Bridgefunding Is Crowdfunding for Startups across the Private Equity Gap

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BRIDGEFUNDING IS CROWDFUNDING FOR STARTUPS ACROSS THE PRIVATE EQUITY GAP

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ABSTRACT

Title III of the JOBS Act of 2012, which attempts to encourage entrepreneurship by allowing startups and small business to sell stock to the general public over the Internet through “crowdfunding,” is completely backwards. Its ceiling should be a floor—the $1 million limit should be inverted. By capping startups at raising $1 million from crowdfunding, the JOBS Act does not address the private equity gap, a fundamental problem in startup markets, and exposes unsophisticated investors to risk and fraud.

This Article presents a regulatory framework premised on “bridgefunding,” an approach that this article develops to protect new investors by encouraging them to fill a gap in the market. Startups have the greatest difficulty raising between $1 and $5 million, not the initial $1 million. That failure in the startup funding market could be solved with crowdfunding, but only if the regulations are changed. Bridgefunding also explains why startups should obtain financing from professional investors first, and then turn to crowdfunding. Bridgefunding takes crowdfunding to its logical conclusion, allowing crowdfunding to act as a means by which to bridge the funding gap, and thus occupy a valuable niche in the startup investment market.

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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. Whittlebee extended that model to the retail clothing market in an exciting new way. Each month, busy parents would receive high quality clothing for a low price.\(^2\) At first it seemed like a runaway success. Initial investors contributed a shocking $2.5 million, five times what startups usually raise.\(^3\) Wittlebee deployed the capital to grow quickly. It developed a user friendly web site, poached successful customer acquisition guru Chris Nella from ShoeDazzle, and even purchased another startup called Cottonseed Clothing.\(^4\) 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. But in 2012, the money disappeared, and it has not returned. One thousand startups were “orphaned” that year.\(^5\)

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\(^1\) Sean Percival, *Introducing Wittlebee*, http://seanpercival.com/2012/02/13/introducing-wittlebee/ (last visited Dec. 21, 2014) (Describes Wittlebee as “a new way to keep up with your kids’ basic clothing needs.”).

\(^2\) Id. (Explaining that Wittlebee is a new concept in the “subscription commerce” space.)


including Wittlebee, who eventually sold its business to Fabkids for pennies on the dollar in November 2013. Wittlebee is now a successful subsidiary, sustained by its parent company. 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. 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 first in legal literature to explore whether this gap is a market failure, and whether that failure is an unintended consequence of certain legal regulations. Many assume that capital markets are free markets, but in fact they are heavily regulated. Only “accredited investors” can purchase large amounts of private equity. 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. 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.” Many claim that this gap results from a liquidity problem, which is often referred to as the “Series A Crunch.” This Article is

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7 See 17 C.F.R §230.501(a) (Defining “accredited investor” as that term is used in Regulation D.).


9 See, e.g., John Peltz, *Lightbank Looks to Plug the Series A Gap*, Crain’s Chicago Bus. J. (Mar. 26, 2013) (“There are a lot of quality seed-stage companies that have done well but not well enough to get over the hump.”).

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. It exempts “crowdfunding” from the Securities Act of 1933, allowing startups to sell $1 million of private equity to the general public. Crowdfunding will introduce a new participant, “crowds,” into the private equity market. Crowds invest pursuant to a different set of dynamics than either angels or venture capitalists. 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. Instead, it merely allows the general public to compete with professional angel investors to make the first investment in startup companies. Angels funded 70,730 U.S. companies in 2013, when they invested almost $25 billion at an average of $350,000 per company.11 There is no sub-million-dollar liquidity problem. The JOBS Act thereby “solved” a problem that did not exist.

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. 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 (to obtain independent audits, disclosure documents, filing fees, legal fees, etc.) before selling equity

Bigfoot and Nessie and is entering the realm of truth, at least according to Fenwick & West.

11 Jeffrey Sohl, The Angel Investor Market in 2013: A Return to Seed Investing, CENTER FOR VENTURE RESEARCH (Apr. 30, 2014), available at http://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/2013%20Analysis%20Report%20FINAL.pdf (“Total investments in 2013 were $24.8 billion...A total of 70,730 entrepreneurial ventures received angel funding in 2013...The average angel deal size in 2013 was $350,830.”).
via crowdfunding.\textsuperscript{12} 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. Under current regulations, it seems that only startups who 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.\textsuperscript{13} 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 like disclosure requirements. It is harder to commit bridgefunding fraud because angels have already vetted and continue to monitor the startup when crowds invest. Portals could further reduce crowdfunding investor risk by forcing individuals to diversify their investments. 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 that 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


\textsuperscript{13} \textit{See infra} Part II.
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 it explores why alternative exemptions fail to fill the gap. This Article concludes by reviewing the competitive advantage of crowds to fund the gap.

Part 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. The differences between these two players in the private equity market have lead to a gap in startup financing. Subpart A provides a descriptive review of 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. Subpart 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.

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.\textsuperscript{14} Stock is a type of equity, and equity reflects an ownership

\textsuperscript{14} See, e.g., Education Center, FUNDERSCLUB, https://fundersclub.com/learn/ (last visited Dec. 27, 2014) (“Individuals who invest in startups are called angel investors (Angel Investing), whereas institutions that invest in startups are called Venture Capital firms.”).
right in a company. Startups are generally corporations, 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. 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, the right of shareholders to obtain financial information about the corporation, the right of shareholders to prevent other shareholders from selling the corporation’s stock or the right of shareholders 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. 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,” but they are also the only source of money. This creates the unique dynamic called the startup financing cycle.

15 See Kyle Hulten, Why C Corporations are the Preferred Entity for Tech Startups, iLVG BLOG (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.).

1. PRIVATE EQUITY MARKET PARTICIPANTS

As discussed, there are two main types of investors in the private equity market: angels and VCs. These investors are purchasers of private equity. In 2013, angels invested an average of $0.4 million in 70,730 startups, while VCs invested an average of $7.3 million in 4,041 startups. Despite investing a similar total amount, their investment strategies are quite different. Angels form groups to invest small amounts of their own money in brand new startups. VCs form funds to invest large amounts of other people’s money in more mature startups. While the angels and venture capitalists 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.

17 See supra Part I.A.
18 Sohl, supra note 11.
19 Yearbook 2014, NAT’L VENTURE CAPITAL ASS’N (Mar. 2014), available at http://nvca.org/research/stats-studies/ (Figure 3.10, which shows Venture Capital Investments in 1985-2013 by Stage, provides that in 2013 VCs made $9.896 billion in early stage investments and 29.5452 billion in total investments. Figure 3.11, Venture Capital Investments in 1985-2013 by Stage (Number of Deals), provides that in 2013 VCs made 2,031 early stage deals and 4,041 total deals. Data thus show that VCs invested an average of $4.872 million per early stage deal and $7.311 million per deal generally in 2013.).
21 See Dan Primack, VC Deals are Down, but VC Deal Sizes are WAY Up, FORTUNE (July 3, 2014, 12:04 PM), http://fortune.com/2014/07/03/vc-deals-are-down-but-vc-deal-sizes-are-way-up/.
Figure 1: Angels and VC invest a similar total amount per year (about $25 billion).

Figure 2: Angels invest several hundred thousand dollars in each startup, whereas VCs invest several million dollars in each startup.
i. 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. Distinguishing between the two is important because private equity investment works for startups, not small businesses.

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

A small business, on the other hand—like a bike store, cobbler's shop, deli, espresso cafe or food truck—is designed to grow

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22 For example, When President Barack Obama, signed the JOBS Act into law, he proclaimed, “startups and small business will now have access to a big, new pool of potential investors—namely, the American people.” President Barack Obama, Remarks by the President at the JOBS Act Bill Signing (Apr. 5, 2012), available at http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing.


24 Id.

25 See Startups & High Growth Businesses, 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 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).

26 All of these are examples from Inc. Magazine’s article, 10 Inspiring Success Stories to celebrate Small Business Month, available at http://www.inc.com/ss/10-inspiring-small-business-success-stories (last visited Jan. 30, 2015).
sustainably. Small businesses are wonderful and vital for the American economy. They provide employment and opportunity for millions of American. But they generally make terrible equity investments.\textsuperscript{27} Half of small businesses fail in their first five years,\textsuperscript{28} which is similar to the 52\% failure rate of startups.\textsuperscript{29} But small businesses do not grow exponentially as startups do, so equity investors would get the same risk but far lower returns. That is why small business are mostly financed with owner investment and an average of $80,000 a year in bank credit.\textsuperscript{30} It is unrealistic that private equity markets will provide a significant source of financing 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.\textsuperscript{31} 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.\textsuperscript{32} Less than a year later, Facebook received $12.7 million in a Series A from the venture firm Accel Partners in May 1, 2005, which it used to develop core social

\textsuperscript{27} In future work, the author of this Article will discuss how crowd lending might be an excellent source of funding for small business.


\textsuperscript{30} Id.

\textsuperscript{31} See Thomas R. Eisenmann, Geoffrey Parker and Marshall W. Van Alstyne, Strategies for Two-Sided Markets, HARV. BUS. R. (October 2006) (stating that competition lucrative for two-sided network like PC operating systems, credit card networks, internet ad serving, etc. have a winner-take-all dynamic requires operating on razor-thin margins or even giving subsidies to build the network).

infrastructure and expand to more U.S. universities and international student networks. Facebook needed a huge infusion of cash to expand rapidly, illustrating the point that $1 million is not a lot of money for a startup. Many startups raise millions of dollars throughout the startup financing cycle. Accordingly, this Article focuses on the startups, not small business.

ii. Angel Investors

Angels are professionals who invest their own money in startups. Traditionally, angels were hard to find. Through the late 1980s, these wealthy gurus connected with startups through informal and even secretive channels. In the early 1990s, angels began to form groups and publicize their activities. The first prominent angel investment group formed in 1994. Silicon Valley’s “Band of Angels” began with 12 members, and grew to 110 members by 1998. From then on, angel groups sprouted up throughout the United States. The number of registered angel groups has tripled since 1999. The Angel Capital Association estimates that there are between 10,000 and 15,000 angel groups operating in the United States today, which an average of 42 members per group. Many of these angel groups now have a prominent web site that contains a contract form, public membership list and even a list of portfolio companies.

Not all angels invest in groups. Some of the most popular angels continue to invest in the traditional, solitary, secretive way. Many of these traditional angels – like Peter Thiel (who seeded Facebook) and Naval Ravikant (who funded Twitter and Uber) – are famous for

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33 CRUNCHBASE, Facebook (last visited Jan. 30, 2015).
34 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).
35 Id.
37 Id.
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 $200,000 in annual income.\(^\text{39}\) 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,\(^\text{40}\) which is about 3% of the U.S. population.\(^\text{41}\) The Angel Capital Association estimates that about 4 million potential angels reside in the U.S.\(^\text{42}\)

Despite the large number of potential angels, only about 225,000 Americans made an angel investment in the past two years.\(^\text{43}\) 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.\(^\text{44}\) Angel investment is not for everyone.

### iii. 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


\(^{42}\) See supra note 36.

\(^{43}\) *Id.*

\(^{44}\) See supra note 29. (asserting that due diligence, experience, and participation are the three largest factors impacting the outcome of angel investments).
excess of most angel's personal net wealth, and VCs have to deploy this money very quickly because the funds typically have eight to twelve year life spans. 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. Since the beginning of the industry to the end of 2013, 1,938 VC firms were founded. These firms raised 4,957 funds totaling $569.2 billion. While the number of VC funds has increased dramatically, the number of VC fund managers has not. In 1993 there were 5,217 VC professionals. In 2013 there were 5,891. Put simply, there is a similar number of people managing an exponentially larger amount of money.

VC funds focus on high technology investments. These funds invested $29.6 billion in 2013. Over two-thirds of that capital went to information technology companies. VCs also focus on follow-on investment. In other words, VCs frequent fund the same company several different times throughout the startup financing lifecycle. In fact, over 60% of VC investments in 2013 were follow-on investments. Despite making 4,041 investments in 2013, VCs only invested in 157 new non-high-technology companies that year.


See supra note 19, at 20.

Id.

Id. at 9.

Id.

See id.

Id. at 12.

Id. at 12.

Id. at 12.
Figure 3: VC funds have increased both in size and number.

Like angel investment, venture fund investment is not for everyone. Only “qualified purchasers” – those individuals who are natural persons that own $5 million or more in investments or funds that own $25 million or more in investments,\(^{55}\) – 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.

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“Seedfunding” is the beginning of the startup financing cycle. Startups use seedfunding to research, assess and develop an initial concept.56 “Friends, family and fools” (fools referring to the high risk associated with investment in nascent startups) provide a small amount of seedfunding 57 although angel investors provide most seedfunding capital.58

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.59 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.”60

After the break even, a startup enters an “early stage,” where venture capital firms become substantially more interested in investing in that startup.61 Startups decidedly exit the seed valley of death when a venture capital firm make the first early stage investment, called “Series A.”62 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 invest in growth even if doing so causes net profits to become negative again.63

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

57 Id. at 6.
58 Id. (citing Andrew W. Wong, Angel Finance: The ‘Other’ Venture Capital, Working Paper, University of Chicago (2002)). See also Laura Entis, Where Startup Funding Really Comes From, ENTREPRENEUR (Nov. 20, 2013), http://www.entrepreneur.com/article/230011.
59 Id.
60 Id. at 7.
61 Id.
62 Id.
63 Id.
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 investment.\(^{64}\)

The chart below depicts the startup financing cycle.

**Figure 4: The Startup Financing Cycle\(^{65}\)**

3. **THE SERIES A GAP IN THE PRIVATE EQUITY MARKETS**

Seedfunding is only the first step in the startup financing cycle, and startups rarely survive on seedfunding alone. As Professor Darian M. Ibrahim writes:\(^{64}\)

\(^{64}\) *Id.* at 592.

\(^{65}\) *Id.* at 7.
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.66

In other words, between the seed funding 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 quantities evidence 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 1000 or so VC firms also invest about $20 billion in 1000 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.67

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

Since Professor Ibrahim’s article was published in 2008 and Mr. Payne’s article was published in 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 the gap is a persistent and growing phenomenon. Fenwick’s 2012 study of seedfunding found that there is an increasing institutionalization of seed financing. 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.

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69 Id.

70 Payne, supra note 67.

In 2013, Angels invested $24.8 billion in a total of 70,730 startups (an average of $350,801 per angel deal).\(^{72}\) Venture capital firms—who provide funding from Series A to IPO—invested $29.5 billion in a total of 4,041 deals (an average of $7.3 million per venture deal).\(^{73}\) 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).\(^{74}\) Between these two peaks of investment at $0.35 million and $7.3 million is a valley where funding is increasingly hard to find. The valley reaches a critical low point—a gap—between about $1 to $5 million, where startups fails 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.”\(^{75}\) Amar Bhide\(^{76}\) in his chapter “A Poor Fit”\(^{77}\) summarily explains that “belief in a ‘big money’ model of entrepreneurship … has little in common with the traditional low-budget start-up.”\(^{78}\) Venture capital investors look for high growth starters founded by successful entrepreneurship experience.\(^{79}\) As a result, there are endless startups who build iPhone apps and similar products. But companies that design hardware or biotechnology—and the entire life science startup field in general—struggle to access capital.\(^{80}\)

\(^{72}\) Sohl, supra note 11.
\(^{73}\) Yearbook 2014, supra note 19.
\(^{74}\) Id.
\(^{75}\) 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/.
\(^{76}\) Thomas Schmidheiny Professor of International Business, Tufts University.
\(^{78}\) Id.
\(^{79}\) Id.
\(^{80}\) Laura Lorek, More Venture Capital Needed for Life Science Startups, SILICONHILLS (Dec. 4, 2014),
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.” 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, “One thousand startups [in 2012] 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.”

Startup-focused website Launch published a “Series A Crunch Survivor’s Guide.” More pessimistic observers such as Richard Meyer of the Capital Formation Institute called this the “Start-Up Enterprise Valley of Death” and remarked that “its 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.”

Fenwick’s 2012 Seed Financing Survey reported that the “number of seed financings increasing 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.” This indicates that the Series A Gap has become higher, meaning that more companies who receive seedfunding will not receive Series A funding, as illustrated by the chart below.

http://www.siliconhillsnews.com/2014/12/04/more-venture-capital-needed-for-life-science-startups/

81 See, e.g., Grant, supra note 10.
82 Will Oremus, Tech Startups Are about to Start Dropping like Flies, SLATE (last visited Dec. 21, 2014), http://www.slate.com/blogs/future_tense/2012/12/20/series_a_crunch_tech_startups_are_about_to_start_dropping_like_flies.html
85 Kramer, supra note 71.
Angel/seed-backed companies start to feel the crunch

Figure 6: Ratio of seedfunded to Series A funded startups

The above chart illustrates that the ratio of companies who received seedfunding to the number of seedfunded companies who received Series A funding has increased from 1.9:1 in 2009 to 3.3:1 in 2012. CB Insights, who maintains the Venture Capital Database, reported in late 2012 that only 40% of seed-funded companies will raise a Series A round. This dramatically increases the risk associated with forming, joining or investing in a startup company, and thus chills those desirable behaviors.

B. CROWDFUNDING AND THE PRIVATE EQUITY MARKET

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 private equity market through “crowdfunding.” This Article refers to that general investing public as “crowds.”

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88 See supra note 8.
“Crowdfunding” has a general and a 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.”\textsuperscript{89} Crowdfunding in this sense has been occurring since at least 2005 with the founding of Kiva.\textsuperscript{90}

Since Kiva began in 2005, over a million people have made interest-free crowdfunded microloans to impoverished entrepreneurs through Kiva.\textsuperscript{91} 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.\textsuperscript{92} Small businesses start and grow with for-profit crowdfunded loans from InvestNextDoor.com\textsuperscript{93} and Lending Club.\textsuperscript{94} The Oceti Sakowin Indian tribe offered a thank you reward to everyone who contributed $20 to save the Black Hills and other Sioux sacred land on Indiegogo.\textsuperscript{95} These are examples of the donative, pre-ordering, rewards and lending models of crowdfunding.

On the other hand, \textit{equity} crowdfunding – which is selling a small amount of stock to a large number of people via web sites called


\textsuperscript{90}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.” Terry Waghorn, \textit{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/.

\textsuperscript{91}About Us, KIVA, http://www.kiva.org/about (last visited Jan. 12, 2015).

\textsuperscript{92}Angela Moscaritolo, \textit{Pebble Smartwatch Sells Out, Collects $10 Million on Kickstarter}, PC MAG. (May 10, 2012), http://www.pcmag.com/article2/0,2817,2404295,00.asp.


funding portals – was illegal until the JOBS Act created a new exemption to the Securities Act of 1933. A more specific definition of crowdfunding for present purposes relates express 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 1934.96

The JOBS Act amends Section 4(a)(6) of the Securities Act of 1933, as amended97 (the “Securities Act”), 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. This new exemption to registration under the Securities Act is generally called “crowdfunding,” although it is more specifically called “equity crowdfunding.”98

Equity crowdfunding will be allowed when the SEC promulgates its final rules99 – which at the time of this publication are overdue100 – 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 crowdfunding.101 Individuals who have or annually earn less

99 H.R. 306 §303(b).
100 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.
101 § 77d(a)(6)(B)(ii).
than $100,000 may invest the greater of $2,000 or 5% of their annual income each year in startups.102

The JOBS Act also creates the new term “funding portal,” which is a financial intermediary who can sell startup stock online to non-accredited investors.103 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.104 Any broker-dealer or funding portal that engages in crowdfunding must register with the SEC and FINRA.105 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 recommendations106.

All of this regulation comes at a price. The SEC estimates that raising $100,000 may cost up to $39,000 in portal and compliance fees.107 Raising $1,000,000 may cost up to $151,660.108 In comparison, raising a similar amount of money from angels through series seed preferred stock financing pursuant to Regulation D Rule 506109 costs

102 § 77d(a)(6)(B)(i).
103 § 78c(a)(80).
104 Id.
105 Crowdfunding Portals, FINRA (list visiting Jan. 12, 2014).
106 Id.
108 Id.
109 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) without 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
between $10,000 and $30,000 in legal fees.\textsuperscript{110} 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?

**Part II. BRIDGEFUNDING**

This Article argues that crowdfunding regulations are exactly backwards. Instead of limiting investment to $1 million per startup,\textsuperscript{111} 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) Startup needs 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. 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. 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.

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 of 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, on the board, a director who is not a shareholder. 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 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. 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. 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, 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 for overinvesting in mature startups, (3) a prior independent professional 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.\footnote{See Grant, supra note 10.} 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.\footnote{This may be in part because the 100-investor limit prevents angels from forming large enough syndicates to fund companies through this gap.} Even companies like Wittlebee – who received an unusually large $2.5 million investment in the Series Seed round\footnote{See supra note 3.} – may require more investment before they are 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. Both provide small-to-average Series Seed rounds of about $1 million.\footnote{15 U.S.C. § 77d(a)(6)(A). See also supra Part I.A.1.} 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,\footnote{15 C.F.R. § 230.506; 15 U.S.C. § 77c(2)(a).} which will be discussed in depth later. Those exemptions allow startups to raise at least $50 million.\footnote{Id.} Regulation D in particular might be preferred by startups that want to avoid extra disclosure liability imposed by the crowdfunding exemption.\footnote{Deborah L. Jacobs, The Trouble With Crowdfunding, FORBES (Apr. 17, 2013, 2:59 PM), http://www.forbes.com/sites/deborahljacobs/2013/04/17/the-trouble-with-crowdfunding/} Put simply, crowdfunding has to compete not only with angel investment, but 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. 119 This Article challenges that assumption and suggests instead that angels are a unique player in the market with whom crowds cannot complete. Angels are often wealthy market leaders, industry experts, and visionaries. 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. 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. Angel investment alone is not sufficient to fully grow a startup. Crowdfunding alone is equally unlikely to create a viable, long-term company. These groups typically invest once, at the beginning of a startup’s lifecycle, so the startup can grow large enough to attract Venture investment. Venture investment, unlike crowdfunding or angel investment, can sustain a company throughout its lifecycle. Venture funds have access to hundreds of

119 See supra Part I and accompanying notes.
millions or billions of dollars.\textsuperscript{120} Once a Venture investor has a vested interest in a company, the investor may singlehandedly ensure 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 \textit{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. Data evidencing the “Series A Crunch,” has shown this niche in the ecosystem is already overcrowded.\textsuperscript{121} 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 shouldn’t be operating as such. What critics are missing, however, 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 are 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 UBS accessories.\textsuperscript{122} The Dash raised almost $3.4 million to produce a wireless in ear headphone and fitness tracker.\textsuperscript{123} Pono Music (founded by Neil Young) raised

\textsuperscript{120} See Yearbook 2014, supra note 19.
\textsuperscript{121} See, e.g., supra note 10.
almost $6.3 million to create a high fidelity portable music player.124 OUYA raised $8.5 million to create an open-source video game console that is powered by Android OS and plays on a television.125

3. BRIDGEFUNDING ADDRESSES FRAUD

Crowdfunding understandably raises concerns about investor protections. Scholars such as Professor Thomas Lee Hazen caution that “[i]f history teaches us anything, the lesson is that social media technologies increase rather than decrease the potential for fraud.”126 I disagree with the premise that social media enhances fraud – in other work I argue that Twitter and other social media enhances collective shareholder activism.127 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 anti-fraud 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

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new technologies. For example, telephonic cold calling has been supplemented or superseded by spam emails.\textsuperscript{128}

None of these concerns have 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.\textsuperscript{129} Other crowdfunding securities can be advertised online, but there are scant reports of spam scams from LendingClub, Prosper, RealityMogul or any other debt crowdfunding portals. If anything, social media makes crowdfunding safer. Investors can share information, form groups, build trust and establish rapport despite geographic boundaries, all thanks to social media. Crowdfunding happens instantly online, making transactions transparent. Monitoring is easy, and information flows freely. Ordinary Americans are savvy to online scams.\textsuperscript{130}

Other articles flatly state that “the risk of fraud against such well-intentioned people and their potential backers is very real,”\textsuperscript{131} but why is this fraud more worrisome than other investment risks? Public Citizen, a D.C. think tank, uses similar rhetoric: “the 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.”\textsuperscript{132} Putting aside the fact that crowdfunding has almost nothing to do with Wall Street – this is a more of a Silicon Valley kind of regulation – more flat claims of fraud with no specifics should by understood as sound and fury, signifying nothing.

\textsuperscript{128} Hazen, \textit{supra} note 126, at 1767-68 (internal citations omitted).
\textsuperscript{130} See, e.g., Ohio Attorney General Mike DeWine, \textit{Watch Out for These Scams in 2015}, CINCINNATI.COM (Jan. 10, 2015) (The Ohio Attorney General provided some common-sense advice how not to fall for internet scams).
The truth is, crowdfunding is not more prone to fraud than other forms of investment. Merely being on the Internet doesn’t make it worse. Social media doesn’t hurt investors, it helps them collaborate. But Congress watered down Regulation Crowdfunding – perhaps to ensure the JOBS Act would quickly pass\textsuperscript{133} – 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 \textit{per se} more fraudulent. The Internet also prevents fraud by giving investors the ability to instantly discuss 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 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 Section 17 of the Securities Act (which makes it unlawful to conduct fraudulent interstate securities transactions)\textsuperscript{134} 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

\textsuperscript{133} See generally Joan MacLeod Heminway, \textit{How Congress Killed 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).

\textsuperscript{134} Securities Act of 1933 § 17(a), 15 U.S.C.A. § 77q(a) (2010).
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.\(^\text{136}\)

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).\(^\text{137}\) 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,\(^\text{138}\) nor must plaintiffs prove that defendants acted willfully.\(^\text{139}\)

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 Reg 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 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 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\textsuperscript{140} recognize that “[t]o be useful to small business issuers, a crowdfunding exemption needs to be relatively simple and inexpensive.”\textsuperscript{141} To qualify for the exemption, startups and portals must strictly comply will all the requirements of Regulation Crowdfunding – there is no “substantial compliance” rule as is found in other securities exemptions.\textsuperscript{142} 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.\textsuperscript{143} Complying with these complex regulations requires startups to retain the services of lawyers and accountants, thus adding cost through complexity.\textsuperscript{144}

Portals must register with the SEC as a broker or a “funding portal.”\textsuperscript{145} Registering as a funding portal is expensive, but portals can be disqualified in several ways:

\textsuperscript{140} Earl Dunlap Distinguished Professor of Law, University of Nebraska-Lincoln College of Law.


\textsuperscript{142} Id.

\textsuperscript{143} Id.

\textsuperscript{144} Id.

\textsuperscript{145} 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.\textsuperscript{146}

Strict compliance with Regulation Crowdfunding is difficult, and any noncompliance by a crowdfunding issuer can disqualify its portal from making any crowdfunding offerings.\textsuperscript{147} 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.\textsuperscript{148} 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.\textsuperscript{149} As discussed earlier, using Regulation D costs about $25,000,\textsuperscript{150} and in 2013 angel investors invested $24.8 billion, with an average deal size of

\textsuperscript{146} 15 U.S.C.A. § 80.
\textsuperscript{147} Bradford, supra note 141.
\textsuperscript{148} Id.
\textsuperscript{149} Neiss, supra note 107.
\textsuperscript{150} The standard form of Series Seed Term Sheet specifies that company will reimburse purchaser’s counsel a flat fee of $10,000. It is generally understood that company’s counsel usually bills about 1.5x what purchaser’s counsel does. See Term Sheet, www.SeriesSeed.com (last visited (Feb. 22, 2015).
That implies about 70,000 startups have access to initial angel investment annually. Crowdfunding is so expensive that its investors are likely to be privy only to the 70,001\textsuperscript{st} 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 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….startups with real potential will continue to use other programs.”\textsuperscript{152} He then raises concerns that series seed angel investments may also be unprofitable\textsuperscript{153} (this may be true about venture capital funds certain periods too\textsuperscript{154}). I am concerned


\textsuperscript{152} Michael B. Dorff, The Siren Call of Equity Crowdfunding, 39 J. CORP. L. 493 (2014).

\textsuperscript{153} Id. at 509-520.

\textsuperscript{154} Robert S. Harris, Tim Jenkinson and Steven N. Kaplan, Private Equity Performance: What Do We Know?, __ J. Fin. __ (2014) (studying the
that crowdfunding is even worse than angel investment in this regard, but do not doubt the necessity of series seed funding for startups to continue innovating. Nevertheless, Dorff and I arrive at virtually the same conclusion: “The most promising companies – that small percentage of startup companies that account for the bulk of angel investors’ gains – will seek their financing far from the costly crowd.”

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.” 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. “First, Title III should appeal to high-quality startups that are too young for “professional financing...[second,] Title III would appeal to that subset of startups that need cash but to not need value-added services from investors.” 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” 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 don’t drop much as the amount raised decreases. And while I agree that startups who need money – but not services – could prefer crowdfunding over venture capital, that argument assumes that crowdfunding is cheaper than venture capital (it’s not) and that crowdfunding and venture capital fundraising overlaps (it doesn’t). Crowdfunding simply isn’t a substitute for venture capital – although it could become a good alternative to venture capital if the

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155 Id. at 520.
156 Id. at 521.
158 Id. at 138.
159 Id. at 137.
160 Neiss, supra note 107.
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 R. Palmiter\(^\text{161}\) pinpoints a critical non-fraud problem in crowdfunding.\(^\text{162}\) 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? Prof. Palmiter suggests that startups should be responsible for proposing the price and being responsible for the methodology behind that proposal.\(^\text{163}\) Prof. Palmiter also recognizes that the SEC cannot police every tiny offering, so he proposes a new self-help scheme for defrauded crowdfunding investors.

The failure of a crowdfunding issuer to disclose clear, plain-English assumption underlying the chosen method for determining price of the offered securities would be materially false and misleading.\(^\text{164}\) But enforcing the anti-fraud rule 10b-5 requires either public or private action. The plaintiff’s recovery in a private enforcement action against a crowdfunding issuer pursuant to 10b-5 for failure to disclose pricing methodology is limited to the amount invested, so damage award can be at most $1 million.\(^\text{165}\) Plaintiffs’ attorneys’ fees, which are on average between 20 and 30 percent of the settlement amount,\(^\text{166}\) would be too small to justify commencing the action.\(^\text{167}\)

\(^{161}\) Howard L. Oleck Professor of Business Law at the Wake Forest University School of Law.


\(^{163}\) Id. at 374.

\(^{164}\) Id. at 415.

\(^{165}\) Id. at 416.


\(^{167}\) Palmiter, *supra* note 162, at 417.
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 the public; (2) the amount of investors harm done; (3) the deterrent value of the action and (4) the SEC’s visibility in certain areas. The SEC’s investigations department only 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 the SEC will prosecute crowdfunding violations. Arbitration could be a faster and cheaper alternative to public or private action for the policing of 10b-5 (fraud) violations in crowdfunding disclosures. But the JOBS Act currently lacks any mandate for arbitration, so issuers do not have to agree to arbitrate claims. Arbitration is also problematic because arbiters are not required to produce any written explanation behind their award of damages. Arbitration decisions in securities law also have no precedential value.

Prof. 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.

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168 Id. at 418-19, citing Ames 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 the integrity of the financial markets).

169 Id. at 420, citing U.S. SEC. & EXCH. COMM’N, Regulation D Exemption Process 8, 13 (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).

170 Id. at 422.

171 Id.

172 Id.

173 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 McMahon).

174 Palmiter, supra note 162, at 426.
insurance 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 single small investors find it worth their while to thoroughly investigate risks. Fortunately, the concern is 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. For example, someone who owns 1 million out of 10 million shares has 10% of StartX. How much 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. The most common is convertible debt. There are loans which can automatically convert the principal owed (and sometimes the interest accrued) into an amount of stock based on 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. For example, StartX sells $1 million of convertible debt to Angela. The debt agreement provides for 1% simple annual interest. Angela's debt covert 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. Such transactions are not useful in valuing bridgefunding stock. That is why such

\[175\text{Id.}\]
transactions do not qualify as a prior independent professional investment as described in Part II.A above.

7. BRIDGEFUNDING OPENS UP NEW STARTUP BUSINESS MODELS

As demonstrated above, VCs primarily invest in high-tech companies and secondarily in life science companies. Bridgefunding creates a new source of funding that may inspire entrepreneurs to build alternative business models. Furthermore, the data shows that VCs strongly prefer to invest in local startups. 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.

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 app, an encryption algorithm or database management tools – and spending money on marking can have a direct effect on making lucrative sales. 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 software is not the only innovation we need. Life sciences, biotechnology, apparel, are left out of the mix. It gets worse than that. Women are disadvantaged when

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176 See supra Part I.
177 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”).
seeking venture capital. Individuals located outside of Silicon Valley are overlooked or ignored. Startup investment’s diversity problem is so pronounced that Mirror Digital’s CEO Shelia Marmon launched the Venture Capital Access Program to help women and minority-led business to raise capital.

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.

Part III. Why Current Regulations Fail

Bridgefunding is supported and informed by theories in the literatures of business innovation and law & 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.

179 There seem to be two main reasons for why female led startups struggle to secure venture capital. First, venture firms like to invest in leaders, not just a great idea. As it presently stands, almost all venture managing partners are men, and they seem to be more comfortable investing in startups led by male entrepreneurs. Second, and interrelated, there is a dearth of woman venture capitalists generally, and they are often negatively stereotyped by their male counterparts in the industry. 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.

180 Madison Park Group, Guide to Venture Capital, http://madisonparkgrp.com/pdf/gtvc.pdf (Angels and VC funds will not invest in companies outside their geographic area (usually 100-150 miles from the VC’s office)).

A. LAW & 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. 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 the failed startups actually got funding and measure the performance of that private equity market against the real world. But this Article does present evidence that startups failed in droves 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. These facts at lease sew reasonable doubt that the gap is desirable.

The second possible conclusion is that the private equity market is not in equilibrium but is responding to some sort of shock. 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 shows the gap has existed and has been expanding since at least 2011. 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 markets. Market failure can results from a number situations, including regulations, monopoly power, transaction costs, lack of information and irrational actors.

182 See Jeffrey M. Perloff, MICROECONOMICS 24-26 (5th ed. 2009).
183 See supra notes 1-6 and accompanying text.
184 Perloff, supra note 182 at 24-31.
185 See Kramer, supra note 71.
1. ECONOMIC THEORY EXPLAINS THE GAP

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

Some of these situations can quickly be ruled out. For example, there is no evidence of any monopoly or even market power in the private equity market. Rather, the private equity markets 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 2013.186

It also appears unlikely that the gap is the result of irrational actors. While it is true that angel investors often speak about caring about more than money and about giving back to the startup community, in general these investors are sophisticated professionals who are looking to make a profit. 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.187 VC managers simply cannot expect to usurp fund opportunities or profit themselves at the expense of the fund and to continue to be able to raise money.

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.188 Therefore it would be irrational to raise less than $25,000 by selling stock in all instances. Transaction costs increase slows 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

186 Primack, supra note 45.
187 See Yearbook 2014, supra note 19.
188 See supra note 150.
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,\textsuperscript{189} simple agreements for future equity,\textsuperscript{190} or other instruments that require spending only a few thousand dollars in transaction costs.

While there do 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.\textsuperscript{191} 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.\textsuperscript{192} 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. 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 hold out problem, which can lead to angel underinvestment in the private equity market.

Angels can also seek a positive externality by free riding on another investor’s efforts. Diligence, also called due diligence, is the process by which an investor and his counsel review a potential investment. This


\textsuperscript{190} Id.

\textsuperscript{191} See Perloff, \textit{supra} note 182 at 605-607.

\textsuperscript{192} See \textit{supra} Part I.A.2.
involves obtaining stage agency filings to ensure the company was properly created and is up to date on its tax payments, confirming that no creditors have a lean on the company or its assets, verifying that the capitalization table accurately reflects who owns how much of the startup, ensuring that the startup actually owns its intellectual property, checking whether the startup’s board of directors properly authorized any corporation 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. 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 receive and store the stock certificate. 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.

Angels can avoid these costs by following a “lead” angel. A lead angel is 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 like 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 a prisoner's dilemma. In this game, two co-conspirators who cannot communicate are charged with arson and murder, for which there is

194 See Perloff, supra note 182 at 481-82.
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 confess, both will serve two years in prison for arson. If one confessors 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. 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 most 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 investment and only qualified purchasers make venture capital investments. 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.

195 See id.
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.\textsuperscript{197} This is roughly equal to the amount of investment in initial public offerings that year,\textsuperscript{198} and about the same amount that gold mining corporations invested on projects and acquisitions in 2010.\textsuperscript{199} In contrast, shareholders in public stock markets received $1,167 billion of income in dividends alone in 2014.\textsuperscript{200}

This section has taken a law and economics approach to the question of why is there 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 un-fundable 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,

\textsuperscript{197} Yearbook 2014, supra note 19; Sohl, supra note 11.
\textsuperscript{198} 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/ (222 companies went public in 2013, raising nearly $55 billion).
venture financing involves a lot of legal costs, and firms provide many value-add services to their portfolio companies – but those costs do not increase much as the amount invested increases. In other words, venture capital investments have economies of scale.\footnote{See Perloff, supra note 182 at 208.}

Data bears out 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)\footnote{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).} from $1.7 million in 1985 to $4.9 million in 2013.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{average_vc_investment.png}
\caption{Average Venture Investment in Early Stage Financing over Time ($M)}\footnote{Data aggregated from Yearbook 2014, supra note 19.}
\end{figure}

In addition to a strong 20-year trend, the most recent data also seems to support this.\footnote{Primack, supra note 21.} From the third quarter of 2013 to the second quarter of 2014, Venture capital investment increased from $12 to $22
billion while the number of deals steadily dropped from 1,944 to 1,590.205

Top Venture firms like Andreessen Horowitz are “more than money.”206 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.207 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,208 which is approximately 3% of the U.S. population.209 Practically, an angel should have a solid understanding of business planning, corporate finance, preferred stock investment and market conditions, plus a risk-seeking constitution.210 Approximately 225,000 Americans made an angel investment in the past two years.211

Angels invest in groups called “syndicates.” A syndicate makes angel investment more efficient because only one angel needs to source, review or negotiate a seedfunding investment opportunity. Syndicates can be quite large. The largest established syndicate, Ohio TechAngel Funds, has 282 angels. But only 100 angels can invest in a single

205 Id.
206 See supra note 16.
207 Angel Definition, BLACK’S LAW DICTIONARY (9th ed. 2009), available at WestlawNext.
210 See generally Wiltbank, supra note 29 (asserting that due diligence, experience, and participation are the three largest factors impacting the outcome of angel investments).
211 See supra note 36.
company, so many Syndicates such as Seattle’s Alliance of Angels, Southern California’s Pasadena Angels and New York City Angel each have 100 members

Recently, angel online investing became hugely popular thanks to web sites such as AngelList, which was founded in January 2010 as an online funding portal where founders can solicit investment from angels, which has over 3,500 registered angels. 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. Celebrity investors also enjoy special status. Actor-turned-investor Ashton Kutcher has 23,060 followers. Even if you are not a “qualified purchaser” that can invest in a venture fund, on AngelList, you can invest with Marc and Ashton.

As you can imagine, popular AngelList leads’ rounds get oversubscribed, but not in the way you’d expect. Securities laws limit angel group size to 100 investors, even if that is not enough to sufficiently fund the company. Brad Feld, another very popular lead

214 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 (Sep. 20, 2011, 12:56 PM); Laura Baverman, FundersClub Fills Void for Start-Up Investors, USA TODAY (Mar. 17, 2014, 5:21 PM).
216 See Fell, supra note 214.
angel, due to this quirk in the law, sometimes angel money gets left on the table.

When an angel group determines 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 25 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 she wants to invest in order to close the round.

Angels need to diversify that investment. Studies show that angels who invest in 10 or fewer startups generally lose money. Since 52% of startups fail, to earn a market rate of return (about 2.5x), angels have to invest in about 50 startups. 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.

Technology such as AngelList has 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.

217 Mr. Feld has 28,159 followers on AngelList. He is also the Managing Director of the Venture firm Foundry Group.


219 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 an investment company pursuant to Section 3(c)(1) of the ICA. This effectively limits angel syndicates to 100 members.


221 Wiltbank, supra note 29 at 1.


223 Id.
Figure 8: Average and Total Angel Seedfunding ($M)

B. EXISTING EXEMPTIONS DO NOT FILL THE GAP

As discussed in Part II, crowdfunding is heavily criticized in the scholarly literature. This Article even 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 the others.”[^224] Is crowdfunding the worst way to seed fund a company, except for all the other exemptions? Unfortunately for crowdfunding, it is not the best alternative for a startup to raise seed funding 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 in the ecosystem, only inferior companies will choose the 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 ecosystem 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.

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. Regulation A also allows private companies to raise capital by selling stock without registering with the SEC. In addition, the SEC plans to promulgate an expanded Regulation A known widely as “Regulation A+.”

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. However, Rule 504 is different from (and less useful than) crowdfunding because general solicitation is not permitted in a Rule 504 offering. 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. Regulation A+ does not yet exist, but some commentators suggest it will be very similar to crowdfunding and are even calling it

225 Pursuant to the Securities Act, all offers to sell securities must be registered with the SEC unless they are exempt. SEC, Regulation D Offerings (last visited Jan 13, 2015).
226 Id.
227 Regulation A, 17 C.F.R §§ 230.251-.263.
“crowdfunding plus.” Crowdfunding is inferior to its alternatives in terms of cost. Raising $1,000,000 via Regulation Crowdfunding will cost between $76,660 and $151,660. In contrast, raising a similar amount of money via Regulation D costs about $25,000. Additionally, stock sold under Regulation D has fewer limitations. This section will not explain these alternative equity fundraising exemptions in detail.

1. REGULATION D

Regulation D includes Rules 504, 505 and 506. Common to all three of these “Reg D” exemptions is that companies issuing restricted stock pursuant to Reg D must file a “Form D” electronically online after selling the securities. Complying with Reg D has preclusive effect over state blue sky laws. In other words, an issuer who complies

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231 Neiss, supra note 107.

232 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 SERIESSEED.COM, Series Seed Term Sheet.


234 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. See Jean L. Batman, Raising Money Through Private Placements, AMER. BAR ASS’N (April 2012),
with federal security law Reg D may not have to comply with state securities laws.

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 12-month period. Prior to 1992, Rule 504 offerings could be done through general solicitation, but the SEC determined this created too many opportunities for fraud.

To put it another way, 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) without a general solicitation to non-accredited investors without a disclosure document. 235 But even if a startup issues securities under Rule 504 without a disclosure document, the company is still subject to fraud rules. 236 An omission of material information may be considered a false or misleading statement. 237 Therefore, startups issuing securities under rule 504 are generally advised to provide a disclosure


235 17 C.F.R. § 230.504(b)(1)(i)-(iii) (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 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.”)


237 Id.
document, even if they do not have a general solicitation or selling only to accredited investors.\textsuperscript{238} 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 for issuers are subject only to general anti-fraud liability under the Exchange Act Rule 10b-5.\textsuperscript{239} Crowdfunding issuers are subject to 10b-5 liability plus liability under Securities Act Sections 12(b) and 13.\textsuperscript{240} Rule 504 issues are not required to make any specific disclosure (although they are liable for fraud for material omissions).\textsuperscript{241} Crowdfunding issuers must file a Form C with the SEC.

Perhaps the most significant way in which crowdfunding is designed to “protect” investors more than Rule 504 is that crowdfunding issuers must sell through a broker-dealer intermediary,\textsuperscript{242} whereas Rule 504 issuers can sell directly to the non-accredited investing public.\textsuperscript{243} The crowdfunding intermediary is called a “funding portal,” which is essentially a website that connects investors to investment opportunities.\textsuperscript{244} Unlike the non-equity crowdfunding portals that exist today (e.g., Kickstarter, Indiegogo), which mainly offer listing services but not accreditation, diligence and

\textsuperscript{238} Id.


\textsuperscript{240} 15 U.S.C. § 78(b): § 78m. 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.

\textsuperscript{241} 17 C.F.R. § 240.10b-5.


\textsuperscript{243} 17 C.F.R. § 230.504.

\textsuperscript{244} Joan MacLeod Heminway, \textit{The New Intermediary on the Block: Funding Portals under the Crowdfund Act}, 13 U.C. Davis Bus. L.J. 177, 190 (2013) (explaining what is a “portal” under the CROWDFUND Act).
disclosure services, crowdfunding portals that can broker the sale of securities will be required to perform diligence and ongoing review of listed issuers. Some commentators have recognized that this mandatory requirement will greatly increase the cost and legal risk for crowdfunding portals so much that such portals will need to devise a new business model.

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

Professor Thomas Lee Hazen raised several concerns about startups deceiving crowdfunding investors in his article, Crowdfunding or Fraudfunding? Mr. Hazen reminds us that “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.” Mr. Hazen and other scholars are therefore concerned that crowdfunding may give rise to a new wave of fraudsters, despite the protections it offers.

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247 Heminway, supra note 245 at 190.
250 Hazen, supra note 126.
251 Id. at 1763.
252 Id.
3. RULE 505

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.\textsuperscript{253} Stock sold in this manner cannot be resold for at least six months unless the stock is registered with the SEC.\textsuperscript{234} Rule 505 is distinguishable from Regulation A – which also allows for the sale of up to $5 million in securities – because Regulation A does allow general solicitation of the securities for sale, whereas Rule 505 does not. However, this advertising advantage of Regulation A versus Rule 505 is outweighed by the fact that Rule 505, along with the other Regulation D offerings, has preclusive effect over state blue sky laws, whereas Regulation A offers 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.\textsuperscript{255} This makes Rule 506 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.\textsuperscript{256} Like Rule 505, under Rule 506 the issuer may sell securities to an unlimited number of accredited investors and 35 other purchasers.\textsuperscript{257} However, unlike Rule

\textsuperscript{234} Id.
\textsuperscript{254} 17 C.F.R. § 230.506.
under Rule 506 the non-accredited investors must be "sophisticated."\textsuperscript{258}

Until recently, issuers hoping to take advantage of Rule 506 were not generally allowed to solicit or advertise in order to market their securities. But 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.\textsuperscript{259}

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, like a registered broker-dealer\textsuperscript{260} (Crowdfunding, on the other hand, will require issuers to sell stock through a broker-dealer or a funding portals).\textsuperscript{261} Rule 506 is also superior to Rule 504 or 505 in that only Rule 506 permits general solicitation of securities.\textsuperscript{262}

5. **REGULATION A**

Crowdfunding and Regulation D Rule 504 are not the only ways to sells stock to non-accredited investors. The Securities Act also contains an unpopular and infrequently used exemption called Regulation A.\textsuperscript{263} Regulation A permits the sale of up to $5 million in startup equity to non-accredited investors. But Regulation A is rarely used because it requires issuers to circulate a complex disclosure document called an

\textsuperscript{258} Id. (sophisticated means "they 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").

\textsuperscript{259} Id.


\textsuperscript{263} 17 C.F.R. § 230.251; § 230.263.
“offering circular,” and it does not preempt state securities laws. Therefore, issuers may be subject to a wide range of additional regulation depending on where the investors live.\footnote{David Rodman, Note, Regulation A+, the Jobs Act, and Public Offering Lite, 90 DENV. U.L. REV. ONLINE, 99, 99 (2013) (“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.”).}

Regulation A issuers must file a Form 1-A with the SEC, which must attach the offering circular and financial statements that are compliant with generally accepted accounting principles.\footnote{Id. at 100.} This is not only expensive, but it also subjects the issuers for liability if the information on the circular is determined \textit{post hoc} to be deficient or inaccurate.\footnote{Id. at 103; \textit{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 (asserting that “taking a small business public is an important, but expensive process that requires millions in underwriting costs”).} Moreover, the public filing of such a statement makes it impossible for the startup to remain in “stealth mode,”\footnote{Startup “stealth mode” is the practice of running a company in secrecy, or at least in relative anonymity. 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. Matt Villano, \textit{Why Startups Launch in ‘Stealth Mode’ and Others Don’t}, ENTREPRENEUR (Oct. 17, 2013), http://www.entrepreneur.com/article/229461.} 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, which makes it hard for secondary purchasers to value stock issued under Regulation A and therefore limits the liquidity of those shares.\footnote{U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-839, Securities Regulation: Factors That May Affect Trends In Regulation A Offerings 5, 7 (2012).}

Due to the problems with Regulation A and the superiority of its alternatives, Regulation A is rarely used. Only 19 Regulation A
offerings were made in all of 2011, compared with 15,500 Regulation D offerings.

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+.” 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 instead of just $5 million. More mature startups may thus consider using Regulation A+ as an alternative to Regulation D where the cost of the Regulation A+ disclosures are outweighed by the benefits of obtaining investment from non-accredited investors.

Regulation A+, however, like 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. The requirements of Regulation A proved too costly for startups to use that provision to raise up to $5 million. 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.

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. Likewise, crowdfunding costs exponentially more than its alternatives, and it can be used to raise only $1 million. Bridgefunding is similar to Regulation A+, which recognizes the failures of an expensive regulation by increasing the amount that can be raised under it. Regulation A+ provides a potentially viable alternative to an IPO. Bridgefunding may provide a potentially viable alternative for private equity financing.

269 Id. at 9.
270 Id. at 10-11.
272 § 77c(b)(2)(a).
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, but crowdfunding 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 private equity market. Crowds have special features which make them better at certain types of investment. This Article has shown that crowds can occupy a valuable niche in the private equity 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 finance 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 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 funding cycle makes investment significantly safer for unsophisticated crowds. This bridgefunding proposal not only articulates the above solutions for the currently backwards crowdfunding initiative of the JOBS Act, but also illuminates how securities regulation can be made more efficient by accounting for market dynamics.