FINANCING MINORITY ENTREPRENEURSHIP

CARLOS BERDEJÓ*

Racial disparities pervade America's socioeconomic fabric: minorities lag in educational attainment, employment, income, and wealth. Minorities are also underrepresented in the entrepreneurial space. For example, although minorities account for thirty-eight percent of the population, they own just nineteen percent of businesses. Despite numerous initiatives to promote minority business ownership, racial disparities in entrepreneurship have been stubbornly persistent over time.

This Article analyzes one of the major barriers that minorities face in undertaking entrepreneurial ventures. Informational asymmetries are especially pronounced when entrepreneurs attempt to raise money for their nascent businesses. Traditionally, social networks have offered an effective way to address the informational asymmetries that potential investors face when evaluating startup investments. Most minority entrepreneurs, however, lack access to these kinds of helpful social networks.

Recognizing the links between startup financing, information asymmetry, and social networks offers an analytic framework that can explain why minority entrepreneurs struggle in financing their businesses. This framework also suggests why current programs designed to address racial disparities in entrepreneurship have failed and offers guidance for new kinds of programs that are more likely to succeed in facilitating the financing of minority-owned businesses.

* Professor of Law and J. Howard Ziemann Fellow, Loyola Law School, Los Angeles. I would like to thank Brian Broughman, Benjamin Edwards, Ofer Eldar, Michael Guttentag, Justin Levitt, Elizabeth Pollman, and Lauren Willis for their extremely valuable and helpful comments on earlier drafts and the members of the *Wisconsin Law Review* for their wonderful editorial assistance. All errors and omissions are my own.

INTRODUCTION

Racial disparities pervade the socioeconomic fabric of twenty-first century America: minorities lag in educational attainment, employment, income, and wealth.[1] The average net worth of white households ($139,300) is over ten times the average net worth of African American households ($12,780) and almost seven times that of Hispanic households

1. *See* REGINALD A. NOËL, U.S. BUREAU OF LAB. STAT., RACE, ECONOMICS, AND SOCIAL STATUS, REPORT IN SPOTLIGHT ON STATISTICS 1–3, 5 (2018), https://www.bls.gov/spotlight/2018/race-economics-and-social-status/pdf/race-economics-and-social-status.pdf [https://perma.cc/E74J-YGU3]; Lynnise E. Phillips Pantin, *The Wealth Gap and the Racial Disparities in the Startup Ecosystem*, 62 ST. LOUIS U. L.J 419, 421 (2018); Thomas W. Mitchell, *Growing Inequality and Racial Economic Gaps*, 56 HOW. L.J. 849, 852 (2013).

($19,990).[2] White households are over 50% more likely to own equity in their own homes than African American or Hispanic households.[3] Unemployment rates also vary substantially along racial lines: the unemployment rate for African Americans (7.5%) is twice that of whites (3.8%), with Hispanics (5.1%) in between these two groups.[4] Individuals belonging to minority groups are less likely to have a bachelor's degree: while 40% of white individuals graduate from four-year colleges, only 30% of African Americans and 20% of Hispanics do.[5]

Disparities along racial lines also characterize the entrepreneurial space,[6] where minorities are significantly underrepresented.[7] This is evident not only in disparate business ownership rates but also in the share of the self-employed population and in the comparative success rates of entrepreneurial ventures.[8] According to census data, minorities, which form 38% of the U.S. population, own just 19% of businesses.[9] This gap is more pronounced in inner cities, where minorities make up 67% of the population but own 23% of businesses.[10] Self-employment statistics provide a similar perspective: the self-employment rate among whites

---

2. *Wealth and Asset Ownership for Households, by Type of Asset and Selected Characteristics 2015*, U.S. CENSUS BUREAU (2015), https://www.census.gov/data/tables/2015/demo/wealth/wealth-asset-ownership.html [https://perma.cc/DQ7V-5JZ5].

3. *Id.* According to census data, 71.2% of white households own equity in their own home, which is substantially higher than the 40.7% and 46.6% ownership rates of African American and Hispanic households. *Id.* On average, white households own $100,000 in home equity, while African American and Hispanic households own $56,000 and $65,000, respectively. *Id.*

4. BUREAU OF LAB. STAT., LABOR FORCE CHARACTERISTICS BY RACE AND ETHNICITY: 2017 1 (2018), https://www.bls.gov/opub/reports/race-and-ethnicity/2017/pdf/home.pdf [https://perma.cc/A636-NGWK].

5. *Id.* at 3.

6. For a description of the most influential definitions of entrepreneurship, see D. Gordon Smith & Darian M. Ibrahim, *Law and Entrepreneurial Opportunities*, 98 CORNELL L. REV. 1533, 1540–45 (2013).

7. *See* Robert W. Fairlie & Alicia M. Robb, *Why Are Black-Owned Businesses Less Successful than White-Owned Businesses? The Role of Families, Inheritances, and Business Human Capital*, 25 J. LAB. ECON. 289, 290–91 (2004); VICTOR HWANG, SAMEEKSHA DESAI & ROSS BAIRD, ACCESS TO CAPITAL FOR ENTREPRENEURS: REMOVING BARRIERS 10 (Kauffman Foundation, Apr. 2019), https://www.kauffman.org/wp-content/uploads/2019/12/CapitalReport_042519.pdf [https://perma.cc/AJ9G-5FCY] [hereinafter KAUFFMAN REPORT] ("The landscape of entrepreneurship in the United States is marked by significant differences across racial and ethnic groups.").

8. *See* INITIATIVE FOR A COMPETITIVE INNER CITY, HELPING ENTREPRENEURS OF COLOR GROW THEIR BUSINESS 3 (2018), http://icic.org/wp-content/uploads/2018/12/ICIC_Ascend2020_Report_r8_final_post_v2.pdf [https://perma.cc/Q4QP-XTDX] [hereinafter ICIC REPORT].

9. *Id.*

10. *Id.*

(10.9%) is twice that of African Americans (5.2%).[11] Notably, there are significant differences in entrepreneurship across minority groups, as African Americans tend to have the lowest self-employment rates, followed by Hispanics and Asians.[12]

Not only are minorities less likely to start and own their own businesses, but those who do financially underperform their non-minority counterparts.[13] Minority-owned firms earn, on average, less than half of the revenue earned by non-minority firms,[14] are less profitable,[15] and experience higher failure rates.[16] As with startup rates, there are notable differences in the financial performance of small businesses across minority groups.[17] Despite numerous initiatives to promote minority

---

11. *See* STEVEN F. HIPPLE & LAUREL A. HAMMOND, BUREAU OF LAB. STAT., SELF-EMPLOYMENT IN THE U.S. 8 (2016), https://www.bls.gov/spotlight/2016/self-employment-in-the-united-states/pdf/self-employment-in-the-united-states.pdf [https://perma.cc/V2ML-AV2G]; Fairlie & Robb, *supra* note 7, at 290 ("Only 3.8% of black workers are self-employed business owners as compared to 11.6% of white workers."); ROBERT W. FAIRLIE & ALICIA M. ROBB, U.S. DEP'T OF COM., DISPARITIES IN CAPITAL ACCESS BETWEEN MINORITY AND NON-MINORITY-OWNED BUSINESSES 9 (2010), https://www.mbda.gov/sites/default/files/migrated/files-attachments/DisparitiesinCapitalAccessReport.pdf [https://perma.cc/L5JH-2ZEZ] (reporting similar figures for 2008).

12. *See* HIPPLE & HAMMOND, *supra* note 11 (reporting self-employment rates of 9.6% and 8.3% for Asians and Hispanics, respectively); Rafael Efrat, *Minority Entrepreneurs in Bankruptcy*, 15 GEO. J. ON POVERTY L. & POL'Y 95, 98 (2008) ("The largest discrepancy exists among Blacks, who make up 12% of the general population but less than 4% of all businesses in the United States. Similarly, Hispanics make up almost 11% of the general population but less than 5% of all businesses. In contrast, Asian Americans have representation in business greater than their proportion in the general population."); ICIC REPORT, *supra* note 8, at 3 ("African Americans are still less likely to start a business than non-minorities and some other minority groups.").

13. *See* Fairlie & Robb, *supra* note 7, at 292–93 ("Black-owned firms have worse outcomes than white-owned firms.").

14. *See* HIPPLE & HAMMOND, *supra* note 11; FAIRLIE & ROBB, *supra* note 11, at 13 (reporting average gross receipts of $167,000 for minority-owned firms and $439,000 for non-minority firms).

15. *See* ICIC REPORT, *supra* note 8, at 3 (reporting that minority-owned businesses earn 44% of the profits earned by non-minority-owned firms); Fairlie & Robb, *supra* note 7, at 293 ("[O]nly 13.9 percent of black-owned firms have annual profits of $10,000 or more, compared to 30.4 percent of white-owned firms.").

16. *See* Fairlie & Robb, *supra* note 7, at 293 (finding that 40% of Black-owned firms had negative profits and that the average probability of business closure was 26.9% for Black-owned firms compared to 22.6% for white-owned firms); Efrat, *supra* note 12, at 99 ("Minority-owned businesses not only are underrepresented in the entrepreneurial sector, but also tend to have a higher failure rate relative to White-owned businesses.").

17. *See* FAIRLIE & ROBB, *supra* note 11, at 14 (reporting average annual gross receipts of $292,214 for Asian-owned businesses, $141,044 for Hispanic-owned businesses, and $74,018 for African American-owned firms).

business ownership, racial disparities in entrepreneurship stubbornly persist.[18]

What explains the long-standing comparative difficulties faced by minorities in succeeding in entrepreneurial ventures? One of the major hurdles faced by minority entrepreneurs is access to capital, a challenge also faced by non-minority entrepreneurs but to a lesser degree.[19] This Article explores why financing new businesses may be especially challenging for minority entrepreneurs. First, it describes why minority-owned startups are especially likely to face informational asymmetry problems when raising capital.[20] Second, it expands on a theory grounded in behavioral economics literature that highlights the importance of social networks in addressing the informational asymmetries inherent in the financing of small businesses, particularly minority-owned ones.[21] Third, it reviews evidence that many minority entrepreneurs have been excluded from crucial social and professional networks.[22] Building upon these three insights, the Article proposes a policy intervention to facilitate minority entrepreneurs' access to capital.[23]

The framework developed in this Article also explains why private markets have been unable to meet the financing needs of minority-owned businesses and why government programs meant to facilitate minority entrepreneurs' access to capital have instead fallen short. This Article shows that these programs have failed for two reasons: their reliance on debt as a financing mechanism and their reliance on large, hierarchical institutions as gatekeepers, despite those institutions' inability to confront certain types of informational asymmetries.[24] Although private equity's organizational structure and investment strategies are ideally suited for addressing the informational asymmetries associated with investing in minority-owned businesses, the lack of diversity in their ranks has rendered these tools ineffective, leaving fund managers to fall prey to implicit biases.[25] Crowdfunding, which many had hoped would level the

18. *See* Efrat, *supra* note 12, at 98 ("[M]inorities remain significantly underrepresented in the self-employment sector."); Fairlie & Robb, *supra* note 7, at 291 ("The 3 to 1 ratio of white to black self-employment rates noted above has remained roughly constant over the past 90 years."); FAIRLIE & ROBB, *supra* note 11, at 14 ("These ethnic and racial disparities have also existed throughout the past two decades and trends in average gross receipts do not indicate recent improvements.").

19. *See infra* Section I.B.3.

20. *See infra* notes 82–92 and accompanying text.

21. *See infra* notes 93–99 and accompanying text.

22. *See infra* notes 100–105 and accompanying text.

23. *See infra* Part III.A.

24. *See infra* notes 127–133, 172–184 and accompanying text.

25. *See infra* notes 103–104, 208–211 and accompanying text.

playing field, has also failed because well-intentioned investors seeking a financial return cannot individually overcome informational issues.[26]

The Article proposes a program that addresses the shortcomings of prior initiatives in this area through the creation of venture capital style funds (referred to as Local Impact Small Business Investment Companies or LISBICs) that focus their investment efforts on minority-owned businesses and the geographical areas where they are often located. To promote the development of these LISBICs, this Article proposes a series of policy interventions grounded on the existing regulatory framework of the Small Business Administration's Small Business Investment Company program (SBIC). The proposed LISBIC program borrows various elements from former SBIC initiatives, which should facilitate its implementation both from an administrative and political standpoint.

Current events have added to the urgency of addressing racial disparities in entrepreneurship. The COVID-19 pandemic has devastated small businesses and local communities.[27] To survive in a post-pandemic world, minority-owned businesses' access to capital will need to improve considerably.[28] Encouraging the survival and growth of minority-owned businesses would also help rebuild low-income minority communities and address some of the long-standing racial injustices highlighted by recent events.[29] More generally, this Article illustrates how long-standing racial

---

26. *See infra* notes 251–257 and accompanying text.

27. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., MONETARY POLICY REPORT (2012), https://www.federalreserve.gov/monetarypolicy/files/20200612_mprfullreport.pdf [https://perma.cc/X5CS-JX3T] ("The pandemic poses acute risks to the survival of many small businesses [whose] widespread failure would adversely alter the economic landscape of local communities and potentially slow the economic recovery and future labor productivity growth."); Robert W. Fairlie, *The Impact of Covid-19 on Small Business Owners: Evidence of Early-Stage Losses from the April 2020 Current Population Survey* 4–5 (Nat'l Bureau of Econ. Rsch., Working Paper No. 27309, 2020), https://www.nber.org/papers/w27309 [https://perma.cc/F3SW-7N7S] (finding a loss of 3.3 million small business owners (or 22%) from February to April 2020).

28. *See* Fairlie, *supra* note 27, at 5 (finding that the number of African-American and Hispanic business owners dropped by 41% and 32%, respectively); Kristopher J. Brooks, *40% of Black-Owned Businesses Not Expected to Survive Coronavirus*, CBS NEWS (June 12, 2020), https://www.cbsnews.com/news/black-owned-busineses-close-thousands-coronavirus-pandemic [https://perma.cc/SCE2-GXHJ] (describing the difficulties faced by African-American owned businesses during the COVID-19 pandemic, including their inability to raise capital).

29. *See, e.g.*, James Thorne, *Funds, Recruiting and Support: VCs Address Diversity and Inequality*, PITCHBOOK (June 8, 2020), https://pitchbook.com/news/articles/vcs-address-diversity-institutional-bias [https://perma.cc/TT39-W8NL] ("Against a backdrop of widespread protests over the killings of black Americans, the venture capital industry has been forced to reckon with its own staggering lack of diversity."); Zoë Bernard & Kate Clark, *As Silicon Valley Turns Attention to Race, Black Entrepreneurs Detail Prejudice*, THE INFO. (June 11, 2020),

disparities and inequities in society migrate into the entrepreneurial space—a process that feeds into the cycle of poverty that continues to shatter minority communities.[30]

This Article proceeds as follows. Part I summarizes the existing evidence describing the causes and effects of racial disparities in entrepreneurship, highlighting the critical role of access to capital and the reasons why minority entrepreneurs may struggle to finance their businesses. Building upon this evidence, the Article develops a theoretical framework centered on informational asymmetries and the "soft" nature of information relevant to many minority businesses to explain observed disparities. Part II describes existing programs and initiatives that seek to facilitate minority entrepreneurs' access to capital and uses the framework developed in Part I to explain why these have generally been unsuccessful. Informed by this application of the theoretical framework, Part III proposes a policy initiative that addresses the key shortfalls of the programs discussed in Part II and discusses the potential challenges raised by its implementation.

I. THE STATE OF MINORITY ENTREPRENEURSHIP

This Part first describes the critical role of entrepreneurship in society and its untapped potential to develop the economies of distressed minority communities. It then discusses the main challenges faced by minority entrepreneurs, particularly in raising capital, and develops a framework to explain the racial disparities that characterize the entrepreneurial space. This framework is then used to evaluate existing initiatives in Part II and to inform the policy proposals outlined in Part III.

A. Why Minority Entrepreneurship Matters

The benefits to society and the economy from entrepreneurship are well documented: new businesses generate employment and income, introduce innovative products and services, and can act as engines of

---

https://www.theinformation.com/articles/as-silicon-valley-turns-attention-to-race-black-entrepreneurs-detail-prejudice?utm_source=top10 [https://perma.cc/54CP-VCS4].

30. *See* Michael B. Teitz & Karen Chapple, *The Causes of Inner-City Poverty: Eight Hypotheses in Search of Reality*, 3 CITYSCAPE 33, 56 (1998) ("There is little doubt that an entrepreneurship and business deficit exists and is related to poverty in the inner cities."); MAURICE KUGLER, MARIOS MICHAELIDES, NEHA NANDA & CASSANDRA AGBAYANI, U.S. SMALL BUSINESS ADMIN., ENTREPRENEURSHIP IN LOW-INCOME AREAS 6 (2017) ("[L]ow-income urban neighborhoods face a similar continuing cycle of poverty and social problems due to the lack of profitable businesses and jobs.").

social change.[31] Nationally, minority-owned businesses play these macroeconomic roles, contributing to income and employment, as well as introducing new products and services.[32] But, minority-owned businesses also play a key role in developing local economies and improving neighborhoods, especially in socioeconomically distressed areas where poverty and unemployment levels are historically higher than the national average, like inner cities.[33] In these communities, entrepreneurship presents an alternative means to generate and accumulate wealth, thus providing a mechanism to bridge the wealth gap.[34]

At a personal level, entrepreneurship is critical for individuals for whom self-employment represents the most attractive employment option. Self-employment is especially attractive for groups that have traditionally faced obstacles in pursuing advanced degrees, that have suffered discrimination in the labor market, and whose social networks lack those connections that can serve as sources of job opportunities.[35]

This source of economic growth and social development has remained untapped due to the relatively low number of minority-owned businesses and the exceptional difficulties faced by minorities that engage in the entrepreneurial space.[36] As noted earlier, the self-employment rate among whites is twice that of African Americans.[37] Not only are minorities less likely to start their own businesses, but minority-owned businesses

---

31. *See* C. Mirjam van Praag & Peter H. Versloot, *What Is the Value of Entrepreneurship? A Review of Recent Research*, 29 SMALL BUS. ECON. 351, 351–52 (2007).

32. *See* ROBERT KLOOSTERMAN & JAN RATH, *Introduction* to IMMIGRANT ENTREPRENEURS 2–3 (2003). According to census figures, just over 1 million minority-owned firms employed 8.7 million individuals and contributed $1.3 trillion in revenues to the economy. Nora Esposito, *Small Business Facts: Spotlight on Minority-Owned Employer Businesses*, U.S. SMALL BUS. ADMIN. OFF. OF ADVOC. (May 2019), https://cdn.advocacy.sba.gov/wp-content/uploads/2019/05/31131339/Small-Business-Facts-Spotlight-on-Minority-Owned-Employer-Businesses.pdf [https://perma.cc/96RS-UPM6].

33. *See* KLOOSTERMAN & RATH, *supra* note 32, at 2–3; ICIC REPORT, *supra* note 8, at 3.

34. *See* ICIC REPORT, *supra* note 8, at 3.

35. *See* Ivan Light, *Disadvantaged Minorities in Self-Employment*, 20 INT'L J. COMPAR. SOCIO. 31, 35–38 (1979); Pyon Gap Min & Mehdi Bozorgmehr, *United States: The Entrepenurial Cutting Edge*, *in* IMMIGRANT ENTREPRENEURS 17, 30 (2003) (noting that labor market disadvantages stimulate minority members to become self-employed); *cf.* Rachel S. Shinnar & Cheri A. Young, *Hispanic Immigrant Entrepreneurs in the Las Vegas Metropolitan Area: Motivations for Entry into and Outcomes of Self-Employment*, 46 J. SMALL BUS. MGMT. 242, 244 (2008) (noting the relationship between factors that push individuals to self-employment, such as discrimination and inadequate education, as well as factors that pull individuals to self-employment, such as higher earnings and enhanced professional standing).

36. *See supra* note 30 and accompanying text.

37. *See supra* notes 8–11 and accompanying text.

also tend to be less profitable than non-minority businesses and experience higher failure rates.[38] The next section discusses how scholars have grappled with these disparities.

B. Challenges Faced by Minority Entrepreneurs

This section explains why minority entrepreneurs are, on average, less successful than non-minority entrepreneurs. It begins by discussing how an entrepreneur's socioeconomic characteristics (such as human capital and wealth) and the nature of the businesses they operate can affect their fortunes. These two factors interact between themselves and are also closely related to the third, and most critical, factor: access to capital.

1. ENTREPRENEUR CHARACTERISTICS

Some scholars have sought to explain racial disparities in entrepreneurial outcomes by focusing on socioeconomic variables, arguing that underlying disparities in human capital and wealth between minority and non-minority entrepreneurs lead to differences in entrepreneurial success.[39] This has led some to conclude that addressing these underlying disparities is the best way to bridge the entrepreneurial gap, though there is no universal consensus as to the true explanatory power of these demographic variables.[40]

a. Human Capital

Starting and operating a business is not a trivial endeavor. An entrepreneur must have a good understanding of the relevant product and geographic market, be able to negotiate with suppliers, customers and investors, and, most importantly, have the capacity to make effective managerial decisions in a fast-moving environment rife with uncertainty.[41] These complexities explain why an entrepreneur's formal education is a key determinant of the entrepreneur's ability to successfully start and operate a business and why those with lower levels of education are consequently disadvantaged.[42] Education might also indirectly affect

---

38. *See supra* notes 13–16 and accompanying text.

39. *See* Phillips Pantin, *supra* note 1, at 438–40.

40. *See id.* at 456–58; *infra* notes 45, 56.

41. Michelle M. Harner, *Mitigating Financial Risk for Small Business Entrepreneurs*, 6 OHIO ST. ENTREPRENEURIAL BUS. L.J. 469, 474–76 (2011).

42. *See* FAIRLIE & ROBB, *supra* note 11, at 22 ("Education has . . . been found in the literature to be a major determinant of business ownership."); Rafael Efrat, *The Tax Burden and the Propensity of Small-Business Entrepreneurs to File Bankruptcy*, 4 HASTINGS BUS. L.J. 175, 176 (2008) ("[W]hereas a quarter of the general population earned

entrepreneurial success by facilitating the development of valuable social and professional networks that improve future access to business and financing opportunities.[43] The fact that minorities tend to have lower levels of education than non-minorities can thus explain part of the racial disparities in entrepreneurship rates and firm performance.[44] Some scholars, however, question the importance of education as a determinant of entrepreneurial success and the extent to which racial disparities in the entrepreneurial space are the result of an educational gap.[45]

Like formal education, prior business experience is a key determinant of entrepreneurial success.[46] The knowledge gained from prior business exposure helps an entrepreneur evaluate the financial risks associated with starting a company.[47] Limited business experience can lead to over-optimism and unrealistic expectations regarding risks and financial adversities.[48] Equally important in this sense is an individual's informal exposure to business experience via family and social networks.[49] Since individuals belonging to minority groups are less likely to have a self-

---

a bachelor's degree or more, small-business owners are twice as likely to have earned the degrees.").

43. *See* Miller McPherson, Lynn Smith-Lovin & James M. Cook, *Birds of a Feather: Homophily in Social Networks*, 27 ANN. REV. SOCIO. 415, 426–27 (2001) (explaining why individuals tend to have relationships with others of the same level of education); *infra* note 100 and accompanying text.

44. *See* Fairlie & Robb, *supra* note 7, at 297 (noting that small business outcomes are positively associated with the owner's education level and that Black business owners generally had lower education levels); FAIRLIE & ROBB, *supra* note 11, at 22–23 (arguing that lower levels of education limit minority business ownership rates by "challenging the business performance of some minority entrepreneurs").

45. *See* Robert W. Fairlie, *The Absence of the African-American Owned Business: An Analysis of the Dynamics of Self-Employment*, 17 J. LABOR ECON. 80, 90 (1999) (finding that "the relationship between education and entry into self-employment is weak"); Magnus Lofstrom & Timothy Bates, *African Americans' Pursuit of Self-Employment*, 40 SMALL BUS. ECON. 73, 74–76 (2013) (summarizing the conflicting literature in the area).

46. *See* Efrat, *supra* note 42, at 179; Harner, *supra* note 41, at 485.

47. *See* Harner, *supra* note 41, at 478 ("Identifying and properly assessing these multi-faceted risks would be difficult for even the most sophisticated risk managers. The task often is Herculean for small business entrepreneurs either because of their lack of experience, resources or professional guidance; or . . . their entrepreneurial characteristics.").

48. *See id.* at 479–80 ("Overconfidence is one of several cognitive biases that commentators suggest can affect decision-making and, consequently, success in the business context.").

49. *See* FAIRLIE & ROBB, *supra* note 11, at 24 (stressing the importance of family business backgrounds and composition of social networks in determining self-employment and that "the probability of self-employment is substantially higher among the children of the self-employed"); Fairlie, *supra* note 45, at 84 ("[T]here is a strong intergenerational link in self-employment due to the transmission of informal business or managerial experience.").

employed family member or acquaintance, they have limited opportunities to receive the type of informal training that takes place in a family business and its related social networks.[50]

b. Wealth

Starting and operating a business requires money. The primary building blocks of an entrepreneur's investment capital are the entrepreneur's own personal assets, followed by those of family and friends.[51] As noted earlier, minorities, particularly Hispanics and African Americans, have lower levels of wealth and own fewer financial assets than non-minorities.[52] Not only do minorities have fewer liquid assets that can readily be used as startup capital, but they also lack non-liquid assets, such as real estate, that could be used to secure a line of credit.[53] Scholars have found that these economic disparities are likely to be a major factor in explaining low startup rates among minority entrepreneurs,[54] though there is no universal consensus on whether differences in wealth are a major determining factor of entrepreneurial disparities.[55]

2. BUSINESS CHARACTERISTICS

The size and form of minority-owned businesses can also help explain their relatively poor performance. Smaller businesses are more likely to perform poorly than bigger ones,[56] and minority-owned

50. *See* Fairlie & Robb, *supra* note 7, at 297–99 (arguing that black business owners' disadvantaged family and business background and their lack of family business experience contributes to their relative lack of success); FAIRLIE & ROBB, *supra* note 11, at 24 ("African American business owners are much less likely than white business owners to have had a self-employed family member prior to starting their businesses and are less likely to have worked in that family member's business.").

51. *See infra* notes 62–63 and accompanying text; KAUFFMAN REPORT, *supra* note 7, at 11–12.

52. *See supra* notes 2–4 and accompanying text.

53. *See* FAIRLIE & ROBB, *supra* note 11, at 18 (noting that "[l]ess than half of Hispanics and African Americans own their own home compared with three quarters of non-minorities" and that these disparities "in home equity may be especially important in providing access to startup capital").

54. *See id.*; Robert W. Fairlie, *Entrepreneurship Among Disadvantaged Groups: Women, Minorities and the Less Educationed*, *in* THE LIFE CYCLE OF ENTREPRENEURIAL VENTURES 437, 460 (Simon Parker ed., 2006).

55. *See* Erik Hurst & Annamaria Lusardi, *Liquidity Constraints, Household Wealth, and Entrepreneurship*, 112 J. POL. ECON. 319, 321 (2004) (finding that the relationship between wealth and entry into self-employment is generally insignificant); Lofstrom & Bates, *supra* note 45, at 76 ("[T]he consensus view that nonminority whites achieve higher entry rates than African Americans because they are relatively wealthier and better educated . . . is simplistic.").

56. *See* Efrat, *supra* note 12, at 101; Efrat, *supra* note 42, at 205–06.

businesses are, on average, smaller than non-minority-owned businesses, both in terms of the number of employees and revenues.[57] Business organization also appears to correlate with the success of an enterprise: incorporated businesses tend to outperform sole proprietorships, and minority-owned businesses tend to be organized as the latter.[58]

Macro-economic factors also explain the relative underperformance of minority-owned businesses. Minority entrepreneurs are generally more likely to engage in low-value and non-growth industries, like services and retail, that are less profitable and more prone to failure.[59] Moreover, minority entrepreneurs tend to operate in low-income neighborhoods with a less affluent client base and, as a result, generate lower profits, are more prone to failure,[60] and have less ready access to financing.[61]

3. Access to Capital

Accessing capital is a critical challenge faced by all small businesses. Entrepreneurs need capital to fund operations, inventory, wages, and other

---

57. *See* Efrat, *supra* note 12, at 101–02.

58. *See* Efrat, *supra* note 42, at 179; Richard J. Boden & Briand Headd, *Race and General Differences in Business Ownership and Business Turnover*, BUS. ECON., Oct. 2020, at 61, 66.

59. *See* Efrat, *supra* note 12, at 102 ("[M]inority entrepreneurs would seem to be more prone to business failure compared to White entrepreneurs because minority entrepreneurs are underrepresented in the high-value and growth industry sectors."); Fairlie & Robb, *supra* note 7, at 311 (noting that black-owned businesses appear to be overrepresented in less successful industries relative to white-owned businesses); Efrat, *supra* note 42, at 178 (noting that business failure is more common in the retail and service industry). It could be that minority entrepreneurs focus on these industries because these are not capital intensive and so their lack of access to capital is less of a barrier. *See* ICIC REPORT, *supra* note 8, at 8 ("Entrepreneurs of color are also more likely to enter industries with low capital requirements and high failure rates instead of high-growth sectors."); Lofstrom & Bates, *supra* note 45, at 83–84.

60. *See* Timothy Bates & Alicia Robb, *Analysis of Young Neighborhood Firms Serving Urban Minority Clients*, 60 J. ECON. & BUS. 139, 144–46 (2008) (finding that businesses that serve local minority communities were substantially more likely to close, possibly because their clientele may have less access to outside capital); FAIRLIE & ROBB, *supra* note 11, at 22 ("[M]inority-owned businesses are all more likely to serve a local market . . . and are much more likely to sell to a minority clientele than are white businesses, which may reflect more limited market access.").

61. *See* ICIC REPORT, *supra* note 8, at 8. Geographic factors exacerbate the financing challenges faced by minority entrepreneurs as financing for inner city businesses is insufficient, in part because of biases in bank lending patterns against inner city neighborhoods. *See* Timothy Bates, *Alleviating the Financial Capital Barriers Impeding Business Development in Inner Cities*, 76 J. AM. PLANNING ASSOC. 349, 353 (2010); Timothy Bates & Alicia Robb, *Greater Access to Capital Is Needed to Unleash the Local Economic Development Potential of Minority-Owned Businesses*, 27 ECON. DEV. Q. 250, 252–53 (2013).

expenses associated with starting and operating a business.[62] Since early-stage businesses are not likely to generate these funds internally, securing external debt or equity financing becomes crucial especially if the entrepreneur lacks adequate personal financial resources.[63] Raising capital presents an even bigger challenge for businesses owned by minority entrepreneurs for several reasons.[64]

Minority businesses are more likely to be denied credit than non-minority businesses.[65] These disparities in loan denial rates are robust even when controlling for personal and business factors that affect an applicant's creditworthiness, such as wealth and credit history.[66] Those minority-owned businesses that are approved for credit are still at a disadvantage: loans received by minority-owned businesses are smaller than those received by non-minority businesses and often carry higher interest rates, even after controlling for factors affecting applicants'

---

62. *See* Christopher W. Cole, *Financing an Entrepreneurial Venture: Navigating the Maze of Corporate, Securities, and Tax Law*, 78 UMKC L. REV. 473, 476–77 (2009).

63. *Cf. id.*

64. *See* Shinnar & Young, *supra* note 35, at 247 ("[O]btaining financing for start-up and capital for growth has been listed as one of the biggest challenges for minority-owned businesses."); FAIRLIE & ROBB, *supra* note 11, at 17 ("Financial constraints are the most significant issue affecting minority business ownership and business performance."); KAUFFMAN REPORT, *supra* note 7, at 10 ("Capital access is also marked by striking differences across racial and ethnic groups . . . . Minority-owned firms are found to face significant barriers to capital."); Michael Porter, *The Competitive Advantage of the Inner City*, 73 HARV. BUS. REV. 55, 64 (1995).

65. *See* MELS DE ZEEUW, FED. RSRV. BANK OF ATLANTA, SMALL BUSINESS CREDIT SURVEY: 2019 REPORT ON MINORITY-OWNED FIRMS iv–v (finding that approval rates for loans or lines of credit sought by minority-owned firms at small banks or online lenders were lower than those for white-owned firms); FAIRLIE & ROBB, *supra* note 11, at 20; ICIC REPORT, *supra* note 8, at 8. *But see* Robert Watson, Kevin Keasey & Mae Baker, *Small Firm Financial Contracting and Immigrant Entrepreneurship*, in IMMIGRANT BUSINESS 70, 80 (Jan Rath ed., 2000).

66. *See* Ken S. Cavalluzzo, Linda C. Cavalluzzo & John D. Wolken, *Competition, Small Business Financing, and Discrimination: Evidence from a New Survey*, 75 J. BUS. 641, 676 (2002) ("We found evidence of substantial differences across demographic groups . . . even after controlling for a broad set of characteristics describing the firm and owner."); Ken Cavalluzzo & John Wolken, *Small Business Loan Turndowns, Personal Wealth and Discrimination*, 78 J. BUS. 2153, 2154 (2005); David G. Blanchflower, *Minority Self-Employment in the United States and the Impact of Affirmative Action Programs*, 5 ANNALS FIN. 361, 386–87 (2009) (finding that minority-owned firms are more likely to be denied credit and be charged higher interest rates, a pattern that is only partially explained by creditworthiness); *Minority Entrepreneurship: Assessing the Effectiveness of SBA's Programs for the Minority Business Community*: *Hearing Before the Comm. on Small Bus. & Entrepreneurship*, 110th Cong. 27 (2007) [hereinafter *Senate Hearings*] (statement of Jon Wainwright, Vice President, National Economic Research Associates, Inc.) ("[M]inority-owned firms are substantially and statistically significantly more likely to be denied credit than are white-owned firms with similar balance sheets and similar credit histories.").

creditworthiness.[67] Minority entrepreneurs also face difficulties in obtaining equity financing from venture capital firms and angel investors, despite the fact that funds specializing in minority firms provide returns that are at least as large as those offered by mainstream funds.[68]

As a result, minority and non-minority businesses are financed quite differently.[69] Minority entrepreneurs rely less on formal funding sources like banks and private equity financing for their startup capital and instead turn to informal funding sources, such as personal savings, loans from friends and family, and credit card debt.[70] These sources, however, tend to be limited and expensive, making it more difficult for minority entrepreneurs to start their businesses.[71] Moreover, the resulting undercapitalization reduces the ability of new minority businesses to thrive and survive.[72]

---

67. *See* ICIC REPORT, *supra* note 8, at 8; FAIRLIE & ROBB, *supra* note 11, at 20–21; *Senate Hearings*, *supra* note 66, at 27 (statement of Jon Wainwright, National Economic Research Associates, Inc.) ("[W]hen minority-owned firms do receive loans, they are obligated to pay higher interest rates than comparable white-owned firms."); Alan Greenspan, Chairman, Bd. of Governors of the Fed. Rsrv. Sys., Keynote Address: Changes in Small Business Finance, *in* Summary: Business Access to Capital and Credit, March 8–9, 1999, at 39, 43 (noting that higher denial rates for minority-owned businesses are not "readily explained by income, balance sheet factors, or credit histories").

68. *See infra* notes 200–205 and accompanying text.

69. *See* FAIRLIE & ROBB, *supra* note 11, at 20 ("Minority and non-minority entrepreneurs differ in the types of financing they use for their businesses."); KAUFFMAN REPORT, *supra* note 7, at 10 ("Owner equity for black owners is more than half of total financial capital while white owners put up less than one-third. Outside equity accounted for 1.5 percent and 17 percent of total financial capital in black- and white-owned new businesses, respectively. And, outside debt accounted for close to one-third and more than half of total financial capital in black- and white-owned new business, respectively.").

70. *See* Shinnar & Young, *supra* note 35, at 247 ("Hispanic entrepreneurs tend to rely on informal funding sources for business start-up rather than banks and venture capital. . . . This reliance on informal sources may be attributed to the higher rates of denials for Hispanic loan applicants, which may deter individuals from approaching financial institutions in order obtain loans."); FAIRLIE & ROBB, *supra* note 11, at 20 ("African American entrepreneurs rely less on banks than whites for startup capital" and that "African American business owners are more likely to rely on credit cards for startup funds than are white business owners."); DE ZEEUW, *supra* note 65, at IV–V (reporting that minority owners relied to a greater extent on personal funds); KAUFFMAN REPORT, *supra* note 7, at 10 (noting that minority entrepreneurs have to rely more on credit cards to fund their businesses and that high interest rates on credit cards make them a costly form of capital).

71. *See* DE ZEEUW, *supra* note 65, at V (reporting that minority-owned firms more frequently applied for potentially higher-cost and less-transparent credit products, such as merchant cash advance and factoring).

72. *See* Efrat, *supra* note 12, at 100 ("[M]inority entrepreneurs' higher failure rate has been blamed on limited access to credit. . . . Higher levels of capitalization have a positive effect on survival rates of small businesses."); FAIRLIE & ROBB, *supra* note 11, at 19 ("Undercapitalized businesses will likely have lower sales, profits and employment and will be more likely to fail than businesses receiving optimal levels of startup capital.").

C. Overcoming Informational Asymmetries

What explains the lack of outside financing available to minority entrepreneurs? The studies cited in the previous section suggest that non-economic factors certainly play an important role.[73] Even though the existence of racial bias is undeniable, the full picture is likely more nuanced and complex.[74] This section tries to untangle this complexity by exploring the role of informational asymmetries in racially disparate access to capital.[75]

Investing in young, small businesses is risky: the vast majority of startups fail.[76] This high rate of failure, coupled with the lack of easily available information about these businesses, subjects potential investors to significant risks.[77] Though the use of collateral by borrowers can

---

73. *See supra* notes 66–67 and accompanying text (providing evidence that racial disparities in financing are present even after controlling for various entrepreneur characteristics); Efrat, *supra* note 12, at 100 ("The limited access to financial capital is partly due to the lower asset levels the minority entrepreneurs have accumulated, the discrimination they face from some financial institutions, fewer ties to financial institutions, lower loan application submissions, and a higher financing rejection rate."); Watson, Keasey & Baker, *supra* note 65, at 79–80; FAIRLIE & ROBB, *supra* note 11, at 21 ("A factor posing a barrier to obtaining financial capital for minority-owned businesses is racial discrimination in lending practices."); Cavalluzzo & Wolken, *supra* note 66, at 2154 (arguing that lending patterns are consistent with a finding of racial discrimination in the credit market by banks).

74. *See* Watson, Keasey & Baker, *supra* note 65, at 79–80.

75. *See* KAUFFMAN REPORT, *supra* note 7, at 12 ("The persistence of information asymmetry in capital markets between the supply of capital (investors) and the demand for capital (entrepreneurs) gives rise to barriers faced by entrepreneurs.").

76. According to some estimates this failure rate can be as high as 90%. *See* SMALL BUS. ADMIN., FREQUENTLY ASKED QUESTIONS 2 (2019), https://cdn.advocacy.sba.gov/wp-content/uploads/2019/09/24153946/Frequently-Asked-Questions-Small-Business-2019-1.pdf [https://perma.cc/EZ4T-TP47] (explaining that only about one-third of new businesses survive at least ten years); Erin Griffith, *Why Startups Fail, According to Their Founders*, FORTUNE (Sept. 25, 2014, 2:00 PM), http://fortune.com/2014/09/25/why-startups-fail-according-to-their-founders [https://perma.cc/Y2SV-6JAJ]; Neil Patel, *90% of Startups Fail: Here's What You Need to Know About the 10%*, FORBES (Jan. 16, 2015, 10:00 AM), http://www.forbes.com/sites/neilpatel/2015/01/16/90-of-startups-will-fail-heres-what-you-need-to-know-about-the-10/#3a755fee55e1 [https://perma.cc/6VWH-35TC]. More conservative estimates put this figure closer to 50%. *See* SMALL BUS. ADMIN., *supra*; U.S. BUREAU OF LAB. STAT., BUSINESS EMPLOYMENT DYNAMICS: ENTREPRENEURSHIP AND THE U.S. ECONOMY (2016), http://www.bls.gov/bdm/entrepreneurship/bdm_chart3.htm [https://perma.cc/8A7Y-R49K].

77. *See* Watson, Keasey & Baker, *supra* note 65, at 77; Claudia Lin-Yung Zhang, *How to Solve the Dilemma of Small Business Finance: A Proposal for Creditors' Statutory Information Right*, 13 U.C. DAVIS BUS. L.J. 128, 129–30 (2012) (noting that small businesses have difficulties communicating value to potential lenders because their contracts are generally not publicly available and they lack audited financial statements).

reassure potential creditors,[78] this use does not effectively solve the inherent informational asymmetry problems, and the resulting overleveraging can adversely impact a business's performance and development.[79] Loan applications by small startups are often denied as a result.[80] For these same reasons, raising capital via equity can also be prohibitively expensive and often is not a realistic alternative for many small enterprises.[81] The discussion that follows explains how the effects of these informational asymmetries are exacerbated in the context of minority-owned businesses.

1. UNTANGLING "SOFT" INFORMATION

This high degree of informational asymmetries is due to the lack of reliable and verifiable information about young, small businesses: there are no detailed financial statements about past performance, for example.[82] Individuals and entities investing in these businesses must then rely on subjective or "soft" information, "information that cannot be directly verified by anyone other than the [person] who produces it."[83] For example, "knowing" that a firm manager is honest and hardworking is an intangible fact that can be gained through personal experience, but one that cannot be as easily documented and credibly communicated as a financial report, a resume, or another form of "hard," "objective," or "verifiable"

78. *See* Zhang, *supra* note 77, at 137 ("Collateral is also a useful way to deliver private information and overcome borrower/lender incentive conflicts.").

79. *See id.* at 136 ("Collateral may impose opportunity costs on borrowers by drying up assets that might otherwise be put into more productive uses."); Efrat, *supra* note 42, at 178 (noting that small firms that receive financing can fail because they tie up their assets or the debt overwhelms them).

80. *See infra* note 190. *See also* Watson, Keasey & Baker, *supra* note 65, at 80; Zhang, *supra* note 77, at 130 ("The information costs, with the concomitant free-rider problem, severely impair small banks' lending ability, especially when they are new entrants in the local market.").

81. *See* Nancy Huyghebaert & Linda M. Van de Gucht, *The Determinants of Financial Structure: New Insights from Business Start-Ups*, 13l EUR. FIN. MGMT. 101, 110 (2007) ("Start-ups, however, cannot access public equity and . . . are also not likely to attract venture capital."); Stewart Myers, *The Capital Structure Puzzle*, 39 J. FIN. 574, 584–85 (1984) (arguing that the value of debt, by virtue of being a more senior security than equity, is less sensitive to private information); FAIRLIE & ROBB, *supra* note 11, at 17.

82. *See* Hédia Fourati & Habib Affes, *The Capital Structure of Business Start-Up: Is There a Pecking Order Theory or a Reversed Pecking Order?*, 4 TECH. & INV. 244, 247 (2013) (noting that due to their lack of historical and reputation effects, new firms are informationally opaque, which reduces the availability of external finance).

83. *See* Jeremy C. Stein, *Information Production and Capital Allocation: Decentralized Versus Hierarchical*, 57 J. FIN. 1891, 1892–93 (2002); Elizabeth Pollman, *Startup Governance*, 169 U. PA. L. REV. 155, 171–73 (2019); George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305, 307 (2001).

information.[84] The critical role of soft information in the assessment of the risks and prospects of investing in a small business explains several patterns documented in the corporate finance literature.[85]

Loan applications by small businesses are more likely to be approved by lenders that operate within a decentralized decision-making system, like one where local branch managers make approval decisions.[86] Studies that have examined lending patterns of big and small banks indicate that small, local banks have a comparative advantage in lending to small businesses based on soft information, while big banks prefer to lend to larger businesses and rely on hard information to make their lending decisions.[87] As it turns out, "soft information loans" can be profitable for the banks that are able to make them—these loans do not have higher default rates, and the borrowers are as productive as other firms.[88] Unfortunately, the continuing trend of bank consolidation and concentration has complicated matters for small businesses, as small local banks are disappearing and being replaced by bigger banks less suited to deal with soft information.[89]

---

84. *See* Stein, *supra* note 83, at 1892.

85. *See* Fourati & Affes, *supra* note 82, at 247 (noting that credit relationships are "based on 'soft' information generated by the banking experience with the lender and by a continuous contact"); Allen N. Berger & Gregory F. Udell, *Small Business and Debt Finance*, *in* HANDBOOK OF ENTREPRENEURSHIP RESEARCH 299, 300 (Zoltan J. Acs & David B. Audretsch eds., 2003).

86. In a hierarchical setting, soft information loses its value as local managers cannot credibly transmit the information to their decision-making superiors and thus have less incentive to produce it. *See* Stein, *supra* note 83, at 1893; Jose M. Liberti & Atif R. Mian, *Estimating the Effect of Hierarchies on Information Use*, 22 REV. FIN. STUD. 4057, 4060 (2009) (finding that sensitivity of credit decisions to objective information is higher at higher levels of approval, while sensitivity to subjective information is lower); Atif R. Mian, *Distance Constraints: The Limits of Foreign Lending in Poor Economies*, 61 J. FIN. 1465, 1467–68 (2006) (finding that greater cultural and geographical distance between a bank's headquarters and its local branches leads to less lending to informationally difficult yet fundamentally sound firms requiring relational contracting, such as small firms).

87. *See* Allen N. Berger, Nathan H. Miller, Mitchell A. Petersen, Raghuram G. Rajan & Jeremy C. Stein, *Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks*, 76 J. FIN. ECON. 237, 240–41 (2005). A study using data from the National Survey of Small Business Finance (which covers firms with fewer than 500 employees and a median asset value of $680,000) found that large banks lend primarily to larger firms with good accounting records while smaller banks lend to businesses for which creditworthiness is more difficult to assess with "hard" information. *Id.* Large banks lend at a greater distance, interact more impersonally, and have shorter and less exclusive relationships than smaller banks. *See id.*

88. *See* Mian, *supra* note 86, at 1498–99.

89. *See* Stein, *supra* note 83, at 1891; Cavalluzzo, Cavalluzzo & Wolken, *supra* note 66, at 643 ("The level of concentration in banking markets is of particular interest because small businesses tend to borrow locally, rather than nationally. A recent and continuing wave of mergers in the banking industry suggests that these local markets are becoming more concentrated.").

The importance of soft information in assessing small businesses also explains patterns in equity investments. Individuals active in the public equity markets tend to invest more in nearby companies.[90] This local bias is stronger for small and highly leveraged companies that produce locally consumed goods and services, exactly the type of firm that one expects local investors to have better access to soft information and for which this information would be most valuable.[91] More generally, private equity investors rely heavily on relationship-driven and geographically focused screening and monitoring mechanisms, as well as sophisticated contractual provisions, to gather and exploit soft information when investing in small, young businesses.[92]

2. MINORITY-OWNED BUSINESSES AS SOURCES OF SOFT INFORMATION

For minority entrepreneurs, informational asymmetries present an even greater obstacle to raising capital. Minority entrepreneurs often cannot take advantage of traditional strategies used to mitigate investors' informational concerns, as these strategies require personal wealth and resources that minority entrepreneurs often do not have.[93] For example, personal assets can serve as collateral in securing a loan or a home equity line of credit can be obtained using the entrepreneur's house.[94] Relatedly,

---

90. *See* Gur Huberman, *Familiarity Breeds Investment*, 14 REV. FIN. STUD. 659, 660–61 (2001) (finding that investors are more likely to hold shares of their local regional phone company than of any other regional phone company); Joshua D. Coval & Tobias J. Moskowitz, *Home Bias at Home: Local Equity Preference in Domestic Portfolios*, 54 J. FIN. 2045, 2047 (1999) [hereinafter Coval & Moskowitz, *Home Bias*] (finding that fund managers invest in companies which are around 10% closer than the average firm they could have held); Joshua D. Coval & Tobias J. Moskowitz, *The Geography of Investment: Informed Trading and Asset Prices*, 109 J. POL. ECON. 811, 812–13 (2001) (finding that mutual fund managers outperform in their local investments and concluding that there is some valuable information about these firms that these managers are getting on the ground).

91. *See* Coval & Moskowitz, *Home Bias*, *supra* note 90, at 2047–48.

92. *See supra* notes 83–84 and accompanying text.

93. *See* FAIRLIE & ROBB, *supra* note 11, at 19 ("[L]ow levels of personal wealth and liquidity constraints also limit the ability of minority entrepreneurs to raise adequate levels of startup capital."); Robert B. Avery, Raphael W. Bostic & Katherine A. Samolyk, *The Role of Personal Wealth in Small Business Finance*, 22 J. BANKING & FIN. 1019, 1021 (1998) (finding that the majority of all small business loans have personal commitments).

94. *See* FAIRLIE & ROBB, *supra* note 11, at 17 ("Low levels of wealth and liquidity constraints create a substantial barrier to entry for minority entrepreneurs because the owner's wealth can be invested directly in the business, used as collateral to obtain business loans or used to acquire other businesses."); Cavalluzzo & Wolken, *supra* note 66, at 2154 (finding that personal wealth, primarily through home ownership, decreases the probability of loan denials among existing business owners).

outside equity investors prefer that the entrepreneur has some "skin in the game" by investing enough personal resources as firm capital.[95]

Collecting and digesting available information thus becomes crucial for those seeking to invest in minority-owned businesses. In this respect, minority-owned businesses face two disadvantages relative to non-minority-owned businesses. First, soft information might be even more important for assessing a minority-owned business due to a greater unavailability of hard, verifiable information. Minority-owned businesses tend to be organized as sole-proprietorships rather than corporations and often lack a formal business plan.[96] Such informality is not conducive to producing hard, verifiable information that can be easily accessed and assessed by investors.[97] Second, investors might have a more difficult time producing and digesting soft information for minority-owned businesses, a premise explored next.

3. Professional Investors as Recipients of Soft Information

Large hierarchical institutions, a label that describes most banks and institutional investors, are ill-suited to make investment decisions based on soft information.[98] Even in flat hierarchical settings, socioeconomic and cultural differences between investors and entrepreneurs complicate the production and digestion of soft information. For example, it is easier for an investor to uncover and interpret soft information when that investor

---

95. *See* FAIRLIE & ROBB, *supra* note 11, at 17 ("Investors frequently require a substantial level of owner's investment of his/her own capital as an incentive, commonly referred as 'skin in the game.'").

96. *See* Efrat, *supra* note 42, at 179; Shinnar & Young, *supra* note 35, at 247, 251. These disparities in business formalities suggests that there exists a role for pro bono or easily accessible legal services. Although some county bar associations have placed a focus on helping small businesses address legal issues, only a handful of these programs exist nationwide. *See* The ACBA Public Service Committee, *Public Service Committee Starts Small Business Legal Assistance Program*, LAWS. J., Sept. 20, 2013, at 4. Law school clinics could also step in to address these disparities. *See generally* Jared Nicholson, *Offering Transactional Legal Aid to Low-Income Entrepreneurs*, 6 IND. J.L. & SOC. EQUAL. 1 (2018).

97. *See* Fourati & Affes, *supra* note 82, at 248 ("The legal form of organization provides . . . a signal that indicates credibility and formality of operations and ensures future growth . . . . There is, then, a positive correlation between debt and organization in incorporation."); Gavin Cassar, *The Financing of Business Start-Ups*, 19 J. BUS. VENTURING 261, 262, 268 (2004) (arguing that the fact that "both outside and bank finances appeared to increase as a result of the firm's incorporation" evidences that incorporation is a signal that portrays credibility and formality of operations); Fairlie, *supra* note 27, at 5 ("Incorporated businesses are viewed as more growth-oriented, committed, pro-cyclical and entrepreneurial . . . .").

98. *See supra* notes 85–89 and accompanying text.

enjoys cultural proximity with the entrepreneur.[99] Common networks are also critical for the collection, dissemination, and interpretation of soft information, as many investors informally rely on acquaintances to act as "gatekeepers" for potential financings.[100]

The fact that professional investors—most of whom are non-minority[101]—and minority entrepreneurs belong to different networks increases the costs for the former in identifying, assessing, and monitoring businesses owned by the latter.[102] Investors lacking the required knowledge and connections to assess soft information may resort to the use of heuristics, using, for example, an entrepreneur's race (an observable attribute) as a proxy for business risk (an unobservable attribute).[103] In this context, implicit biases can lead investors to make decisions that systematically disfavor minority entrepreneurs.[104]

---

99. *See* Watson, Keasey & Baker, *supra* note 65, at 79.

100. *See* Julia S. Rubin, *Venture Capital and Underserved Communities*, 45 URB. AFFS. REV. 821, 824–25 (2010) ("Venture capitalists heavily rely on their networks in identifying investment opportunities, conducting due diligence on those opportunities, and monitoring investment performance . . . .").

101. Sarah Lyons-Padilla, Hazel Rose Markus, Ashby Monk, Sid Radhakrishna, Radhika Shah, Norris A. "Daryn" Dodson IV & Jennifer E. Eberhardy, *Race Influences Professional Investors' Financial Judgments*, 116 PNAS 17,225, 17,225 (2019).

102. *See* Rubin, *supra* note 100, at 824–25 ("Since traditional venture capitalists' networks include few women and people of color, they have limited access to and understanding of companies owned by these populations. This translates into higher search costs in identifying, conducting due diligence on, and monitoring firms owned by women and people of color . . . .").

103. For an overview of the sources of implicit biases, see Anthony G. Greenwald & Linda Hamilton Krieger, *Implicit Bias: Scientific Foundations*, 94 CALIF. L. REV. 945, 952–57 (2006); Christine Jolls & Cass R. Sunstein, *The Law of Implicit Bias*, 94 CALIF. L. REV. 969, 969–70 (2006) (providing examples of both explicit and implicit bias). Implicit biases are closely related to the concept of statistical discrimination. *See* Cavalluzzo, Cavalluzzo & Wolken, *supra* note 66, at 642 ("[L]enders may be unable to observe, or it may be costly to collect, economically relevant information that is correlated with demographic group. If these lenders use demographic attributes as a proxy for missing information, then the resulting disparate treatment has an economic basis. This form of disparate treatment is called statistical discrimination . . . ."); Kenneth Arrow, *What Has Economics to Say About Racial Discrimination?*, 12 J. ECON. PERSP. 91, 96–97 (1998) (describing the statistical discrimination model); Ian Ayres & Peter Siegelman, *Race and Gender Discrimination in Bargaining for a New Car*, 85 AM. ECON. REV. 304, 317 (1995) ("'Statistical discrimination' is based not on a psychological distaste for associating with blacks or women, but rather on sellers' use of observable variables (such as race or gender) to make inferences about a relevant but unobservable variable.").

104. *See* Daniel Applewhite, *Founders & Venture Capital: Racism Is Costing Us Billions*, FORBES (Feb. 15, 2018, 8:00 AM), https://www.forbes.com/sites/forbesnonprofitcouncil/2018/02/15/founders-and-venture-capital-racism-is-costing-us-billions/?sh=1ab3726c2e4a [https://perma.cc/3CTT-53EE] ("Pattern recognition has enabled VC's to mitigate risk but has also limited their profit potential and created an inherent funding bias. This bias stems from barriers to early-stage capital, a lack of representation in the investing space and is perpetuated by systems of

Recent Federal Reserve data on small business lending helps illustrate this point.[105] Among low credit risk applicants, minority and white business owners are denied at the same rate (15%). Racial disparities arise once we look at riskier applicants for whom the available verifiable information by itself is not reassuring. In the pool of medium credit risk applicants, minority applicants are denied 34% of the time, while white applicants are denied 25% of the time—an eleven-point difference. Examining the riskier set of applicants reveals even greater disparities: white applicants are denied 46% of the time, while minority applicants are denied 73% of the time—a twenty-seven-point difference. The fact that race seems to play a role in situations where there is less reliable verifiable information about an entrepreneur suggests that an entrepreneur's race is being employed as a proxy for business risk.[106]

II. WHY EXISTING PROGRAMS HAVE FAILED

This Part explores major initiatives aimed at helping small businesses raise capital and the manner in which these have been tailored to target minority-owned businesses. The federal government plays an important role in these initiatives, though its role and the nature of its involvement has varied from directly guaranteeing loans to indirectly enhancing access to capital by relaxing regulatory requirements.

A. Government-Led Programs

The U.S. Small Business Administration (SBA) directly supports entrepreneurs and small businesses through a three-pronged strategy.[107]

---

racism that destroy opportunity within communities of color."); Benjamin P. Edwards & Ann C. McGinley, *Venture Bearding*, 52 U.C. DAVIS L. REV. 1873, 1877 (2019) ("[U]ncorrected implicit biases pervade the business environment, tilting the investment decisions made by venture capitalists toward men. Because venture capitalists are overwhelmingly white and male, they may be particularly vulnerable to implicit bias in favor of white male founders in evaluating investment opportunities.").

105. *See* DE ZEEUW, *supra* note 65, at 11.

106. These patterns produced by implicit biases have been observed in other areas where racial disparities in outcomes have been identified, such as in criminal law. *See* Carlos Berdejó, *Criminalizing Race: Racial Disparities in Plea-Bargaining*, 59 B.C. L. REV. 1187, 1240–41 (2018) (finding that racial disparities in plea-bargaining are driven by "low information" cases in which defendants have no prior convictions or are accused of less serious offenses and arguing that these patterns suggest that race is being used as a proxy for recidivism and inherent criminality).

107. The SBA is one of two U.S. government agencies that are involved in promoting minority-owned businesses. *See* Min & Bozorgmehr, *supra* note 35, at 34. The other agency, the Minority Business Development Agency (MBDA), is part of the Department of Commerce. *See* EUGENE BOYD, CONG. RSCH. SERV., R45015, MINORITY BUSINESS DEVELOPMENT AGENCY: AN OVERVIEW OF ITS HISTORY AND CURRENT ISSUES 1

First, the SBA facilitates access to capital by providing a government-backed guarantee on loans granted by financial institutions to qualifying small businesses.[108] Second, the SBA oversees the federal government's efforts to deliver a percentage of federal contracts to certain small businesses.[109] Finally, the SBA provides counseling to small businesses via a network of local offices.[110]

1. SBA Business Development and Loan Programs

a. Business Development Programs

The SBA's 8(a) Business Development Program provides support to small businesses owned by "socially and economically disadvantaged" individuals.[111] Socially disadvantaged individuals are "those who have been subjected to racial or ethnic prejudice or cultural bias within American society because of their identities as members of groups and without regard to their individual qualities."[112] Members of certain designated groups, including African Americans, Hispanics, and Native Americans, are entitled to a rebuttable presumption of social disadvantage.[113] Economically disadvantaged individuals include those "whose ability to compete in the free enterprise system has been impaired due to diminished capital and credit opportunities as compared to others in the same or similar line of business."[114] To initially qualify as economically disadvantaged, applicants must have a net worth lower than $250,000, among other requirements.[115]

Businesses that meet the 8(a) Program's eligibility requirements enjoy limited competition for federal government contracts known as set-aside and sole-source contracts.[116] Participants in the 8(a) Program are also

(2017). This Article will not focus on the MBDA for two reasons. First, this agency plays a limited role in financing, as it mainly provides technical and managerial support to minority-owned businesses. *Id.* at 6. Second, it primarily focuses on businesses with annual revenues of at least $1 million operating in high-growth areas, such as technology and bio-medicine. *Id.*

108. *See infra* notes 120–126 and accompanying text.

109. *See infra* note 116 and accompanying text.

110. *See infra* notes 117–119 and accompanying text.

111. 13 C.F.R. § 124.101 (2020). For an overview of the 8(a) program, see ROBERT JAY DILGER, CONG. RSCH. SERV., R44844, SBA'S "8(A) PROGRAM": OVERVIEW, HISTORY, AND CURRENT ISSUES (2019).

112. 13 C.F.R. § 124.103(a).

113. § 124.103(b).

114. § 124.104(a).

115. § 124.104(c)(2).

116. A set-aside award is a contract awarded in which only certain contractors may compete, whereas a sole-source award is a contract awarded without competition. 48

eligible to receive assistance through the 7(j) Management and Technical Assistance Program,[117] be assigned a business opportunity specialist to help navigate federal contracting and obtain general business development assistance,[118] and participate in a mentor-protégé program.[119]

b. SBA Loan Guarantee Programs

The SBA does not act as a lender to small businesses but rather provides guarantees for small business applicants. Depending on the program, loans are provided by intermediaries such as banks (SBA 7(a) loans) or Certified Development Companies (CDCs) (SBA 504 loans) that interact with the small business applicant and make credit decisions.[120] These two programs are available for small businesses that have a tangible net worth lower than $15 million and an average net income of $5 million or less for the preceding two years.[121]

Amounts borrowed under the 7(a) loan program can be used for any business purpose, including working capital, inventory, financing

---

C.F.R. §19.501(a) (2019); *Type of Contracts*, U.S. SMALL BUS. ADMIN., https://www.sba.gov/federal-contracting/contracting-guide/types-contracts [https://perma.cc/K4W4-F23H] (last visited Feb. 17, 2021). There are government-wide and agency-specific goals regarding the percentage of procurement dollars awarded to 8(a) participants. 15 U.S.C. § 644(g); 13 C.F.R. §124.1002 (2020). It is worth noting that federal procurement has not been particularly helpful for minority-owned small businesses. *See* Brian G. Smith, *Size Standards and Contract Bundling in the Federal Marketplace: An Uphill Battle for Small Business Owners*, 1 ENTREPRENEURIAL BUS. L.J. 175, 179–80 (2007); Courtney Bublé, *Biden Administration Likely to Increase Contracting Opportunities for Small and Minority-Owned Businesses*, GOV'T EXEC. (Dec. 29, 2020), https://www.govexec.com/management/2020/12/biden-administration-likely-increase-contracting-opportunities-small-and-minority-owned-businesses/171031/ [https://perma.cc/P3UR-BL8Z].

117. This program provides support such as training, executive education, and consulting in areas such marketing, accounting, opportunity development and capture, contract management, compliance, and financial analysis. 13 C.F.R. §§ 124.701–03.

118. *See* § 124.704.

119. § 124.520. The mentor-protégé program is designed to "improve [a small business'] ability to successfully compete for contracts" by providing assistance through mentor businesses, including technical or management training, financial assistance, trade education, and assistance in competing for or performing prime contracts with the federal government. 13 C.F.R. § 125.9.

120. *See* 13 C.F.R. § 120.2; *Loans*, U.S. SMALL BUS. ADMIN., https://www.sba.gov/funding-programs/loans [https://perma.cc/3MW7-3UBP] (last visited Feb. 18, 2021).

121. *See* CONG. RSCH. SERVS., R41146, SMALL BUSINESS ADMINISTRATION 7(A) LOAN GUARANTY PROGRAM 21 (2021) [hereinafter CRS 7(A) REPORT]; CONG. RSCH. SERV., R41184, SMALL BUSINESS ADMINISTRATION 504/CDC LOAN GUARANTY PROGRAM 5 n.19 (2020) [hereinafter CRS 504 Report].

leasehold improvements, and refinancing debt.[122] Although borrowers may use the 7(a) program to fund capital investments, the SBA's 504 loan program offers certain advantages for small businesses to fund these capital investments.[123] The 504 program offers borrowers a fixed rate for 10 or 20 years, generally with lower fees than the 7(a) program, which typically have shorter maturities and variable interest rates.[124] Borrowings under the 504 program require a down payment of 10%,[125] whereas the 7(a) loan program requires certain loans to be fully collateralized.[126]

The overall effectiveness of these SBA loan programs has been widely questioned.[127] Some have argued that the policy rationales underlying these programs are unsound, highlighting the opaqueness of the selection process and maintaining that the ultimate winners are big banks who do not need financial support from taxpayers.[128] Setting that policy question aside, it is debatable whether debt financing is the most appropriate vehicle to fund certain early-stage businesses, as it can be relatively expensive and cause undue financial strains in the short term.[129] Indeed, for some early-stage businesses, the temporal flexibility of equity financing and the advice and involvement of equity investors often provide a more attractive alternative.[130]

122. § 120.120. For information on the terms, conditions, and eligibility of SBA loans, see *7(a) Loan Program: Terms, Conditions and Eligibility*, U.S. SMALL BUS. ADMIN., https://www.sba.gov/partners/lenders/7a-loan-program/terms-conditions-eligibility [https://perma.cc/4L2N-R77A] (last visited Feb. 18, 2021); CRS 7(A) REPORT, *supra* note 121, at 4.

123. *See* CRS 504 REPORT, *supra* note 121, at 6–7.

124. *See id.* at 9–10; CRS 7(A) REPORT, *supra* note 121, at 4–6.

125. 504 Loans are typically structured with SBA providing 40% of the total project costs, a participating lender covering up to 50% of the total project costs, and the borrower contributing10% of the project costs. *See* CRS 504 REPORT, *supra* note 121, at 1.

126. A small business borrower typically has to pledge all collateral available, including their personal residence, to secure the loan. *See* CRS 7(A) REPORT, *supra* note 121, at 6.

127. *Senate Hearings*, *supra* note 66, at 4 (opening statement of Hon. Olympia Snowe) (noting that "the effectiveness of [SBA] programs have been repeatedly called into question").

128. Tad DeHaven, *Terminate the Small Business Administration*, CATO INST. (Aug. 17, 2011), https://www.cato.org/publications/commentary/terminate-small-business-administration [https://perma.cc/V2TT-N7QU]; Tad DeHaven, *Waste, Fraud, and Abuse in Small Business Administration Programs*, CATO INST. (June 16, 2011), https://web.archive.org/web/20150708045957/https:/www.cato.org/publications/congressional-testimony/waste-fraud-abuse-small-business-administration-programs; Editorial Board, *The Small Business Administration Needs Reforming*, WASH. POST (Dec. 18, 2016), https://www.washingtonpost.com/opinions/the-sba-needs-reforming/2016/12/18/b639fc4c-c159-11e6-8422-eac61c0ef74d_story.html [https://perma.cc/JP49-FZV2].

129. *See infra* notes 187–192 and accompanying text.

130. *See infra* notes 193–199 and accompanying text.

The performance of these SBA programs is even more troubling if we look at their effects on minority-owned businesses. SBA programs have not increased minority entrepreneurship.[131] Minority-owned businesses are less likely to receive loans under the SBA programs, and those who do receive loans receive smaller loans relative to non-minority-owned businesses.[132] The failure of these SBA lending programs is not surprising given the importance of soft information in assessing minority-owned businesses and the fact that most SBA lenders are large banks, precisely the type of institution that has a comparative disadvantage in that informational setting.[133]

2. SMALL BUSINESS INVESTMENT COMPANIES

Small Business Investment Companies (SBICs) are privately-owned companies, licensed and regulated by the SBA, that make long-term investments in small businesses.[134] To fund their investments, SBICs raise regulatory capital from private investors, generally institutional investors such as banks, insurance companies, pension funds, and university endowments, as well as high net-worth individuals.[135] These funds are

131. *See* Min & Bozorgmehr, *supra* note 35, at 34–35 (summarizing the relevant literature).

132. *Senate Hearings*, *supra* note 66, at 2 (opening statement of Hon. John F. Kerry, Chairman) ("When we look at SBA lending, the share of loan dollars to minorities is largely stagnant. And more interestingly, minorities who have obtained SBA loans have seen their average loan size shrink by more than those to non-minorities.").

133. *See* Editorial Board, *supra* note 128 (stating that lenders in the SBA programs are large banks); *supra* notes 98–106 and accompanying text (discussing the importance of soft-information and which institutions are best positioned to rely on it). Notably, the ever-growing concentration of the banking sector has rendered it even less able to meet the capital needs of minority-owned businesses. *See supra* note 89 and accompanying text; Cavalluzzo, Cavalluzzo & Wolken, *supra* note 66, at 676 ("Small businesses that were owned by African Americans were more likely to be denied credit and have unmet credit needs as the level of lender market concentration increased. In addition, African American owners were less likely to apply for credit with increases in lender market concentration.").

134. *See* JOHN PAGLIA & DAVID T. ROBINSON, FED. RSCH. DIV., LIB. OF CONG., MEASURING THE REPRESENTATION OF WOMEN AND MINORITIES IN THE SBIC PROGRAM 8 (2016) ("[T]he SBIC Program's mission is to stimulate and supplement the flow of private equity capital and long-term loan funds for the growth, expansion, and modernization of small businesses for which such capital and loan funds are not available in adequate supply . . . ."); Ethan D. Dunn, *Early Stage SBICs: A New Source of Capital for Private Investors, Equity for Start-Ups, and Possible Volker Rule Exemption for Banks*, N.C. BANKING INST. 357, 361 (2013) ("[SBICs] lend or invest [a] mixture of private and SBA-guaranteed capital to early stage small businesses with hopes of profits above their borrowed rates. The availability of government-backed debt and equity improves small business access to long-term debt and private equity, in turn financing operations and expansion.").

135. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-16-107, SMALL BUSINESS INVESTMENT COMPANIES: CHARACTERISTICS AND INVESTMENT PERFORMANCE OF SINGLE

supplemented by the SBA mainly in the form of guaranteed debt: for every $1 an SBIC raises from a private investor, the SBA typically provides $2 of debt capital, up to $175 million ("leverage capital").[136] Once capitalized, SBICs act as managed investment funds that invest capital raised from private investors in businesses operating in sectors and industries where the fund managers have expertise.[137]

a. SBIC Programs

Active SBICs are licensed to participate in one of four main programs: the Debenture Program, the Participating Securities Program, the Bank-Owned/Non-Leveraged Program, and the Specialized SBIC Program.[138] As of September 30, 2018, there were 305 licensed SBICs, of which 227 belonged to the Debenture program; 25 belonged to the Participating Securities program; 47 belonged to the Bank-Owned/Non-Leveraged Program; and 6 belonged to the Specialized SBIC Program.[139]

Under the Debenture Program, an SBIC receives SBA leverage in the form of a guaranteed debenture (i.e., loan obligations), which allows the SBIC to borrow at favorable terms.[140] There are a number of capital

---

AND MULTIPLE LICENSEES 3 (2016), https://www.gao.gov/assets/680/674813.pdf [https://perma.cc/2V5Q-67VD]; Mark A. Kromkowski & Bryan P. Bylica, *A Summary of the SBIC Program*, MCGUIRE WOODS 1, 2 (2018), http://media.mcguirewoods.com/publications/2018/SBIC-Program-Summary.pdf [https://perma.cc/6QNA-ZBWD]; U.S. SMALL BUS. ADMIN., THE SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM 1 (2018), https://www.sba.gov/sites/default/files/2019-02/2018%20SBIC%20Program%20Overview.pdf [https://perma.cc/VFE8-NE24] [hereinafter SBIC Overview]; OFF. OF THE COMPTROLLER OF THE CURRENCY, SMALL BUSINESS INVESTMENT COMPANIES: INVESTMENT OPTION FOR BANKS 1 (2015), https://www.newyorkfed.org/medialibrary/media/outreach-and-education/cra/reports/OCC-Small-Business-Investment-Companies.pdf [https://perma.cc/5AKG-UWZQ] [hereinafter OCC SBIC REPORT].

136. *See* CONG. RSCH. SERV., R41456, SBA SMALL BUSINESS INVESTMENT COMPANY PROGRAM 1–2 (2020) [hereinafter CRS SBIC REPORT].

137. *See id.* SBICs can be organized under state law as corporations, a limited partnerships or limited liability companies. *See id.* at 4. SBICs are organized as limited partnerships with the SBIC managers acting as the general partner. *See* OCC SBIC REPORT, *supra* note 135, at 1.

138. *See* CRS SBIC REPORT, *supra* note 136, at 4; U.S. SMALL BUS. ADMIN, *supra* note 135, at 1.

139. *See* U.S. SMALL BUS. ADMIN., SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM OVERVIEW (Sept. 30, 2018), https://www.sba.gov/sites/default/files/2018-11/Fiscal%20Year%20Data%20for%20the%20period%20ending%20September%2030%2C%202018%20_0.pdf [https://perma.cc/F3M2-PHBM] [hereinafter SBIC QUARTERLY REPORT].

140. CRS SBIC Report, *supra* note 136, at 1. When an SBIC wants to draw leverage, it notifies the SBA and issues a debenture, which the SBA temporarily holds

requirements that need to be satisfied by an SBIC participating in the Debenture Program, but a detailed discussion of these is not necessary for our purposes.[141] Notably, Debenture SBICs can only invest in businesses with a tangible net worth under $19.5 million.[142]

The fixed and periodic nature of the payments that an SBIC must meet under the Debenture Program makes startup and early-stage businesses less attractive investment targets for SBICs as compared to older, more established businesses.[143] Investing in young, small businesses generally requires the ability to purchase equity interests in them, interests which are unlikely to provide a predictable stream of returns.[144] As a result, SBICs in the Debenture Program focus on debt instruments and mezzanine financing and prefer to invest in later-stage businesses with larger cash flows.[145]

To facilitate the formation of SBICs that would make equity investments in startups and early-stage companies, the SBA established the Participating Securities Program in 1994.[146] Unlike the Debenture Program, where the SBA is practically a creditor of the SBIC, the Participating Securities Program allows the SBA to guarantee equity-type securities, requiring SBICs to pay the SBA a prioritized payment (or preferred return) and a profit share when the SBIC realizes profits.[147] Due to mounting losses associated with this Program, the SBA terminated it in

---

(providing funds in the interim to the SBIC) and then sells the debentures to the public pooled with others (to receive the funds back). *See* U.S. SMALL BUS. ADMIN., MEMORANDUM OF INSTRUCTIONS APPLICATION FOR COMMITMENT OF SBIC DEBENTURES 1, 7 (2016), https://www.sba.gov/document/policy-guidance--commitment-instructions [https://perma.cc/9M38-3XWS].

141. Debenture SBICs are required to have a private capital investment of at least $5 million. 13 C.F.R. § 107.210 (2020). At least 30% of a debenture SBIC's regulatory and leverageable capital must come from three people unaffiliated with the fund's management and unaffiliated with each other. § 107.150.

142. *See* Dunn, *supra* note 134, at 364; SBIC Overview, *supra* note 135, at 2.

143. Debenture SBICs must make semiannual payments to cover interest and other charges. *See* CRS SBIC REPORT, *supra* note 136, at 12.

144. *See infra* notes 189–191 and accompanying text.

145. *See* CRS SBIC REPORT, *supra* note 136, at 11; Dunn, *supra* note 134, at 365. Of the $5,159 million financed by SBICs in 2018, $3,221 million (66.33%) was in the form of straight debt, $945 million was in the form of equity (18.32%) and $791.8 million was in the form of hybrid securities (15.35%). *See* SBIC QUARTERLY REPORT, *supra* note 139, at 2.

146. This was made possible by an act of Congress that authorized the SBA to guarantee a broader set of securities. Small Business Credit and Business Opportunity Enhancement Act of 1992, Pub. L. No. 102-366, 106 Stat. 986, 1007–20 (1992). (Title IV, the Small Business Equity Enhancement Act of 1992).

147. Participating securities are redeemable, preferred, equity-type securities issued by SBICs in the form of limited partnership interests, preferred stock, or debentures with interest payable only to the extent of earnings. *See* CRS SBIC REPORT, *supra* note 136, at 7.

October 2004 and stopped issuing new commitments for participating securities leverage or licensing new SBICs using that leverage.[148] In the following years, congressional and market actors expressed interest in reviving a similar program to assist startup and early-stage small businesses.[149]

One such program was part of the Obama Administration's 2011 Startup America Initiative, under which the SBA established a five-year, $1 billion early-stage SBIC program.[150] Early-stage SBICs were required to invest at least 50% of their financings in early-stage small businesses, businesses that have never achieved positive cash flow from operations in any fiscal year.[151] In recognition of the higher risk associated with investments in these early-stage small businesses, the initiative included "several new regulatory provisions intended to reduce the risk that an early-stage SBIC would default on its leverage and to improve SBA's recovery prospects should a default occur."[152] Since the program was not renewed, the SBA stopped accepting new applicants for the early-stage SBIC initiative in 2017.[153]

b. Efforts Targeting Minority-Owned Businesses

Two SBIC programs have sought to encourage SBIC investment in minority-owned businesses and facilitate the latter's access to capital: the Specialized SBIC (SSBIC) Program and the Impact Investment SBIC Initiative. Although neither of these programs still exists, their history provides valuable insights for the design of alternative approaches to address minority entrepreneurs' difficulties in accessing capital.

The SSBIC Program was designed to target small business entrepreneurs "whose participation in the free enterprise system is hampered because of social or economic disadvantage," a category meant to capture minority-owned small businesses.[154] The program, however,

---

148. *See id.* at 7.

149. *Id.*

150. Small Business Investment Companies—Early Stage SBICs, 77 Fed. Reg. 25,042, 25,043, 25,050 (Apr. 27, 2012) (to be codified 13 C.F.R. pt. 107).

151. *See id.* at 25,051–53.

152. *Id.* at 25,043.

153. *See* CRS SBIC REPORT, *supra* note 136, at 11; Small Business Investment Companies (SBIC): Early Stage Initiative, 83 Fed. Reg. 26,875, 26,875–76 (June 11, 2018) (to be codified 13 C.F.R. pt. 107).

154. CRS SBIC REPORT, *supra* note 136, at 3. *See* PAGLIA & ROBINSON, *supra* note 134, at 9. The SSBIC was an outgrowth of the Minority Enterprise Small Business Investment Company (MESBIC) program which had been developed in the 1970s and 1980s to facilitate equity-capital investing in small firms located in inner-city minority communities. *See* Bates, *supra* note 61, at 353; *Small Business Investment Companies (SBIC)*, INC., https://www.inc.com/encyclopedia/small-business-investment-companies-

was repealed in 1996 and no new SSBIC licenses have been issued since.[155] During the existence of the program, the SBA issued 288 SSBIC licenses.[156] In 1997, there were 77 active SSBICs.[157] As of 2018, only 6 remained.[158] Some have argued that the decline of the SSBIC program resulted in a corresponding decline of SBIC financings to minority-owned small businesses.[159]

The Impact Investment SBIC Initiative was a $1 billion effort established by the SBA in 2011.[160] Under the terms of the program, an impact investment SBIC was required to target at least 50% of their investments in "areas of critical national priority including underserved markets and communities facing barriers to access to credit and capital."[161] These areas initially included businesses located in underserved communities,[162] as well as in sectors like education and clean energy.[163] Nine impact investment SBICs were licensed, and, as of September 30, 2018, they managed $905 million in assets and had investments in 81 businesses.[164]

Yet, this program was also short-lived. In September 2017, the SBA announced that it would no longer accept new applications for impact investment SBIC licenses and withdrew a proposed rule that would have provided impact investment SBICs additional benefits "to encourage qualified private equity fund managers with a focus on social impact to

sbic.html (last visited Feb. 13, 2021). Despite its questionable effectiveness, the MESBIC program gave birth to the minority-focused venture capital industry. *See infra* note 202 and accompanying text.

155. CRS SBIC REPORT, *supra* note 136, at 3.

156. *See* PAGLIA & ROBINSON, *supra* note 134, at 9.

157. *Id.*

158. *See* SBIC QUARTERLY REPORT, *supra* note 139, at 1.

159. *See* PAGLIA & ROBINSON, *supra* note 134, at 9.

160. CRS SBIC REPORT, *supra* note 136, at 8.

161. *See* U.S. SMALL BUS. ADMIN., IMPACT INVESTMENT SMALL BUSINESS INVESTMENT COMPANY ("SBIC") FUND 1, https://www.sba.gov/sites/default/files/files/Impact_Investment_Call_for_Action.pdf [https://perma.cc/8SHX-H23H].

162. The SBA defines underserved communities as low or moderate income (LMI) zones. 13 C.F.R. § 107.50 (2012). This definition tracks, among others, census-tracts designations made by the Financial Institutions Examination Council that are used in the Community Reinvestment Act of 1977. *See* Ben Horowitz, *Defining "Low- and Moderate Income" and "Assessment Area,"* FED. RES. BANK MINNEAPOLIS (Mar. 8, 2018), https://www.minneapolisfed.org/article/2018/defining-low--and-moderate-income-and-assessment-areas [https://perma.cc/9W2F-K8ZX]; Community Reinvestment Act of 1977, 12 U.S.C. § 2901.

163. CRS SBIC REPORT, *supra* note 136, at 9.

164. *Id.*

apply to the SBIC program."[165] The SBA indicated that the cost of the proposed additional benefits was "not commensurate" with the benefits, particularly because so few qualified SBICs had applied to participate in the program and that many of the program's participants would have applied to the SBIC program regardless.[166]

c. Assessing SBICs' Performance

Overall, the SBIC program has been successful. From the SBIC Program's inception to December 31, 2018, SBICs provided approximately $97.6 billion of funding in more than 181,185 financings to businesses, including companies like Amgen, Apple Computer, Costco, Federal Express, Intel, Tesla, and Whole Foods.[167] The SBIC Program also laid the foundation for the modern venture capital industry, as the risk involved in these investments was quite substantial for the private sector to absorb without initial government support.[168] More recently, however, SBIC programs have focused on providing debt financing to mid-stage companies, greatly neglecting the needs of small, early-stage companies.[169] This neglect is primarily due to the type of leverage provided by the SBA: mainly debt, which induces SBICs to invest in debt instruments issued by relatively stable companies.[170] Moreover, as discussed later, raising capital via debt is generally not the best choice for small, early-stage companies.[171]

Whether the SBIC program has helped develop minority businesses is debatable. At a 2007 congressional hearing, the SBA recognized that

165. *See* Small Business Investment Company Program—Impact SBICs, 83 Fed. Reg. 26,874, 26,874–75 (June 11, 2018) (to be codified at 13 C.F.R. pt. 107) [hereinafter *Impact SBICs Withdrawal*]. Impact investment SBIC applicants would have received a 60% discount on the licensing fee and a 10% discount on the examination base fee. *See* CRS SBIC REPORT, *supra* note 136, at 9 n.42.

166. *See Impact SBICs Withdrawal*, *supra* note 165 at 26,874–75. The SBA indicated that due to the risk associated with this class of SBICs the proposed rule was expected to increase the cost to all SBICs by increasing the annual fee by approximately 6.1 basis points. *Id.*

167. *See* Kromkowski & Bylica, *supra* note 135, at 2.

168. Rubin, *supra* note 100, at 829; Sean Silverthorne, *Government's Positive Role in Kick-Starting Entrepreneurship*, HARV. BUS. SCH. (Dec. 7, 2009), http://hbswk.hbs.edu/item/6318.html [https://perma.cc/8MKD-MWHN] (citing Josh Lerner as stating that the SBIC program "led to the formation of the infrastructure for much of the modern venture capital industry"); JOSH LERNER, BOULEVARD OF BROKEN DREAMS 68–69 (Princeton Univ. Press 2009) ("[M]any pioneering venture funds have garnered . . . low [financial] returns" and "that no matter how promising the returns of entrepreneurial activity ultimately are, in a venture market's early years, low returns are likely.").

169. *See supra* notes 143–145 and accompanying text.

170. *Id.*

171. *See infra* notes 189–199 and accompanying text.

"minority representation in [the SBIC program] is low."[172] The situation has not improved since. As of 2018, Black- and Hispanic-owned businesses were involved in only 1.9% and 1.0%, respectively, of SBICs financings.[173] Non-minority businesses, on the other hand, were involved in 95.2% of the financings.[174] Looking at the aggregate amount of funds disbursed reveals a similar pattern. Black-owned businesses received 0.6% of the total disbursed funds, while Hispanic-owned businesses received 0.2%.[175] Non-minority businesses, on the other hand, received a striking 97.6% of the total financing.[176]

Although the SBA has acknowledged the problematic nature of these figures, it ultimately has no control over the SBICs' decision-making process and cannot mandate racially-based investment quotas.[177] Establishing programs to aid minority entrepreneurs is tricky, as the SBA does not have the statutory authority to proactively target racially diverse companies, and SBICs must provide financing to all qualifying small enterprises on an equal opportunity basis.[178] As a result, the SBA instead focuses its efforts on encouraging SBICs to finance racially diverse portfolio companies and encouraging private equity funds with women or minority partners to apply to the SBIC Program.[179]

That second effort is of particular interest, as funds led by minorities would be better suited to produce and digest the type of soft information necessary to invest in minority-owned businesses.[180] As in private equity, the diversity of the SBIC investor base (i.e., the decisionmakers) mirrors the diversity of the businesses that receive funding.[181] A 2016 study found that of the 303 active funds, 272 (89.8%) were non-racially diverse and 31

---

172. *Full Committee Hearing on Legislation Updating and Improving the SBA's Investment and Surety Bond Programs: Hearing on S. 110-44 Before the H. Comm. on Small Business*, 110th Cong. 16 (2007) (statement of Steven C. Preston, Adm'r, Small Bus. Admin.); CRS SBIC Report, *supra* note 136, at 23.

173. *See* CRS SBIC REPORT, *supra* note 136, at 23. Other minority groups have similar numbers: Asians (1.8%) and Native Americans (0.0%). *Id.*

174. CONG. RSCH. SERV., R41456, SBA SMALL BUSINESS INVESTMENT COMPANY PROGRAM 23 (2019) [hereinafter CRS SBIC Report 2019]. *See also* PAGLIA & ROBINSON, *supra* note 134, at 18 (finding that about 4% of the SBIC financings between June 1, 2013 and September 30, 2015 involved portfolio companies with a minority chief executive officer or president).

175. CRS SBIC REPORT 2019, *supra* note 174, at 23.

176. *Id.* at 24.

177. *See id.* at 23–24.

178. *See* PAGLIA & ROBINSON, *supra* note 134, at 8–9.

179. *Id.* at 9.

180. This argument has been made by market actors, including the Small Business Investor Alliance (formerly known as the National Association of Small Business Investment Companies). *See Full Committee Hearing on Increasing Capital for Small Business, Before the H. Comm. on Small Business*, 111 Cong. 51–89 (Oct. 14, 2009).

181. *See infra* notes 208–211 and accompanying text.

(10.2%) had at least one minority investment partner.[182] Racially diverse SBICs were more likely to invest (and invest more) in minority-owned businesses than non-racially diverse SBICs.[183] Despite these differences in their investment strategies, there were no significant differences in the financial performance of racially diverse and non-racially diverse SBICs.[184]

B. Broadening the Investor Base

Two common attributes of the government-sponsored programs discussed above render them ill-suited to meet the financing needs of small businesses, particularly those owned by minority entrepreneurs. First, these programs rely on large financial intermediaries to act as gatekeepers, and these types of institutions are not well adapted to collect and assess soft information from minority-owned businesses.[185] The second limitation relates to each program's heavy reliance on debt financing as a tool to promote entrepreneurship.[186] As discussed below, for many small and young firms, debt is not necessarily the best source of financing. Moreover, innovative technological-driven schemes that were expected to help minority-owned businesses access equity financing have fallen short.

1. PRIVATE EQUITY

The first sources of financing used by entrepreneurs are personal funds (e.g., savings) and contributions from friends and family.[187] Once these sources of capital are exhausted, the entrepreneur needs to seek

---

182. PAGLIA & ROBINSON, *supra* note 134, at 17. These patterns are fairly stable across different types of funds. Of the 205 active debenture funds, only 21 (10.2%) were racially diverse. *Id.* To measure the racial diversity, the authors considered whether a SBIC's investment team had at least one member from an ethnic or racial minority. *Id.* at 15.

183. *Id.* at 24–25.

184. *See id.* at 33 (concluding that "there is no apparent difference in performance between diverse SBIC funds and other funds").

185. *See supra* notes 83–87 and accompanying text.

186. The reliance on debt for the SBA's loan programs flows directly from the SBA guarantee of the loans made by banks to small businesses. *See supra* Section II.A.1. The reliance on debt instruments by SBICs when investing in small businesses is the result of the manner in which SBICs are capitalized and leveraged. *See supra* Section II.A.2.

187. Pollman, *supra* note 83, at 170 ("[F]ounders often 'bootstrap' the business using their own funds, and those of family and friends, to finance development efforts and early operations."); Fourati & Affes, *supra* note 82, at 247 (noting that due to their lack of "historical and . . . reputation effects," new firms are "informationally opaque" and this complicates attracting external financing).

external financing.[188] Although established firms seeking outside financing often prefer to issue debt before equity, relying heavily on debt is often not the best choice for young firms.[189] First, the cash-flow uncertainty faced by young businesses makes it difficult for them to commit to a schedule of fixed payments, as is expected under debt instruments.[190] Second, the type of informational asymmetries that characterize small, young firms can actually make debt more expensive than equity, a reversal of the traditional pecking order.[191]

For small, young businesses, raising equity capital from the public is not practical—the informational asymmetries and related transaction costs of a public offering are just too high.[192] Entrepreneurs seeking external equity financing must thus turn to private equity investors, such as angel investors and venture capital firms, that specialize in funding startups.[193]

188. *See* Pollman, *supra* note 83, at 170 (noting that once personal funds are exhausted start-ups must seek alternate sources of capital).

189. *See* Stuart Paul, Geoff Whittam & Janette Wyper, *The Pecking Order Hypothesis: Does It Apply to Start-Up Firms*, 14 J. SMALL BUS. & ENTER. DEV. 8, 9 (2007) ("[I]n the majority of cases . . . entrepreneurs move from self-funding to external equity as a means of financing their businesses in preference to, or instead of, bank finance."); Fourati & Affes, *supra* note 82, at 246 ("Literature has recently introduced a revised version of the [pecking order theory], where external equity is preferred over external debt in the case of innovative firms."); Paolo Fulghieri, Diego Garcia & Dirk Hackbarth, *Asymmetric Information and the Pecking (Dis)Order*, 24 REV. FIN. 961, 968–73, 991–92 (2020) (presenting a model explaining why small firms may prefer equity over debt financing when informational asymmetries are severe).

190. *See* George Deeb, *Comparing Equity, Debt and Convertibles for Startup Financings*, FORBES (Mar 19, 2014, 2:25 PM), https://www.forbes.com/sites/georgedeeb/2014/03/19/comparing-equity-vs-debt-vs-convertibles-for-startup-financings/#6bd21c6169ff [https://perma.cc/Q782-LGXH]; Pollman, *supra* note 83, at 170 ("Traditional banks do not lend to startups, particularly in their early stages, due to their lack of a track record, negative cash fow, lack of tangible assets, and high failure rate."); Huyghebaert & Van de Gucht, *supra* note 81, at 110 ("The reason is that debt generally is not a suitable financing source for high-growth firms: to finance their growth, firms need to make large investments upfront whereas cash flows will only realise in the future. As a result, it is difficult for firms to pay off their debts from internally generated sources and equity is a more suitable financing source.").

191. *See* Paul, Whittam & Wyper, *supra* note 189, at 9 ("The evidence presented shows that in the majority of cases a bridged pecking order applies in that entrepreneurs move from self-funding to external equity as a means of financing their businesses in preference to, or instead of, bank finance."); Carmen Cotei & Joseph Farhat, *The Evolution of Financing Structure in U.S. Startups*, 19 J. ENTREPRENEURIAL FIN. 1, 12 (2017) ("[I]nformationally opaque firms are less likely to use outsiders' debt, credit line, credit card, and bank loan capital injections. . . . [Attributable to the fact that] informationally opaque firms are less likely to access debt financing due to severe frictions in the debt markets.").

192. For a discussion of the rules governing the public offering process and their disparate impact on small businesses see *infra* notes 223–231 and accompanying text.

193. *See* Pollman, *supra* note 83, at 170 ("Two types of investors specialize in financing startups: angel investors and VCs.").

Sales of securities to these private equity investors are exempt from the registration requirements of securities laws,[194] which reduces transaction costs.[195] To manage the informational asymmetries involved in investing in a small business, private equity investors rely on informal relationship-based and geographically-focused screening and monitoring devices that are well-suited for the collection of soft information.[196] Generally, these investors rely on their social and professional networks to identify and screen potential opportunities before personally assessing them,[197] and then take an active role in managing their investments by providing contacts, strategic advice, and follow-on funding that can take a company on an entirely different trajectory.[198] This last point highlights a key advantage of having an equity investor for young, small businesses, as creditors lack the ability or incentives to provide the valuable ongoing business advice and networking opportunities that equity investors do.[199]

Although private equity's organizational structure and investment strategy are tailor-made for the collection and assessment of soft information—precisely the type of information that those seeking to invest in minority-owned businesses would need to rely on—minority entrepreneurs do not appear to enjoy ready access to this financing channel. Minority-owned startups are significantly less likely to obtain equity financing from venture capital firms and angel investors.[200] Consequently, an extremely low percentage of minority businesses are backed by private equity: only 1% of venture-capital-backed startups are

194. *See id.* at 163–65.

195. *See infra* notes 223–231 and accompanying text.

196. *See* Pollman, *supra* note 83, at 171–73.

197. *See supra* notes 100–102 and accompanying text.

198. *See* Pollman, *supra* note 83, at 169–73; Paul Gompers & Josh Lerner, *Equity Financing*, *in* 5 HANDBOOK OF ENTREPRENEURSHIP RESEARCH 183, 190 (Zoltan J. Acs & David B. Audretsch eds., 2d ed. 2010) (noting how staged capital infusions allow for the periodic evaluation of a business).

199. *See* Paul, Whittam & Wyper, *supra* note 189, at 9 ("Rather than the external equity being regarded as expensive, it is viewed as good value as a well-chosen investor can add business skills and social capital in the form of commercial contacts and access to relevant networks."); Timothy Bates & William D. Bradford, *Venture-Capital Investment in Minority Business*, 40 J. MONEY, CREDIT & BANKING 489, 501–02 (2008) (finding that active guidance and assistance by minority-focused venture capital funds adds value to the portfolio company, thus increasing the funds' rate of return).

200. *See* John K. Paglia & Maretno A. Harjoto, *The Effects of Private Equity and Venture Capital on Sales and Employment Growth in Small and Medium-Sized Businesses*, 47 J. BANKING & FIN. 177, 189 (2014) (finding that small and mid-sized minority-owned businesses were less likely to receive private equity (-21.7%) and venture capital (-22.2%) funding); ICIC REPORT, *supra* note 8, at 8 ("[W]hile a similar share of minority- and nonminority-owned businesses tried to raise capital, only half of the minority-owned businesses that tried to raise equity were successful, compared to 84 percent of nonminority-owned businesses.").

led by African Americans.[201] Remarkably, these racial disparities do not reflect the profitability of venture capital funds that specialize in minority-owned businesses,[202] which earn returns that are at least as large as those offered by mainstream funds.[203] The undeniable reality, however, is that few private equity funds target minority-owned businesses.[204] Even venture capitalists now acknowledge their failures to fund non-white enterprises and the resulting lack of diversity in their portfolio companies.[205]

Multiple factors explain why minority businesses are underserved by private equity. Minority businesses tend to be located in inner cities,

---

201. *See* Mark Stricherz, *Obama Administration Shifts Emphasis on Crowdfunding*, CQ ROLL CALL (Aug. 3, 2016) ("[O]nly 3 percent of America's venture capital-backed startups are led by women, and even fewer are led by African-Americans and Latinos . . . ."); Press Release, The White House, Office of the Press Secretary, Fact Sheet: President Obama Announces New Commitments from Investors, Companies, Universities, and Cities to Advance Inclusive Entrepreneurship at First-Ever White House Demo Day (Aug. 4, 2015), https://obamawhitehouse.archives.gov/the-press-office/2015/08/04/fact-sheet-president-obama-announces-new-commitments-investors-companies [https://perma.cc/4QD8-GF7L] (noting that "only around one percent [of venture-capital-backed startups] are led by African-Americans"); Applewhite, *supra* note 104 ("Less than 1% of American venture capital-backed founders are black and the percentage of Black's [sic] in decision making roles within Venture Capital isn't much better.").

202. The MESBIC program (the predecessor of the SSBIC) gave birth to a small minority-focused venture capital industry. *See* Bates & Bradford, *supra* note 199, at 492.

203. *See* FAIRLIE & ROBB, *supra* note 11, at 20; Bates & Bradford, *supra* note 199, at 490 ("Overall, the measured investment returns generated by the minority-focused VC funds were broadly consistent with those of mainstream funds."); Timothy Bates, William Bradford & Julia Sass Rubin, *The Viability of the Minority-Oriented Venture-Capital Industry Under Alternative Financing Arrangements*, 20 ECON. DEV. Q. 178, 186–87 (2006) (finding that minority-focused venture capital funds had financial returns that were comparable to or better than those of conventional venture capital); Rubin, *supra* note 100, at 824–25 ("These funds' strong financial performance undermines the possibility that companies owned by entrepreneurs of color attract fewer venture capital investments because they do not represent a financially attractive investment opportunity.").

204. *See* FAIRLIE & ROBB, *supra* note 11, at 20; GLENN YAGO & AARON PANKRAT, MILKEN INST. & MINORITY BUS. DEV. AGENCY, THE MINORITY BUSINESS CHALLENGE: DEMOCRATIZING CAPITAL FOR EMERGING DOMESTIC MARKETS 15–17 (2000).

205. *See* Will Butler, *Will Addressing Silicon Valley's Race Problem*, NEW YORKER (Dec. 18, 2013), https://www.newyorker.com/business/currency/addressing-silicon-valleys-race-problem [https://perma.cc/42JM-3AB8]; Yuliya Chernova, *SoftBank, Andreessen Horowitz Set Up Funds to Back Diverse Founders*, WALL ST. J. (June 4, 2020, 3:14 PM), https://www.wsj.com/articles/softbank-andreessen-horowitz-set-up-funds-to-back-diverse-founders-11591298091 [https://perma.cc/UP5B-NYBE]; Priya Anand & Sarah McBride, *For Black CEOs in Silicon Valley, Humiliation Is a Part of Doing Business*, BLOOMBERG (June 16, 2020, 7:00 AM), https://www.bloomberg.com/news/articles/2020-06-16/black-lives-matter-highlights-adversity-facing-black-tech-ceos [https://perma.cc/XV35-MC3Q] (noting recent proposals by venture capital groups to help minority entrepreneurs, including more than $300 million in contributions to minority-owned businesses).

geographically removed from venture capital networks, which complicates relationship-driven screening and monitoring.[206] Moreover, the venture capital industry has traditionally focused on companies engaging in innovation or technology, not the types of activities generally pursued by minority entrepreneurs.[207]

A third explanation also fits within the framework developed in this Article. Private equity firms are not diverse themselves: racial disparities in venture capital financing mirror disparities in investors' demographics.[208] As a result, private equity investors—mostly white males—and minority-entrepreneurs belong to different social, cultural, and professional networks.[209] These demographic differences increase the costs for investors to collect the soft information needed to identify, assess, and monitor minority-owned businesses, leaving them in a position where implicit biases may influence their decision-making.[210] In sum, while investing in minority-owned businesses can be lucrative, success here

---

206. *See supra* notes 60–61, 196 and accompanying text; Rubin, *supra* note 100, at 823–24; MICHAEL S. BARR, THE HAMILTON PROJECT, MINORITY AND WOMEN ENTREPRENEURS: BUILDING CAPITAL, NETWORKS, AND SKILLS 5–6 (2015).

207. *See supra* note 59 and accompanying text; Pollman, *supra* note 83, at 166 ("Early-stage startups are highly entrepreneurial and focused on innovation and technology."); Gompers & Lerner, *supra* note 198, at 190 ("[Venture capitalists focus] on high-technology firms (e.g., communication, computers, electronics, biotechnology, and medical/health).").

208. *See* Thorne, *supra* note 29 (noting lack of diversity in the venture capital industry). A survey of venture capital investors found that "87 percent were Caucasian, nine percent were Asian, two percent were African American or Latino, and two percent were of mixed race." *See NVCA Forms Diversity Task Force to Foster Greater Inclusion Across the Innovation Ecosystem*, NAT'L VENTURE CAP. ASS'N BLOG, https://nvca.org/pressreleases/nvca-forms-diversity-task-force-foster-greater-inclusion-across-innovation-ecosystem/ [https://perma.cc/R3PS-U9DT] (last visited Feb. 20, 2021). The low rate of minority-owned business making their pitch to angel investors also reflects the low proportion of minority individuals among angel investors. *See* JEFFREY SOHL, CTR. FOR VENTURE RSCH., THE ANGEL INVESTOR MARKET IN 2008: A DOWN YEAR IN INVESTMENT DOLLARS BUT NOT IN DEALS, https://scholars.unh.edu/cgi/viewcontent.cgi?article=1006&context=cvr [https://perma.cc/JYH7-7F6B] (noting that 3.6% of angel investors were minorities and that 3.7% of businesses pitching their business ideas to angel investors were minority-owned); Stricherz, *supra* note 201.

209. *See supra* notes 99–102 and accompanying text.

210. *See* Barr, *supra* note 206, at 15–16 ("One likely reason that minorities are disproportionately underserved by institutional sources of venture capital may be an information failure that results from a lack of common networks."); Rubin, *supra* note 100, at 824–25 ("Leaving aside possible discrimination, the most likely reason that minority and female entrepreneurs are disproportionately underserved by the venture capital industry is the information failure that results from a lack of common networks . . . ."). *See also supra* notes 103–104 and accompanying text. Notably, a piece of advice often given to black entrepreneurs, hiring a white wing-man, is a strategy that addresses this informational problem. *See* Anand & McBride, *supra* note 205.

requires specialized knowledge and unconventional research, placing most private capital funds at a competitive disadvantage because of their location, industry focus, and demographic makeup.[211]

Small businesses that struggle to access outside equity are invariably placed in a situation where they either do not have enough external financing or must rely on excessive and expensive leverage that can put the operational and financial health of the business at risk.[212] In recent years, technological and regulatory developments have spurred new financing channels that seek to remedy some of the difficulties faced by small businesses in raising equity capital and less-expensive debt capital.[213] A common strategy is to minimize frictions by reducing the role of financial intermediaries that stand between the ultimate suppliers of capital and issuers.[214] The rise of the internet has led to the development of online platforms that allow entrepreneurs to connect directly with both debt and equity investors, bypassing these financial intermediaries.[215] For many, this made crowdfunding and other financial technology (FinTech) developments, such as online lending platforms, promising game-changers.[216]

---

211. *See* FAIRLIE & ROBB, *supra* note 11, at 6, 19–20, 22. Anecdotal evidence indicates that funds focused on minority-owned businesses use unconventional, relationship-based networks to identify investment opportunities. *See* Timothy Bates & William Bradford, *Traits and Performance of the Minority Venture Capital Industry*, 613 ANNALS AM. ACAD. POL. & SOC. SCI. 95, 106 (2007); Rubin, *supra* note 100, at 825.

212. Susan Coleman & Richard Cohn, *Small Firms' Use of Financial Leverage: Evidence from the 1993 National Survey of Small Business Finances*, 12 J. BUS. & ENTRPENEURSHIP 81, 83–84 (2000) (noting that small firms generally cannot access equity capital and thus may overrely on debt which, can make them "susceptible to the problems of financial distress and failure").

213. *See* Joern H. Block, Massimo G. Colombo, Douglas J. Cumming & Silvio Vismara, *New Players in Entrepreneurial Finance and Why They Are There*, 50 SMALL BUS. ECON. 239, 240 (2018) ("These new players and instruments have emerged, among others, because of the difficulties faced by entrepreneurs and early-stage new ventures in raising funds . . . .").

214. *See id.* at 247 ("[T]he value of intermediation is now questioned as innovations allow to by-pass intermediaries so that the participants at the end of the supply and demand chain (i.e., savers/investors and borrowers/fund raisers) meet directly.").

215. *See id.* ("[T]he development of online platforms has created new opportunities for entrepreneurs to raise seed capital and for non-professional investors to disintermediate their investments. By easing the manner in which demand for capital meets supply, recent financial innovations are expected to improve the efficiency of financial markets.").

216. Online lending platforms have recently become a source of debt financing for small business, particularly minority-owned, that have been underserved by traditional banking. *See* Usman Ahmed, Thorsten Beck, Christine McDaniel & Simon Schropp, *Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises*, 10 INNOVATIONS 34, 35–36 (2016). A number of reasons may be driving this trend. Online platforms might use decision-making algorithms that consider hard, verifiable information in a more objective manner than a loan officer does (though

2. CROWDFUNDING

Crowdfunding initially developed to support ventures by facilitating donations or product prepurchases.[217] The revolutionary feature of crowdfunding was empowering individuals to "directly" interact with members of the public via online platforms in order to raise funds, cutting out middlemen.[218] Early funding platforms followed the reward and prepurchase models, where "investors" willing to fund a particular project would receive a copy of the product being created or a "reward" related to the funded project.[219] Crowdfunding soon emerged as an alternative vehicle to raise relatively small amounts of capital from retail investors.[220] Early microfinance portals allowed investors to lend money to microentrepreneurs for return of principal and nominal interest.[221] The application of federal securities laws, however, limited the development

---

attenuated biases do still remain). *See* Robert Bartlett, Adair Morse, Richard Stanton & Nancy Wallace, *Consumer-Lending Discrimination in the FinTech Era* at 6–7 (Nov. 2019), https://faculty.haas.berkeley.edu/morse/research/papers/discrim.pdf [https://perma.cc/3A9C-62BN]. Various online lending platforms are marketed towards underserved populations. *See* Mark Schweitzer & Brett Barkley, *Is "Fintech" Good for Small Business Borrowers? Impacts on Firm Growth and Customer Satisfaction* 11 (Fed. Rsrv. Bank of Cleveland, Working Paper No. 17-01, 2017). Though promising, the effectiveness of such platforms in bridging disparities is an open question. First, these platforms focus only on debt (not on equity or hybrid instruments) and are not tailored to gather and assess soft information problems and provide advice to the business they invest in. *See* Block, Colombo, Cumming & Vismara, *supra* note 213, at 241–42, 246–47. The terms of these loans are also far from ideal. *See* Brett Barkley & Mark E. Schweitzer, *The Rise of Fintech Lending to Small Businesses: Businesses' Perspectives on Borrowing* 18 (Fed. Rsrv. Bank of Cleveland, Working Paper No. 20-11, 2020). The size of loans disbursed by online lenders are smaller than those of traditional lenders. *Id.* at 18. Moreover, the unregulated nature of these markets subjects borrowers to potential abuses, including worse terms and higher interest rates than traditional banking. *See* Lenore Palladino, *Another Risk for Small Business: Lightly Regulated Fintech Loans*, BARRONS (April 21, 2020), https://www.barrons.com/articles/small-businesses-risk-predatory-loans-to-survive-51587492858 [https://perma.cc/R4F2-HRZJ]; Lenore Palladino, *Small Business Fintech Lending: The Need for Comprehensive Regulation*, 24 FORDHAM J. CORP. & FIN. L. 77, 78–79 (2018).

217. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 10–11 (2012); John S. Wroldsen, *The Crowdfund Act's Strange Bedfellows: Democracy and Start-Up Company Investing*, 62 U. KAN. L. REV. 357, 359 (2013).

218. *See* Bradford, *supra* note 217, at 10; Kelly Mathews, *Crowdfunding, Everyone's Doing It: Why and How North Carolina Should Too*, 94 N.C. L. REV. 276, 299–300 (2015).

219. *See* Bradford, *supra* note 217, at 16–17.

220. Linday Sherwood Fouse, *The Crowdfunding Act: A New Frontier*, 16 DUQ.BUS. L.J. 21, 39 (2013) (noting crowdfunding's potential to provide capital to early-stage businesses).

221. *See id.* at 25–26.

of crowdfunding as a vehicle for more sophisticated debt instruments and equity investments.[222]

a. The Evolution of Crowdfunding

A business offering or selling securities must prepare a set of disclosure documents, including a registration statement (filed with the Securities and Exchange Commission, or SEC) and a prospectus to be distributed to investors.[223] In addition, a set of "gun jumping" rules regulate the timing, manner, and form of communications made during the offering process.[224] Preparing the required disclosure documents and complying with the gun jumping rules is time consuming and costly.[225] The significant fixed component of these compliance costs disproportionately affects smaller businesses.[226]

To avoid these costs, issuers conduct exempt offerings.[227] One of the most commonly used exemptions is Rule 506,[228] under which an issuer may offer and sell, without registration, an unlimited aggregate principal amount of securities to any number of "accredited investors" so long as certain other conditions are met.[229] However, the numerous conditions of Rule 506 limit the usefulness of this exemption for small businesses,

222. *See* Bradford, *supra* note 217, at 29–31.

223. THOMAS LEE HAZEN, FEDERAL SECURITIES LAW 2–3 (3d ed. 2011). The broad manner in which terms like "offer," "sale," and "securities" are generally construed makes the provisions of Securities Act of 1933 (Securities Act) far reaching. *See* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 907 (2011) (noting broad sweep of Section 5 of the Securities Act).

224. *See* Carlos Berdejó, *Going Public After the JOBS Act*, 76 OHIO. ST. L.J. 1, 9–10 (2016). Non-compliance with any of the requirements contained in the rules can result in substantial liability for the issuer. *Id.* at 10.

225. *Id.* at 10.

226. *See* B. Espen Eckbo, Ronald W. Masulis & Øyvind Norli, *Security Offerings*, *in* HANDBOOK OF CORPORATE FINANCE 233, 262–65 (2007) (citing studies finding that flotation costs as a percent of gross proceeds were fall with a rise in issue size); *Informal Guide for Small Entities*, 62 Fed. Reg. 15,604, 15,605 (Apr. 2, 1997) (describing the SEC's historical formal and informal efforts on behalf of small entities).

227. *See* Berdejó, *supra* note 224, at 20. The primary statutory exemption for private placements is Section 4(a)(2) of the Securities Act, which exempts "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(a)(2). Since the statute does not define "public offering," *see* 15 U.S.C. § 77b, the SEC promulgated Regulation D to provide clarity and predictability in the use of this exemption. *See* Heminway & Hoffman, *supra* note 223, at 915–18 (highlighting clarifying purpose of Regulation D).

228. *See* Berdejó, *supra* note 224, at 28.

229. 17 C.F.R. § 230.506(b)(2)(ii) (2020). The term "accredited investor" includes institutional investors such as banks, insurance companies, registered investment companies, and SBICs, as well as individuals with a net worth over $1 million or annual income over $200,000. §§ 230.501(a)(1)–(6).

especially those owned by minorities.[230] Exempt offerings generally involve accredited investors exclusively, and an entrepreneur who does not know or have ready access to these accredited investors will have a difficult time conducting a successful exempt offering.[231]

The costs and difficulties faced by small businesses and minority-owned businesses in tapping accredited investors, who generally belong to a different social and professional network, made crowdfunding a revolutionary and exciting financing vehicle.[232] As part of its efforts to facilitate capital raising by small issuers, the JOBS Act of 2012 created a new exemption under the Securities Act for capital raised through "crowdfunding," enabling the use of the internet to pool small individual investments.[233] These offerings are open to a wide variety of investors, not just accredited ones.[234] The exemption's set of relaxed requirements not only expands the pool of investors that small businesses can tap but also reduces the costs of raising capital by providing for scaled disclosure requirements, which vary according to the aggregate offering amount.[235]

---

230. *See* § 230.506(b) (requiring businesses to meet all terms and conditions of §§ 230.501–502, not exceed the purchaser limit, and ensure purchasers have the requisite level of sophistication).

231. Reaching out to investors to attract their attention is not easy given that issuers cannot use "any form of general solicitation or general advertising" as part of an offering involving any non-accredited investors. § 230.502(c). This prohibits the use of advertising, newspaper or magazine articles, Internet websites, media broadcasts, email campaigns, and public meetings to promote an offering. *See* Berdejó, *supra* note 224, at 28–29.

232. *See* David Mashburn, *The Anti-Crowd Pleaser: Fixing the Crowdfund Act's Hidden Risks and Inadequate Remedies*, 63 EMORY L.J. 127, 132, 136 (2013); Wroldsen, *supra* note 217, at 359–62.

233. JOBS Act, Pub. L. No. 112-106, § 201, 126 Stat. 306, 313–14 (2012). The SEC adopted the final rules on October 30, 2015. *See SEC Adopts Rules to Permit Crowdfunding* (Oct. 30, 2015), https://www.sec.gov/news/pressrelease/2015-249.html [https://perma.cc/879X-SKCS]. For a description of the adopted rules see *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, (May 13, 2016), https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm [https://perma.cc/M6X7-WHN5]. The exemption currently allows issuers to raise up to $1.07 million from investors in a twelve-month period. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 85 Fed. Reg. 17,956, 17,992 (proposed Mar. 31, 2020) (to be codified at 17 CFR Parts 227, 229, 230, 239, 249, 270, and 274) [hereinafter SEC Proposed CF Amendments]. The regulations restrict securities offerings to registered funding portals, which must meet various requirements, including the dissemination of mandated disclosures. *See* Wroldsen, *supra* note 217, at 367.

234. Sherwood Fouse, *supra* note 220, at 32. The Act limits the amount individuals may invest in crowdfunded offerings. These yearly limits are based on an investor's income or net worth and range from $2,000 to $100,000. 15 U.S.C. § 77d(a)(6).

235. *See* Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 U. ILL. L. REV. 217, 248, 261; Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1467 (2013); Sherwood Fouse, *supra* note 220,

b. The Promise and Shortcomings of Crowdfunding

The Obama Administration promoted the JOBS Act as a tool to improve access to capital for minority- and women-owned businesses,[236] touting the important role of crowdfunding in "empower[ing] diverse entrepreneurs to launch successful businesses after traditional sources of capital turned them down."[237] The Administration's optimism reflected the idea that crowdfunding could provide an avenue for the democratization of capital markets for small businesses, particularly minority-owned ones.[238] Many hoped that providing minority-owned businesses with direct access to individuals eager to invest in them would level the playing field.[239]

---

at 33–34. Limited periodic disclosures to investors are required after the offering. *See* Wroldsen, *supra* note 217, at 372.

236. THE AMERICAN JOBS ACT: IMPACT FOR AFRICAN AMERICAN FAMILIES AND THE ECONOMY 2 (2011), https://obamawhitehouse.archives.gov/sites/default/files/image/af-am_sheet_9-8_final_version.pdf [https://perma.cc/HN3T-R8PY]; THE AMERICAN JOBS ACT: IMPACT FOR WOMEN AND THE ECONOMY 2 (2011), https://obamawhitehouse.archives.gov/sites/default/files/women_factsheet_jobs.pdf [https://perma.cc/J87Q-DSKY].

237. *See* Thomas Kalil & Doug Rand, *The Promise of Crowdfunding and American Innovation* (June 8, 2016), https://obamawhitehouse.archives.gov/blog/2016/06/08/promise-crowdfunding-and-american-innovation [https://perma.cc/9NDY-LST9]; Stricherz, *supra* note 201 (analyzing blog posts by the Obama Administration suggesting that crowdfunding under the JOBS Act was intended to help minority businesses).

238. *See* Andrew A. Schwartz, *The Digital Shareholder*, 100 MINN. L. REV. 609, 624 (2015); Jason Greenberg & Ethan R. Mollick, *Activist Choice Homophily and the Crowdfunding of Female Founders*, 62 ADMIN. SCI. Q. 341, 343–45 (2017); Alma Pekmezovic & Gordon Walker, *The Global Significance of Crowdfunding: Solving the SME Funding Problem and Democratizing Access to Capital*, 7 WM. & MARY BUS. L. REV. 347, 364–65 (2016); Editorial Board, *Equity Crowdfunding and the Rights of Man*, CSQ MAG. (Dec. 2015), https://csq.com/2015/12/equity-crowdfunding-and-the-rights-of-man [https://perma.cc/8UPY-75P7] ("By opening the opportunity to invest in private company equity to everyone, and broadening access to capital typically denied to companies outside traditional financial sectors, we should expect an influx of female and minority entrepreneurs, investors, and executives.").

239. *See* William Michael Cunningham, *Crowdfunding Can Provide New Financing Option for Minority Firms*, WASH. POST. (June 3, 2012), https://www.washingtonpost.com/business/capitalbusiness/commentary-crowdfunding-can-provide-new-financing-option-for-minority-firms/2012/06/01/gJQAThq7BV_story.html [https://perma.cc/KT8V-Q9Q2]; Anita Li, *The Black Entrepeneur Trying to End Startup Racism Is Almost Out of Cash*, Mashable (July 21, 2014), https://mashable.com/2014/07/21/startup-racism [https://perma.cc/KUL5-ZKRW]; Zach Komes, *How New Equity Crowdfunding Rules Will Benefit Black Entrepreneurs*, FAST COMPANY (Dec. 8, 2015), https://www.fastcompany.com/3054276/how-equity-crowdfunding-empowers-black-entrepreneurs [https://perma.cc/2PQ2-YNLR] ("Equity crowdfunding is emerging as a way to increase capital access to the black-owned businesses that need it most.");

A recent SEC report found that the number of crowdfunding offerings and the total amount of funding has been "relatively modest."[240] Market participants have made a number of proposals to revitalize crowdfunding, including increasing the amount a company can raise during a 12-month period,[241] increasing individual investors' investment limits,[242] and reducing the reporting and disclosure obligations that, as is, are too burdensome and costly for many of the small issuers that rely on the rule.[243] The SEC has recently proposed a series of revisions to the existing rules to address many of these concerns.[244]

Participation rates among traditionally underrepresented businesses have been discouragingly low during the early years of equity crowdfunding.[245] Although some minority entrepreneurs have successfully employed crowdfunding to raise capital for their

Project Entrepreneur, *This Latina Founder Is Empowering the Next Latinx Generation of Innovators to Break Barriers*, INC. (Dec. 22, 2017), https://www.inc.com/project-entrepreneur/this-latina-founder-is-empowering-next-latinx-generation-of-innovators-to-break-barriers.html [https://perma.cc/R6M6-EB65] ("[Regulation Crowdfunding] represents a huge opportunity for women and minorities founders to access seed capital.").

240. U.S. SEC. & EXCH. COMM'N, REPORT TO THE COMMISSION ON REGULATION CROWDFUNDING 4 (June 18, 2019), https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf [https://perma.cc/P267-N38C] [hereinafter SEC CF Report].

241. *See* LINDSAY M. ABATE, U.S. SMALL BUS. ADMIN., OFF. OF ADVOCACY, ONE YEAR OF EQUITY CROWDFUNDING: INITIAL MARKET DEVELOPMENTS AND TRENDS 8, 13 (2018), https://www.sba.gov/sites/default/files/advocacy/Crowdfunding_Issue_Brief_2018.pdf [https://perma.cc/3SA7-Y95K] [hereinafter SBA Study]; *Policy Position Paper*, ASS'N OF ONLINE INV. PLATFORMS (June 18, 2019), https://www.aoiplatforms.org/official-positions [https://perma.cc/R9MX-7NW6], [hereinafter AOIP Paper] ("The current $1.07 million cap is arbitrary and creates a negative selection bias for companie—as quality companies requiring larger amounts of capital are discouraged from utilizing Reg CF."); SEC CF Report, *supra* note 240, at 37 (citing one platform as stating that "while few offerings reach the current limit, many issuers choose not to rely on the crowdfunding exemption because the limit is too low"). Proposals recommend limits ranging from $5 to $20 million, more in line with average early-stage funding of starts-ups. *Id.* (citing recommended limits ranging from $5 million to $20 million); AOIP Paper, *supra*, at 1 (recommending limit be increased to $10 million while noting that the "average early-stage funding round is . . . $7 million").

242. *See* AOIP Paper, *supra* note 241, at 2.

243. *See id.* at 3; SEC CF Report, *supra* note 240, at 24 (noting that the most costly portion of a crowdfunding campaign relates to disclosure). Other costs include the creation of a campaign page and other marketing expenses. *See id.* at 23 ("[T]he total cost of creating a campaign page, issuer disclosures, film, and video, and hiring a marketing firm, a lawyer, and an accountant amounts to approximately 5.3% of the amount raised.").

244. *See* SEC Proposed CF Amendments, *supra* note 233, at 17,994 (proposing to increase the crowdfunding ceiling from $1.07 to $5 million and placing no limits on how much accredited investors invest in crowdfunded offerings).

245. *See* SBA Study, *supra* note 241, at 13 (noting that businesses in areas not already considered technology and finance hubs have struggled).

businesses,[246] the existing evidence suggests that crowdfunding has not been effective in reducing disparities in access to capital between minority and non-minority entrepreneurs.[247] The prevalence of racial disparities in the crowdfunding space is consistent with discrimination in other FinTech markets, like online lending platforms, that have otherwise facilitated borrowings by small businesses.[248]

What can explain the underwhelming performance of these promising game-changers? A recent study of crowdfunded equity offerings found that, even when minority entrepreneurs attract a higher number of investors, they are no more likely to secure their target funding.[249] That is, minority entrepreneurs tend to attract "small investors" (who follow a "community logic") rather than "professional investors" (who follow a "market logic") and, as a result, raise less capital than their non-minority counterparts.[250] Why are "professional investors" who follow a "market logic" hesitant to invest in minority businesses?[251]

---

246. *See, e.g.*, Brandon Andrews, *The Best New Way for African Americans to Invest In or Start a Business: Equity Crowdfunding*, BLACK ENTER. (Feb. 8, 2018), https://www.blackenterprise.com/equity-crowdfunding-black-investors-entrepreneurs/ [https://perma.cc/YJQ3-UVYG] (providing examples of minority founders who have been successful in equity crowdfunding). Some of these success stories were publicized by the Obama administration as it promoted the JOBS Act. For example, the White House honored a minority female who was able to open a bookstore with the help of crowdfunding after banks had declined her loan applications. *See* Aurora Anaya Cerda, *More than a Bookstore* (June 6, 2013, 4:22 PM), https://obamawhitehouse.archives.gov/blog/2013/06/06/more-bookstore [https://perma.cc/539B-QS4Q]. For other similar examples, see Emily Nunez, *Taking 'Made in the USA' to the Next Level* (June 6, 2013, 4:36 PM), https://obamawhitehouse.archives.gov/blog/2013/06/06/taking-made-usa-next-level [https://perma.cc/K8MG-7Y9K]; Kalil & Rand, *supra* note 237.

247. *See* Peter Younkin & Venkat Kuppuswamy, *The Colorblind Crowd? Founder Race and Performance in Crowdfunding*, 64 MGMT. SCI. 3269, 3276–77 (2018) (finding that funders remain biased against African-American founders due to an unconscious prejudice); Lauren Rhue & Jessica Clark, *The Consequences of Authenticity: Quantifying Racial Signals and Their Effects on Crowdfunding Success* 6–7 (July 23, 2018), https://ssrn.com/abstract=2837042 [https://perma.cc/6DY2-A2T4] (finding that "race is relevant to crowdfunding outcomes").

248. *See* Ahmed, Beck, McDaniel & Schropp, *supra* note 216, at 42; Lauren Rhue, *Crowd-Based Markets: Technical Progress, Civil and Social Regression*, *in* RACE IN THE MARKETPLACE 193, 199 (Guillaume D. Johnson, Kevin D. Thomas, Anthony Kwame Harrison & Sonya A. Grier eds., 2019); Devin G. Pope & Justin R. Sydnor, *What's in a Picture? Evidence of Discrimination from Prosper.com*, 46 J. HUM. RES. 53, 53–55 (2011) (analyzing activity in a peer-to-peer loan platform and finding that loans with African Americans are less likely to receive funding).

249. *See* Douglas J. Cumming, Michele Meoli & Silvio Wismara, *Does Equity Crowdfunding Democratize Entrepreneurial Finance?*, SMALL BUS. ECON. (2019), https://link.springer.com/article/10.1007/s11187-019-00188-z [https://perma.cc/2RFB-BFC7].

250. *See* Cumming, Meoli & Vismara, *supra* note 249, at 16.

251. *See generally* Rhue, *supra* note 248, at 198–99.

One leading theory is that implicit biases drive investors in the crowdfunding markets away from minority-owned businesses.[252] This should not be surprising. Investing in small, minority-owned businesses requires the collection and analysis of soft information, and the collecting and analyzing of such information is not cost-effective for individual retail investors involved in crowdfunding. These unresolved informational asymmetries place these investors in a position where they can ultimately be influenced by their implicit biases, very much like banks and private equity investors so often are.[253]

Some have argued that concealing the race of the entrepreneur is the most effective way to address investor biases and even the playing field.[254] Other arguments acknowledge the role of implicit biases but suggest that alternative strategies, such as project promotion, are just as effective in addressing informational issues.[255] Allowing promising projects to differentiate themselves from the "crowd" (i.e., allowing them to credibly signal their quality) could help minority entrepreneurs with good ideas raise capital and grow, which in turn may enhance the social perception of minority business.[256] Differentiation can be a particularly powerful tool if minority businesses are (or are perceived to be) on average less profitable or present less opportunity for growth than non-minority businesses.[257]

252. *See* Rhue & Clark, *supra* note 247, at 2, 7, 11, 23 (finding that Black founders who conceal their race in their fundraiser photos perform better than campaigns where Black founders have Black fundraiser pictures); Younkin & Kuppuswamy, *supra* note 247, at 3274 (noting that in a setting where entrepreneurs can provide a picture, "projects from black founders continue to underperform projects from non-black founders and those without a founder picture").

253. *See supra* notes 103–105 and accompanying text.

254. *See* Younkin & Kuppuswamy, *supra* note 247, at 3286. The nature of crowdfunding platforms make it possible to conceal an entrepreneur's race by not showing a picture of the entrepreneur or disclosing his or her race. *See id.* at 3283, 3286 (concluding that Black founders may improve their chances of success in raising money through crowdfunding by choosing a profile picture with race obscured or with a company logo). Similar concealment tactics are employed by female entrepreneurs to overcome gender biases. *See* Edwards & McGinley, *supra* note 104, at 1877, 1879 (describing techniques used by women in technology "to pass for an idealized masculine identity or to cover their otherwise stigmatized identities . . . for the purpose of accessing social and economic resources").

255. Younkin & Kuppuswamy, *supra* note 247, at 3270. Project promotion may be more effective because it can be extremely difficult, if not almost impossible, to effectively conceal race since campaigns contain multiple racial signals, ranging from the entrepreneur's name to project description. *See* Rhue & Clark, *supra* note 247, at 8, 13. Moreover, in a space where "authenticity leads to success," anonymous campaigns could still face an uphill battle to be successful in attracting support. *See id.* at 2, 11.

256. *See* Younkin & Kuppuswamy, *supra* note 247, at 3270, 3285–86.

257. *See id.* at 3270–71, 3285–86.

III. Designing an Alternative Approach

A program that seeks to facilitate minority entrepreneurs' access to capital must address the shortcomings of the initiatives discussed in Part II. First, it must enable the use of equity and hybrid securities to accommodate the operational needs of small businesses while alleviating informational asymmetry issues.[258] Second, it must facilitate the production and analysis of soft information in a cost-effective manner by minimizing the level of hierarchies in decision-making.[259] Third, it must present this soft information to potential investors in a credible manner to allow for differentiation.[260] Fourth, it must provide an active role for investors in advising and counseling entrepreneurs on an ongoing basis.[261] Fifth, it must be inclusive, enabling the participation of retail investors to further democratize the capital markets and provide a channel for grassroots efforts to address economic racial disparities.[262]

Existing government programs have failed because of their reliance on debt as a financing mechanism and on large, hierarchical institutions that are ill-suited to navigate a niche imbued with soft information to act as gatekeepers.[263] Crowdfunding's disintermediation strategy has failed because well-intentioned investors seeking a financial return are unable to overcome informational asymmetries on an individual basis and fall prey to their own implicit biases.[264] Although private equity's organizational structure and investment strategy appear to be ideally suited for this task, the lack of diversity in its management ranks has rendered these tools ineffective in addressing the financing needs of minority-owned businesses.[265] As leaders in the industry come to recognize the racial disparities in their portfolio companies and the need for change, we must figure out how to increase private equity participation in minority-owned businesses.[266]

---

258. *See supra* notes 188–212 and accompanying text.
259. *See supra* notes 93–100 and accompanying text.
260. *See supra* notes 255–257 and accompanying text.
261. *See supra* note 199 and accompanying text.
262. *See supra* notes 236–239 and accompanying text.
263. *See supra* notes 127–133, 172–184 and accompanying text.
264. *See supra* notes 251–257 and accompanying text.
265. *See supra* notes 103–104, 208–211 and accompanying text.
266. *See* James Thorne, *Funds, Recruiting and Support: VCs Address Diversity and Inequality*, PITCHBOOK (June 8, 2020), https://pitchbook.com/news/articles/vcs-address-diversity-institutional-bias?sourceType=NEWSLETTER [https://perma.cc/6797-XF9L] ("Against a backdrop of widespread protests over the killings of black Americans, the venture capital industry has been forced to reckon with its own staggering lack of diversity.").

One possibility is to mandate such investments via regulatory mechanisms such as the Community Reinvestment Act.[267] A similar possibility is to require that private equity funds increase the racial, industrial, and geographical diversity of their management ranks so that they are better positioned to successfully invest in minority-owned businesses.[268] Coercive solutions like these, however, are unlikely to address the underlying structural problems and be sustainable in the long run. A wiser approach is to recruit private equity, not just as part of the solution, but as a partner in developing it alongside the government and members of the community. This can be achieved by channeling government and community efforts to provide actors in the private equity space the incentives to start investing in minority-owned businesses and retaining managers that are members of minority groups who can more effectively screen and monitor these investment opportunities. This sort of organic solution is more likely to motivate a positive feedback process, promote diversity within private equity ranks, and lead to the development of a self-sustaining industry, in a way much like how the early SBIC program gave birth to the venture capital industry.[269]

The first section of this Part outlines the basic structure for such a program using existing and past government initiatives as building blocks. The second discusses how to overcome some of the legal and policy hurdles that might hinder its successful implementation. The last discusses fiscal strategies to help capitalize the program and spread the risks involved to facilitate private equity's entry into this market.

A. Local Impact Small Business Investment Companies

The existing regulatory and market framework governing SBICs can provide the building blocks from which to design a new program. To facilitate our discussion, let us label a new type of SBIC, the "Local Impact Small Investment Company" (LISBIC). LISBICs will match investors (institutional and retail) seeking to finance minority-owned businesses with those businesses by raising capital from those investors through the issuance of LISBIC equity securities and then pool that capital to invest in minority-owned businesses.[270] Properly vested with decision-making authority in a flat hierarchical structure, the LISBIC manager would be in a good position to collect soft information about potential investment

267. *See* Rubin, *supra* note 100, at 829 ("The federal government also can increase private sources of subsidy by strengthening the [Community Reinvestment Act] and expanding its reach to more types of financial institutions.").

268. *See supra* notes 208–211 and accompanying text.

269. *See supra* notes 167–168 and accompanying text.

270. *See supra* note 262 and accompanying text.

opportunities and credibly signal this information to investors by its willingness to absorb some of the risks involved.[271] The LISBIC manager would be able to negotiate terms with the issuer on behalf of all investors and structure these transactions by employing equity or hybrid securities.[272] Post investment, the LISBIC can mentor the company on an ongoing basis and periodically decide whether additional amounts should be invested, subject to any regulatory ceilings.[273]

The underwhelming history of Minority Enterprise SBICs (MESBICs) (and their successors, SSBICs) provide a cautionary tale of what happens when funds are unable to raise enough capital to cover operating costs and achieve a minimum size to diversify their portfolio and engage professional managers with the requisite expertise.[274] Minority-business focused venture capital funds provide us a sense of the required scale: their median capitalization is about $30 million,[275] and their preferred investment begins at the $1 million range.[276] LISBICs could initially tap three sources to obtain this level of required capital.

The first group would be institutional investors like pension funds, banks, and insurance companies that already provide the largest contributions to venture capital funds targeting minority-owned businesses.[277] Recruiting pension funds should not be complicated, as investing in minority-owned businesses fits their political strategy.[278] For banks, investing in a fund licensed as an SBIC is even more attractive as

271. *See supra* notes 259–260 and accompanying text. Requiring that LISBICs invest in local companies (i.e., located near the manager and investors) could facilitate achieving these objectives.

272. *See supra* note 258 and accompanying text; SEC CF Report, *supra* note 240, at 58.

273. *See supra* note 261 and accompanying text; SEC CF Report, *supra* note 240, at 58.

274. *See* Bates, *supra* note 61, at 354.

275. *See* Bates & Bradford, *supra* note 199, at 490 ("The minority-oriented funds are typically small relative to the VC industry mainstream, starting out with a median capitalization of under $30 million."). *See also* Bates, *supra* note 61, at 354 ("Small-business investment companies typically benefit from operational scale economies if they have at least $20 million in assets.").

276. *See* Bates & Bradford, *supra* note 199, at 499 ("Managers of the minority-oriented VC funds indicate that their preferred investment size is the $1 million to $2 million range, considerably more than the $747,517 mean . . . .").

277. *See id.* at 492 ("The funds responding to our survey raised over $2.1 billion from institutional investors, the largest of which were public pension funds, commercial banks, and insurance companies.").

278. *See id.* ("State pension funds that invest in minority VCs have high proportions of minority residents in their respective states: MBE-targeted in vesting is politically popular.").

it provides a number of regulatory advantages over other investments.[279] To maintain the right perspective among the LISBIC investor base, LISBICs should raise a share of their capital from non-institutional investors in crowdfunding-style offerings. Including retail investors would help deliver crowdfunding's promise of democratizating capital; provide an additional avenue for investors following a "community logic" to effectively support businesses they care about; and help ensure that LISBICs are managed in a manner that promotes social change.[280] The presence of a manager screening and monitoring portfolio companies would attract those retail investors who follow a "market logic" and who have so far been hesitant to support minority-owned businesses in crowdfunding offerings.[281] Finally, the government could provide financial support to LISBICs directly via leverage (as it does with SBICs) or indirectly via tax exemptions.[282]

B. Implementation of the LISBIC program

Organizing and operating a LISBIC in the manner envisioned above raises a number of legal questions. Facilitating access to capital is key, but the application of the Securities Act might increase the costs LISBICs face in raising capital. Registration and reporting obligations under the Investment Company Act of 1940 (ICA) could also increase the costs of organizing and operating a LISBIC.[283] Protecting small, retail investors who are entrusting the LISBIC manager with their money and ensuring

279. For example, through their SBIC investments, banks may own indirectly more than 5% of the voting stock of a small business and bypass general prohibitions from owning interest in or sponsoring a private equity fund. *Compare* 12 C.F.R. § 225.22(d)(5) (2020) (stating that acquisitions of less than 5% do not require Board approval), *and* 12 U.S.C. § 1843(c)(6) (stating that an ownership share of less than 5% is exempt from the prohibition on owning or controlling an entity that is not a bank), *with* 12 C.F.R § 225.11(b) (2020) (stating that a bank may acquire ownership or control of an SBIC subject to some limits). Additionally, banks receive Community Reinvestment Act credit for SBIC investments since these are presumed by regulatory agencies to be a "qualified investment" for such purposes. *See* OCC SBIC Report, *supra* note 135, at 4–5; SBIC Overview, *supra* 135, at 2. Participating in a LISBIC would also give banks the opportunity to establish relationships with companies that are not ready for "big bank debt" but that may be so in the future. *See* Stephen Newton, *Demystifying SBICs for Community Banks*, ABA BANKING J. (Oct. 9, 2017), https://bankingjournal.aba.com/2017/10/demystifying-sbics-for-community-banks/ [https://perma.cc/W9C8-6LZK]; Rubin, *supra* note 100, at 829.

280. *See supra* notes 236–238, 245–246 and accompanying text.

281. *See supra* notes 249–250 and accompanying text.

282. *See infra* Part III.C.

283. Investment Company Act of 1940, 15 U.S.C. §§ 80a-8, 80a-29, 80a-51.

that the LIBIC manager adheres to the investment objectives of the LISBIC is another consideration.[284] This section addresses these issues.

1. SECURITIES ACT CONSIDERATIONS

Relying on an intermediary introduces an additional securities transaction. First, the LISBIC must raise funds from the investors by issuing and selling security interests in the LISBIC. Once it has pooled such funds, the LISBIC would then invest in small businesses by purchasing securities issued by the latter. As those two sets of transactions are subject to the Securities Act, we need to find an exemption from registration that works for each.[285] Obtaining an exemption for the second transaction is straightforward. The availability of Regulation D to exempt the sale of securities by a small business to the LISBIC hinges on the LISBIC's status as an accredited investor, a term that explicitly includes licensed SBICs.[286] Raising money from investors poses a less trivial question. Looking at the exemptions relied upon by SBICs is not very helpful, as these entities raise money via Rule 506 of Regulation D, which would be unavailable for LISBICs raising money from non-accredited retail investors.[287] Two alternatives designed to accommodate financing small, retail investors are considered below.

a. Crowdfunding

Existing crowdfunding regulations prohibit entities that qualify as investment companies from relying on the crowdfunding exception.[288] As a result, a LISBIC would not be able to raise funds from non-accredited investors under the crowdfunding exemption if they qualified as investment companies. There are two ways of addressing this problem. First, LISBICs could be exempted from the definition of investment companies.[289] Another option is to amend the crowdfunding rules to allow

---

284. *See* SEC CF Report, *supra* note 240, at 58–59.

285. *See supra* notes 223–231 and accompanying text.

286. *See supra* notes 227–231 and accompanying text; 17 C.F.R. § 230.501(a) (2020).

287. *See Investment Company Registration and Regulation Package*, U.S. SEC. & EXCH. COMM'N (Dec. 21, 2014), https://www.sec.gov/investment/fast-answers/divisionsinvestmentinvcoreg121504htm.html [https://perma.cc/CDV3-GSFQ] [hereinafter SEC ICA FAQs]. The author also conducted his own analysis of SEC filings by SBICs listed in the SBA official directory.

288. *See* Securities Act of 1933 § 4A(f)(3), 15 U.S.C. § 77d-1(f)(3) (2018); 17 C.F.R. § 227.100(b)(3). *See also* Crowdfunding, 80 Fed. Reg. 71,397 (Nov. 16, 2015). For a discussion of the basic framework governing the crowdfunding exemption see *supra* notes 232–235 and accompanying text.

289. *See infra* Section III.B.2.

certain entities that would qualify as investment companies to instead rely on the crowdfunding exemption. In fact, various market participants and the SEC have already considered the possibility of amending the crowdfunding laws to allow certain special purpose vehicles organized to invest in a single company (which fall under the investment company exclusion) to be able to raise money using the crowdfunding exemption.[290] Those modifications to the crowdfunding rules, which the SEC has now proposed, provide a springboard to the requisite exemptive language for LISBICs.[291]

Additional changes to the rules would also be necessary. The aggregate amount that an entity can raise over the course of 12 months (currently $1.07 million) needs to be revised.[292] Raising this ceiling for individual issuers has been the subject of several proposals, and the SEC is considering raising it to $5 million.[293] Even then, a fund that intends to invest in several businesses would likely need a more generous limit. Strict disclosure requirements for small businesses would not be necessary as the LISBIC could negotiate what the reporting obligations are, allowing requirements to vary from company to company. A more challenging question relates to the disclosure requirements that should be imposed on the LISBICs to protect its investors. Disclosure requirements under securities laws would depend on the exemption that the LISBIC (as the issuer) and LISBIC investors rely upon.[294] Setting that consideration aside,

---

290. *See* SEC CF Report, *supra* note 240, at 57–58 (noting proposals that "recommended allowing the use of SPVs to promote simplification of the capitalization table by aggregating investors"); U.S. DEP'T. OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES CAPITAL MARKETS 41 (2017) (recommending "allowing single-purpose crowdfunding vehicles advised by a registered investment adviser"); U.S. SEC. & EXCH. COMM'N., 2015 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION FINAL REPORT 26–27 (2016) (recommending that the SEC permit investments by SPVs, including those that share an adviser, and determine that such SPVs are not "investment companies"). These proposals recommend the use of an SPV to address concerns that the large number of crowdfunding investors can become unmanageable and raise corporate governance and finance complications. *See* SEC CF Report, *supra* note 240, at 58; Nicholas Tommarello, *Until Congress Acts, Don't Invest in Startups to Make Money*, FORBES (July 22, 2016), https://fortune.com./2016/07/22/equity-crowdfunding/ [https://perma.cc/A4NN-P5JK].

291. *See* SEC Proposed CF Amendments, *supra* note 229, at 17,997 (proposing "a new exclusion under the Investment Company Act for limited-purpose vehicles ('crowdfunding vehicles') that function solely as conduits to invest in businesses raising capital through the vehicle under Regulation Crowdfunding").

292. *See id.* at 17,992.

293. *See supra* note 241–244 and accompanying text.

294. Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1767–78 (2011).

SBIC rules provide for certain reporting obligations that are applicable to licensed SBICs, as discussed below.[295]

b. Intra-State Crowdfunding

Localized investing—where a LISBIC raises funds from investors located in the same region the LISBIC is headquartered and then also invests in businesses located in that region—would help achieve several of the LISBIC objectives outlined earlier.[296] A LISBIC following this strategy could use the Rule 147A safe harbor, an issuing exemption that is loosely based on the intra-state exemption of Section 3(a)(11).[297] Under that rule, a LISBIC would be deemed a resident of the state where its principal place of business is located.[298] And as long as the issuer's employees are based in that state or territory, it would also be deemed to be doing business in that state.[299] Relying on that exemption, the LISBIC would then be able to sell securities without registration to investors whose principal residence is located in that same state.[300] However, since Rule 147A is not available to an investment company registered or required to be registered under the ICA,[301] the availability of this exemption would hinge on the treatment of the LISBIC under the ICA or an enabling modification to Rule 147A.[302]

2. INVESTMENT COMPANY ACT CONSIDERATIONS

The use of LISBICs would raise issues under the Investment Company Act of 1940[303] (ICA) and the Investment Advisors Act of 1940.[304] Investment companies are subject to a number of registration and

295. *See infra* notes 320–328 and accompanying text.

296. *See supra* notes 258–261 and accompanying text.

297. *Compare* 17 C.F.R. § 230.147A (2020), *with* Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2018) (Rule 147A imposing additional requirements for exemption).

298. § 230.147A(c)(1).

299. § 230.147A(c)(2)(iv).

300. § 230.147A(d)(2).

301. § 230.147A(a).

302. *See infra* Section III.B.2. Integration of a Rule 147A offering with a Rule 506 offering (targeted at institutional investors) that takes place more than six months after completion of the Rule 147A offering could raise additional issues. § 230.147A(g).

303. 15 U.S.C. §§ 80a-1–64.

304. Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1–80b-2. Under the Advisors Act persons who manage the portfolios of registered investment companies must register with the SEC. Section 202(a)(11) of the Advisers Act generally defines an "investment adviser" as any person or firm that for compensation is engaged in the business of providing advice or making recommendations on securities, among other activities. § 80b–2(a)(11). Investment advisors must register with the SEC unless they are exempt from

periodic disclosure requirements under the ICA.[305] Under the ICA, an investment company is "any issuer which is . . . engage[d] primarily . . . in the business of investing, reinvesting, or trading in securities," the latter term being broadly construed.[306] LISBICs would certainly appear to fall under this definition. Therefore, an exemption from registration under the ICA might be necessary for LISBICs to qualify for some of the Securities Act exemptions.[307]

There are a number of exemptions available under the ICA,[308] the most common being the "private investment company" exemptions under Section 3(c)(1)[309] and Section 3(c)(7).[310] These exemptions, relied upon by entities like SBICs and hedge funds, would not be of use to the LISBICs because of their limits on the number of investors and requirements relating to their wealth.[311] However, the SEC does have broad statutory authority to promulgate additional exemptions as long as "such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the ICA]."[312]

3. PROTECTING RETAIL INVESTORS

Unlike existing SBICs that raise funds exclusively from institutional and accredited investors, LISBICs contemplate the inclusion of small, retail investors. Due to their backgrounds and limited size of their individual investments, these investors might lack the knowledge, experience, and financial incentives to monitor LISBIC managers in order

---

registration. § 80b–3(b). These exemptions cover investment advisors providing advise to private funds (such as hedge funds) or to SBICs. §§ 80b–3(b)(1), (7)(a).

305. *See* SEC ICA FAQs, *supra* note 287.

306. 15 U.S.C. § 80a–3(a)(1)(A). Investment securities are broadly defined to include "all securities" except a narrow set of securities that is not applicable. § 80a–3(a)(2).

307. *See supra* notes 288, 301 and accompanying text.

308. *See* SEC ICA FAQs, *supra* note 287.

309. Section 3(c)(1) covers issuers whose outstanding securities are beneficially owned by not more than one hundred persons and that is not making or planning to make a public offering of its securities. § 80a–3(c)(1). This is the most commonly used exemption by SBICs. *See* James D. Miller, *Small Business Investment Companies: Licensing, Tax and Securities Considerations*, 36 BUS. LAW. 1679, 1689–90 (1981).

310. Section 3(c)(7) covers issuers whose outstanding securities are owned exclusively by qualified purchasers and that is not making or planning to make a public offering of its securities. § 80a–3(c)(1). The term "qualified purchaser" is defined in Section 2(a)(51) of the ICA. § 80a–2(a)(51).

311. § 80a–3(c)(1), 3(c)(7).

312. § 80a–6(c)(1).

to ensure that these are not engaging in self-dealing transactions and are staying true to the fund's purpose.[313]

There are two possible solutions to the first agency problem. The larger institutional investors will have the ability and incentive to monitor the LISBIC manager's financial performance.[314] LISBIC's managers will also have the incentive to protect their reputational capital with these institutional actors with whom they repeatedly interact.[315] In addition, state law might impose additional disclosure and fiduciary requirements on the LISBICs and those managing them.[316] LISBICs will need to be organized under state law as corporations, limited liability companies, or limited partnerships.[317] This organizational choice will determine the default legal rights of investors and define the obligations and duties of the LISBIC manager.[318] As many of these provisions are default rules that can be contracted around in a LISBIC's organizational documents, regulatory provisions could mandate that LISBICs provide for a menu of statutorily-mandated rights in these organizational documents to facilitate investor protection.[319]

A second set of agency problems revolves around a LISBIC's goal of investing in minority-owned businesses and providing them with active advice. Intermediary institutions, such as pension and mutual funds, have limited incentives to actively exercise governance rights in order to improve the performance of their portfolio companies, preferring instead to exit questionable investments.[320] This can be true even when the investors funding the intermediary would be better off with the intermediary exercising its governance rights.[321] This dynamic is unlikely to characterize a LISBIC's management of its portfolio companies,

313. *See* Marco Becht, Patrick Bolton & Ailsa Röell, *Corporate Governance and Control*, *in* HANDBOOKS IN ECONOMICS 1, 17 (Kenneth J. Arrow, Michael D. Intriligator eds. 2003) (explaining how dispersed shareholders with small equity interest have little incentive to incur management monitoring costs).

314. *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 573 (2015) ("[S]ubstantial equity investment encourages [large shareholders] to monitor management . . . ."); Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 464–65 (1986) (presenting a formal model of the corporate governance role of large shareholders).

315. *See* Ian Ayres & Peter Crampton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033, 1034–35 (1994).

316. *See supra* note 297–302 and accompanying text.

317. *See supra* note 137.

318. *See* THERESA A. GABALDON & CHIRSTOPHER L. SAGERS, BUSINESS ORGANIZATIONS 31–36 (2d ed. 2019).

319. *See id.*

320. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865 (2013) (describing this dynamic which they refer to as "agency capitalism").

321. *See id.*

however. Unlike traditional intermediaries, a LISBIC would not be competing against other funds invested in the same businesses and would therefore not be worried about others freeriding on its mentoring and assistance of a portfolio company. Another set of concerns relates to the selection process of LISBIC portfolio companies: will managers select investments that are consistent with a LISBIC's non-monetary goals? The fact that for-profit organizations are often not in the best position to effectively pursue social goals heightens this concern.[322]

SBA regulations provide a framework that we can employ to promote transparency and monitor the performance of LISBICs and their pursuit of non-monetary goals. SBICs must prepare an annual financial report for each fiscal year, audited by an independent certified public accountant.[323] This report includes an assessment of the social-economic impact of each financing made by the SBIC, specifying its impact on job creation or retention, the revenues, and profits of the business, and taxes paid by the business and its employees.[324] For each reporting period, SBICs must also prepare a valuation report that provides an estimate of the value of their loans and investments.[325] Periodically, for each small business financing, SBICs submit a portfolio financing report.[326] The SBA's Office of Examinations annually reviews SBICs' financial health and regulatory compliance and monitors the performance of SBICs through key metrics.[327] These reports would also facilitate the involvement of LISBIC's retail investors, who are more likely to care about a LISBIC's social goals and so have the incentive to verify that the LISBIC is fulfilling such goals.[328]

C. Fiscal Incentives to Capitalize LISBICs

Government involvement would be critical in the development of LISBICs. In addition to leading coordination efforts across government agencies and market actors, public financial support would spread the risks

---

322. *See* Ofer Eldar, *Designing Business Forms to Pursue Social Goals*, 106 VA. L. REV. 937, 942–44 (2020) (explaining challenges faced by for-profit entities in pursuing social goals and proposing new legal forms that, with key structural elements, give managers the incentives and competence to accomplish such goals).

323. 13 C.F.R. § 107.630(a) (2020).

324. § 107.630(d).

325. § 107.650.

326. § 107.640.

327. *See* OCC SBIC Report, *supra* note 135, at 1.

328 Another strategy to address this issue could involve a certification process that verifies a LISBIC's investment strategy and social impact. *See* Eldar *supra* note 322, at 978–80 (describing the certification process for community development financial institutions).

inherent in developing a new market and incentivize private equity funds to incur the initial expenses necessary to successfully enter this niche. The current socioeconomic climate and will to address racial economic disparities make outlays of this type more politically feasible than in the past.[329] This section describes two possible forms of public financial support.

1. GOVERNMENT LEVERAGE

A new SBIC program could revitalize the diminishing role of the federal government in promoting and providing financial support to minority-owned businesses, but past mistakes should not be repeated.[330] LISBICs should be afforded the regulatory flexibility and predictability that SSBICs never had.[331] More importantly, debt should not be the primary leveraging mechanism.[332] Since LISBICs would also be investing in the equity of young, risky firms, having a debt obligation might be unduly burdensome and undesirably restrict a LISBIC's investing options.[333]

In providing leverage to LISBICs, the SBA should pursue the policy goals of the now-defunct Specialized SBICs and Impact Investments SBICs but employ a funding mechanism more akin to the now-defunct SBA Participating Securities Program or the Startup America Initiative.[334] Though these programs entail greater risk for the SBA, the amount could be capped and managed. Pursuing this alternative takes us closer to an initiative that is merely a pure hybrid of the SSBIC and Participating Securities programs. Though this is certainly an attractive and expedient approach to promote minority entrepreneurship,[335] there is value to having small investors participate and set the tone as to the social and financial

329. Sheryl Stolberg, *House Democrats, With Pelosi's Support, Will Consider a Commission on Reparations*, N.Y. TIMES (June 18, 2019), https://www.nytimes.com/2019/06/18/us/politics/house-democrats-reparations.html [https://perma.cc/3M2P-CMF6].

330. *See* Bates & Bradford, *supra* note 199, at 492 ("The federal government as a VC funder is fading into insignificance, as neither the newer funds nor the older SSBICs are currently raising capital from this source.").

331. *See id.* at 499–500 ("Fund status as an SSBIC requires adherence to restrictive and changing SBA regulations, which is costly to SSBICs . . . ."). For example, rules governing the information that SBICs must obtain from portfolio companies might need to be relaxed for LISBICs to reduce the burdens on minority-owned businesses. *See* 13 C.F.R. § 107.620 (2020).

332. *See supra* notes 188–212 and accompanying text.

333. *See supra* note 150 and accompanying text.

334. *See supra* notes 146–161 and accompanying text.

335. This author also supports this hybrid approach and proposes it as an alternative to the LISBICs contemplated in this Article.

expectations of LISBICs' investments, something that would be missing from a pure hybrid SBA program.

2. PREFERENTIAL TAX TREATMENT

Providing either tax deductions based on amounts invested in LISBICs or a lower tax rate for income and capital gains derived from LISBIC investments would help LISBICs attract capital and provide incentives to private equity funds to establish these in the first place.[336] Using the tax code to encourage investment in young and small businesses is not a novel idea. A number of programs in the U.K. offer favorable tax treatment to investors participating in crowdfunding issuances by small companies.[337] These tax advantages have been identified as one of the reasons why the U.K. crowdfunding market has performed better than the U.S. market.[338] An association of online platforms has recently proposed similar tax exemptions for investors participating in crowdfunding investments as a way to maximize the potential of crowdfunding to fuel business and economic growth.[339] Some groups have proposed a more

---

336. A similar tax preferential treatment strategy is employed by the New Market Tax Credit Program (NMTC Program), which provides investors a tax credit in exchange for making equity investments in Community Development Entities, specialized intermediaries that finance projects, such as the construction or rehabilitation of real estate, in low-income communities. *See* Eldar, *supra* note 322, at 978–80; Anna Kovner & Josh Lerner, *Doing Well by Doing Good? Community Development Venture Capital*, 24 J. ECON. & MGMT. STRATEGY 643, 645–47 (2015). For an overview and assessment of the NMTC Program, see MARTIN D. ABRAVANEL, NANCY M. PINDUS, BRETT THEODOS, KASSIE BERTUMEN, RACHEL BRASH & ZACH MCDADE, U.S. DEP'T OF THE TREASURY, NEW MARKETS TAX CREDIT (NMTC) PROGRAM EVALUATION (2013).

337. The U.K. has two programs designed to boost innovation and entrepreneurship. The Seed Enterprise Investment Scheme (SEIS) and the Enterprise Investment Scheme (EIS) provide immediate tax deductions and no capital gain taxes to investors participating in qualifying offerings. *See* HM Revenue & Customs, *Tax Relief for Investors Using Venture Capital Scheme*, GOV.UK (Jan. 25, 2019), https://www.gov.uk/guidance/venture-capital-schemes-tax-relief-for-investors [https://perma.cc/2VV4-TC4H]. For more information on the SEIS and EIS programs, see HM Revenue & Customs, *Use the Enterprise Investment Scheme (EIS) to Raise Money for Your Company*, GOV.UK (July 11, 2019), https://www.gov.uk/guidance/venture-capital-schemes-apply-for-the-enterprise-investment-scheme and HM Revenue & Customs, *Use the Seed Enterprise Investment Scheme (EIS) to Raise Money for Your Company*, GOV.UK (Oct. 12, 2018), https://www.gov.uk/guidance/venture-capital-schemes-apply-to-use-the-seed-enterprise-investment-scheme.

338. *See* SEC CF Report, *supra* note 240, at 16–17.

339. *See* AOIP Paper, *supra* note 241, at 1, 3 (proposing reasonable tax credits or deductions to encourage private investments in small businesses).

general tax credit specifically targeted to promote venture capital investments in minority businesses.[340]

3. Constitutional Considerations

Any government program that seeks to specifically target minority-owned businesses for preferential treatment could be challenged under the Equal Protection Clause.[341] Under Supreme Court precedent, strict scrutiny review applies to all preference programs based on racial classifications, thus requiring that such classifications be narrowly tailored to further compelling governmental interests.[342] This section outlines two strategies to address these potential legal challenges.

One approach is to use the SBA's 8(a) Business Development program's definition of "socially and economically disadvantaged individuals," which includes "those who have been subjected to racial or ethnic prejudice or cultural bias within American society because of their identities as members of groups and without regard to their individual qualities."[343] This statutory definition of "socially disadvantaged individuals" in the SBA Act has survived constitutional challenges.[344]
The SSBIC Program, which was designed for small business entrepreneurs "whose participation in the free enterprise system is hampered because of social or economic disadvantage," followed a similar strategy in targeting minority-owned small businesses.[345]

Another possibility is to focus on the geographical region where the business receiving the financing is located by designating certain zip-codes or census tracts. These types of "place-based incentive programs"

340. *See* Algernon Austin, Ctr. for Glob. Pol'y Sols., The Color of Entrepreneurship: Why the Racial Gap Among Firms Costs the U.S. Billions 20, (2016) ("Entrepreneurs of color often lack access to the informal networks that are critical for attracting venture capitalists to help support their business pursuits. Providing tax incentives for venture capitalists who invest in businesses owned by people of color could help to overcome this significant barrier to growth."); Kate Losse, *The Art of Failing Upward*, N.Y. Times (Mar. 5, 2016), http://www.nytimes.com/2016/03/06/opinion/sunday/the-art-of-failing-upward.html [https://perma.cc/L6QJ-8CX8].

341. U.S. Const. amend. XIV, § 1; *Ararand Constructors, Inc. v. Peña*, 515 U.S. 200, 222 (1995).

342. *Peña*, 515 U.S. at 227.

343. *See supra* notes 111–115 and accompanying text.

344. *See Rothe Dev., Inc. v. U.S. Dep't. Def.*, 836 F.3d 57, 61–62 (D.C. Cir. 2016); David S. Black & Joseph Hornyak, *D.C. Circuit Rules That the 8(a) Program Is Constitutional, But Its Reasoning Raises Questions*, Holland & Knight (Sept. 26, 2016), https://www.hklaw.com/en/insights/publications/2016/09/dc-circuit-rules-that-the-8a-program-is-constituti [https://perma.cc/B66T-XX8X].

345. *See supra* note 154 and accompanying text; CRS SBIC Report, *supra* note 136, at 3, 23–24.

are used by local governments to revitalize economically depressed communities by providing investors preferential tax treatment or financial assistance through low-interest rate loans.[346] Such designations have also been employed under the Community Reinvestment Act and the Impact Investment SBIC program.[347] A recent program enacted as part of the Tax Cuts and Jobs Act of 2017 provides investors temporary preferential tax treatment if they invest in real estate or equity located in an area designated as an opportunity zone, a community designated by the Internal Revenue Service as being "economically distressed."[348] Though the program's implementation has been criticized,[349] it provides an example of a politically viable "place-based incentive program" at the federal level used to target investors to help the development of minority communities.[350]

346. *See* David Neumark & Helen Simpson, *Do Place-Based Policies Matter?*, FRBSF ECON. LETTER 2015-7 at 1–2 (Mar. 2, 2015); SCOTT EASTMAN & NICOLE KAEDING, TAX FOUND., OPPORTUNITY ZONES: WHAT WE KNOW AND WHAT WE DON'T (2019); David Neumark & Helen Simpson, *Place-Based Policies*, *in* 5 HANDBOOK OF REGIONAL & URBAN ECONOMICS 1197, 1198–99 (2015).

347. *See supra* notes 160–162 and accompanying text.

348. *See Opportunity Zones Frequently Asked Questions*, IRS (Oct. 22, 2019), https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions [https://perma.cc/AE9H-ZDYZ] [hereinafter IRS OZ FAQs]; Morgan Simon, *What You Need to Know About Opportunity Zones*, FORBES (Mar. 30, 2019, 4:03 PM), https://www.forbes.com/sites/morgansimon/2019/03/30/what-you-need-to-know-about-opportunity-zones [https://perma.cc/PS4Q-XY9K]. These low-income areas are generally defined as census tracts with a poverty rate of 20% and median family income of 80% of the surrounding metropolitan area. *See* Matthew Blake, *Opportunity Zones Program Finally Kicks off in Los Angeles*, THE REAL DEAL L.A. (Jan. 20, 2020, 4:28 PM), https://therealdeal.com/la/2020/01/20/opportunity-zones-program-finally-kicks-off-in-los-angeles/ [https://perma.cc/8KEZ-YYGA].

349. *See, e.g.*, Simon, *supra* note 348 (discussing "impact washing" and the low multiplier effects of investments in low income communities); Alan Sage, Mike Langen & Alex Van de Minne, *Where Is the Opportunity in Opportunity Zones? Early Indicators of the Opportunity Zone Program's Impact on Commercial Property Prices* (May 1, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3385502 (finding that opportunity zone designation did not impact all properties prices, but resulted in a 13.5% price increase for "redevelopment" properties and a 9.6% price increase for vacant development sites, which suggests that the program has primarily passed through the tax benefits to existing land owners, with limited evidence of additional value creation); Lisa Christensen Gee & Lorena Roque, *Opportunity Zones Bolster Investors' Bottom Lines Rather than Economic or Racial Equity*, INST. OF TAX'N & ECON. POL'Y (Dec. 2019), https://itep.org/wp-content/uploads/121219-Opportunity-Zones-Bolster-Investors%E2%80%99-Bottom-Lines-Rather-than-Economic-or-Racial-Equity.pdf [https://perma.cc/5HM4-288N]; Ofer Eldar & Chelsea Garber, *Does Government Play Favorites? Evidence from Opportunity Zones* 3 (Duke Law School Public Law & Legal Theory Series No. 2020-28, Sept. 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3463541 [https://perma.cc/XQN5-32JW] (finding evidence that political favoritism plays a role in the designation of opportunity zones).

350. *See* Eastman & Kaeding, *supra* note 346, at 2.

CONCLUSION

In light of recent political and economic events, removing the financial barriers faced by minority entrepreneurs is more crucial now than ever. Promoting the growth of minority-owned businesses is also sound policy, as it would have a considerable impact both at the local and national levels. Locally, it would help the economic development of minority communities in need of new jobs and better infrastructure. Diverting efforts and resources from redistributive transfer and relief to an initiative that mobilizes grassroots and private capital to help minority-owned businesses will strengthen a second front in the war against poverty by providing a market-based channel to remedy long-standing racial inequities.[351] The aggregate economic effect of these efforts would also be felt nationally: due to discriminatory financing practices, our nation is losing over "1.1 million minority-owned businesses, and as a result, foregoing over 9 million potential jobs and $300 billion" in national income.[352]

The problem examined in this Article has been widely acknowledged; the body politic and market participants are more willing than ever to act.[353] That past programs have been relatively unsuccessful should not be discouraging. Understanding why past programs have come up short helps us design ones better suited to solve the problem at hand. Finding the right approach, however, requires identifying specific processes that drive disparities. This Article starts that conversation by highlighting the importance of soft information for minority-owned businesses and explaining how related informational issues have kept mainstream investors away. Most of the ingredients for a successful program, such as the one proposed in the Article, are already in place. The key lies in coordinating different regulatory frameworks and administrative bodies and involving private equity investors and members of the community. The costs and risks involved are great, but the benefits are immeasurable.

---

351. *See* Angela Blackwell & Michael McAfee, *Banks Should Face History and Pay Reparations*, N.Y. TIMES (June 26, 2020), https://www.nytimes.com/2020/06/26/opinion/sunday/banks-reparations-racism-inequality.html [https://perma.cc/V7RP-K5KL]; Porter, *supra* note 64, at 55.

352. *See* Applewhite, *supra* note 104; Austin, *supra* note 340, at 3.

353. *See supra* notes 329, 340 and accompanying text.