* at 111.

[108] Laura Lorek, *More Venture Capital Needed for Life Science Startups*, SILICON HILLS (Dec. 4, 2014), http://www.siliconhillsnews.com/2014/12/04/more-venture-capital-needed-for-life-science-startups/.

[109] *See, e.g.*, Grant, *supra* note 14.

[110] Will Oremus, *Tech Startups Are about to Start Dropping like Flies*, SLATE (Dec. 20, 2012), http://www.slate.com/blogs/future_tense/2012/12/20/series_a_crunch_tech_startups_are_about_to_start_dropping_like_flies.html.

[111] *The Series A Crunch Survivor's Guide*, LAUNCH (Jan. 2, 2013), http://blog.launch.co/blog/the-series-a-crunch-survivors-guide.html.

marked that "[i]ts width ranges from $2,000,000 to $10,000,000, dictated by the minimum investment that VC firms prefer to invest to match their costs of management."[112]

Data show that the Series A crunch is a serious problem. Fenwick's 2012 Seed Financing Survey reported that the "number of seed financings increased from 472 in 2009 to 1749 in 2012, while the number of Series A rounds only increased from 418 to 692 during the same period."[113] This indicates that the Series A gap has become greater, meaning that more companies who receive seedfunding will not receive Series A funding, as illustrated by the chart below.

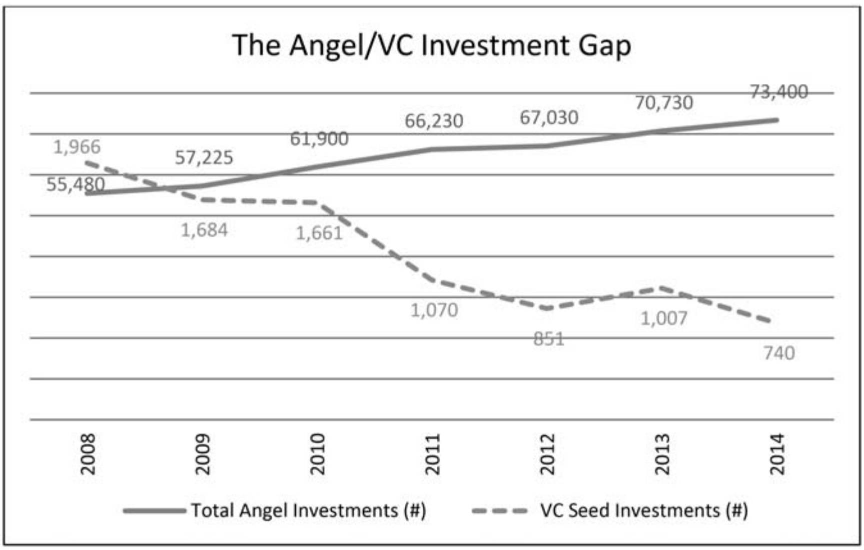

Figure 6: While angels continue to make more seed-stage investments each year, VC seedfunding has dropped to less than half of 2008 levels.[114]

GeekWire reported warnings of a Series A crunch in early 2013. The above chart illustrates the ratio of companies that received seedfunding to the number of seedfunded companies that received Series A funding.[115] CB Insights, which maintains the Venture Capital Database,[116] reported in late 2012 that only about 40% of seed-funded companies will

112 Richard Meyer, *The Start-Up Enterprise Valley of Death*, CAPITAL FORMATION INST., http://www.cfi-institute.org/VP - The Start-Up Enterprise Valley of Death - Meyer.html (last visited Dec. 21, 2014).

113 Kramer & Levine, *supra* note 97, at 3.

114 Data aggregated from *CVR Analysis Reports*, *supra* note 38; NAT'L VENTURE CAPITAL ASS'N, *supra* note 35, at 38 fig.3.10.

115 John Cook, *The Series A Crunch Is Alive and Well*, GEEKWIRE (Jan. 18, 2013), http://www.geekwire.com/2013/chart-series-crunch-real/. The ratio increased from 1.9:1 in 2009 to 3.3:1 in 2012.

116 *Seed Investing Report—Startup Orphans and the Series A Crunch*, CB INSIGHTS, https://www.cbinsights.com/blog/seed-investing-report/ (last visited Dec. 21, 2014).

raise a Series A round.[117] This dramatically increases the risk associated with forming, joining, or investing in a startup company, and thus chills those desirable behaviors.

B. The Market for Entrepreneurial Finance

The JOBS Act of 2012 created the possibility of a new entrant into the private equity market. In addition to the established investors—angels and VCs—the JOBS Act will permit the general public to invest in the market for entrepreneurial finance through "crowdfunding."[118] This Article refers to that general investing public as "crowds."

Crowdfunding has a general and specific meaning in the context of this Article. Crowdfunding can be generally understood as "the practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet."[119] Crowdfunding in this sense has been occurring at least since 2005 with the founding of Kiva.[120]

Since Kiva began in 2005, over a million people have made interest-free crowdfunded microloans to impoverished entrepreneurs through Kiva.[121] Now, crowdfunding is popular on Kickstarter.com, where, for example, an initiative called the Pebble Smartwatch project raised $10 million by pre-selling the finished project.[122] Small businesses start and grow with for-profit crowdfunded loans from InvestNextDoor.com[123] and Lending Club.[124] The Oceti Sakowin Indian tribe offered a thank you reward to everyone who contributed $20 to save the Black Hills and

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[117] *See id.*

[118] *See, e.g.*, Press Release, Sec. & Exch. Comm'n, SEC Issues Proposal on Crowdfunding (Oct. 23, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677.

[119] Tanya Prive, *What Is Crowdfunding and How Does It Benefit the Economy*, FORBES (Nov. 27, 2012), http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy/.

[120] Terry Waghorn, *Premal Shah: Loans that Change Lives*, FORBES (Nov. 4, 2013), http://www.forbes.com/sites/terrywaghorn/2013/11/04/premal-shah-loans-that-change-lives/ (noting that Kiva is "a global microfinance organization that connects borrowers who need funding to launch poverty-transforming businesses with socially minded lenders who have as little as $25 to invest in their success").

[121] *About Us*, KIVA, http://www.kiva.org/about (last visited Jan. 12, 2015).

[122] Angela Moscaritolo, *Pebble Smartwatch Sells Out, Collects $10 Million on Kickstarter*, PC MAGAZINE (May 10, 2012), http://www.pcmag.com/article2/0,2817,2404295,00.asp.

[123] *See generally Pre-Launch Guide for Your Small Business Crowdlending Campaign*, INVESTNEXTDOOR (Nov. 7, 2014), https://www.investnextdoor.com/blog/guide-preparing-small-business-crowdlending-campaign/.

[124] *See generally* LENDINGCLUB, https://www.lendingclub.com/business/ (last visited Jan. 12, 2015).

other Sioux sacred land on Indiegogo.[125] These are examples of the donative, pre-ordering, rewards, and lending models of crowdfunding.

On the other hand, *equity* crowdfunding—which is selling a small amount of stock to a large number of people via web sites called funding portals—was illegal until the JOBS Act created a new exemption to the Securities Act of 1933.[126] A more specific definition of crowdfunding for present purposes relates expressly to equity crowdfunding as permitted by the JOBS Act and SEC rules:

> Regulation Crowdfunding would prescribe rules governing the offer and sale of securities under new Section 4(a)(6) of the Securities Act of 1933. The proposal also would provide a framework for the regulation of registered funding portals and brokers that issuers are required to use as intermediaries in the offer and sale of securities in reliance on Section 4(a)(6). In addition, the proposal would exempt securities sold pursuant to Section 4(a)(6) from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934.[127]

The JOBS Act amends Section 4(a)(6) of the Securities Act of 1933 (the Securities Act)[128] to allow a private corporation to offer and sell up to $1 million worth of equity securities (stock) in a twelve-month period to the general public without registering the securities with the SEC.[129] This new exemption to registration under the Securities Act is generally called "crowdfunding," although it is more specifically called "equity crowdfunding."[130]

Equity crowdfunding will be allowed when the SEC promulgates its final rules[131]—which at the time of this publication are overdue[132]—although some of the crowdfunding rules are provided in the JOBS Act itself. Individuals who have between $100,000 and $1 million in annual income or net worth may invest 10% of it each year in startups through

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125 *See generally Pe' Sla: Help Save Lakota Sioux Sacred Land!*, INDIEGOGO, https://www.indiegogo.com/projects/pe-sla-help-save-lakota-sioux-sacred-land (last visited Jan. 12, 2015).

126 *See generally* 15 U.S.C. § 77 (2012).

127 Crowdfunding, 78 Fed. Reg. 66,427 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240 & 249).

128 *See* 15 U.S.C. § 77d(a)(6).

129 *See id.*

130 *See, e.g.*, *Jumpstart Our Business Startups Act Frequently Asked Questions About Crowdfunding Intermediaries*, SEC. & EXCH. COMM'N (May 7, 2012), https://www.sec.gov/divisions/marketreg/tmjobsact-crowdfundingintermediariesfaq.htm.

131 Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 303(b), 126 Stat. 306, 321 (2012).

132 *See id.* Rulemaking was due "not later than 270 days after the date of enactment of this Act," which was signed into law on April 5, 2012. *Id.*

crowdfunding.[133] Individuals who have or annually earn less than $100,000 may invest the greater of $2,000 or 5% of their annual income each year in startups.[134]

The JOBS Act also creates the new term "funding portal," which is a financial intermediary that can sell startup stock online to non-accredited investors.[135] A private company raising capital under the crowdfunding exemption from the Securities Act must sell the stock through either a registered broker-dealer or a funding portal.[136] Any broker-dealer or funding portal that engages in crowdfunding must register with the SEC and the Financial Industry Regulatory Authority (FINRA).[137] The funding portal may not solicit transactions for securities displayed on its website or portal, compensate anyone for soliciting investors, pay compensation based on the sale of securities on its website or portal, hold customer funds or securities, or offer investment advice or recommendations.[138]

All of these regulations come at a price. The SEC estimates that raising $100,000 may cost up to $39,000 in portal and compliance fees.[139] Raising $1,000,000 may cost up to $151,660.[140] In comparison, raising a similar amount of money from angels through series seed preferred stock financing pursuant to Regulation D Rule 506[141] costs between $10,000 and $30,000 in legal fees.[142] This huge cost difference disfavoring crowdfunding begs the question: Why would startups choose to use this vastly more expensive fundraising method when equity fundraising alternatives are widely available?

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133 15 U.S.C. § 77d(a)(6)(B)(ii).

134 15 U.S.C. § 77d(a)(6)(B)(i).

135 15 U.S.C. § 78c(a)(80).

136 *Id.*

137 *See generally Funding Portals*, FINRA, http://www.finra.org/industry/issues/funding-portals (last visited Jan. 12, 2014).

138 *Id.*

139 *See* Neiss, *supra* note 22.

140 *Id.*

141 *See infra* Part III.B. Equity fundraising involves the sale of unregistered securities, so it must be done under an exemption from the Securities Act. Regulation D (or Reg D) contains three rules (Rules 504, 505, and 506) providing exemption from registration, and they will be discussed in greater depth later on in this Article. Rule 504 allows startups to sell up to $1 million of securities in one of three ways: (1) in a general solicitation to non-accredited investors with a disclosure document, (2) in a general solicitation to accredited investors without a disclosure document, and (3) in a general solicitation to non-accredited investors without a disclosure document. Rule 505 of Regulation D allows the issuer to sell up to $5 million of its securities in a 12-month period to an unlimited number of accredited investors and up to 35 other persons. Rule 506 of Regulation D is the only "unlimited" exemption from the Securities Act, meaning that only under Rule 506 can issuers raise an unlimited amount of money from issuing unregistered securities. This makes Rule 506 a popular exemption.

142 Scott Edward Walker, *Everything You Ever Wanted to Know About Convertible Note Seed Financings (But Were Afraid to Ask)*, TECHCRUNCH (Apr. 7, 2012), http://techcrunch.com/2012/04/07/convertible-note-seed-financings/.

II. BRIDGEFUNDING

This Article argues that crowdfunding regulations are backwards. Instead of limiting investment to $1 million per startup,[143] crowdfunding should require startups to raise at least $1 million and up to $5 million annually. The Article uses the term "bridgefunding" to describe its new theory of an inverted crowdfunding regulation.

This Article proposes that bridgefunding may be an effective way to allow crowds to participate in the private equity market while limiting fraud and providing a valuable new source of capital for startups. This Article's theory of bridgefunding is based on three main points: (1) startups need capital in the private equity gap of about $1 to $5 million; (2) crowds are better at making second-period (gap) investment instead of first-period (seed) investment; and (3) fraud concerns about crowdfunding can be sufficiently addressed without a $1 million limit.

The policy implications of these observations are a recommendation for the JOBS Act to invert the $1 million limit for crowdfunding. Instead of a ceiling, that should become a floor. Startups should be required to raise at least $1 million from crowdfunding, and the ceiling should rise to at least $5 million.

A. *The Bridgefunding Proposal*

Bridgefunding means creating a regulatory regime whereby the general public can invest in early stage startups. Early stage startups are distinguished from seed stage startups in that early stage startups have already received some seed capital from angels or other professional investors.[144] There are two regulatory mechanisms that can be employed to ensure that bridgefunding is directed to early stage, not seed stage, startups.

First, regulators can set a $1 million floor on bridgefunding investment. This will do little to harm crowdfunding because crowdfunding is already far too expensive for sub-million-dollar investment rounds. As discussed later in this Part, rational startups will not seek crowdfunding if they can obtain seed funding from angels, as angel investment is more efficient. Angel investment is generally not available for startups that are very low quality or that need more than $1 million.[145] A $1 million floor bars low quality startups from seeking bridgefunding while allowing high quality startups to obtain bridgefunding in the more-than-million-dollar range where angel funding is not readily available.

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143 15 U.S.C. § 77d(a)(6)(A) (2012).

144 *Alternative Investments—The Stages in Venture Capital Investing*, INVESTOPEDIA, http://www.investopedia.com/exam-guide/cfa-level-1/alternative-investments/venture-capital-investing-stages.asp (last visited Oct. 8, 2015).

145 *See FAQs About Angel Groups*, *supra* note 58.

Second, regulators can require that a startup must have at least one significant, independent stockholder before that startup may raise money through bridgefunding. The purpose of this requirement is to bring an angel or other professional investor into the startup before allowing crowds to invest. That professional investor provides diligence and oversight while influencing pricing functions that make crowdfunding less risky and more efficient.

The particular threshold for who qualifies as a "significant investor" merits further study, but this Article proposes the following framework predicated on diligence, oversight, and influence. First, the independent professional investor must make an investment large enough to compel a reasonable professional investor to perform thorough due diligence of the startup. Due diligence includes tasks like making sure the company is duly incorporated, confirming that all stock grants have been authorized by the board, checking the capitalization table for accuracy, considering the efficacy of the business model, evaluating the competitive landscape, and determining the viability of the proposed product.

Second, the independent professional investor must acquire rights to review the startup's books and records and to attend board meetings. These oversight rights are commonly found in management rights letters in venture capital contracts. Third, the independent professional investor must own enough stock to influence corporate decision making. Influence by minority stockholders is often bargained for in the private equity contracting process. Influential rights include protective provisions, whereby the investor can veto fundamental corporate transactions such as a liquidation or another stock issuance; rights of first refusal and co-sale, whereby the investor can effectively prevent the founders from selling their shares; and board participation rights, whereby the investor is guaranteed a number of seats on the board of directors.

The professional investor must be independent in order for the diligence, oversight, and influence roles to be meaningfully carried out. Independence has a different meaning in securities law. In public corporations, the requirement for an "independent director" means the company must have a director on the board who is not a shareholder.[146] In the context of bridgefunding, however, the requirement for an "independent investor" means an individual who is not related or beholden to the founders of the startup. This would disqualify family members and close friends from playing the role of an independent investor.

While the requirements of a $1 million floor and a prior significant independent professional investor ensure that bridgefunding is not used

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[146] Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1482 (2007).

for seedfunding, a $5 million cap on bridgefunding also focuses investment on early stage startups. Startups that require substantially more than $5 million have access to a venture capital investment that can fuel the startup to reach its later stages.[147] Startups of this size do not face a liquidity crunch, so there does not seem to be any immediate need for crowds to fund these companies. Moreover, additional risks of startup investment emerge in the later stages. For example, startups may need to make acquisitions to grow in later stages. The general public may be in a poor position to understand whether to funnel money into Startup X so it can use that capital to purchase Startup Y. The decentralized nature of crowds mean they cannot give the same sort of specific advice that venture capital managers provide to their portfolio companies. The $5 million cap balances the need for startup capital with the need for investor protection. Moreover, as discussed in detail below, focusing bridgefunding on the $1 to $5 million range encourages crowds to invest where they have unique advantages over other participants in the private equity market.

Bridgefunding can be made more efficient through default provisions in the investment contracts. Crowds are large heterogeneous groups of unsophisticated, inexperienced investors.[148] They may not know how to protect their rights through specific provisions in venture capital contracts. The law can protect these investors by creating default or mandatory rules. These rules can be rigid or flexible. For example, a flexible rule about crowdfunding investment agreements may require that crowds get the same rights that the independent preferred angel investor received. It is typical that a later stage investor receives the same or greater rights than an earlier stage investor does,[149] so this regulation would normalize investment contracts with crowds in the private equity market. Crowds might also be protected by rigid default rules. For example, laws may require that crowds receive anti-dilution protections, rights to veto a sale of company or a later financing round, rights to inspect books and records, or even the right to have a crowd representative installed on the board of directors.

In summary, the bridgefunding proposal has four main components: (1) a $1 million floor to keep low quality startups from obtaining seed financing from bridgefunding, (2) a $5 million ceiling to prevent crowds from overinvesting in mature startups, (3) a prior independent profes-

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147 *See FAQs About Angel Groups*, *supra* note 58.

148 *See* 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, 1766 (2012).

149 Ibrahim, *supra* note 54, at 1430–31.

sional investor to vet and monitor the startup, and (4) default terms that make crowdfunding equity contracts more efficient.

B. Why Bridgefunding Works

The pragmatic thrust of this Article is that bridgefunding works, even though crowdfunding fails. The remainder of this section reviews the criticisms of crowdfunding to demonstrate many of the reasons why bridgefunding can succeed.

1. Bridgefunding Can Fill the Private Equity Gap

The Series A crunch demonstrated that it is getting harder for startups with Series Seed funding to attract Series A investment.[150] There's a gap between an average of $1 million invested by angels and an average of $5 million invested by venture funds that relatively few investors seem willing to fill.[151] Even companies like Wittlebee—which received an unusually large $2.5 million investment in the Series Seed round[152]—may require more investment before it is able to demonstrate profitability and thus secure venture investment.

Crowdfunding could potentially bridge the gap. But where does crowdfunding fit in the startup life cycle? Crowdfunding, as designed by the JOBS Act, largely aims to take the place of angel investment. Crowdfunding and angel investment occupy the same space in the startup ecosystem.[153] Both provide small to average Series Seed rounds of about $1 million.[154] Unfortunately, therein lies the problem. Creating another source of seed-stage capital around the $1 million mark is not what the market needs. The market needs a gap investment that can provide funding between angel investment and venture investment.

The $1 million dollar investment limit also seems to be inherently counterintuitive, preventing startups from wanting to use crowdfunding. Instead of relying on the crowdfunding exemption, startups can rely on Regulation A+ or Regulation D Rule 506,[155] which will be discussed in depth later. Those exemptions allow startups to raise at least $50 million.[156] Regulation D, in particular, might be preferred by startups that want to avoid extra disclosure liability imposed by the crowdfunding ex-

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150 *See* Grant, *supra* note 14.

151 This may be in part because the 100-investor limit prevents angels from forming large enough syndicates to fund companies through this gap.

152 *See Wittlebee*, *supra* note 4.

153 *See* Ibrahim, *supra* note 54, at 1416 (noting that angel investment is usually available in smaller amounts than venture capital).

154 15 U.S.C. § 77d(a)(6)(A); *see also supra* Part I.A.1.

155 15 U.S.C. § 77c(a)(2)(2012); 17 C.F.R. § 230.506 (2014).

156 15 U.S.C. § 77c(a)(2); 17 C.F.R. § 230.506.

emption.[157] Put simply, crowdfunding has to compete not only with angel investment, but also with other statutory exemptions, both of which are attractive alternatives to crowdfunding. If there are superior strategies or better alternatives, crowdfunding simply won't work. Crowdfunding needs some sort of competitive advantage in order for it to be popular, effective, and profitable for investors and startups.

Increasing the maximum amount startups can receive from crowdfunding would allow crowdfunding to fill a valuable niche. The Series A crunch showed that there is a problem with investing between Series Seed and Series A, creating an opportunity for investors. Bridgefunding would capitalize on this opportunity and establish the crowdfunding exemption as an attractive, innovative source of capital.

2. Crowds Are Suited for Bridgefunding

Crowdfunding, as currently regulated, presumes that crowds will be able to take the place of angels—those investors who find, fund, and guide nascent startup corporations.[158] This Article challenges that assumption and suggests instead that angels are a unique player in the market with whom crowds cannot compete. Angels are often wealthy market leaders, industry experts, and visionaries.[159] They are ideally suited to help a brand new venture realize its latent potential. Crowds, on the other hand, reflect the general wisdom and consensus of the population at large.[160] Crowds are, by definition, less wealthy than angels, and the sheer number of crowdfunding investors creates a bell curve dynamic where crowds will tend to fund popular companies.

These initial differences show that treating crowdfunding and angel investment as if they were competitors is ill founded. Startups require staged, multi-period investment.[161] Angel investment alone is not sufficient to fully grow a startup.[162] Crowdfunding alone is equally unlikely to create a viable, long-term company.[163] These groups typically invest once at the beginning of a startup's lifecycle, so the startup can grow large enough to attract venture investment.[164] Venture investment, unlike crowdfunding or angel investment, can sustain a company through-

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[157] Deborah L. Jacobs, *The Trouble with Crowdfunding*, FORBES (Apr. 17, 2013), http://www.forbes.com/sites/deborahljacobs/2013/04/17/the-trouble-with-crowdfunding/.

[158] *See supra* Part I and accompanying text.

[159] *See FAQs About Angel Groups*, *supra* note 58.

[160] Tom Kalil & Doug Rand, *Crowdfunding: Democratizing Investment for Entrepreneurs*, WHITE HOUSE (Nov. 4, 2011), https://www.whitehouse.gov/blog/2011/11/04/crowdfunding-democratizing-investment-entrepreneurs.

[161] Oranburg, *supra* note 26.

[162] *Id.*

[163] *See* Prive, *supra* note 119 (noting that crowdfunding can help an established business expand its product range).

[164] *See* Ibrahim, *supra* note 54, at 1416–17.

out its lifecycle.[165] Venture funds have access to hundreds of millions or billions of dollars.[166] Once a venture investor has a vested interest in a company, the investor may singlehandedly ensure that the startup survives unprofitable periods.

In order to propel startups through the Series A gap and allow them to secure this much sought after venture capital, crowdfunding should be regulated in a way that allows it to operate *alongside* angel investment, not in competition with it. As it stands, the $1 million crowdfunding limit means crowdfunding and angel investment occupy the same space in the startup ecosystem—that is, the Series Seed, sub $1 million investment.[167] Data evidencing the Series A crunch has shown that this niche in the ecosystem is already overcrowded.[168] The imposition of a $1 million hard cap on investment bars crowds from fulfilling their unique potential and establishes unnecessary competition in a saturated market. Therefore, criticism that crowdfunding is too limited, expensive, risky, and complex to be an effective substitute for alternative first-period financing for startups is well founded. It should not be operating as such. What critics are missing is that crowdfunding—reengineered as bridgefunding—has the potential to safely inject capital into the second investment period, when startups need cash desperately and when none of the current investors is likely to finance post-seed, pre-revenue investments. Bridgefunding would allow crowds to immediately step in and play a valuable role in startup financing.

Crowds have proven their willingness to invest $1 to $5 million or more in promising early stage projects. Nomad raised several million dollars via several campaigns for three novel USB accessories.[169] The Dash raised almost $3.4 million to produce a wireless in-ear headphone and fitness tracker.[170] Pono Music (founded by Neil Young) raised almost $6.3 million to create a high fidelity portable music player.[171]

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165 *Id.* at 1411–12.

166 *See* NAT'L VENTURE CAPITAL ASS'N, *supra* note 35.

167 *See* Ibrahim, *supra* note 54, at 1416; 15 U.S.C. § 77d(a)(6)(A) (2012); *see also supra* Part I.A.1.

168 *See, e.g.*, Grant, *supra* note 14.

169 Erin Hobey, *Crowdfunding on CircleUp, Nomad Connects with Fluxmob: Grows Smartphone Accessory Brand to over $2 Million in Sales*, CROWDFUND INSIDER (July 14, 2014), http://www.crowdfundinsider.com/2014/07/44021-crowdfunding-circleup-nomad-connects-fluxmob-grows-smartphone-accessory-brand-2-million-sales/.

170 *The Dash—Wireless Smart In Ear Headphones*, KICKSTARTER, https://www.kickstarter.com/projects/hellobragi/the-dash-wireless-smart-in-ear-headphones (last visited Jan. 17, 2015).

171 *Pono Music—Where Your Soul Rediscovers Music*, KICKSTARTER, https://www.kickstarter.com/projects/1003614822/ponomusic-where-your-soul-rediscovers-music (last visited Jan. 17, 2015).

OUYA raised $8.5 million to create an open source video game console that is powered by Android OS and plays on a television.[172]

3. Bridgefunding Addresses Fraud

Crowdfunding, understandably, raises concerns about investor protections. Scholars such as Professor Thomas Lee Hazen caution, "[i]f history teaches us anything, the lesson is that social media technologies increase rather than decrease the potential for fraud."[173] I disagree with the premise that social media enhances fraud—in other works I argue that Twitter and other social media enhance collective shareholder activism.[174] Rather, it seems that fraud concerns are overblown, and those concerns can be diminished when crowdfunding is used as gap financing. The concerns underlying claims for more antifraud regulations are out of touch with how crowdfunding and startup investment actually work. For example, Professor Hazen writes:

> The Internet and social networking offer fertile ground for scammers. Scammers and securities fraudsters have for nearly a century found ways to adapt their scams to new technologies. Consider, for example, high-pressure boiler room sales operations or the promotion of fictitious or worthless securities to build Ponzi schemes. The Internet has also proven to be fertile ground for pump and dump schemes. Boiler room tactics have adapted to new technologies. For example, telephonic cold calling has been supplemented or superseded by spam emails.[175]

None of these concerns has anything to do with social media. In fact, the most recent case cited in support of "pump and dump operations" was resolved in 2006—when social media barely existed. Fast forward to 2013, when spam emails (like phishing scams) are actually declining.[176] Other crowdfunding securities can be advertised online, but there are scant reports of spam scams from LendingClub, Prosper, RealtyMogul, or any other debt crowdfunding portals.[177] If anything,

[172] *OUYA: A New Kind of Video Game Console*, KICKSTARTER, https://www.kickstarter.com/projects/ouya/ouya-a-new-kind-of-video-game-console?ref=sidebar (last visited Jan. 17, 2015).

[173] Hazen, *supra* note 148, at 1769.

[174] Seth C. Oranburg, *A Little Birdie Said: How Twitter Is Disrupting Shareholder Activism*, 20 FORDHAM J. CORP. & FIN. L. 695, 695 (2015).

[175] Hazen, *supra* note 148, at 1767–68 (citations omitted).

[176] Victoria Lund-Funkhouser, *Top 7 Phishing Scams of 2013*, RETURN PATH (Dec. 26, 2013), http://blog.returnpath.com/blog/tori-funkhouser/top-7-phishing-scams-of-2013.

[177] *See, e.g.*, *LendingClub Corporation*, BETTER BUS. BUREAU, http://www.bbb.org/greater-san-francisco/business-reviews/financial-services/lendingclub-corporation-in-san-fran-

social media makes crowdfunding *safer*. Investors can share information, form groups, build trust, and establish rapport despite geographic boundaries, all thanks to social media.[178] Crowdfunding happens instantly online, making transactions transparent. Monitoring is easy and information flows freely. Ordinary Americans are savvy to online scams.[179]

Other articles state that "the risk for fraud against such well-intentioned people and their potential backers is very real,"[180] but why is this fraud more worrisome than other investment risks? Public Citizen, a D.C. think tank, uses similar rhetoric: "[T]he public will be outraged if . . . Congress approves legislation that further deregulates Wall Street and facilitates more financial fraud. The House should reject H.R. 3606."[181] Putting aside the fact that crowdfunding has almost nothing to do with Wall Street—this is more of a Silicon Valley kind of regulation—more claims of fraud with no specificity should be understood as sound and fury, signifying nothing.

The truth is, crowdfunding is not more prone to fraud than other forms of investment. Merely being on the Internet does not make it worse. Social media does not hurt investors; it helps them collaborate. But Congress watered down Regulation Crowdfunding—perhaps to ensure that the JOBS Act would quickly pass[182]—in response to antifraud (and, bizarrely, anti-Wall Street) rhetoric. The result is a regulation that is too complicated and expensive to be useful.

Merely because something takes place on the Internet does not make it per se more fraudulent. For instance, the Internet prevents fraud by giving investors the ability to instantly discuss concerns with each other. But some fraud concerns are actually supported by real-world instances, which can happen online or offline, like pump-and-dump schemes. And even without fraud, startup investment is very risky. But the literature seems to overlook a very powerful antifraud device built

cisco-ca-361746 (last visited Oct. 9, 2015) (giving LendingClub an A+ rating, but noting that the company's name has been used in an online lending scam).

178 Oranburg, *supra* note 174, at 707.

179 *See*, *e.g.*, *OH Attorney General: Watch Out for These Scams in 2015*, CINCINNATI.COM (Jan. 10, 2015), http://www.cincinnati.com/story/news/2015/01/10/oh-attorney-general-watch-scams/21582267/ (noting Ohio Attorney General Mike DeWine's advice on how not to fall for internet scams).

180 Jacques F. Baritot, *Increasing Protection for Crowdfunding Investors Under the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 259, 281 (2013) (concluding that "the risk for fraud against [unsophisticated investors]" is very real, without providing any examples or support).

181 *Vote NO on JOBS Act*, PUBLIC CITIZEN, http://www.citizen.org/documents/vote-no-on-jobs-act.pdf (last visited Jan. 26, 2015).

182 *See generally* Joan MacLeod Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments that Begs for a Happy Ending*, 102 KY. L.J. 865 (2014) (explaining how fear of crowdfunding combined with the political necessity to vote for the JOBS Act led to a watered down rule).

into Regulation Crowdfunding: personal liability of the founder and other parties related to the issuer for fraud. Moreover, bridgefunding happens after seedfunding, when angels invest. Angels provide a front line of defense against fraud that crowdfunders can enjoy.

Regulation Crowdfunding imposes personal liability on the founders and other parties related to the issuer. These additional liabilities make crowdfunding even more costly and less attractive. Alternative fundraising modalities, like Regulation D, are subject to fewer causes of action for fraud. These additional fraud liabilities should, however, quell the fraud concerns discussed above.

All securities issuances are subject to fraud liability under § 17 of the Securities Act, which makes it unlawful to conduct fraudulent interstate securities transactions,[183] and Rule 10b-5 of the Exchange Act, which imposes liability for "any untrue statement of a material fact or [omission of] a material fact necessary in order to make the statements made."[184] In addition, Regulation Crowdfunding imposes liability on issuers for omission of "a material fact required to be stated," even if that fact is not necessary in order to make the statement made.[185]

Regulation Crowdfunding also imposes liability on "any person who is a director or partner of the issuer, and the principal executive officer or officers, principal financial officer, and controller or principal accounting officer of the issuer (and any person occupying a similar status or performing a similar function)."[186] To win an award of damages from fraud under Regulation Crowdfunding, plaintiffs do not have to prove that the defendant's fraud caused the plaintiff's loss,[187] nor must plaintiffs prove that defendants acted willfully.[188]

The triple threat of personal liability for the executive officers, a lower standard for proving fraud and a broader definition of fraud by omission, greatly increases the liability of issuers who use Regulation Crowdfunding vis-à-vis those who use Regulation D. All else being equal, issuers will prefer to sell stock under another exemption (such as Regulation D) that imposes less liability on the company and its agents. This added antifraud protection helps Regulation Crowdfunding discourage fraudulent issuers from using crowdfunding.

Moreover, it is much easier to set up a nascent shell corporation than it is to operate a company for a year, obtain angel seedfunding investment, and develop a product (not just a promise). Due to the costs of

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[183] Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2012).
[184] Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2012).
[185] 15 U.S.C. § 77d-1(c)(2)(A).
[186] 15 U.S.C. § 77d-1(c)(3).
[187] 15 U.S.C. § 77d-1(c)(1)(B).
[188] 15 U.S.C. § 77d-1(c)(2)(B).

committing such fraud on bridgefunding investors—who are not the first investors in a company—it seems unlikely that bridgefunding would be used for naked fraud in a way that seedfunding scams could exist.

However, there are simple regulatory solutions that could quell whatever marginal fraud concerns arise from allowing a startup to raise $5 million instead of $1 million. For example, Regulation Crowdfunding already limits investors to 10% of their annual income or net worth to invest in crowdfunding each year. This could simply be extended to limit any particular investor to investing 10% of his or her annual income or net worth in any particular startup.

Finally, it is worth pointing out that if a scammer wants to steal $5 million via crowdfunding, he can do so under Regulation Crowdfunding as it is currently drafted almost as easily as if the limit were higher. The scammer could simply set up five separate pseudo-startups. There is nothing in the law, nor any rules, which prohibit such a parallel offering. Simply put, the $1 million limit does not protect investors, and it prevents good companies from genuinely benefitting from crowdfunding.

4. Bridgefunding Addresses Cost

Scholars such as Professor C. Steven Bradford[189] recognize that "[t]o be useful to small business issuers, a crowdfunding exemption needs to be relatively simple and inexpensive."[190] To qualify for the exemption, startups and portals must strictly comply with all the requirements of Regulation Crowdfunding—there is no "substantial compliance" rule as is found in other securities exemptions.[191] Regulation Crowdfunding requires startups to file with the SEC and make available to the public disclosures about the company's financial information, ownership, capital structure, business plan, and risk factors.[192] Complying with these complex regulations requires startups to retain the services of lawyers and accountants, thus adding cost through complexity.[193]

Portals must register with the SEC as a broker or a "funding portal."[194] Registering as a funding portal is expensive, and portals can be disqualified in several ways:

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189 Earl Dunlap Distinguished Professor of Law, University of Nebraska-Lincoln College of Law.

190 C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195 (2012).

191 *See id.*

192 *Id.*

193 *Id.*

194 *Id.*

> The term "funding portal" means any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others . . . that does not—
> (A) offer investment advice or recommendations;
> (B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;
> (C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
> (D) hold, manage, possess, or otherwise handle investor funds or securities; or
> (E) engage in such other activities as the Commission, by rule, determines appropriate.[195]

Strict compliance with Regulation Crowdfunding is difficult, and any noncompliance by a crowdfunding issuer can disqualify its portal from making any crowdfunding offerings.[196] This is problematic because crowdfunding needs a crowd to congregate on a portal and make crowdsourced decisions. The high risk of total, across-the-board portal disqualification for minor, technical noncompliance by an issuer on that portal makes becoming a portal less attractive. And, as if being a portal were not disfavored enough, the JOBS Act also forbids portals from compensating its employees or agents based on sales. This seems to disadvantage portals vis-à-vis registered brokers, who are not subject to this restriction.[197] Portals will have to pass these costs to crowdfunding issuers.

Startups can raise only $1 million pursuant to Regulation Crowdfunding, and doing so costs up to $151,660.[198] As discussed earlier, using Regulation D costs about $25,000,[199] and in 2014 angel investors invested $24.1 billion, with an average deal size of $328,300.[200] About 70,000 startups obtain initial angel investment annually. Crowdfunding is so expensive that its investors are likely to be privy only to the 70,001st best startup that year. That is why many commentators have thrown in the towel and declared that crowdfunding will fail.

One of the primary purposes of bridgefunding is to avoid this unfortunate result. Recall that the costs associated with crowdfunding are

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195 15 U.S.C. § 78c(a)(80) (2012).

196 *See* Bradford, *supra* note 190.

197 *Id.*

198 Neiss, *supra* note 22.

199 *See Series Seed—Term Sheet*, SERIES SEED, www.seriesseed.com (last visited Feb. 22, 2015) (describing that the standard form of Series Seed Term Sheet specifies that a company will reimburse purchaser's counsel with a flat fee of $10,000). It is generally understood that the company's counsel usually bills about 1.5 times what a purchaser's counsel does.

200 Sohl, *supra* note 20.

mostly fixed costs; they do not increase very much as the amount of money raised increases. As a result, the cost per dollar raised decreases when a startup raises $5 million instead of $1 million. Somewhere in the range of $3 to $5 million, bridgefunding becomes about as expensive—on a per-dollar-raised basis—as raising money from angel investors. This solves much of the cost issue.

The issue of complication is directly tied in with the cost. Complication is something that can be dealt with given sufficient resources. Startups can hire lawyers, accountants, and other professionals to resolve some of the JOBS Act's complicated requirements if the startup raises enough money to pay the associated fees, with enough money left over to actually operate.

5. Bridgefunding Addresses Business Risk

Startup investment is risky business, but crowdfunding may attract the riskiest startups. Scholars such as Professor Michael B. Dorff argue that "[t]he problem [with crowdfunding] is that the companies that participate will be terrible prospects . . . . [S]tart-ups with real potential will continue to use other programs . . . ."[201] He then raises concerns that series seed angel investments may be unprofitable,[202] which may also be true about venture capital funds for certain periods.[203] I am concerned that crowdfunding is even worse than angel investment in this regard, but do not doubt the necessity of series seedfunding for startups to continue innovating. Nevertheless, Professor Dorff and I arrive at virtually the same conclusion: "The most promising companies—that small percentage of start-up companies that account for the bulk of angel investors' gains—will seek their financing far from the costly crowd."[204] That is the extent of our agreement, however. I do not agree that "the SEC's best option is to kill retail crowdfunding with excessive regulation."[205] Instead, regulators should revive crowdfunding through the concept of bridgefunding so it will attract some of the best companies.

Professor Darian M. Ibrahim argues that crowdfunding might actually attract some high-quality entrepreneurs and investors.[206] "First, Title III should appeal to high-quality startups that are too young for

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201 Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 IOWA J. CORP. L. 492, 492 (2014).

202 *Id.* at 509–20.

203 *See* Robert S. Harris, et al., *Private Equity Performance: What Do We Know?*, 69 J. Fin. 1851 (2014) (studying the performance of nearly 1,400 buyout and venture capital funds and concluding that such funds performed below the S&P 500 average in the 2000s).

204 Dorff, *supra* note 201, at 519.

205 *Id.* at 522.

206 *See* Darian M., Ibrahim, *Equity Crowdfunding: A Market for Lemons?* 100 MINN. L. REV. 561, 604 (2015).

'professional' financing . . . . Second, . . . Title III would appeal to that subset of startups that need cash but do not need value-added services from investors."[207] I disagree with both possibilities. Title III cannot possibly appeal to "startups [that] are too early stage for even a $100,000 angel investment to be on the table"[208] because complying with regulations could cost more than the startup would raise. Raising $100,000 through crowdfunding could cost $39,000, most of which are fixed costs that do not drop much as the amount raised decreases.[209] And while I agree that startups who need money—but not services—could prefer crowdfunding over venture capital, that argument assumes incorrectly that crowdfunding is cheaper than venture capital and that crowdfunding and venture capital fundraising overlap. Crowdfunding simply is not a substitute for venture capital, although it could become a good alternative to venture capital if the crowdfunding limit were raised to at least $5 million, a solution this Article proposes.

6. Bridgefunding Addresses Price Uncertainty

How does the general public determine what a brand new startup security is worth? How do investors know whether startup securities are being sold for the right price? Professor Alan Palmiter[210] pinpoints a critical non-fraud problem in crowdfunding.[211] His recent paper, *Pricing Disclosure: Crowdfunding's Curious Conundrum*, asks: How do inexperienced, small, casual investors know they are buying startup securities for the "right" price?[212] Professor Palmiter suggests that startups should be responsible for proposing the price and methodology behind that proposal.[213] Professor Palmiter also recognizes that the SEC cannot police every tiny offering, so he proposes a new self-help scheme for defrauded crowdfunding investors.[214]

The failure of a crowdfunding issuer to disclose clear assumptions underlying the chosen method for determining the price of offered securities would be materially false and misleading.[215] But enforcing the antifraud Rule 10b-5 requires either public or private action.[216] The plaintiff's recovery in a private enforcement action against a crowdfunding issuer pursuant to Rule 10b-5 for failure to disclose pricing method-

207 *Id.* at 589–90.
208 *Id.* at 589.
209 *See* Neiss, *supra* note 22.
210 Howard L. Oleck Professor of Business Law, Wake Forest University School of Law.
211 *See generally* Alan R. Palmiter, *Pricing Disclosure: Crowdfunding's Curious Conundrum*, 7 ENTREPREN. BUS. L.J. 373 (2012).
212 *See id.* at 374.
213 *See id.*
214 *See id.* at 375.
215 *See id.* at 415.
216 *See id.* at 418.

ology is limited to the amount invested, so damage awards can be at most $1 million.[217] Plaintiffs' attorneys' fees, which are on average between twenty and thirty percent of the settlement amount,[218] would be too small to justify commencing the action.[219]

Will the public authorities step in where it is economically unfeasible for private lawyers to take action? The SEC prioritizes its limited resources for enforcement action based on "(1) the message delivered to the industry and public; (2) the amount of investors harm done; (3) the deterrent value of the action; and (4) the SEC's visibility in certain areas . . . ."[220] The SEC's investigations department very rarely refers Regulation D violations (which reflect greater harm from a more frequent and visible type of transaction than crowdfunding) to the SEC's enforcement division, so it is highly unlikely that the SEC will prosecute crowdfunding violations.[221] Arbitration could be a faster and cheaper alternative to public or private action for the policing of 10b-5 (fraud) violations in crowdfunding disclosures.[222] But the JOBS Act currently lacks any mandate for arbitration, so issuers do not have to agree to arbitrate claims.[223] Arbitration is also problematic because arbiters are not required to produce any written explanation behind their award of damages.[224] Arbitration decisions in securities law also have no precedential value.[225]

Professor Palmiter presents a novel alternative in both public and private litigation and arbitration. Price insurance would be a new way to ensure that crowdfunding investors are not bamboozled.[226] The insur-

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217 *See id.* at 416.

218 *See id.* at 417–18 (citing John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 889–90 (1987)); *see also Frequently Asked Questions About Class Actions*, BERNSTEIN LIEBHARD LLP, http://www.bernlieb.com/FAQs/index.html (last visited Feb. 28, 2016).

219 Palmiter, *supra* note 211, at 417.

220 *Id.* at 418–19 (citing James D. Cox et al., *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 751 (2003) (explaining that SEC enforcement is used as a beacon showing what the SEC considers important to preserving financial market integrity)).

221 *See id.* at 420 (citing OFFICE OF INSPECTOR GENERAL, U.S. SEC. & EXCH. COMM'N, REGULATION D EXEMPTION PROCESS 13, 18–20 (2009) (explaining that, despite discovering multiple violations in a sample of forty-one Regulation D filings, in the fifteen-month period ending in December 2008, the Division of Corporate Finance's Office of Small Business Policy only referred one Regulation D issue to the Enforcement division).

222 *See id.* at 422–21.

223 *See id.* at 422.

224 *See id.* at 424.

225 *See id.* at 425 (citing Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1001 (2002)) (pointing out that because most cases are now heard by an arbitration panel, as opposed to a judge or jury, law in the field has matured only slightly since *Shearson/Am. Express v. McMahon*, 482 U.S. 220 (1987)).

226 *See* Palmiter, *supra* note 211, at 426.

ance provider would be incentivized to investigate startups issuing crowdfunding securities on behalf of all the small investors, thus solving a collective action problem where no small investors find it worth their while to thoroughly investigate risks.[227] Fortunately, the concern of mispricing is diminished when a startup has operated for a period of time and has completed at least one priced equity fundraising round from angel investors. Raising the crowdfunding limit thus alleviates some pricing uncertainty.

Moreover, bridgefunding requires prior equity investment by professional angel investors. That means a priced round of stock has been sold. Stock reflects a percentage ownership of a company.[228] For example, someone who owns 1 million out of 10 million shares owns 10% of StartX. How much he or she paid for that percentage of shares translates into an objective valuation of StartX. If she paid $1 million to end up with 10% of StartX, the enterprise as a whole is worth $10 million. Valuation is inherent in a priced round of stock.

In contrast to a priced round, startups can sell convertible securities. There are several types of convertible securities. A common type is convertible debt. These are loans which can automatically convert the principal owed (and sometimes the interest accrued) into an amount of stock based on a per-share stock value. The amount of stock can be fixed at the time the convertible debt is issued. More commonly, however, the stock value is determined when the next financing occurs. Debt holders often get a discount at that time.[229] For example, StartX sells $1 million of convertible debt to Angela. The debt agreement provides for a 1% simple annual interest. Angela's debt converts to preferred stock whenever the next investor buys Series Seed preferred stock of StartX, say for $1 per share. Angela bargained for a discount of 80% of the per share price of the next investor. At the closing of the preferred stock sale, Angela's debt automatically converts into 1,262,500 shares of StartX preferred stock.

Convertible securities—which also come in more exotic flavors like a "simple agreement for future equity" and "convertible equity"—defer the valuation of a startup until the next financing.[230] Such transactions are not useful in valuing bridgefunding stock. That is why such transac-

[227] *See id.*

[228] *See Stock*, INVESTOPEDIA, http://www.investopedia.com/terms/s/stock.asp (last visited Oct. 8, 2015).

[229] Peter Werner, *Primer on Convertible Debt*, COOLEY LLP, https://www.cooleygo.com/convertible-debt/ (last visited Oct. 8, 2015).

[230] Melody Peng, *Using Convertible Equity: What Startups Need to Know*, LIGHTER CAPITAL (May 1, 2015), https://www.lightercapital.com/blog/using-convertible-equity-what-startups-need-to-know/.

tions do not qualify as a prior independent professional investment as described in Part II.A above.

7. Bridgefunding Opens New Business Models

As demonstrated above, VCs primarily invest in high-tech companies and secondarily in life science companies.[231] Bridgefunding creates a new source of funding that may inspire entrepreneurs to build alternative business models. Furthermore, the data show that VCs strongly prefer to invest in local startups.[232] That means, for many entrepreneurs, moving to Silicon Valley. The Bay Area is one of the most expensive places in the world to live, and the attraction of venture capital there continues to draw residents and increase prices. Other regions have attempted to create their own, local "Silicon Valley," but they have been met with limited success.[233]

Venture capital firms prefer to invest in high technology. Software firms are especially popular targets for VC investment. Intellectual property is highly scalable. Once good code is developed—whether an iPhone application, an encryption algorithm, or database management tools—spending money on marketing can have a direct effect on making lucrative sales.[234] Some readers may recall when Internet advertising was the business model of most startups. Now many startups rely on in-app purchases.

Software is clearly important, but it is not the only innovation we need. Life sciences, biotechnology, and apparel are left out of the mix.[235] It gets worse than that. Women are disadvantaged when seeking venture capital.[236] Individuals located outside of Silicon Valley are over-

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[231] *See supra* Part I.

[232] *See* Merrill F. Hoopengardner, *Nontraditional Venture Capital: An Economic Development Strategy for Alaska*, 20 ALASKA L. REV. 357, 368 (2003) ("Thus, in addition to economic considerations, the hand-holding nature of the venture capital business is compromised if the venture capital firm is geographically removed from the business in which it is investing.").

[233] Vivek Wadhwa, *Silicon Valley Can't Be Copied*, MIT TECH. REV. (July 3, 2013), http://www.technologyreview.com/news/516506/silicon-valley-cant-be-copied/.

[234] Dragana Mendel, *Is Your Startup a High Growth Venture Capital Type?* (Feb. 2, 2015), http://www.anagard.com/blog/2015/02/02/is-your-startup-a-high-growth-venture-capital-type/.

[235] *See* Bruce Booth, *Debunking Myths About Biotech Venture Capital*, FORBES (May 22, 2013), http://www.forbes.com/sites/brucebooth/2013/05/22/debunking-myths-about-biotech-venture-capital/.

[236] *See* Tom Kaneshige, *Why Venture Capitalists Don't Fund Women-Led Startups*, CIO (Feb. 12, 2015), http://www.cio.com/article/2882826/venture-capital/why-venture-capitalists-dont-fund-women-led-startups.html. Tom Kaneshige from CIO argues that there seems to be two main reasons why female-led startups struggle to secure venture capital. First, venture firms like to invest in leaders, not just great ideas. As it presently stands, almost all venture managing partners are men, and they seem to be more comfortable investing in startups led by

looked or ignored.[237] Startup investment's diversity problem is so pronounced that Mirror Digital's CEO, Sheila Marmon, launched the Venture Capital Access Program to help women and minority-led businesses to raise capital.[238]

Bridgefunding can democratize startup investment. Whereas today the preferences of venture capital firms dictate how angels invest and which startups succeed, in the future, a crowdsourced approach to equity financing may allow the general public to pick the next Facebook.

III. WHY CURRENT REGULATIONS FAIL

Bridgefunding is supported and informed by theories in the literatures of business innovation, law, and economics. This Part addresses and incorporates those into the literature regarding securities law, while explaining why existing regulations are insufficient to bridge the private equity gap.

A. Law and Economics of the Private Equity Gap

The Series A gap appears to be a failure in the private equity market, but economic theory suggests that well-functioning markets should not suffer failures in equilibrium.[239] Ascribing to this theory leads to three possible conclusions. The first possible conclusion is that the gap is not a market failure, but an artifact of a well-functioning market. Perhaps the gap simply reflects that an increasing quantity of untenable startups were founded this decade. This Article cannot explore a counterfactual world, where all failed startups actually received funding, and measure the performance of that private equity market against the real world. But this Article does present evidence that startups failed largely and without any correlation to their long term potential for success. Wittlebee—as mentioned earlier—failed to get funding, was sold to another company in a fire sale liquidation (where investors got pennies on the dollar for their investment), and went on to thrive as a subsidiary of its new parent organization.[240] These facts, at least, sew reasonable doubt that the gap is desirable.

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male entrepreneurs. Second, and interrelated, there is a dearth of women venture capitalists generally, and they are often negatively stereotyped by their male counterparts in the industry.

237 Alicia Purdy & Kaja Kwasneiewska, *The Fine Print on Investing in Venture Capital*, FIN. POISE (Sept. 30, 2013), https://www.financialpoise.com/accreditedinvestormarkets/print/3018/ (noting that angels and VC funds normally "will not invest in companies outside their geographic area (usually 100–150 miles from the VC's office)").

238 David Teten, *Helping Women and Minorities Raise Angel Capital*, DAVID TETEN, http://teten.com/blog/2014/04/18/helping-women-and-minorities-raise-angel-capital/ (last visited Jan. 30, 2015).

239 *See* JEFFREY M. PERLOFF, MICROECONOMICS 24–26 (5th ed. 2009).

240 *See supra* notes 1–10 and accompanying text.

The second possible conclusion is that the private equity market is not in equilibrium, but is responding to some sort of shock.[241] Perhaps a crash in public stock markets temporarily changed investor behavior in the private equity market. If the gap exists only in disequilibrium, it will go away when the shock has finished rippling through the market. Only time will tell if the gap exists in disequilibrium or is persistent, but data show that the gap has existed, and has been expanding, since at least 2011.[242] The expansion of the gap for four years appears to be prima facie evidence that it is not merely a disequilibrium state.

The third possible conclusion is that the gap is the result of a market failure, which can possibly be addressed by law. This Article argues that there is good evidence of market failure in the private equity market.

1. Economic Theory Explains the Gap

It is not the aim of this Article to prove that there is a market failure in the private equity market through economic modeling. Rather, the intention is to show that there are several reasonable bases for concluding that the gap is not merely a positive market characteristic or a temporary glitch.

Market failure can result from a number of situations, including regulations, monopoly power, transaction costs, lack of information, and irrational actors. Some of these situations can be quickly ruled out. For example, there is no evidence of any monopoly or even market power in the private equity market. Rather, the private equity market has tens of thousands of participants. The largest participant, NEA, which raised $3 billion, reflects only 0.5% of the cumulative amounts that VC funds have raised since 1985 and only 1.5% of the money under management by VC funds in 2013.[243]

It also appears unlikely that the gap is the result of irrational actors. While it is true that angel investors often speak of caring about more than money and giving back to the start-up community, in general these investors are sophisticated professionals who are looking to make a profit.[244] Some might claim that venture fund managers make decisions that benefit the managers to the detriment of the fund. That may occur at the margins, but fund managers have to raise money from investors every seven to ten years.[245] VC managers simply cannot expect to usurp fund opportunities or profit themselves at the expense of the fund and continue to be able to raise money.

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241 PERLOFF, *supra* note 239, at 24–31.

242 *See* Kramer & Levine, *supra* note 97.

243 Primack, *supra* note 67.

244 *FAQs About Angel Groups*, *supra* note 58.

245 *See* NAT'L VENTURE CAPITAL ASS'N, *supra* note 35.

Transaction costs in the private equity market are higher than in public stock markets, and this factor does, in fact, seem to have affected behavior in the private equity market. Raising money by selling stock costs at least $25,000 in legal fees.[246] Therefore, it would be irrational to raise less than $25,000 by selling stock in all instances. Transaction costs increase as the amount raised increases, so larger transactions tend to have lower transaction costs on a per-dollar-raised basis than smaller transactions. This may be one reason why angels invest in groups. Angel groups share transaction costs among all the investors, so each investor can contribute a small amount, yet the aggregate amount contributed is enough to outweigh the transaction costs. Transaction costs become less of a factor in VC transactions. Spending $100,000 in legal fees to secure an investment of $10,000,000 is well within the range of transaction costs that allow proper market functioning. Moreover, if angels wish to invest in startups without purchasing equity, they can make similar investments with convertible notes,[247] simple agreements for future equity,[248] or other instruments that require spending only a few thousand dollars in transaction costs.

While there does not seem to be any obvious externalities in the private equity market, the group dynamics of angel investment may prove otherwise. An externality is a cost or benefit imposed on individuals not participating in the trade.[249] It seems, at first, that only the startup and the investor gain or lose from the purchase of equity. However, it is critical to remember that startup investment is a multi-period strategy.[250] In order for a first-period (seed) investment to pay off, someone else must make a second-period investment as well. In fact, many startups require several stages of funding before that startup can be profitably sold in a merger event or made liquid through an initial public offering.[251] In the private equity market, an angel in the first period enjoys a positive externality when a different investor invests in the company in the second period.

Angels invest in groups, but the entire group does not need to reinvest in order for the startup to survive. If an angel joins a group that makes a startup investment, the group as a whole may want to reinvest in that startup to prevent it from failing, but an individual angel in the group may prefer to let the rest of the group save the startup. This is called a

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246 *See supra* note 199.

247 *Are Safe Investment Docs Safer than Convertible Notes?*, START UP LAW PROF. BLOG (July 8, 2014), https://startuplawprof.wordpress.com/2014/07/08/are-safe-investment-docs-safer-than-convertible-notes/.

248 *Id.*

249 *See* PERLOFF, *supra* note 239, at 605–07.

250 *See supra* Part I.A.2.

251 *See supra* Part I.A.

hold-out problem, which can lead to angel underinvestment in the private equity market.[252]

Angels can also seek a positive externality by free riding on another investor's efforts.[253] Diligence, also called due diligence, is the process by which an investor and his counsel review a potential investment.[254] This involves obtaining stage agency filings to ensure that the company was properly created and is up to date on its tax payments. This confirms that no creditors have a lien on the company or its assets, verifying that the capitalization table accurately reflects who owns how much of the startup. In turn, this ensures that the startup actually owns its intellectual property, checking whether the startup's board of directors properly authorized any corporate actions, reviewing the financial statements, investigating the history of the founders and the key employees, assessing the business risks of the startup, and evaluating the competitive landscape for that business model.[255] Then the angel has to negotiate the terms of the preferred stock purchase agreement, review the documents to ensure they comply with the terms, execute a wire transfer, and ensure that the stock certificate has been received and stored. In addition, an angel may continue to oversee the startup after the investment is consummated by sitting on the board of directors, reviewing financial information, advising the leadership team, or physically inspecting the prototype or product.[256]

Angels can avoid these costs by following a "lead" angel. A lead angel is a member of an angel group who bears the costs of the diligence, negotiations, and oversight. Recall that angel groups can be organized or ad hoc. Organized angel groups such as the Hyde Park Angels may have a formal process by which members alternate responsibility for diligence tasks and get reimbursed by the group for associated fees. Ad hoc angel groups, on the other hand, may be formed solely for the purpose of making a single investment. In such groups, angels prefer to avoid the costs associated with diligence by allowing another to bear those costs, then interpreting that other investor's willingness to invest as a signal that the diligence turned out favorably. In this way, an angel can derive a positive externality by free riding on another's efforts.

Angel free riding problems can be formalized in a game called the prisoner's dilemma.[257] In this game, two co-conspirators who cannot

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252 *See* Oranburg, *supra* note 26.

253 *Id.*

254 *Due Diligence*, INVESTOPEDIA, http://www.investopedia.com/terms/d/duediligence.asp (last visited Oct. 9, 2015).

255 *See The Due Diligence Process in Venture Capital (VC)*, MARS (Dec. 6, 2013), http://www.marsdd.com/mars-library/the-due-diligence-process-in-venture-capital/.

256 *See* Ibrahim, *supra* note 54, at 1432–33.

257 *See* PERLOFF, *supra* note 239, at 481–82.

communicate are charged with arson and murder, for which there is evidence for arson, but not murder. A confession by either conspirator, however, would be sufficient for a murder conviction. The prosecutor offers the following plea bargain: If neither confesses, both will serve two years in prison for arson. If one confesses and the other does not, the confessor will walk free and the other will serve ten years for murder. If they both confess, they will both be charged with murder but receive a lesser sentence of six years for their cooperation. The best outcome for both is that both remain silent (resulting in a total sentence of four years), but they cannot communicate and agree to be silent.[258] Accordingly, both will confess, resulting in a total sentence of twelve years. This is a sub-optimal outcome.

The prisoner's dilemma applies to angel investment in the following way. Two angels want to invest in the same startup, but they are not aware of each other's existence, so they cannot communicate. There is a lack of information in the market about other investors' interest in a startup. Each angel will decide to undergo the cost of diligence, similar to how both conspirators decided to confess, even though this is a sub-optimal outcome for the angels. Accordingly, angel investment costs more than it would in an optimal environment, so certain angel investments that are socially desirable do not get made. This result, again, is underinvestment.

Yet another reason for a failure in the startup private equity market is regulation, which leads to a lack of liquidity. As mentioned earlier, the Securities Act of 1933 requires that only accredited investors make angel investments and only qualified purchasers make venture capital investments.[259] In other words, regulations limit who may participate in the private equity market. Regulations also impose various disclosure requirements and fraud liabilities on market participants. The effect is to shrink the pool of entities for whom it is possible and economically rational to participate in this market. Regulations can therefore lead to a liquidity crunch.

It may seem that there is endless capital in the private equity market. But in context, it becomes apparent that capital is somewhat limited. In 2013, angels and VC firms together invested almost $55 billion.[260]

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258 *See id.*

259 The term "accredited investor" is defined in 17 C.F.R. § 230.501(a). The term "qualified purchaser" mirrors the accredited investor term. Defining the Term "Qualified Purchaser" Under the Securities Act of 1933, 66 Fed. Reg. 66,839 (Dec. 27, 2001) (to be codified at 17 C.F.R. pt. 230).

260 NAT'L VENTURE CAPITAL ASS'N, *supra* note 35; Sohl, *supra* note 20. VCs invested much more—$49.1 billion—in 2014, but seems to be an outlier, especially since 85% of those investments were follow-on investments. *See* NAT'L VENTURE CAPITAL ASS'N, *supra* note 35, at 56 fig.3.19.

This is roughly equal to the amount of investment in initial public offerings that year,[261] and about the same amount that gold mining corporations invested on projects and acquisitions in 2010.[262] In contrast, shareholders in public stock markets received $1,167 billion of income in dividends alone in 2014.[263]

This section has taken a law and economics approach to the question of why there is a Series A gap and a Series A crunch. The next section will attempt to explain the gap based on market fundamentals. There are two dynamics that drive the Series A gap to become wider and taller, thus creating a larger gap, which leads to more companies failing in the Series A crunch. The first dynamic, which makes the gap wider, is inherent in the nature of successful venture firms making larger investments. The second dynamic, which makes the gap taller, results from new technology that allows more angels to better diversify by making more small investments. The wider gap is harder to cross and extends the range of startups whose business models are unfundable even though they may otherwise be ultimately profitable.

2. Venture Capital Success Widens the Gap

As venture firms succeed, they receive more money under management, so they need to either make more investments or larger investments. Making venture capital investments is costly—venture firms spend significant resources considering a potential investment, venture financing involves a lot of legal costs, and firms provide many value-added services to their portfolio companies—but those costs do not increase much as the amount invested increases.[264] In other words, venture capital investments have economies of scale.[265]

Data support this claim. The average venture capital investment in early stage startup financing has increased steadily (except for a huge increase during the dot-com bubble)[266] from $1.76 million in 1985 to $7.32 million in 2014.

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261 Ben Rooney, *Stocks: 2013 Is One for the Record Books*, CNN MONEY (Dec. 31, 2013), http://buzz.money.cnn.com/2013/12/31/stocks-record-bull-market/ (noting that 222 companies went public in 2013, raising nearly $55 billion).

262 Nathan Vardi, *How Gold Miners Became A Terrible Investment,* FORBES (July 1, 2013), http://www.forbes.com/sites/nathanvardi/2013/07/01/how-gold-miners-became-a-terrible-investment-2/ (determining that gold mining operations invested $60 billion in 2010).

263 *Global Dividend Income Hits New Record of $1.167 Trillion*, BBC NEWS (Feb. 16, 2015), http://www.bbc.com/news/business-31485930.

264 *See* PERLOFF, *supra* note 239, at 208.

265 *Id.*

266 *See, e.g.*, William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1865 (2013) (explaining venture capital investment during the peak of the dot-com bubble in 2000).

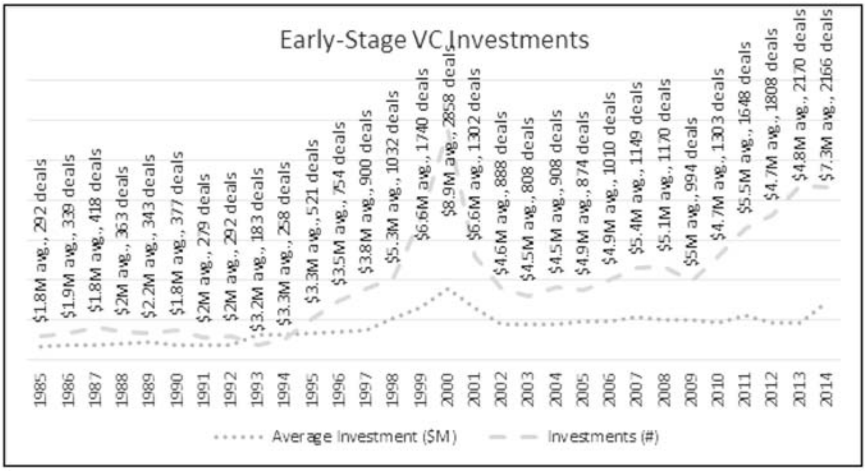

Figure 7: While the number of VC early-stage deals has increased, the amount invested per early-stage VC deal has also increased.[267]

From the third quarter of 2013 to the second quarter of 2014, venture capital investment increased from $12 to $22 billion,[268] while the number of deals steadily dropped from 1,944 to 1,590.[269]

Yet to become successful, top venture firms like Andreessen Horowitz distinguish themselves by offering services and distinction to startups in their investment portfolios.[270] For venture firms to generate an appropriate return on their investment, time, and ancillary services spent on portfolio companies, they need to make relatively large investments in relatively mature companies.

3. Angel Technology Heightens the Gap

Angels are individuals who invest their own money directly in early-stage startups. Who are these angels and how do they make investments? Not everyone can be an angel. Legally, an angel must have at least $1 million in net wealth or $200,000 in annual income,[271] which is approximately 3% of the U.S. population.[272] Practically, an angel should have a solid understanding of business planning, corporate finance, preferred stock investment and market conditions, plus a risk-seeking con-

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267 Data aggregated from NAT'L VENTURE CAPITAL ASS'N, *supra* note 35, at 38 figs.3.10 & 3.11.

268 Primack, *supra* note 37.

269 *Id.*

270 *See* Menn, *supra* note 31.

271 17 C.F.R. § 230.501(a)(5)–(6) (2013).

272 Schlesinger, *supra* note 63.

stitution.[273] Approximately 300,000 Americans made an angel investment in the past two years.[274]

Angels invest in groups called "syndicates." A syndicate makes an angel investment more efficient because only one angel needs to source, review, or negotiate a seedfunding investment opportunity.[275] Syndicates can be quite large. One of the largest established syndicates, Ohio TechAngel Funds, has over 300 angels.[276] But only 100 angels can invest in a single company,[277] so many syndicates, such as Seattle's Alliance of Angels, Southern California's Pasadena Angels, and New York Angels each have 100 members.[278]

Recently, angel online investing became hugely popular thanks to websites such as AngelList, which was founded in January 2010 as an online funding portal where companies can solicit investment from over 2,500 registered angels.[279] There are two kinds of angels on AngelList: "leads" and "followers." A lead on AngelList performs many of the sourcing, diligence, and negotiations tasks. If the lead does not take a management fee—thus allowing other angels to free ride on those efforts—it is called an "angel syndicated deal." An AngelList deal where the lead receives a management fee is called an "angel advertised deal."

Some venture fund managers are also leads for angels. For example, Marc Andreessen, general partner of Andreessen Horowitz, has 21,512 followers on AngelList.[280] Celebrity investors also enjoy special status. Actor-turned-investor, Ashton Kutcher, has 23,060 followers.[281] Even if you are not a "qualified purchaser" that can invest in a venture fund, on AngelList you can invest with Marc and Ashton.

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[273] *See generally* WILTBANK & BOEKER, *supra* note 47 (asserting that due diligence, experience, and participation are the three largest factors impacting the outcome of angel investments).

[274] *See FAQs About Angel Groups*, *supra* note 58.

[275] Jeremy Shure, *AngelList Syndicates: Why Pooling Resources Is Good for Early Stage Investing*, INC. (Oct. 10, 2013), http://www.inc.com/jeremy-shure/angellist-why-pooling-resources-is-good-for-early-stage-investing.html.

[276] *See OTAF Has Invested $29M in 50+ Companies*, REV1 VENTURES, https://www.rev1ventures.com/investments/techangel-fund/ (last visited Feb. 27, 2016).

[277] 15 U.S.C. § 80a-3(c)(1) (2012).

[278] Jason Fell, *The Top 10 Angel Investor Groups*, ENTREPRENEUR (Aug. 14, 2011), http://www.entrepreneur.com/article/220149.

[279] AngelList is only one of several online funding portals for the purpose of startup investment. FundersClub, established in 2011, was the first online venture capital firm devoted to facilitating more inclusive startup investment. *See* Nate C. Hindman, *Naval Ravikant, AngelList: A Social Network that Connects Startups with Investors*, HUFFINGTON POST (Sept. 20, 2011), http://www.huffingtonpost.com/2011/09/20/naval-ravikant-angellist-startups-investors_n_966167.html; Laura Baverman, *FundersClub Fills Void for Start-Up Investors*, USA TODAY (Mar. 17, 2014), http://www.usatoday.com/story/money/business/2014/03/17/baverman-funders-club-online-venture-fund/6291007/.

[280] *Marc Andreessen*, ANGELLIST, https://angel.co/pmarca (last visited Oct. 9, 2015).

[281] *Ashton Kutcher*, ANGELLIST, https://angel.co/aplusk (last visited Oct. 9, 2015).

As you can imagine, popular AngelList leads' rounds get oversubscribed, but not in the way you would expect. Securities laws limit an angel group size to 100 investors, even if that is not enough to sufficiently fund the company.[282] Brad Feld, another very popular lead angel,[283] blogs about his experience with this problem.[284] Due to this quirk in the law, sometimes angel money gets left on the table.[285]

When an angel group decides to syndicate an investment into a startup, the group first reaches out to its members to see who is interested in funding the company. In a relatively small group of twenty five investors, for example, everyone can always participate. The issue for such a small group is whether they can collectively raise enough money to meet the startup's capital requirement. Each investor in a small group may have to come up with more than he or she wants to invest in order to close the round.

Angels need to diversify that investment. Studies show that angels who invest in ten or fewer startups generally lose money.[286] Since 52% of startups fail[287] to earn a market rate of return (about 2.5x),[288] angels would be wise to invest in about 50 startups.[289] In other words, investing in a small number of startups is like playing roulette in Vegas by betting on a single number again and again. Statistically, such a strategy will eventually result in losing all money. Instead, angels prefer to invest in a portfolio of companies.

Websites such as AngelList have made it cheaper for angels to invest in more companies, and data show that angels do in fact invest less per startup, even though total angel investment has increased.

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282 *See* Fell, *supra* note 278.

283 Mr. Feld has 28,159 followers on AngelList at the time this Article is being written. *Brad Feld*, ANGELLIST, https://angel.co/bfeld (last visited Oct. 9, 2015). He is also the Managing Director of the venture firm Foundry Group.

284 Brad Feld, *The 99 Investor Problem*, FELD THOUGHTS (Jan. 22, 2014), http://www.feld.com/archives/2014/01/99-investor-problem.html.

285 15 U.S.C. § 80a-3 (2012). A syndicate is a limited liability company created for the sole purpose of making a particular investment. As such, a syndicate will have to register as an investment company under the Investment Company Act of 1940 (the "ICA"), unless it is exempt. There is a straightforward exemption. Companies that have 100 or fewer members, all of whom are accredited investors, are expressly defined as not investment companies pursuant to 15 U.S.C. § 80a-3(c)(1). This effectively limits angel syndicates to 100 members.

286 *How Does Diversification Apply to Startup Investing*, FUNDERSCLUB, https://fundersclub.com/learn/investment-strategies/diversification/how-diversification-apply-to-startup-investing/ (last visited Dec. 19, 2014).

287 WILTBANK & BOEKER, *supra* note 47, at 3.

288 Robert Wiltbank, *Angel Investors Do Make Money, Data Shows 2.5x Returns Overall*, TECHCRUNCH (Oct. 13, 2012), http://techcrunch.com/2012/10/13/angel-investors-make-2-5x-returns-overall/.

289 *Id.*

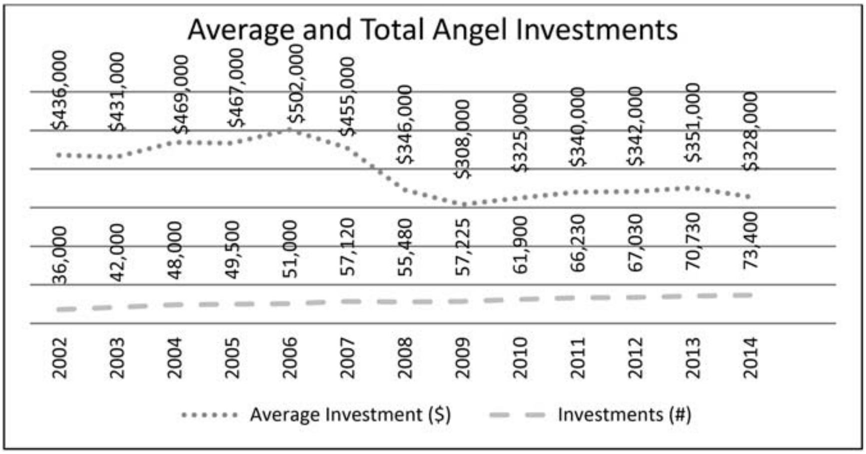

Figure 8: In sharp contrast to average early-stage VC investments, which have recently increased to over $7M per investment, average angel seed-stage investments have fallen to just over $300,000 per investment, even though total angel investment has generally increased over the same period.[290]

B. *Existing Exemptions Do Not Fill the Gap*

As discussed in Part II, crowdfunding is heavily criticized in scholarly literature. This Article also presents new criticisms about crowdfunding. But a flawed system can still be the best system. As Winston Churchill famously said, "Democracy is the worst form of government, except for all those other forms that have been tried from time to time."[291] Is crowdfunding the worst way to seedfund a company, except for all the other alternatives? Unfortunately for crowdfunding, it is not the best alternative for a startup to raise seedfunding of less than $1 million. This section discusses how crowdfunding, as it is currently regulated, is an inferior substitute for existing options.

Regulators should keep in mind the crowdfunding alternatives because (among other reasons) if crowdfunding is designed as an inferior alternative to direct competitors, only inferior companies will choose crowdfunding for equity fundraising. Alternatively, if crowdfunding is redesigned to fill an underexploited niche in the startup ecosystem, which is what this Article proposes as bridgefunding, crowdfunding will improve the system as a whole. This Article will next proceed with a discussion of the non-crowdfunding ways in which a private company may raise capital through the sale of equities.

290 Data aggregated from *CVR Analysis Reports*, *supra* note 38.

291 Ronald Hilton, *Democracy and Churchill*, WORLD ASS'N OF INT'L STUDIES (Sept. 5, 2003), http://wais.stanford.edu/Democracy/democracy_DemocracyAndChurchill%28090503%29.html.

Equity fundraising involves the sale of unregistered securities, so it must be done under an exemption from the Securities Act.[292] Regulation D contains three rules (Rules 504, 505, and 506) providing exemption from registration.[293] Regulation A also allows private companies to raise capital by selling stock without registering with the SEC.[294] In addition, the SEC plans to promulgate an expanded Regulation A, known widely as "Regulation A+."[295]

Of these exemptions, Rule 504, Regulation A, and Regulation A+ are the most similar to crowdfunding, as all three of these exemptions allow companies to sell securities directly to non-accredited investors.[296] Rule 504 is different from (and less useful than) crowdfunding, however, because general solicitation is not permitted in a Rule 504 offering.[297] Regulation A is different from (and more expensive than) crowdfunding because an issuer making a Regulation A offering must comply both with federal securities laws and state blue sky laws.[298] Regulation A+ does not yet exist, but commentators suggest that it will be very similar to crowdfunding, and some are even calling it "crowdfunding plus."[299] Crowdfunding is inferior to its alternatives in terms of cost.[300] Raising $1,000,000 via crowdfunding will cost between $76,660 and $151,660.[301] In contrast, raising a similar amount of money via Regulation D costs about $25,000.[302] Additionally, stock sold under Regulation D has fewer limitations.[303] This section will now explain these alternative equity fundraising exemptions in detail.

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292 *Regulation D Offerings*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/regd.htm (last visited Jan 13, 2015) (stating that pursuant to the Securities Act, all offers to sell securities must be registered with the SEC unless they are exempt).

293 *Id.*

294 17 C.F.R. §§ 230.251–.263 (2013).

295 Samuel S. Guzik, *Regulation A+ Offerings—A New Era at the SEC*, HARV. LAW SCH. FORUM (Jan. 15, 2014), http://corpgov.law.harvard.edu/2014/01/15/regulation-a-offerings-a-new-era-at-the-sec/.

296 *Id.*

297 *Rule 504 of Regulation D*, U.S. SEC. & EXCH. COMM'N (Oct. 27, 2014), http://www.sec.gov/answers/rule504.htm.

298 Rutheford B Campbell, Jr., *Regulation A and the Jobs Act: A Failure to Resuscitate*, 7 ENTREPREN. BUS. L.J. 317, 322–23 (2012) ("The increase in the relative offering costs generated by the obligations to comply with state registration provisions simply price Regulation A out of the marketplace for exemptions . . . .").

299 James Johnson & David Pricco, *Deep Dive: Investment Crowdfunding with "Regulation A+,"* CROWDEXPERT.COM, http://crowdexpert.com/investment-crowdfunding/regulation-a-crowdfunding/ (last visited Jan. 13, 2015).

300 *Id.*

301 Neiss, *supra* note 22.

302 The model preferred stock financing investment agreement provides that the company will reimburse investors' counsel a flat fee of $10,000. Generally, company counsel fees are 150% of investor counsel fees, for a total fee of $25,000. Filing fees are *de minimis*. *See Series Seed—Term Sheet*, *supra* note 199.

303 Johnson & Pricco, *supra* note 299.

1. Regulation D

Regulation D includes three exemptions: Rules 504, 505, and 506.[304] Common to all three of these exemptions is that companies issuing restricted stock pursuant to Regulation D must file a "Form D" electronically online after selling the securities.[305] Complying with Regulation D has preclusive effect over state blue sky laws.[306] In other words, an issuer who complies with Regulation D may not have to comply with state securities laws.[307]

2. Rule 504

Crowdfunding is not entirely new. In fact, it is similar in many ways to the current Rule 504 under Regulation D of the Securities Act. Rule 504 offerings are similar to crowdfunding offerings because both are limited to a sale of up to $1 million in securities in any twelve-month period.[308] Prior to 1992, Rule 504 offerings could be done through general solicitation, but the SEC determined that this created too many opportunities for fraud.[309]

To put it another way, Rule 504 allows startups to sell up to $1 million of securities in one of three ways: (1) through a general solicitation to non-accredited investors with a disclosure document, (2) through a general solicitation to accredited investors without a disclosure document, or (3) without a general solicitation to non-accredited investors without a disclosure document.[310] Even if a startup issues securities

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304 *Regulation D Offerings*, *supra* note 292.

305 *Id.*

306 Jean L. Batman, *Raising Money Through Private Placements*, AM. B. ASS'N, http://www.americanbar.org/publications/gpsolo_ereport/2012/april_2012/raising_money_private_placements.html (last visited Feb. 28, 2016) ("Blue-sky compliance (meaning the securities law compliance in each state where the securities are offered or sold) for Rule 506 offerings was simplified by the National Securities Markets Improvement Act of 1996 (NSMIA), Section 18(b)(4)(D) of the Securities Act of 1933, which preempts a state's registration requirements with respect to securities being offered and sold under Rule 506 of Regulation D. States are permitted only to (i) require a notice filing from the issuer, (ii) impose a filing fee, and (iii) require the issuer to consent to service of process in the state. In accordance with NSMIA, each state generally requires an issuer that offers and sells securities in its state pursuant to Rule 506 to submit the following materials within fifteen days after the first sale of securities in that state in order to qualify for an exemption from registration: (a) an executed copy of Form D Notice of Sale of Securities, (b) an executed copy of Form U-2 Uniform Consent to Service of Process, and (c) a filing fee. A Form D must also be filed with the SEC.").

307 *Id.*

308 *Id.*; *see also Regulation D Offerings*, *supra* note 292.

309 C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 16 (2001).

310 The current Rule 504 only exempts securities that are not offered to the public and the general solicitation unless one of the following circumstances are met: (1) the company registers the offering exclusively in one or more states that require a publicly filed registration statement and delivery of a substantive disclosure document to investors; (2) the company

under Rule 504 without a disclosure document, however, the company is still subject to fraud rules.[311] An omission of material information may be considered a false or misleading statement.[312] Therefore, startups issuing securities under Rule 504 are generally advised to provide a disclosure document even if they do not have a general solicitation or if they are only selling to accredited investors.[313] Because of this onerous requirement, there is limited added value in using Rule 504 as opposed to Rule 506, which offers unregulated offerings.

Crowdfunding protects investors more than Rule 504 in several ways. First, Rule 504 issuers are subject only to general antifraud liability under the Exchange Act Rule 10b-5.[314] Crowdfunding issuers, however, are subject to 10b-5 liability in addition to liability under Securities Act §§ 12(b) and 13.[315] Rule 504 issuers are not required to make any specific disclosure (although they are liable for fraud for material omissions), whereas crowdfunding issuers must file a "Form C" with the SEC.[316]

Perhaps the most significant way in which crowdfunding offers greater protection for investors than Rule 504 is that crowdfunding issuers must sell through a broker-dealer intermediary,[317] whereas Rule 504 issuers can sell directly to the non-accredited investing public.[318] The crowdfunding intermediary is called a "funding portal," which is essentially a website connecting investors to investment opportunities.[319] Unlike the non-equity crowdfunding portals that exist today (e.g., Kickstarter, Indiegogo), which mainly offer listing services but not ac-

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registers and sells the offering in a state that requires registration and disclosure delivery and also sells in a state without those requirements, so long as the company delivers the disclosure documents required by the state where the company registered the offering to all purchasers (including those in the state that has no such requirements); or (3) the company sells exclusively according to state law exemptions that permit general solicitation and advertising, so long as the company sells only to "accredited investors." 17 C.F.R. § 230.504(b)(1)(i)–(iii) (2014).

311 *Rule 504 of Regulation D*, *supra* note 297.

312 *Id.*

313 *Id.*

314 17 C.F.R. § 240.10b-5 (2014); *see also* Anthony J. Zeoli & Georgia P. Quinn, *Summary of Enacted Intrastate Crowdfunding Exemptions*, CROWDCHECK (Mar. 19, 2014), http://www.crowdcheck.com/content/summary-enacted-intrastate-crowdfunding-exemptions.

315 Section 12(b) requires that all securities traded on public exchanges be registered with the SEC, and that the issuers of those securities disclose detailed information about the company and securities it issues. Section 13 essentially functions as a supplement to 12(b), requiring companies to file quarterly and annual reports in addition to various other documents upon the happening of certain events. 15 U.S.C. §§ 78b, 78m (2012).

316 17 C.F.R. § 240.10b-5 (2014).

317 15 U.S.C. § 77d(a)(6)(C).

318 17 C.F.R. § 230.504.

319 Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals Under the Crowdfund Act*, 13 U.C. DAVIS BUS. L.J. 177, 190 (2013) (explaining what a "portal" is under the Crowdfund Act).

creditation, diligence, and disclosure services,[320] crowdfunding portals that can broker the sale of securities will be required to perform diligence and ongoing review of listed issuers.[321] Some commentators have recognized that this mandatory requirement will increase the cost and legal risk for crowdfunding portals so much that such portals will need to devise a new business model.[322]

On the other hand, there is one important way in which crowdfunding is more liberal than Rule 504. Crowdfunding issuers may generally solicit investment from non-accredited investors.[323] In 1992, the SEC took special notice of how pump-and-dump operations defrauded non-accredited investors by general solicitation of bogus securities.[324]

Professor Thomas Lee Hazen has raised several concerns regarding startups deceiving crowdfunding investors.[325] Professor Hazen reminds us, "as the Internet became more popular and widely used, online securities offerings took off and many less scrupulous promoters used the Rule 504 exemption for bogus or fraudulent offerings."[326] Many scholars are therefore concerned that crowdfunding may give rise to a new wave of fraudsters, despite the protections it offers.[327]

3. Rule 505

Rule 505 of Regulation D allows an issuer to sell up to $5 million of securities in a twelve-month period to an unlimited number of accredited investors and up to thirty-five other persons.[328] Stock sold in this manner cannot be resold for at least six months unless the stock is registered with the SEC.[329] Rule 505 is distinguishable from Regulation A—which also allows for the sale of up to $5 million in securities—because Regu-

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320 *See* Tom Cannon, *A Challenge to the Concept of Crowdfunding*, KICKSTARTER (Nov. 14, 2013), https://www.kickstarter.com/projects/1066541019/thriftyvac/posts/662863.

321 *See* Ryan Calbeck, *Why We Are Picky: The Importance of Curation in Crowdfunding*, FORBES (Nov. 20, 2012), http://www.forbes.com/sites/ryancaldbeck/2012/11/20/why-we-are-picky-the-importance-of-curation-in-crowdfunding/.

322 Heminway, *supra* note 319, at 199.

323 *See* 15 U.S.C. § 77d (2012).

324 *See Microcap Stock: A Guide for Investors*, U.S. SEC. & EXCH. COMM'N (Sept. 18, 2013), http://www.sec.gov/investor/pubs/microcapstock.htm; *see also* Luis A. Aguilar, *The Importance of Small Business Capital Formation*, U.S. SEC. & EXCH. COMM'N (Nov. 20, 2014), http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370543532516#.VKGSZEB-ums.

325 Hazen, *supra* note 148, at 1737.

326 *Id.* at 1763.

327 *Id.* at 1767–68.

328 *Rule 505 of Regulation D*, U.S. SEC. & EXCH. COMM'N (Oct. 27, 2014), http://www.sec.gov/answers/rule505.htm.

329 *Id.*

lation A allows general solicitation, whereas Rule 505 does not.[330] This advertising advantage for Regulation A is outweighed by the fact that Rule 505 and the other Regulation D offerings have preclusive effect over state blue sky laws, whereas Regulation A offerings are subject to both federal and state securities laws.

4. Rule 506

Rule 506 of Regulation D is the only "unlimited" exemption from the Securities Act, meaning that only under Rule 506 can issuers raise an unlimited amount of money from issuing unregistered securities.[331] Rule 506, therefore, is a popular exemption. Rule 506 may also become more popular now that the SEC has amended the rule to allow for general solicitations to accredited investors.[332] Similar to Rule 505, under Rule 506 issuers may sell securities to an unlimited number of accredited investors and thirty-five other purchasers.[333] Unlike Rule 505, however, under Rule 506 non-accredited investors must be "sophisticated."[334]

Until recently, issuers hoping to take advantage of Rule 506 were generally not allowed to solicit or advertise in order to market their securities. Rule 506 was recently amended to include Rule 506(c), which allows general solicitation if: (1) the investors in the offering are all accredited investors, and (2) the company has taken reasonable steps to verify that its investors are accredited investors.[335]

Most startup investments are made pursuant to Rule 506 not only because it allows for unlimited fundraising, but also because issuing companies engaged in Rule 506 offerings are not required to use an intermediary such as a registered broker-dealer.[336] Crowdfunding, on the other hand, will require issuers to sell stock through a broker-dealer or a

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330 *Id.*; *see also* David Rodman, *Regulation A+, the Jobs Act, and Public Offering Lite*, 90 DENV. U. L. REV. ONLINE 99, 100–01 (2013), http://www.denverlawreview.org/dlr-onlinearticle/2013/4/27/regulation-a-the-jobs-act-and-public-offering-lite.html.

331 *See generally* 17 C.F.R. § 230.506 (2014).

332 Gary Simon et al., *SEC Amends Rule 506 to Permit General Solicitation in Securities Offerings,* HUGHES HUBBARD & REED LLP, http://www.hugheshubbard.com/PublicationDocuments/eAlert%20%20SEC%20Amends%20Rule%20506%20to%20Permit%20General%20Solicitation%20in%20Securities%20Offerings.pdf (last visited Feb. 28, 2016).

333 *Rule 506 of Regulation D*, U.S. SEC. & EXCH. COMM'N (Oct. 6, 2014), http://www.sec.gov/answers/rule506.htm.

334 *Id.* ("[T]hey must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.").

335 *Id.*

336 *See generally Jumpstart Our Business Startups Act Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act*, U.S. SEC. & EXCH. COMM'N (Feb. 5, 2013), http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.

funding portal.[337] Rule 506 is also superior to Rule 504 or 505 in that only Rule 506 permits general solicitation of securities.[338]

5. Regulation A

Crowdfunding and Rule 504 of Regulation D are not the only ways to sell stock to non-accredited investors. The Securities Act also contains an unpopular and infrequently used exemption called Regulation A.[339] Regulation A permits the sale of up to $5 million in startup equity to non-accredited investors.[340] Nonetheless, Regulation A is rarely used because it requires issuers to circulate a complex disclosure document called an "offering circular," and it does not preempt state securities laws.[341] Therefore, issuers may be subject to a wide range of additional regulation depending on where the investors live.[342]

Regulation A issuers must file a Form 1-A with the SEC, to which they must attach the offering circular and financial statements that are compliant with generally accepted accounting principles.[343] This is not only expensive, but it also subjects the issuers to liability if the information on the circular is determined post hoc to be deficient or inaccurate.[344] Moreover, the public filing of such a statement makes it impossible for the startup to remain in "stealth mode,"[345] so such disclosures can be detrimental to both the startup and its investors. Once the stock is sold, however, the company does not have to continue making disclosures, thus making it difficult for secondary purchasers to value

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337 15 U.S.C. § 77d(a)(6)(C) (2012).

338 *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, U.S. SEC. & EXCH. COMM'N (Sept. 20, 2013), http://www.sec.gov/info/smallbus/secg/general-solicitation-small-entity-compliance-guide.htm.

339 17 C.F.R. §§ 230.251, .263 (2014).

340 Rodman, *supra* note 330, at 100.

341 Guzik, *supra* note 295.

342 Rodman, *supra* note 330, at 99 ("Reg A's unpopularity stems from a number of factors. These include the low ceiling on the amount that can be raised, the applicability of state blue sky laws, and the costs of the required disclosure, including the obligation to file an offering circular.").

343 *Id.* at 100.

344 *Id.* at 103; *see also Small Company Capital Formation Act of 2011; Regulation A Revival?*, MORRISON & FOERSTER (Mar. 30, 2011), http://www.mofo.com/files/Uploads/Images/110330-Small-Company-Capital-Formation-Act-2011.pdf ("Taking a small business public is an important, but expensive process that requires millions in underwriting costs.") (citation omitted).

345 *See* Matt Villano, *Why Startups Launch in 'Stealth Mode' and Others Don't*, ENTREPRENEUR (Oct. 17, 2013), http://www.entrepreneur.com/article/229461 (explaining that startup "stealth mode" is the practice of running a company in secrecy, or at least in relative anonymity, and that while this may be done for a variety of reasons, stealth mode is most commonly used to protect ideas or other types of intellectual property from the public and potential competitors).

stock issued under Regulation A and therefore limiting the liquidity of those shares.[346]

Due to the problems with Regulation A and the superiority of its alternatives, Regulation A is rarely used. There were only 19 Regulation A offerings filed in 2011,[347] compared to 15,500 Regulation D offerings.[348]

6. Regulation A+

The JOBS Act not only created crowdfunding, but also expanded Regulation A to include a new type of securities issuance under what has become known as "Regulation A+."[349] The change is most likely to increase the use of Regulation A+ vis-à-vis Regulation A in that an issuer can raise $50 million[350] instead of just $5 million. More mature startups may thus consider using Regulation A+ as an alternative to Regulation D, where the costs of the Regulation A+ disclosures are outweighed by the benefits of obtaining investment from non-accredited investors.

Regulation A+, however, similar to Regulation A, is not designed to help startups begin their first round of funding. Regulation A+ still requires onerous and expensive disclosures that make it cost-ineffective to raise a small round.[351] Regulation A has proved to be too costly for startups trying to raise up to $5 million.[352] While Regulation A+ may gain use by startups who want to raise between $5 and $50 million, it is unlikely to provide a meaningful vehicle for Series Seed investment of less than $5 million.[353]

In summary, the current crowdfunding regulation most closely resembles the failed Regulation A. That regulation failed to be a viable exemption for startups to raise capital because it was too expensive and too limited.[354] Likewise, crowdfunding is exponentially more expensive than its alternatives, and it can only be used to raise $1 million.[355] Bridgefunding is similar to Regulation A+, which recognizes the failures of expensive regulation by increasing the amount that can be raised. Regulation A+ provides a potentially viable alternative to an initial pub-

346 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-839, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS 5, 7 (2012).

347 *Id.* at 9.

348 *Id.* at 10–11.

349 15 U.S.C. § 77c(b)(2) (2012).

350 15 U.S.C. § 77c(b)(2)(a).

351 Guzik, *supra* note 295.

352 *Id.*

353 *Id.*

354 *Id.*

355 *Id.*

lic offering. Similarly, bridgefunding may provide a potentially viable alternative for private equity financing.

CONCLUSION

This Article has introduced "bridgefunding," a new way to think about crowdfunding. Crowdfunding is not only a way for the general public to have the opportunity to invest in startups. It can also provide an opportunity for startups to access a new source of capital where they need it most. Bridgefunding views crowds as a potential third type of investor in the startup financing market. Crowds have special features that make them better at certain types of investments. This Article has shown that crowds can occupy a valuable niche in the startup financing market by investing $1 to $5 million in startup companies, helping them safely navigate the Series A gap. Promulgating regulations that allow and encourage crowds to invest in the "bridgefunding zone"—between the initial sub-million-dollar "seed stage" and the "Series A" stage of the startup financing cycle—would be extremely beneficial to startups. Crowds have proven on numerous occasions that they are willing to invest millions of dollars in compelling products, products that may very well fail to secure sufficient funding despite their successful premise and often promising starts. Crowds could provide the proverbial "shot in the arm" necessary to make those companies successful. Additionally, investing after angels—who may still provide the initial round of startup financing—lets crowds take advantage of professional investor diligence, oversight, and influence. Following up initial angel investment also assuages fears that crowds may be subject to rampant investment fraud, as investing a little bit later in the startup financing cycle makes investment significantly safer for unsophisticated crowds. This bridgefunding proposal not only articulates the above solutions for the currently backwards antifraud measures of the JOBS Act, but also illuminates how securities regulation can be made more efficient by accounting for market dynamics.