# WHAT THE U.S. SHOULD DO TO IMPROVE ACCESS TO STARTUP CAPITAL FOR MWBE OWNERS

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*SUMMARY: Small businesses owned by women and minorities (MWBEs/HUBs) face multiple obstacles when attempting to raise startup capital. The JOBS Act partially addressed this problem, but the U.S must make more changes to facilitate the process for MWBE entrepreneurs to access much-needed startup capital.*

Key Words: startup capital, equity financing, crowdfunding, securities, MWBE

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## INTRODUCTION

The number of minority and women owned business enterprise (MWBE) startups in the U.S. has been steadily increasing. For example, according to data from the National Association of Women Business Owners (NAWBO, 2020). Current data show there are over 11 million women-owned businesses in the U.S. employing approximately 9 million workers.

Unfortunately, many MWBEs have faced a lack of support in financing their startup. Access to startup capital has long been a barrier for women and minority owners, and national statistics show that business-loan approval rates for MWBEs are up to 20 percent lower compared to their male counterparts.

Economists and politicians widely agree that the emergence of new businesses plays a significant role in economic growth. This is particularly true in the U.S. where startups make meaningful contributions to job creation, productivity growth, and innovation. Emerging entrepreneurs need access to capital to successfully start new businesses, or expand emerging ones, and in the process realize their personal and professional dreams. Startup capital exists in multiple formats, ranging from bank loans to venture capital to equity offerings. However, most of the traditional forms of financing have obstacles that limit access for a segment of the small business startup market seeking capital, especially for MWBEs.

Some analysts point to the need to increase external private institutional capital (venture capital) and/or bank lending as sources of funds for small business startups. Such recommendations, while well meaning, overlook the reality of how, and from whom, many small business creators access capital, and as a result have not made much difference in terms of capital access.

A report by the Kauffman Foundation, (established in the mid-1960s by the late entrepreneur Ewing Marion Kauffman), detailed the results of an extensive study of startup capital. Entitled "Access to Capital for Entrepreneurs: Removing Barriers," the foundation's researchers concluded in the report that over 80 percent of women and minority entrepreneurs do not access external sources, either venture capital or bank loans, at the time of startup. In fact, about two-thirds of entrepreneurial startups owned by women and minorities rely on personal and family savings, and a sizable share, over 10 percent, use their personal credit cards. (Hwang, Desai, & Baird, 2019).

Over the past decade, crowdfunding has emerged as a possible alternative form of financing. To address the problem of limited access to capital for all entrepreneurs, especially women and minorities, Congress passed the JOBS Act of 2012, creating a hybrid financing method by which entrepreneurs could raise capital – online equity-based crowdfunding. Congress hoped the program would stimulate economic growth and expand job creation by improving small business access to capital markets. However, the JOBS Act has not done enough to increase access to capital for women and minority business owners.

## THE JOBS ACT HAS NOT HELPED A SIGNIFICANT NUMBER OF MWBE OWNERS

The question addressed herein is whether the online equity-based crowdfunding program is succeeding at increasing access to capital for female entrepreneurs. Is this program making a big difference for women? The short answer is not in a significant way, based on the most recent SEC report (SEC, 2019). Women-owned businesses remain underrepresented among equity crowdfunding issuers (SEC, 2019). Not surprisingly, there is also relatively low crowdfunding participation among businesses located in states and/or cities areas that are not technology/finance hubs (SEC, 2019).

Congress had hoped that passage of the JOBS Act would make a real difference; that it would help MWBE entrepreneurs overcome the access to capital problem, but that has not been the case, at least not to a great extent. According to researchers at Duquesne University, the data show that capital campaigns receive significantly less funding when the primary signatory is a female or minority owner (Geiger & Oranburg, 2018).

Capital access has always been a challenge for all entrepreneurs, and especially MWBE small business owners. This lack of capital often deters, or significantly slows down, the decision by aspiring women and minority owners to start new businesses. Adequate funding is one of the most challenging barriers facing aspiring entrepreneurs (Fairlie & Robb, 2010). However, until recently, most efforts to expand access to capital and increase new business creation have not successfully answered the challenge.

The capital access problem is an important issue to address because small business entrepreneurs, and the U.S. economy as a whole, would benefit from broadening MWBE access to capital. (Hwang, Desai, & Baird, 2019). Increased capital access is an important gender equity matter. There have been wide gaps in entrepreneurial opportunity for identifiable subgroups. The latest data available from the preceding twenty-year period (1996-2017) show that men are more likely to start businesses than women are. However, this is not because fewer women want to start new businesses, but rather it is primarily due to lack of capital. (Fairlie & Robb, 2010). The access to capital problem has not only financial implications, but socioeconomic and demographic ones as well (Cumming, Meoli & Vismara, 2019).

## LOW SUCCESS RATE FOR MWBE OWNERS RAISING EQUITY CAPITAL

While it is true that some MWBE entrepreneurs are starting to use equity crowdfunding, the program has been a disappointment. According to the most recently released data from the Securities and Exchange Commission (SEC, 2019), the number of MWBE owners using the program is surprisingly low.

The latest data shows only relatively low utilization rates, by all entrepreneurs and especially women-owned businesses. The number of overall users, and specifically female users, is somewhat disappointing, but shows modestly encouraging signs for those small business entrepreneurs who are part of the underserved ownership group (primarily female/minority), is that the socioeconomic profile of crowdfunding issuers is one with which many can relate. The majority of issuers that sought financing under Regulation Crowdfunding were relatively small, early in their business lifecycle, and had limited financial resources. The issuer profile data indicates the primary characteristics of typical offerors include modest financial means:

An analysis, by the Small Business Administration, of equity crowdfunding offerings during 2017, the first operational year of the program, shows that the business owners and executives executing the necessary paperwork were much more likely to be male than female (Figure 1 below).

**Figure 1: Gender Profile of Offerors (Agate/SBA, 2018)**

| Gender of Owner | Absolute Number | Percentile |
|---|---|---|
| Male | 270 | 83% |
| Female | 56 | 17% |

## BRIEF REVIEW OF THE TRADITIONAL PROCESS USED TO RAISE CAPITAL

The original federal securities laws, not designed with online equity crowdfunding in mind, acted as a barrier to entry to capital markets. Generally, the law prohibits companies from offering or selling securities unless the offeror registers with the SEC, or qualifies for one of a limited number of exemptions from registration. Since the registration process is very expensive and time-consuming, using a registered IPO offering is almost never a realistic financing option for a typical small startup company trying to raise small amounts of money from a relatively small number of investors. In addition, for companies with the resources to complete the registration process by making a registered offering, these companies then become subject to the reporting requirements of the securities laws, which makes the process even more unattractive because it adds another layer of cost and complexity.

While the pre-JOBS Act private placement exemptions under federal securities laws registration provided useful means for raising capital, there were significant limitations on the use of that exemption. The level of investor sophistication and wealth requirements, coupled with prohibition on general solicitations, made it practically impossible for small businesses to use the Internet, and/or social media, to find investors. Many private placements are also subject to the state securities (blue-sky) laws that add further cost to the process (PwC, 2017).

A report published by the U.S. Dept. of Commerce, Minority Business Development Agency entitled "Disparities in Capital Access between Minority and Non-minority-owned Businesses: the Troubling Reality of Capital Limitations Faced by MBEs", states that capital access remains the most important factor limiting the establishment, expansion and growth of minority-owned businesses. (Fairlie & Robb, 2010). The problem is that this reality acts as a well-established constraint. The capital-financing environment places a greater burden on minority entrepreneurs who try to keep their businesses thriving in challenging economic times (Fairlie & Robb, 2010).

## OVERVIEW OF VARIOUS CROWDFUNDING ALTERNATIVES

The primary types of crowdfunding include four or five main options. Some of them, such as donation crowdfunding have been around for approximately twenty years. However, the equity-based crowdfunding method has only been available for five years, because the SEC had to amend various securities laws/regulations to allow it.

Equity crowdfunding is essentially the sale of a stake in a business to a number of investors in return for investment. The idea is similar to how investors buy stock in an IPO, or to the process by which venture capitalists take an equity position in a company in which they invest.

Rewards-based crowdfunding, in which individuals donate to a project or business with expectations of receiving in return a non-financial reward, such as goods or services, at a later stage in exchange of their contribution.

Donation-based crowdfunding, in which individuals donate small amounts to meet the larger funding aim of a specific charitable project while receiving no financial or material return.

Peer-to-peer lending, in which the crowd lends money to a company with the understanding that the owners will repay the money with interest. It is very similar to traditional borrowing from a bank, except that you borrow from private investors.

Thus far, more MWBEs have had success with reward-based or donation-based crowdfunding, as opposed to equity crowdfunding. However, always seeking funding by asking for donations or rewards limits the size and success of crowdfunding. Truly successful business need to be able to raise equity capital; they cannot be dependent on donations and/or rewards. That is why Congress amended the securities laws by passing the JOBS Act.

## HOW THE JOBS ACT CHANGED THE TRADITIONAL EQUITY CAPITAL PROCESS

The JOBS Act enhances access to private capital primarily by changing three requirements of US securities laws. (JOBS Act of 2012). The first change expands the ability of companies to raise funds through transactions that are exempt from registration under the federal securities law (Securities Act of 1933). The second change eases the regulatory burdens associated with IPOs by phasing in the compliance obligations for public companies that used crowdfunding. The third change raises the dollar thresholds that require privately held companies to register their securities under federal law (Securities Exchange Act of 1934). This means that fewer small companies are subject to the periodic disclosure requirements applicable to traditional public companies. Taken together, these three changes act as realistic incentives to use a public offering to finance small startups, which is a very significant change.

Essentially, the goal is to make a crowdfunding IPO faster, easier, and cheaper. Going public through an initial public offering has not been a realistic option for most MWBEs attempting to raise small amounts of money. It has been a slow and expensive process not appropriate for many entrepreneurs. A readiness assessment for a prospective IPO usually lasts a year or two. (PwC, 2017). Furthermore, based on recent public registration statements of over 300 companies going through an IPO, the companies have incurred an average underwriting fee equal to approximately 5 percent or more of gross proceeds, plus an additional $4 million of offering costs directly attributable to the IPO. (PwC, 2017). Over 80 percent of CFOs estimated expenses of more than $1M on one-time costs. Legal and accounting fees increase significantly for companies that may face additional complexities in preparing for an IPO. (PwC, 2017). Furthermore, the problem actually doubles in size once a company becomes public. There are significant costs attributable to actually being a public company. Two-thirds of CFOs (67 percent) estimate costs of being public at $1M-2M annually due to increased professional fees paid to accounting and law firms. (PwC, 2017). Obviously, this type of financial burden is not one that most MWBE startups can endure.

The crowdfunding approach attempts to provide a loophole to SMB's (small and mid-size businesses) and ECGs (emerging growth companies) because it offers a less expensive approach. When an EGC is contemplating going public, it can take advantage of the reduced regulations and scaled-back disclosure requirements for an initial period, including exemptions from certain provisions of the Sarbanes-Oxley Act and the Dodd-Frank Act, as well as certain audit rules. Equity crowdfunding also increases access to capital by lifting the prohibition on general solicitation and advertising in certain private placements. The question that remains is how can the U.S. expand these benefits to include more MWBEs?

## EXAMPLE OF SUCCESS

MWBEs can be successful using equity crowdfunding, although in many cases they still face an uphill struggle. An example of a success story in the crowdfunding market is GoldieBlox, a media and entertainment company using storytelling to make STEM fun, (https://goldieblox.com/). The company has a goal of educating and empowering young girls, influencing them to consider STEM careers. Debbie Sterling is the founder and CEO of GoldieBlox. Sterling is an engineer and advocate for women in engineering and technology. Starling developed GoldieBlox after noticing the lack of available engineering toys targeted at girls.

Starling tried to raise investment capital for GoldieBlox at a New York toy fair but encountered doubt about girls' interest in toys traditionally marketed for boys. Unable to raise investment capital, Sterling instead launched a Kickstarter campaign that raised enough money to get started. She then followed that up with an equity crowdfunding effort that was successful. Thus, it appears that one successful path is to combine reward crowdfunding with equity crowdfunding.

## CONCLUSION AND RECOMMENDATIONS

The U.S. online equity crowdfunding program has only been up and running for several years, but the data show only modest success by MWBEs. For those who have used it thus far, it has worked, but only to a modest degree. The reasons for this slow rate of success are perhaps somewhat predictable. Changing decades of deterrent to capital access is a slowly evolving process. Furthermore, investing through equity crowdfunding carries risks such as the greater risk of failure, fraud, doubtful returns, vulnerability to hacker attacks, and mediocre investments. However, it also offers rewards like the potential for huge returns, a greater degree of personal satisfaction, the opportunity to invest like accredited investors, and the prospect of stimulating the economy through business and job creation.

Nevertheless, equity-based crowdfunding has the potential to fulfill its original mission. To achieve the desired level of success, especially for MWBEs, Congress and the SEC should make additional changes to the securities laws/regulations to extend the benefits of the program to reach more small businesses. (Won, 2018).

Cost has been, and still is, a deterrent. Equity-based crowdfunding, though less expensive than an IPO, is still an expensive alternative for many MWBEs. How much does it equity-based crowdfunding cost? It varies on a case-by-case basis, but a Regulation Crowdfunding offering roughly costs between $4,000-$10,000 for the financial review and legal documentation (Crawford, 2019). However, it is worth noting that this excludes the platform fees taken by the funding portal. For example, the StartEngine website indicates that they charge companies 9-14% of the total capital raised in the offering, 2% in equity and 7-12% in cash. The amount varies due to the method of investment (international & credit card investors are charged more), and they take an additional $10,000 deferred.

It would help if Congress and the SEC lowered the transaction costs more; this would be particularly helpful to small underrepresented segments of the entrepreneurial market that are averse to spending too much money on regulatory compliance (Barth, Landsman & Taylor, 2017). Equity crowdfunding in some other countries, such as the UK and India, has been more successful to date, primarily because those nations more significantly reduced the regulatory costs, enabling issuers to raise money in a more cost-effective manner than under the current U.S. program (SEC, 2019). The U.S. should emulate the best practices of other nations in lowering the cost and increasing the access to capital for small business entrepreneurs, many of whom are women and minority-owned business entities.

Another tactic that might help is to use tax credits/deductions to encourage the formation of special-interest crowdfunding websites. A small number of crowdfunding platforms exist that focus on MWBE businesses. For example, for women there is IFundwomen, for black business owners there is fundBLACKfounders, and for the LGBTQ community there is Pinkstart. These platforms do provide an option for MWBE businesses that may help them succeed in raising equity capital. Perhaps federal securities authorities could encourage the formation of more of these special interest crowdfunding portals.

Ultimately, equity-based crowdfunding has the potential to help many entrepreneurs raise startup/expansion capital, but to achieve a higher level of MWBE participation, the federal government must make additional modifications in the current laws and regulations.

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