FINANCING MINORITY ENTREPRENEURSHIP
CARLOS BERDEJÓ *

Racial disparities pervade America’s socio-economic 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 through 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. The author would like to thank Brian Broughman, Benjamin Edwards, Ofer Eldar, Michael Gutten tag, Justin Levitt, Elizabeth Pollman, and Lauren Willis for extremely valuable and helpful comments on earlier drafts. All errors and omissions are my own.
Racial disparities pervade the socio-economic fabric of 21st century America: minorities lag in educational attainment, employment, income and wealth. 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 ($19,990). White households are over fifty percent more likely to own equity in their own home than African American or Hispanic households. Unemployment rates also vary substantially along racial lines: the unemployment rate for African Americans (7.5 percent) is twice that of whites (3.8 percent), with Hispanics (5.1 percent) right in between these two groups. Individuals belonging to minority groups are less likely to have a college degree: while forty percent of white individuals graduate from college, only thirty percent of African Americans and twenty percent of Hispanics do.

---


3 According to census data, 71.2 percent of white households own equity in their own home, substantially higher than the 40.7 and 46.6 percent ownership rate of African American and Hispanic households. On average, white households own $100,000 in home equity, while African American and Hispanic households own $56,000 and $65,000, respectively. See id.


5 See id.
Disparities along racial lines also characterize the entrepreneurial space, where minorities are significantly underrepresented. This is evident not only in disparities in business ownership rates, but also in the share of a population that is self-employed and the comparative success rates of entrepreneurial ventures. According to census data, minorities, which form thirty-eight percent of the U.S. population, own just nineteen percent of businesses. This gap is more pronounced in inner cities, where minorities make up seventy-six percent of the population but own twenty-three percent of businesses. Self-employment statistics provide a similar perspective – the self-employment rate among whites (10.9 percent) is twice that of African Americans (5.2 percent). 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.

---

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


8 See Initiative for a Competitive Inner City, HELPING ENTREPRENEURS OF COLOR GROW THEIR BUSINESS (Dec. 2018) at 3 [hereinafter ICIC Report].

9 See id.


11 See Spotlight on Statistics, supra note 10 (reporting self-employment rates of 9.6 and 8.3 percent for Asians and Hispanics, respectively); Rafael Efrat, Minority Entrepreneurs in Bankruptcy, 15 GEO. J. ON POVERTY L. & POL’Y 95, 98 (2008) [hereinafter Efrat, Minority Entrepreneurs] (“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
Not only are minorities less likely to start and own their own businesses, but those who are successful in doing so financially underperform their non-minority counterparts. Minority-owned firms earn on average less than half of the revenue earned by non-minority firms, are less profitable and experience higher failure rates. As with startup rates, there are notable differences in the financial performance of small businesses across minority groups. Despite numerous initiatives to promote minority business ownership, racial disparities in entrepreneurship have been stubbornly persistent through time.

What can explain 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 at a lesser degree. This Article explores why financing

12 See Fairlie & Robb, Why Are Black-Owned Businesses Less Successful, supra note 7, at 292-93 (concluding that black-owned firms have worse outcomes than white-owned firms).

13 See Spotlight on Statistics, supra note 10; Fairlie & Robb, Disparities in Capital Access, supra note 10, at 13 (reporting average gross receipts of $167,000 for minority-owned firms and $439,000 for non-minority firms).

14 See ICIC Report, supra note 8, at 3 (reporting that minority-owned businesses earn 44 percent of the profits earned by nonminority-owned firms); Fairlie & Robb, Why Are Black-Owned Businesses Less Successful, 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.”).

15 See Fairlie & Robb, Why Are Black-Owned Businesses Less Successful, supra note 7, at 293 (finding that 40 percent of black-owned firms had negative profits and that the average probability of business closure was 26.9 percent for black-owned firms compared to 22.6 percent for white-owned firms); Efrat, Minority Entrepreneurs, supra note 11, 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.”).

16 See Fairlie & Robb, Disparities in Capital Access, supra note 10, at 14 (reporting that 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).

17 See Efrat, Minority Entrepreneurs, supra note 11, at 98 (“[M]inorities remain significantly underrepresented in the self-employment sector.”); Fairlie & Robb, Why Are Black-Owned Businesses Less Successful, 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, Disparities in Capital Access, supra note 10, 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.”).

18 See infra Part I.B.3.
new businesses may be especially challenging for minority entrepreneurs. First, it
describes why startups are especially likely to face informational asymmetry
problems when raising capital. 19 Second, it expands on a theory, grounded in the
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. 20 Third, it reviews evidence that
many minority entrepreneurs have been excluded from crucial social and
professional networks. 21 Building upon these three insights, the Article proposes a
policy intervention to facilitate minority entrepreneurs’ access to capital. 22

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 that have sought to facilitate minority entrepreneurs’
access to capital have fallen short. Government programs have failed because of
their reliance on debt as a financing mechanism and on large, hierarchical
institutions, unable to confront certain types of informational asymmetries, to act
as gatekeepers. 23 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
in a position where they fall prey to implicit biases. 24 Crowdfunding, which many
hoped would level the playing field, has failed because well-intentioned investors
seeking a financial return cannot individually overcome informational issues. 25

19 See infra notes 78-88 and accompanying text.
20 See infra notes 89-95 and accompanying text.
21 See infra notes 96-100 and accompanying text.
22 See infra Part III.A.
23 See infra notes 122-128, 165-177 and accompanying text.
24 See infra notes 98-99, 200-203 and accompanying text.
25 See infra notes 241-247 and accompanying text.
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 business and the geographical areas where these are often located. To promote the development of these LISBICs, the 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 global pandemic has devastated small businesses and local communities. To survive in a post-pandemic world, minority-owned businesses’ access to capital will need to improve considerably. Encouraging the survival and growth of minority-owned businesses would also help rebuild low-income minority communities and address some of the racial injustices highlighted by recent events. More generally, this Article illustrates how longstanding racial

---


27 See Fairlie, supra note 26 at 5 (finding that the number of African-American and Hispanic business owners dropped by 41 and 32 percent, respectively); Kristopher J. Brooks, 40% of Black-owned Businesses not Expected to Survive Coronavirus, CBS News (Jun. 12, 2020), https://www.cbsnews.com/news/black-owned-businesses-close-thousands-coronavirus-pandemic (describing the difficulties faced by African-American owned businesses during the Covid-19 pandemic, including their inability to raise capital).

28 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 (“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 INFORMATION (June 11, 2020), https://www.theinformation.com/articles/as-silicon-valley-turns-attention-to-race-black-entrepreneurs-detail-prejudice?utm_source=top10.
disparities and inequities in society migrate into the entrepreneurial space, a process that feeds into the poverty cycle that has historically shattered minority communities. 29

The Article proceeds as follows. Part I summarizes the existing evidence on the causes and effects of racial disparities in entrepreneurship, highlighting the critical role of access to capital and the reasons why minority entrepreneurs 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 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

The first part of this section describes the critical role of entrepreneurship in society and its untapped potential to develop the economies of distressed minority communities. The second part 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 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 product and services, and can act as engines of social change. Nationally, minority-owned businesses play these macro-economic roles, contributing to income and employment, as well as introducing new products and services. Minority-owned businesses also play a key role in developing local economies and improving neighborhoods, especially in socially and economically distressed areas, such as inner cities, where poverty and unemployment levels are historically higher than the national average. In these communities, entrepreneurship presents an alternative means to generate and accumulate wealth, thus providing a mechanism to bridge the wealth gap discussed earlier.

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

---


32 See Kloosterman & Rath, supra note 31, at 2-3; ICIC Report, supra note 8, at 3.

33 See ICIC Report, supra note 8, at 3.

This source of economic growth and social development has remained untapped due to the relative low number of minority-owned businesses and the exceptional difficulties faced by minorities that engage in the entrepreneurial space. As noted earlier, the self-employment rate among whites is twice that of African Americans. Not only are minorities less likely to start their own businesses, but those who do underperform - minority owned-businesses are less profitable than non-minority businesses and experience higher failure rates. The next sections 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 entrepreneurs’ socio-economic characteristics (such as human capital and wealth) and the nature of the businesses they operate can affect their fortunes. These two factors not only interact among themselves, but are also closely related to the third, and most critical one, access to capital.

1. Entrepreneur Characteristics

Some scholars have sought to explain racial disparities in entrepreneurial outcomes by focusing on socio-economic variables, arguing that differences between minority and non-minority entrepreneurs in human capital and wealth lead to differences in entrepreneurial success among these groups. 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 regarding the explanatory power of these demographic variables.

See supra note 29 and accompanying text.

See supra notes 8-10 and accompanying text.

See supra notes 12-15 and accompanying text.

See Phillips Pantin, The Wealth Gap, supra note 1, at 456-58; infra notes 42 and 52.
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 the effective managerial decisions in a fast-moving environment rife with uncertainty. These complexities explain why an entrepreneur’s formal education is a key determinant of his or her ability to successfully start and operate a businesses and why entrepreneurs with lower levels of education are at a disadvantaged position. Education might also affect entrepreneurial success indirectly by facilitating the development of valuable social and professional networks that can improve future access to business and financing opportunities. The fact that minorities tend to have lower level of education than non-minorities, can thus explain part of the racial disparities in entrepreneurship rates and firm performance. 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.

---

39 See Fairlie & Robb, Disparities in Capital Access, supra note 10, 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) [hereinafter Efrat, The Tax Burden] (“[W]hereas a quarter of the general population earned a bachelor's degree or more, small-business owners are twice as likely to have earned the degrees.”).

40 See Miller McPherson et al., Birds of a Feather: Homophily in Social Networks, 27 ANN. REV. SOCIOL. 415, 426-27 (2001) (explaining why individuals tend to have relationships with others of the same level of education); infra notes 95-97 and accompanying text.

41 See Fairlie & Robb, Why Are Black-Owned Businesses Less Successful, 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, Disparities in Capital Access, supra note 10, at 22-23 (arguing that lower levels of education limit minority business ownership rates by “challenging the business performance of some minority entrepreneurs”).

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

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. As noted earlier, minorities, particularly Hispanics and African Americans, have lower levels of wealth and own

---


44 See Harner, supra note 43, 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.”).

45 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.”).

46 See Fairlie & Robb, Disparities in Capital Access, supra note 10, 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 42, at 84 (noting a strong intergenerational link in self-employment due to the transmission of informal business or managerial experience, among other reasons).

47 See Fairlie & Robb, Why Are Black-Owned Businesses Less Successful, supra note 7, at 297 (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, Disparities in Capital Access, supra note 10, 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”).

48 See infra notes 58-59, 181 and accompanying text.
fewer financial assets than non-minorities. Scholars have found that these economic disparities are likely to be a major factor in explaining low startup rates among minority entrepreneurs, though there is no universal consensus on whether differences in wealth are a major determining factor of entrepreneurial disparities.

2. Business Characteristics

The size and form of minority-owned business can also explain their relative poor performance. Minority-owned business are on average smaller than non-minority owned businesses, both in terms of number of employees and revenues, and smaller businesses are more likely to perform poorly relative to bigger ones. Business form also appears to correlate with the success of an enterprise – incorporated business tend to outperform sole proprietorships and minority-owned businesses tend to be organized as the latter.

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 (such as services and retail

49 See supra notes 2-4 and accompanying text.
50 See Fairlie & Robb, Disparities in Capital Access, supra note 10, 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”).
52 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 42, at 76 (arguing that “the consensus view that nonminority whites achieve higher entry rates than African Americans because they are relatively wealthier and better educated...is simplistic”).
53 See Efrat, Minority Entrepreneurs, supra note 11, at 101; Efrat, The Tax Burden, supra note 39, at 179.
54 See Efrat, The Tax Burden, supra note 39, at 179.
businesses), which are less profitable and more prone to failure. Moreover, businesses in low-income neighborhoods with a less affluent client base, those in which minority entrepreneurs tend to operate, generate lower profits, are more prone to failure and have less ready access to financing.

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 expenses associated with starting and operating a business. Early-stage businesses are not likely to generate these funds internally and thus securing external debt or equity financing becomes crucial if the entrepreneur lacks adequate personal financial resources. Raising capital presents an even bigger challenge for businesses owned by minority entrepreneurs.

---

55 See Efrat, Minority Entrepreneurs, supra note 11, at 102 (arguing that minority entrepreneurs are more prone to business failure “because [they] are underrepresented in the high-value and growth industry sectors”); Fairlie & Robb, Why Are Black-Owned Businesses Less Successful, supra note 7, at 311 (noting that black-owned businesses appear to be overrepresented in less successful industries relative to white-owned businesses); Efrat, The Tax Burden, supra note 39, at 177 (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 42, at 83-84.

56 See ICIC Report, supra note 8, at 4 (noting that businesses that serve local, minority neighborhoods have lower profits and higher firm closure rates); Fairlie & Robb, Disparities in Capital Access, supra note 10, 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.”).


59 See id.

60 See Shinnar & Young, supra note 34, at 247 (“obtaining financing for start-up and capital for growth has been listed as one of the biggest challenges for minority-owned businesses”); Fairlie & Robb, Disparities in Capital Access, supra note 10, at 17 (“Financial constraints are the most
Minority businesses are more likely to be denied credit than non-minority businesses. These disparities in loan denial rates are robust to controlling for personal and business factors that affect an applicant’s creditworthiness, such as wealth and credit history. Even those minority owned-businesses that are approved for credit are still at a disadvantage: loans received by minority-owned business are smaller than those received by non-minority businesses and carry higher interest rates, even after controlling for factors affecting applicants’ creditworthiness. 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.64

As a result, minority and non-minority businesses are financed quite differently. 65  Minority entrepreneurs rely less on formal funding sources such as banks and private equity financing for their startup capital, relying instead on informal funding sources such as personal savings, loans from friends and family, and credit card debt.66  These sources, however, tend to be limited and can be expensive, making it more difficult for minority entrepreneurs to start their businesses.67  Not only does limited access to capital make it more difficult for minority entrepreneurs to “open shop,” but the resulting undercapitalization reduces the ability of new minority businesses to thrive and survive.68

64 See infra notes 192-197 and accompanying text.

65 See Fairlie & Robb, Disparities in Capital Access, supra note 10, 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.”).

66 See Shinnar & Young, supra note 34, at 247 (noting that “Hispanic entrepreneurs tend to rely on informal funding sources for business start-up rather than banks and venture capital” and arguing that “[t]his 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, Disparities in Capital Access, supra note 10, at 20 (noting that “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 61, at IV (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).

67 See de Zeeuw, supra note 61, 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).

68 See Efrat, Minority Entrepreneurs, supra note 11, at 100 (noting that “minority entrepreneurs’ higher failure rate has been blamed on limited access to credit” and that “higher levels of capitalization have a positive effect on survival rates of small businesses”); Fairlie & Robb, Disparities in Capital Access, supra note 10, 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 can explain 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 in explaining why minority entrepreneurs face disparate treatment by banks and other financial entities. Though it is difficult to deny the existence of racially-motivated bias, the full picture is likely more nuanced and complex. This section tries to untangle this complexity by exploring the role of informational asymmetries in the development of these racial disparities in access to capital.

Investing in young, small businesses is risky: the vast majority of startups fail in their first year. This high rate of failures that characterizes small businesses coupled with the lack of easily available information about them subjects potential investors to significant risks. Though the use of collateral by borrowers can

---

69 See supra notes 62-63 and accompanying text (providing evidence that racial disparities in financing are present even after controlling for various entrepreneur characteristics); Efrat, Minority Entrepreneurs, supra note 11, 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 et al., supra note 61, at 80; Fairlie & Robb, Disparities in Capital Access, supra note 10, at 21 (“A factor posing a barrier to obtaining financial capital for minority-owned businesses is racial discrimination in lending practices.”); Blanchflower, supra note 62, at 2154 (arguing that lending patterns consistent with a finding of racial discrimination in the credit market by banks).

70 See Watson et al., supra note 61, at 80.

71 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.”).


73 See Watson et al., supra note 61, at 77; Mark Granovetter, The Economic Sociology of Firms and Entrepreneurs in IMMIGRANT ENTREPRENEURS 128, 132 (noting that credit is difficult to find where information about credit risk is scarce and costly); Claudia Lin-Yung Zhang, How to Solve the Dilemma of Small Business Finance: A Proposal For Creditors’ Statutory Information Right,
reassure potential creditors,\textsuperscript{74} this does not effectively solve the inherent informational asymmetries problems, and the resulting overleveraging can adversely impact the performance and development of a business.\textsuperscript{75} As a result, loan applications by small startups are often denied.\textsuperscript{76} For these very same reasons, raising capital via equity can also be prohibitively expensive and is often not a realistic alternative for many small enterprises.\textsuperscript{77} 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 companies (e.g., detailed financial statements about past performance).\textsuperscript{78} Individuals and entities investing in young, small businesses must thus rely on subjective or “soft” information, i.e., information that cannot be directly verified by anyone other than the person who

---

\textsuperscript{74} See Zhang, supra note 73, at 137 (“Collateral is also a useful way to deliver private information and overcome borrower/lender incentive conflicts.”).

\textsuperscript{75} See Efrat, The Tax Burden, supra note 39, at 178 (noting that small firms that receive financing can fail because they tie up their assets or the debt overwhelms them); Zhang, supra note 73, at 137 (“Collateral may impose opportunity costs on borrowers by drying up assets that might otherwise be put into more productive uses.”).

\textsuperscript{76} See infra note 183. See also Watson et al., supra note 61, at 80; Zhang, supra note 73, at 131 (“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.”).

\textsuperscript{77} See Nancy Huyghebaert & Linda M. Van de Gucht, The Determinants of Financial Structure: New Insights from Business Start-Ups, 131 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 (1984) (arguing that the value of debt, by virtue of being a more senior security than equity, is less sensitive to private information); Fairlie and Robb, Disparities in Capital Access, supra note 10, at 17.

\textsuperscript{78} 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 and this reduces the availability of external finance).
produces it. For example, “knowing” that a firm manager is honest and hardworking is an intangible fact that can be gained through personal experience and interactions but that cannot be easily documented (and credibly communicated) as, or garnered from, “hard,” “objective” or “verifiable” information” (such as a financial report or a resume). 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.

Loan applications by small businesses are more likely to be approved by lenders that operate within a decentralized decision-making system (e.g., where local branch managers make approval decisions). Studies that have examined lending patterns of big and small banks indicate that small, local banks have a comparative advantage in lending based on soft information to small businesses while big banks prefer to lend to larger businesses and rely on hard information when making lending decisions. As it turns out, “soft information loans” can be

---


81 See Fourati & Affes, supra note 78, 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, 1 International Handbook Series on Entrepreneurship 299, 300 (1998).

82 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 79, at 1893; Jose M. Liberti & Atif R. Mian, Estimating the Effect of Hierarchies on Information Use, 22 Rev. Fin. Stud. 4057, 4060-61 (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).

83 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 which creditworthiness is more difficult to assess with “hard” information. See Allen N. Berger et al., Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks, 76 J. Fin. Econ. 237, 240-41 (2005). Large banks lend at a greater distance, interact more
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.\textsuperscript{84} Unfortunately,
the continuing trend of bank consolidation and concentration has complicated
matters for small businesses, as small local banks disappear and are replaced by
bigger banks who are less suited to deal with soft information.\textsuperscript{85}

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 (and more wisely) in nearby companies.\textsuperscript{86} 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.\textsuperscript{87} More generally, private equity investors rely heavily on
relationship-driven and geographically-focused screening and monitoring
mechanism, as well as sophisticated contractual provisions, to gather an exploit soft
information when investing in small, young businesses.\textsuperscript{88}

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

\textsuperscript{84} See Mian, supra note 82, at 1498-99.

\textsuperscript{85} See Stein, supra note 79, at 1891; Cavalluzzo et al., supra note 62, 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.”).

(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, \textit{Home Bias at Home: Local Equity Preference in Domestic Portfolios}, 54 J. FIN. 2045, 2047 (1999) [hereinafter Coval & Moskowitz, \textit{Home Bias}]
(finding that fund managers invest in companies which are around 10% closer than the average firm it could have held); Joshua D. Coval & Tobias J. Moskowitz, \textit{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
are some valuable information about these firms that these managers are getting on the ground).


\textsuperscript{88} See supra notes 79-80 and accompanying text.
advantage of traditional strategies used to mitigate investors’ informational concerns, as these require personal wealth and resources that minority entrepreneurs often do not have.89 For example, to borrow money, 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.90 Similarly, outside equity investors prefer that the entrepreneur has some “skin in the game” by investing enough of his or her personal resources as firm capital.91

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. 92 Such informality in businesses affairs is not conducive to the production of hard,

89 See Fairlie & Robb, Disparities in Capital Access, supra note 10, at 19 (arguing that “low levels of personal wealth and liquidity constraints also limit the ability of minority entrepreneurs to raise adequate levels of startup capital”); Robert B. Avery et al., 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).

90 See Fairlie & Robb, Disparities in Capital Access, supra note 10, 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 62, at 2154 (finding that personal wealth, primarily through home ownership, decreases the probability of loan denials among existing business owners).

91 See Fairlie & Robb, Disparities in Capital Access, supra note 10, 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’.”).

92 See Efrat, The Tax Burden, supra note 39, at 179; Shinnar & Young, supra note 34, at 247. 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, 15 NO. 19 LAWYERS J. 4, 4 (2013). 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. EQUALITY 1 (2018).
verifiable information that can be easily accessed and assessed by investors.93 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.94 Even in flat hierarchical settings, socio-economic and cultural differences between investors and entrepreneurs complicates the production and digestion of soft information. For example, it is easier for an investor to uncover and interpret soft information when that investor enjoys cultural proximity with the entrepreneur.95 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.96

The fact that professional investors (most of whom are non-minority) and minority entrepreneurs belong to different networks increases the costs for the former in identifying, assessing and monitoring businesses owned by the latter.97 Investors lacking the required knowledge and connections to assess soft

93 See Fourati & Affes, supra note 78, at 248 (noting that the legal form of organization can act as “a signal that indicates credibility and formality of operations and ensures future growth” and that there is a “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 26 at 5 ("Incorporated businesses are viewed as more growth-oriented, committed, procyclical and entrepreneurial.").

94 See supra notes 81-85 and accompanying text.

95 See Watson et al., supra note 61, at 79.

96 See Julia S. Rubin, Venture Capital and Underserved Communities, 45 URBAN AFFAIRS 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”).

97 See Rubin, supra note 96, 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.”).
information, may, given the lack of verifiable information, resort to the use of heuristics, i.e., use the entrepreneur’s race (an observable attribute) as a proxy for business risk (an unobservable attribute).\(^9\) In this context, implicit biases can lead investors to make decisions that systematically disfavor minority entrepreneurs.\(^9\)

Recent Federal Reserve data on small business lending helps illustrate this point.\(^1\) 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 11-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 27-point difference). The fact that race seems to play a role in situations

\(^{98}\) For an overview of the sources of implicit biases, see Anthony G. Greenwald & Linda Hamilton Krieger, *Implicit Bias: Scientific Foundations*, 94 CAL. L. REV. 945, 952–957 (2006); Christine Jolls & Cass R. Sunstein, *The Law of Implicit Bias*, 94 CAL. 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 et al., *supra* note 62, 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) (“[s]tatistical 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.”).

\(^{99}\) See Daniel Applewhite, *Founders & Venture Capital: Racism Is Costing Us Billions*, FORBES (Feb. 15, 2018), https://www.forbes.com/sites/forbsnonprofitcouncil/2018/02/15/Founders-and-venture-capital-racism-is-costing-us-billions (“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 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.”).

\(^{100}\) See de Zeeuw, *supra* note 61, at 11.
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.\textsuperscript{101}

\section*{II. WHY EXISTING PROGRAMS HAVE FAILED}

This section 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, thought its role and the nature of its involvement has varied, from directly guaranteeing loans to indirectly enhancing access to capital by relaxing regulatory requirements.

\subsection*{A. Government-led Programs}

The U.S. Small Business Administration (SBA) directly supports entrepreneurs and small businesses through a three-pronged strategy.\textsuperscript{102} First, the SBA facilitates access to capital by providing a government-backed guarantee on loans granted by financial institutions (such as banks) to qualifying small-businesses.\textsuperscript{103} Second, the SBA oversees the federal government's efforts to deliver a percentage of federal contracts to certain small businesses.\textsuperscript{104} Finally, the SBA provides counseling to small businesses via a network of local offices.\textsuperscript{105}

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{101}] 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, \textit{Criminalizing Race: Racial Disparities in Plea-Bargaining}, 59 B.C. L. REV. 1187, 1241 (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).
\item[\textsuperscript{102}] The SBA is one of two U.S. government agencies that are involved in promoting minority-owned businesses. See Min & Bozorgmehr, supra note 34, at 20, 34 (2003). The other agency, the Minority Business Development Agency (MBDA), is part of the Department of Commerce. See Eugene Boyd, \textit{Minority Business Development Agency: An Overview of its History and Current Issues}, Congressional Research Service (Nov. 9, 2017) at 1. 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. 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. See id. at 6.
\item[\textsuperscript{103}] See infra notes 115-121 and accompanying text.
\item[\textsuperscript{104}] See infra note 111 and accompanying text.
\item[\textsuperscript{105}] See infra notes 112-114 and accompanying text.
\end{itemize}
\end{footnotesize}
1. **SBA Business Development and Loan Programs**

   **Business Development Programs**

   The SBA’s 8(a) Business Development program provides support to small businesses owned by “socially and economically disadvantaged” individuals.\(^{106}\) 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.”\(^{107}\) Members of certain designated groups, including African Americans, Hispanics and Native Americans, are entitled to a rebuttable presumption of social disadvantage.\(^{108}\) 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.”\(^{109}\) To initially qualify as economically disadvantaged, applicants must have a net worth lower than $250,000, among other requirements.\(^{110}\)

   Businesses that meet the 8(a) program’s eligibility requirements enjoy limited competition for certain federal government contracts known as set-aside and sole-source contracts.\(^{111}\) Participants in 8(a) program are also eligible to receive assistance through the 7(j) Management and Technical Assistance

---


\(^{107}\) 13 C.F.R. §124.103(a).

\(^{108}\) 13 C.F.R. §124.103(b).

\(^{109}\) 13 C.F.R. §124.104(a).

\(^{110}\) 13 C.F.R. §124.104(c)(2).

\(^{111}\) 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 C.F.R. §19.501(a). There are government-wide and agency-specific goals regarding the percentage of procurement dollars awarded to 8(a) participants. 13 C.F.R. §124.1002. 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 (2006).
program,\textsuperscript{112} be assigned a business opportunity specialist to help navigate federal contracting and obtain general business development assistance,\textsuperscript{113} and participate in the mentor-protégé program.\textsuperscript{114}

\textit{b. SBA Loan Guarantee Programs}

The SBA does not act as a lender to small businesses, but rather provides guarantees for small businesses applicants. Depending on the program, loans are provided by intermediaries such as banks (SBA 7(a) loans) or Certified Development Companies (CDC’s) (SBA 504 loans), which are the entities that interact with the small business applicant and make credit decisions.\textsuperscript{115} 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.\textsuperscript{116}

Amounts borrowed under the 7(a) loan program can be used for any business purpose, including working capital, inventory, financing leasehold improvements and refinancing debt.\textsuperscript{117} Although borrowers may use the 7(a) program to fund capital investments, such as acquiring, constructing or renovating a building and purchasing heavy machinery and equipment, the SBA’s 504 loan program offers certain advantages for small businesses to fund these capital investments in government contracts.

\textsuperscript{112} This program provides support such as training, executive education, and consulting in areas such as marketing, accounting, opportunity development and capture, contract management, compliance, and financial analysis. 13 C.F.R. §§124.701-124.703.

\textsuperscript{113} 13 C.F.R. §124.704.

\textsuperscript{114} 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. §124.520.

\textsuperscript{115} 13 C.F.R. §120.2.


\textsuperscript{117} 13 C.F.R. §120.120. See also U.S. Small Business Administration, \textit{7(a) Loan Program: Terms, Conditions and Eligibility}, https://www.sba.gov/partners/lenders/7a-loan-program/terms-conditions-eligibility; CRS 7(a) Report, supra note 116, at 44-45.
institutions. 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. Borrowings under the 504 program require a down payment of 10%. In contrast, the 7(a) loan program requires certain loans to be fully collateralized.

The overall effectiveness of these SBA loan programs has been widely questioned. Some have argued that the policy rationales underlying the programs are not sound, highlighting the opaqueness of the selection process and maintaining that the ultimate winners are big banks who do not need taxpayers’ financial support. 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 relatively expensive and can place undue financial strains and burdens in the short term. 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.

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

---

118 See CRS 504 Report, supra note 116, at 6-7.
120 504 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 contributing 10% of the project costs. See CRS 504 Report, supra note 116, at 9-10.
121 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 116, at 45.
122 See Senate Hearings, supra note 62, at 4 (opening statement of Hon. Olympia Snowe (noting that “the effectiveness of [SBA] programs have been repeatedly called into question”).
124 See infra note 180-184 and accompanying text.
125 See infra note 183, 190, and accompanying text.
minority entrepreneurship. 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. 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.

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. To fund their investments, SBICs raise capital from private investors (“regulatory capital”), mainly institutional investors such as banks, insurance companies, pension funds and university endowments, as well as high net-worth individuals. These funds are supplemented by the SBA mainly in the

---

126 See Min & Bozorgmehr, supra note 34, at 34-35 (summarizing the relevant literature).

127 See Senate Hearings, supra note 62, 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.”).

128 See supra note 123 (providing evidence that lenders in the SBA programs are large banks) and supra notes 94-100 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 85 and accompanying text. See also Cavalluzzo et al., supra note 62, at 676-77 (“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.”).

129 See John K. Paglia & David T. Robinson, Measuring the Representation of Women and Minorities in the SBIC Program, Federal Research Division Report (Oct. 2016) at 8-9 (“The 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 INSTITUTE (March 2013) at 360-61 (“[SBICs] lend or invest its 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.”).

form of guaranteed debt: for every $1 a SBIC raises from a private investor, the SBA typically provides $2 of debt capital, up to $175 million (“leverage capital”). Once capitalized, SBICs act as managed investment funds that invest capital raised from private investors in businesses operating in sectors and industries in which the fund managers have expertise.\footnote{132}

\paragraph{a. SBIC Programs}

Active SBIC’s 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 SBICs program. 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 six belonged to the Specialized SBIC program.\footnote{133}

The Debenture program has existed since the inception of SBICs in 1958 and is by far the largest program.\footnote{134} Under this program an SBIC receive SBA leverage in the form of a guaranteed debenture (i.e., loan obligations), which allows


\footnote{\text{132} See \textit{id.} SBICs can be organized under state law as corporations, a limited partnerships or limited liability companies. See \textit{id.} at 4. SBICs are organized as limited partnerships with the SBIC managers acting as the general partner. \textit{See OCC SBIC Report, supra} note 130, at 1.}


\footnote{\text{134} During 2018, Debenture SBICs provided $5,159 million in financing, which represented 94.76\% of all funding made available by all type of SBICs during that period ($5,502.6 million).}
the SBICs to borrow at favorable terms. There are a number of capital requirements that need to be satisfied by SBICs participating in the Debenture program, but a detailed discussion of these is not necessary for our purposes. Debenture SBICs can only invest in businesses with a tangible net worth under $19.5 million.

The fixed and periodic nature of the payments that an SBIC under Debenture program must meet makes startup and early-stage businesses less attractive investment targets for SBICs relative to older, more established businesses. Investing in young, small businesses generally requires the ability to purchase equity interests in them, which interests are unlikely to provide a predictable stream of returns. 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.

To facilitate the formation of SBICs that would make equity investments in startups and early stage companies, in 1994 the SBA established the Participating

---

135 See CRS SBIC Report, supra note 131, at 1. When an SBIC wants to draw leverage, it notifies the SBA and issues a debenture, which the SBA temporarily holds (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 Small Business Administration, Commitment Instructions: Memorandum of Instructions Application for Commitment of SBIC Debentures, at 7, https://www.sba.gov/document/policy-guidance-commitment-instructions.

136 Debenture SBICs are required to have a private capital investment of at least $5 million. 13 C.F.R. §107.210. 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. 13 C.F.R. §107.150.

137 See Dunn, Early Stage SBICs, supra note 129, at 364.

138 Debenture SBICs must make semiannual payments to cover interest and other charges. See CRS SBIC Report, supra note 131, at 12.

139 See infra notes 182-184 and accompanying text.

140 See CRS SBIC Report, supra note 131, at 11; Dunn, Early Stage SBICs, supra note 129, 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 133, at 2.
Securities Program. Unlike the Debenture Program, where the SBA is a practically 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. Due to mounting losses associated with this program, the SBA terminated it on October 2004 and stopped issuing new commitments for participating securities leverage or licensing new SBICs using that leverage. In the ensuing years, congressional and market actors expressed interest in reviving a similar program to assist startup and early stage small businesses.

One such program was part of the Obama Administration’s Startup America Initiative in 2012, under which the SBA established a five-year, $1 billion early stage SBIC program. Early-stage SBICs were required to invest at least 50% of their financings in early stage small businesses, defined as small businesses that have never achieved positive cash flow from operations in any fiscal year. In recognition of the higher risk associated with investments in 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.” Since the program

---

141 This was made possible by an act of Congress that authorized the SBA to guarantee a broader set of securities. P.L. 102-366, the Small Business Credit and Business Opportunity Enhancement Act of 1992 (Title IV, the Small Business Equity Enhancement Act of 1992).

142 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 131, at 7.

143 See id. at 20.

144 See id. at 6.

145 See Small Business Investment Companies—Early Stage SBICs, 77 FED. REG. 25043, 25050 (Apr. 27, 2012).

146 See id. at 25051-25053.

147 See id. at 25043.
was not renewed, in 2017 the SBA stopped accepting new applicants for the early-stage SBIC initiative.148

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 is still in existence, 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 that was meant to capture minority-owned small businesses.149 The program, however, was repealed in 1996 and no new SSBIC licenses have been issued by the SBA since then.150 During the existence of the program, the SBA issued 288 SSBIC licenses; in 1997 there were 77 active SSBICs and as of 2018 only 6 remained.151 Some have argued that the decline of the SSBIC program resulted in a corresponding decline of SBIC financings to minority-owned small businesses.152

The Impact Investment SBIC initiative was a $1 billion effort established by the SBA in 2011.153 Under the terms of the program, an impact investment

148 See CRS SBIC Report, supra note 131, at 11; Small Business Investment Companies (SBIC): Early Stage Initiative, 83 FED. REG. 26875, 26875-76 (Jun. 11, 2018).

149 See CRS SBIC Report, supra note 131, at 3; Paglia & Robinson, supra note 129, at 3. 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 57, at 353. Despite its questionable effectiveness, the MESBIC program gave birth to the minority-focused venture capital industry. See infra note 194 and accompanying text.

150 See CRS SBIC Report, supra note 131, at 3.

151 See Paglia & Robinson, supra note 129, at 9; SBIC Quarterly Report, supra note 133, at 2.

152 See Paglia & Robinson, supra note 129, at 9.

153 See CRS SBIC Report, supra note 131, at 8.
SBICs 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.”154 These areas initially included businesses located in underserved communities, 155 as well as other sectors like education and clean energy.156 Nine impact investment SBICs were licensed and as of September 30, 2018, they managed $905 million in assets and had investments in 81 businesses.157

This program was also short-lived. On 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 apply to the SBIC program.”158 The SBA indicated that the cost of the proposed additional benefits was “not commensurate” with the benefits, particularly in light that few qualified SBICs had applied to participate in the program and the fact that many of the program’s participants would have applied to the SBIC program regardless.159


156See CRS SBIC Report, supra note 131, at 8-9.


158See Small Business Investment Companies (SBIC): Impact SBICs, 83 Fed. Reg. 26874, 26874 (June 11, 2018) [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 131, at 8-9.

159See Impact SBICs Withdrawal, supra note 158 at 26874-75. 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. See id.
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 such as Amgen, Apple Computer, Costco, Federal Express, Intel, Tesla and Whole Foods. 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. More recently, however, SBIC programs have focused on providing debt financing to mid-stage companies, neglecting in great part the needs of small, early stage companies. This neglect is mainly 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. Moreover, as discussed later, raising capital via debt is generally not the best choice for small, early stage companies.

Whether the SBIC program has helped in the development of minority businesses is debatable. At a 2007 congressional hearing the SBA recognized that “minority representation in [the SBIC program] is low.” The situation does not seem to have improved since. As of Fiscal Year 2018, black-owned and Hispanic-owned businesses were involved in 1.9% and 1.0%, respectively, of SBICs

---

160 See Kromkowski & Bylica, supra note 130, at 4.
161 See Rubin, supra note 96, at 829; Sean Silverthorne, Government’s Positive Role in Kick-starting Entrepreneurship (Dec. 2009), http://hbswk.hbs.edu/item/6318.html (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) (noting that “many 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.”).
162 See supra notes 138-140 and accompanying text.
163 See id.
164 See infra notes 182-191 and accompanying text.
165 See House Committee on Small Business, Hearing on Legislation Updating and Improving the SBA’s Investment and Surety Bond Programs, 110th Cong., (Sept. 6, 2007) at 15; CRS SBIC Report, supra note 131, at 23.
financings.\textsuperscript{166} Non-minority businesses, on the other hand, were involved in 95.2% of the financings.\textsuperscript{167} Looking at the aggregate amount of funds disbursed reveals a similar pattern. Black-owned businesses receive 0.6% of the total disbursed funds, while Hispanic-owned businesses receive 0.2%.\textsuperscript{168} Non-minority business on the other hand receive a striking 97.6% of the total financing.\textsuperscript{169}

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.\textsuperscript{170} 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.\textsuperscript{171} As a result, the SBA instead focuses its efforts in encouraging SBICs to finance racially diverse portfolio companies and encouraging private equity funds with women or minority partners to apply to the SBIC Program.\textsuperscript{172}

The second type of effort is of particular interest, as funds led by minorities would be better suited to produce and digest the type of soft information that is necessary to invest in minority-owned businesses.\textsuperscript{173} As in private equity, the diversity of the SBIC investor base (i.e., the decision-makers) mirrors the diversity

\textsuperscript{166} See CRS SBIC Report, supra note 131, at 23. Other minority groups have similar numbers: Asians (1.8%) and Native Americans (0.0%).

\textsuperscript{167} See CRS SBIC Report, supra note 131, at 24. See also Paglia & Robinson, supra note 129, at 18 (finding that about 4 percent of the SBIC financings between June 1, 2013 and September 30, 2015 involved portfolio companies with a minority chief executive officer or president).

\textsuperscript{168} See CRS SBIC Report, supra note 131, at 23.

\textsuperscript{169} See id. at 24.

\textsuperscript{170} See id.

\textsuperscript{171} See Paglia & Robinson, supra note 129, at 8-9.

\textsuperscript{172} See id.

\textsuperscript{173} 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, House Committee on Small Business, 111 Cong. 51-89 (Oct. 14, 2009).
of the businesses that receive funding.\footnote{See infra notes 200-203 and accompanying text.} A 2016 study found that of the 303 active funds, 272 (89.8 percent) were non-racially diverse and 31 (10.2 percent) had at least one minority investment partner.\footnote{See Paglia & Robinson, supra note 129, at 17. These patterns are fairly stable across different types of funds. Of the 205 active debenture funds, only 21 (10.2 percent) was racially diverse. See 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. See id. at 15.} Racially diverse SBICs were more likely to invest (and invest more) in minority-owned businesses than non-racially diverse SBICs.\footnote{See id. at 24-25.} Despite these differences in their investment strategies, there were no significant differences in the financial performance of racially diverse and non-racially diverse SBICs.\footnote{See id. at 33 (concluding that “there is no apparent difference in performance between diverse SBIC funds and other funds”).}

B. Broadening the Investor Base

Two common attributes of the government-sponsored programs discussed above renders 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.\footnote{See supra notes 79-83 and accompanying text.} The second limitation relates to the programs’ heavy reliance on debt financing as a tool to promote entrepreneurship.\footnote{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 Part II.A.1.b. 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 Part II.A.2.a.} As discussed below, for many small and young firms debt is not necessarily the best source of financing, the difficulties faced by minority-owned businesses in raising equity through traditional channels, and how innovative technological-driven schemes that were expected to help minority-owned business access equity financing have fallen short.
1. **Private Equity**

The first source of financing used by entrepreneurs are personal funds (e.g., savings) and contributions from friends and family. 180 Once these sources of capital are exhausted, the entrepreneur needs to seek external financing. 181 Although established firms seeking outside financing often prefer to issue debt before equity, for young firms relying heavily on debt is often not the best choice. 182 First, the cash-flow uncertainty faced by young companies make it difficult for them to commit to a schedule of fixed payments, as is expected under debt instruments. 183 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. 184

---

180 See Pollman, supra note 79 at 170 (“founders 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 78, at 247 (noting that due to their lack of historical and reputation effects, new firms are informationally opaque and this complicates attracting external financing).

181 See Pollman, supra note 79, at 171 (noting that once personal funds are exhausted start-ups must seek alternate sources of capital).

182 See Paul Stuart et al., The Pecking Order Hypothesis: Does it Apply to Start-up Firms 14 J. SMALL BUS. & ENTERPRISE DEV. 8, 9 (2007) (“In 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 and Affes, supra note 78, at 246 (noting that the “litrature 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 et al., Asymmetric Information and the Pecking (Dis)order, mimeo (Jul. 17, 2019) at 26 (REV. FIN. (forthcoming 2020)), http://people.bu.edu/dhackbar/FGH-2019.pdf (presenting a model explaining why small firms may prefer equity over debt financing when informational asymmetries are severe).

183 See George Deeb, Comparing Equity, Debt And Convertibles For Startup Financings, FORBES (Mar 19, 2014), https://www.forbes.com/sites/georgedeeb/2014/03/19/comparing-equity-vs-debt-vs-convertibles-for-startup-financings/#6bd21c6169ff (“Traditional banks do not lend to startups, particularly in their early stages, due to their lack of a track record, negative cash flow, lack of tangible assets, and high failure rate.”); Huyghebaert & Van de Gucht, supra note 77 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”).

184 See Stuart et al., supra note 182, at 9–10 (“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) (finding that “that informationally opaque firms are less likely to use outsiders’ debt, credit line, credit card, and bank loan capital injections” a result that the
For young, small 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.\textsuperscript{185} 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.\textsuperscript{186} Sales of securities to these private equity investors are exempt from the registration requirements of the securities laws, which reduces transaction costs.\textsuperscript{187} 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.\textsuperscript{188} Generally, these investors rely on their social and professional networks to identify and screen potential opportunities before personally assessing them\textsuperscript{189} and then monitor their investments by taking an active role in its management, providing contacts, strategic advice and follow-on funding that can take a company on an entirely different trajectory.\textsuperscript{190} 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 advise and networking opportunities that equity investors do.\textsuperscript{191}

\textsuperscript{185} For a discussion of the rules governing the public offering process and their disparate impact on small businesses see infra notes 215-221 and accompanying text.

\textsuperscript{186} See Pollman, supra note 79, at 170 (“Two types of investors specialize in financing startups: angel investors and VCs.”).

\textsuperscript{187} See infra notes 219-221 and accompanying text.

\textsuperscript{188} See Pollman, supra note 79, at 171-73.

\textsuperscript{189} See supra notes 96-97 and accompanying text.


\textsuperscript{191} See Stuart et al., supra note 182, 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 and William D. Bradford, Venture-Capital Investment in Minority Business, 40 J. MONEY CREDIT &
Although private equity’s organizational structure and investment strategy is tailor-made for the collection and assessment of soft information, the precise 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. Consequently, an extremely low percentage of minority businesses is backed up by private equity: only one percent of venture capital backed startups are led by African Americans. Remarkably, these racial disparities in private equity financing do not reflect the profitability of venture capital funds that specialize in minority-owned businesses, which earn returns that are at least as large as those offered by mainstream funds. The undeniable reality, however, is that few private equity

---

192 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. BANK. & 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 (-22.8%) funding); ICIC Report, supra note 8, at 8 (finding that “while 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.”).

193 See Mark Stricherz, Obama Administration Shifts Emphasis on Crowdfunding, CQ ROLL CALL (Aug. 3, 2016) (citing Obama administration officials as noting that “only 3 percent of America’s venture capital-backed startups are led by women, and even fewer are led by African-Americans and Latinos”); White House, President Obama Announces New Commitments from Investors, Companies, Universities, and Cities to Advance Inclusive Entrepreneurship at First-Ever White House Demo Day, Press Release (Aug. 4, 2015), https://obamawhitehouse.archives.gov/the-press-office/2015/08/04/fact-sheet-president-obama-announces-new-commitments-investors-companies (noting that “only around one percent [of venture capital-backed startups] are led by African-Americans”); Applewhite, Founders and Venture Capital, supra note 99 (“Less than 1% of American venture capital-backed founders are black and the percentage of Black's in decision making roles within Venture Capital isn't much better.”).

194 The MESBIC program (the predecessor of the SSBIC) gave birth to a small minority-focused venture capital industry. See Bates and Bradford, supra note 191, at 492.

195 See Fairlie & Robb, Disparities in Capital Access, supra note 10, at 20; Bates and Bradford, supra note 191, at 490 (“Overall, the measured investment returns generated by the minority-focused VC funds were broadly consistent with those of mainstream funds”); Timothy Bates et al., 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 96, at 824-25 (“These funds’ strong financial performance undermines
funds target minority-owned businesses. Even venture capitalists now acknowledge their failures to fund non-white enterprises and the resulting lack of diversity in their portfolio companies.

Multiple factors explain why minority business are underserved by private equity. Minority businesses tend to be located in inner cities, geographically removed from venture capital networks, which complicates relationship-driven screening and monitoring. 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. A third explanation 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. As a result, private equity

---


197 See supra notes 56-57, 188 and accompanying text; Rubin, supra note 96, at 823; Michael S. Barr, Minority and Women Entrepreneurs: Building Capital, Networks, and Skills 3-4 (Hamilton Project, Mar. 2015).

198 See supra note 53 and accompanying text; Pollman, supra note 79, at 166 (“Early-stage startups are highly entrepreneurial and focused on innovation and technology”); Gompers & Lerner, supra note 190 at 190 (noting the “focus by venture capitalists on high-technology firms (e.g., communication, computers, electronics, biotechnology, and medical/healthcare”).

199 See Thorne, supra note 28 (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 National Venture Capital Association, NVCA Forms Diversity Task Force to Foster Greater Inclusion across the Innovation Ecosystem (Dec. 8, 2014), http://nvca.org/pressreleases/nvca-forms-diversity-task-force-foster-greater-inclusion-acrossinnovation-ecosystem/. 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, The Angel Investor Market in 2008: A Down
investors, the vast majority of whom are white males, and minority-entrepreneurs belong to different social, cultural, and professional networks. 201 These demographic differences increase the costs for investors to collect the soft information that is needed to identify, assess and monitor minority-owned businesses, leaving them in a position where implicit biases may influence their decision-making.202 In sum, while investing in minority-owned businesses can be lucrative, success in this niche requires specialized knowledge and non-conventional research, placing most private capital funds at a competitive disadvantage given their location, industry focus and demographic makeup.203

Small businesses, like minority-owned businesses, that struggle accessing outside equity are invariably placed in a situation where they either don’t have enough external financing or where they have to rely on excessive and expensive leverage that can put the operational and financial health of the business at risk.204

In recent years, technological and regulatory developments have spurred new

---

201 See supra notes 95-97 and accompanying text.

202 See Barr, supra note 198, at 15 (“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 96, at 824 (“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 98-99 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 197.


204 See Susan Coleman and Richard Cohn, Small Firms’ Use of Financial Leverage: Evidence from the 1993 National Survey of Small Business Finances, 12 J. BUS. & ENTREPRENEURSHIP 81, 83-84 (2000) (noting that small firms generally cannot access equity capital and thus may over rely on debt which can make them “susceptible to financial distress” and failure).
financing channels that seek to remedy some of the difficulties faced by small businesses in raising equity capital, as well as less expensive debt capital. A common strategy is to minimize frictions by reducing the role of financial intermediaries standing between the ultimate suppliers of capital and issuers. The rise of the internet led to the development of online platforms that allowed entrepreneurs to connect directly with both debt and equity investors, bypassing these financial intermediaries. For many, this made crowdfunding and other financial technology (FinTech) developments, such as online lending platforms, promising game changers.

205 See Joern H. Block et al, New Players in Entrepreneurial Finance And Why They Are There, 50 SMALL BUS. ECON. 239, 240 (“These new players and instruments have emerged, among others, because of the difficulties faced by entrepreneurs and early-stage new ventures in raising funds.”).

206 See id. at 247 (noting that “the 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.”).

207 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.”).

208 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 et al., 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 attenuated biases do still remain). See Robert Bartlett et al., Consumer-Lending Discrimination in the FinTech Era at 6 (Nov. 2019 draft), https://faculty.haas.berkeley.edu/morse/research/papers/discrim.pdf. Various online lending platforms are marketed towards underserved populations. See Mark Schweitzer and Brett Barkley, Is ‘Fintech’ Good for Small Business Borrowers? Impacts on Firm Growth and Customer Satisfaction, Federal Reserve Bank of Cleveland Working Paper 17-01 (Jan. 2017), at 11. 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. The terms of these loans are also far from ideal. The size of loans disbursed by online lenders are smaller than those of traditional lenders. See Brett Barkley and Mark E. Schweitzer, The Rise of Fintech Lending to Small Businesses: Businesses’ Perspectives on Borrowing, Federal Reserve Bank of Cleveland Working Paper 20-11 (Apr. 2020), 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; Lenore Palladino, Small Business Fintech Lending: The Need for Comprehensive Regulation, 24 FORDHAM J. CORP. & FIN. L. 77, 78-79 (2019).
2. Crowdfunding

Crowdfunding initially developed to support ventures by facilitating donations or product pre-purchases.209 The revolutionary feature of crowdfunding was empowering individuals to “directly” interact with members of the public via online platforms in order to raise funds, thus cutting middlemen.210 Early funding platforms followed the reward and pre-purchase 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.211 Crowdfunding soon emerged as an alternatively vehicle to raise relatively small amounts of capital from retail investors.212 Early microfinance portals allowed investors to lend money to micro-entrepreneurs for return of principal and nominal interest.213 The application of the federal securities laws, however, arrested the development of crowdfunding as a vehicle for more sophisticated debt instruments and equity investments.214

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 (distributed to investors).215 In addition, a set of gun-jumping rules regulate the timing, manner, and form of


211 See Bradford, supra note 209, at 16-17.


213 See id. at 27.

214 See Bradford, supra note 209, at 30.

215 See 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).
communications made during the offering process.\textsuperscript{216} Preparing the required disclosure documents and complying with the gun-jumping rules is time consuming and costly. \textsuperscript{217} The significant fixed component of these compliance costs disproportionately affects smaller businesses.\textsuperscript{218}

To avoid these costs issuers conduct “exempt” offerings.\textsuperscript{219} One the most commonly used exemptions is Rule 506, 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.\textsuperscript{220} The numerous conditions of Rule 506 limit the usefulness of this exemption for small businesses, especially those owned by minorities: 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.\textsuperscript{221}

The costs and difficulties faced by small businesses and minority-owned businesses in tapping accredited investors, who generally belong to a different

\begin{footnotesize}
\footnote{216 See Carlos Berdejo, 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. See id.}
\footnote{217 See id. at 10.}
\footnote{218 See B. Espen Eckbo et al., Security Offerings, in 1 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. 15604, 15605 (Apr. 2, 1997) (describing the SEC’s historical formal and informal efforts on behalf of small entities).}
\footnote{219 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,” the SEC promulgated Regulation D to provide clarity and predictability in the use of this exemption. See Heminway & Hoffman, supra note 215, at 915-20 (highlighting clarifying purpose of Regulation D).}
\footnote{220 17 C.F.R. § 230.506(b)(2)(ii). 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. 17 C.F.R. §§ 230.501(a)(1)-(6).}
\footnote{221 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. 17 C.F.R. § 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 Berdejo, supra note 216, at 28-30.}
\end{footnotesize}
social and professional network, made crowdfunding a revolutionary and exciting financing vehicle.222 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 raising though “crowdfunding,” enabling the use of the internet to pool small individual investments.223 These offerings are open to a wide variety of investors and not just “accredited” ones.224 The exemption’s set of relaxed requirements not only expands the pool of investors that small businesses can tap, but are also intended to reduce the costs of raising capital by providing for scaled disclosure requirements, which vary according to the aggregate offering amount.225

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,226 touting the important role of crowdfunding in “empower[ing] diverse entrepreneurs to launch

---


224 See Sherwood Fouse, supra note 212, at 34. 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. § 302(a).


successful businesses after traditional sources of capital turned them down.”

The administration’s optimism reflected the ideal that crowdfunding could provide an avenue for the democratization of the capital markets for small businesses, particularly minority-owned ones. Many hoped that providing minority-owned businesses with direct access to individuals eager to invest in them would level the playing field.

A recent SEC report found that the number of crowdfunding offerings and the total amount of funding has been “relatively modest.” Market participants have made a number of proposals to revitalize crowdfunding, including increasing

227 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; Mark Stricherz, Obama Administration Shifts Emphasis on Crowdfunding, CQ ROLL CALL (Aug. 3, 2016) (analyzing blog posts by the Obama administration suggesting that crowdfunding under the JOBS Act was intended to help minority businesses).

228 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 (2016); 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 MAGAZINE (Dec. 2015), https://csq.com/2015/12/equity-crowdfunding-and-the-rights-of-man (“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.”).


the amount a company can raise during a 12-month period, increasing individual investors’ investment limits, and reducing the reporting and disclosure obligations that are too burdensome and costly for many of the small issuers that rely on the rule. The SEC has recently proposed a series of revisions to the existing rules to address many of these concerns.

Participation rates among traditionally underrepresented businesses has been discouragingly low during the early years of equity crowdfunding. Although some minority entrepreneurs have successfully employed crowdfunding to raise capital for their businesses, the existing evidence suggests that

---

231 See U.S. Small Business Administration Office of Advocacy, One Year of Equity Crowdfunding: Initial Market Developments and Trends, Economic Research Series, https://www.sba.gov/sites/default/files/advocacy/Crowdfunding_Issue_Brief_2018.pdf (hereinafter SBA Study) at 8-9; Association of Online Investment Platforms, Policy Position Paper (June 18, 2019), https://www.aoiplatforms.org/official-positions, [hereinafter, AOIP Paper] at 1 (“The current $1.07 million cap is arbitrary and creates a negative selection bias for companies – as quality companies requiring larger amounts of capital are discouraged from utilizing Reg CF.”); SEC CF Report, supra note 230, 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. See SEC CF Report, supra note 230, at 37 (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”).

232 See AOIP Paper, supra note 231, at 2 (arguing that limits should be eliminated for accredited investors and that “Reg CF could adopt Reg A’s investment limit scheme for non-accredited investors which promote diversification and the spread of capital.”).

233 See AOIP Paper, supra note 231, at 3 and SEC CF Report, supra note 230, 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 SEC CF Report, supra note 230, at 23 (“the 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.”).

234 See SEC Proposed CF Amendments, supra note 223, at 116 (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).

235 See SBA Study, supra note 231, at 13 (noting that businesses in areas not already considered technology and finance hubs have struggled).

236 See, e.g., Brandon Andrews, The Best New Way for African Americans to Invest in or Start a Business: Equity Crowdfunding, BLACK ENTERPRISE (Feb. 8, 2018) https://www.blackenterprise.com/equity-crowdfunding-black-investors-entrepreneurs/ (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),
crowdfunding has not been effective in reducing disparities in access to capital between minority and non-minority entrepreneurs.\textsuperscript{237} The prevalence of racial disparities in the crowdfunding space is consistent with discrimination in other FinTech markets, such as online lending platforms, that have otherwise facilitated borrowings by small business.\textsuperscript{238}

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.\textsuperscript{239} 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.\textsuperscript{240} Why are “professional investors” who follow a “market logic” hesitant to invest in minority businesses? \textsuperscript{241}


\textsuperscript{238} See Ahmed et al., supra note 208, at 38-39; Lauren Rhue, An Overview of Crowd-based Markets and Racial Discrimination, AMCIS PROCEEDINGS (New Orleans, 2018); Devin G. Pope and Justin R. Sydnor, What’s in a Picture? Evidence of Discrimination from Prosper.com, 46 J. HUM. RESOURCES 53, 53-54 (2011) (analyzing activity in a peer-to-peer loan platform and finding that loans with African Americans are less likely to receive funding).

\textsuperscript{239} See Douglas J. Cumming et al., Does Equity Crowdfunding Democratize Entrepreneurial Finance?, SMALL BUS. ECON. (2019) at 1,10.

\textsuperscript{240} See Cumming et al., supra note 239, at 16.

\textsuperscript{241} See generally Lauren Rhue, Crowd-Based Markets: Technical Progress, Civil and Social Regression, in RACE IN THE MARKETPLACE 193 (2019).
One leading theory is that implicit biases drive investors in the
crowdfunding markets away from minority-owned businesses.242 This should not
be surprising. Investing in small, minority-owned businesses requires the
collection and analysis of soft information and collecting and analyzing such
information is not cost-effective for individual retail investors in a 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 are.243

Some have argued that concealing the race of the entrepreneur is the most
effective way to address investor biases and even the playing field. 244 Others,
while acknowledging the role of implicit biases, argue that alternative strategies,
such as project promotion, might be more effective in addressing informational
issues.245 Allowing good projects to differentiate themselves from the “crowd” (i.e.,
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.246 Differentiation can be a particularly powerful tool if minority business

242 See Rhue & Clark, supra note 237, at 5 (finding that black founders who conceal their race
in their fundraiser photos perform better than campaigns where black founders have “black
fundraiser pictures”); Younkin & Kuppuswam, supra note 237, at 3276-77 (2017) (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).

243 See supra notes 98-100 and accompanying text.

244 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 Younkin & Kuppuswam,
supra note 237, at 3276-77 (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 99, at 1877 (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”).

245 See Rhue and Clark, supra note 237, at 1 (“Eliminating racial signals, however, is not a good
strategy in helping minority founders. Instead, platforms can improve success rates for black and
Asian fundraisers by signaling project quality…”). For one, 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 id. at 5. 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.

246 See id.
are (or are perceived to be) on average less profitable or present less opportunity for growth than non-minority businesses.\textsuperscript{247}

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.\textsuperscript{248} 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.\textsuperscript{249} Third, it must present this soft information in a credible manner to potential investors to allow for differentiation.\textsuperscript{250} Fourth, it must provide an active role for investors in advising and counseling entrepreneurs on an ongoing basis.\textsuperscript{251} 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.\textsuperscript{252}

Existing government programs have failed because of their reliance on debt as a financing mechanism and on large, hierarchical institutions, ill-suited to navigate a niche imbued with soft information, to act as gatekeepers.\textsuperscript{253} 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 implicit biases.\textsuperscript{254} Although, private equity’s organizational structure and investment strategy appears

\textsuperscript{247} See id. at 41.
\textsuperscript{248} See supra notes 181-204 and accompanying text.
\textsuperscript{249} See supra notes 89-96 and accompanying text.
\textsuperscript{250} See supra notes 245-247 and accompanying text.
\textsuperscript{251} See supra note 191 and accompanying text.
\textsuperscript{252} See supra note 226-229 and accompanying text.
\textsuperscript{253} See supra notes 122-128, 165-177 and accompanying text.
\textsuperscript{254} See supra notes 241-247 and accompanying text.
to be ideally suited for this task, the lack of diversity in its management ranks has render these tools ineffective in addressing the financing needs of minority-owned businesses. 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.

One possibility is to mandate such investments via regulatory mechanisms such as the Community Reinvestment Act. A similar possibility is to require that private equity funds increase the racial, industry and geographical diversity of their management ranks so that they are in a better position to invest successfully in minority-owned businesses. 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 part of the solution but as a partner in developing it, together with 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, likely members of minority groups, that can screen and monitor these investment opportunities. This sort of organic solution is more likely to set in motion a positive feedback process, promoting diversity within private equity ranks and leading to the development of a self-sustaining industry, much like the early SBIC program gave birth to the venture capital industry.

---

255 See supra notes 98-99, 200-203 and accompanying text.

256 See James Thorne, Funds, Recruiting and Support: VCs Address Diversity and Inequality, PITCHBOOK (Jun. 8, 2020), https://pitchbook.com/news/articles/vcs-address-diversity-institutional-bias?sourceType=NEWSLETTER (“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.”).

257 See Rubin, supra note 96, 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.”).

258 See supra notes 200-203 and accompanying text.

259 See supra notes 160-161 and accompanying text.
The first part of this section outlines the basic structure for such a program using existing and past government initiatives as building blocks. The second part discusses how to overcome some of the legal and policy hurdles that might hinder its successful implementation. The last part 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 in the design of 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 (objective 5). Properly vested with decision-making authority in a flat hierarchical structure, the LISBIC manager will be in a good position to collect soft-information about potential investment opportunities (objective 2) and credibly signal this information to investors by its willingness to absorb some of the risks involved (objective 3).\(^\text{260}\) 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 (objective 1).\(^\text{261}\) 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 (objective 4).\(^\text{262}\)

The underwhelming history of MESBICs (and their successors, SSBICs) provide a cautionary tale of what results when funds are unable to raise enough capital to cover operating costs and achieve a minimum size to diversify their

\(^{260}\) Requiring that LISBICs invest in local companies (i.e., located near the manager and investors) could facilitate achieving these objectives.

\(^{261}\) See SEC CF Report, supra note 230, at 58.

\(^{262}\) See id.
portfolio and engage professional managers with the requisite expertise. 263 Minority-business focused venture capital funds provide us a sense of the required scale: their median capitalization is about $30 million264 and their preferred investment begins at the $1 million range.265 LISBICs could initially tap three sources to obtain this level of required capital.

The first group would be institutional investors, such as pension funds, banks and insurance companies, that already provide the largest contributions to venture capital funds that target minority-owned businesses.266 Recruiting pension funds should not be complicated as investing in minority-owned businesses fits their political strategy.267 For banks investing in a fund licensed as an SBIC is even more attractive as it provides a number of regulatory advantages over other investments.268 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 one of

263 See Bates, supra note 57, at 354.

264 See Bates & Bradford, supra note 191, 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.”); Bates, supra note 57, at 354 (“Small-business investment companies typically benefit from operational scale economies if they have at least $20 million in assets.”).

265 See Bates & Bradford, supra note 191, 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...”).

266 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.”).

267 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”).

268 For example, through their SBIC investments banks may own indirectly more than 5 percent of the voting stock of a small business and bypass general prohibitions from owning interest in or sponsoring a private equity fund. 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 130, at 4-5; Small Business Administration – Office of Investment and Innovation, The Small Business Investment Company Program Overview (Oct. 2018), https://www.sba.gov/sites/default/files/2019-02/2018%20SIC%20Program%20Overview.pdf. Participating in an LISBIC would also give banks the opportunity to establish relationship 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 BANK. J. (Oct. 9, 2017); Rubin, supra note 96, at 829.
the promises of crowdfunding, the democratization of 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.\textsuperscript{269} The presence of a manager screening and monitoring portfolio companies would attract those retail investors who follow a “market logic” and who have been so far hesitant to support minority-owned business in crowdfunding offerings.\textsuperscript{270} Finally, the government could provide financial support to LISBICs directly via leverage (as it does with SBICs) or indirectly via tax exemptions.\textsuperscript{271}

\textbf{B. Implementation of the LISBIC program}

Organizing and operating an 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 could also increase the costs of organizing and operating a LISBIC.\textsuperscript{272} Protecting small, retail investors who are entrusting the LISBIC manager with their money and ensuring that the LIBIC manager adheres to the investment objectives of the LISBIC is another consideration.\textsuperscript{273} This section addresses these issues.

1. \textbf{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

\textsuperscript{269} See supra notes 226-228, 236 and accompanying text.

\textsuperscript{270} See supra note 240 and accompanying text.

\textsuperscript{271} See infra Part III.C.

\textsuperscript{272} Investment Company Act of 1940 (ICA), 15 U.S.C. §§ 80a-1-80a-64.

\textsuperscript{273} See SEC CF Report, supra note 230 at 58-59.
exemption from registration that works for each.\textsuperscript{274} 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.\textsuperscript{275} 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 LISBIC’s when raising money from non-accredited retail investors.\textsuperscript{276} Below, we consider two alternatives designed to accommodate financings involving small, retail investors.

\textit{a. Crowdfunding}

Existing crowdfunding regulations prohibit entities that qualify as investment companies from relying on the crowdfunding exception.\textsuperscript{277} 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 company.\textsuperscript{278} Another option is to amend the crowdfunding rules to allow certain entities that would qualify as investment companies to rely on the crowdfunding exemption. In fact, various market participants and the SEC have 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

\textsuperscript{274} See supra notes 215-221 and accompanying text.

\textsuperscript{275} See supra notes 219-221 and accompanying text; 17 C.F.R. §230.501(a).


\textsuperscript{277} See Section 4A(f)(3), 17 C.F.R. 227.100(b). See also Crowdfunding, SEC. REL. NO. 33-9974 (Oct. 30, 2015) [80 FED. REG. 71387 (Nov. 16, 2015)] (“CF Adopting Release”), at 71397. For a discussion of the basic framework governing the crowdfunding exemption see supra notes 222-225 and accompanying text.

\textsuperscript{278} See infra Part III.B.2.
to raise money using the crowdfunding exemption. Those modifications to the crowdfunding rules, which the SEC has now proposed, provide a springboard to the requisite exemptive language for LISBICs.

Additional changes to the rules would be necessary. The aggregate amount that an entity can raise over the course of 12 months (currently $1.07 million) needs to be revised. Raising this ceiling for individual issuers has been the subject of several proposals and the SEC is considering raising it to $5 million. Even then, a fund that intends to invest in several businesses would likely need a more generous limit than the one afforded to individual ones. 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 the securities laws would depend on the exemption that the LISBIC (as the issuer) and LISBIC investors rely upon. Setting that consideration aside, SBIC rules provide for certain reporting obligations that are applicable to licensed SBICs and which are discussed below.

---


280 See SEC Proposed CF Amendments, supra note 223, at 116 (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”).

281 See supra note 223.

282 See supra note 231 and accompanying text.

283 See infra notes 309-313 and accompanying text.
b. **Intra-state crowdfunding**

Localized investing – where a LISBIC raises funds from investors located in the same region the LISBIC is headquartered and invests in businesses located in that region – would help in achieving several of the LISBIC objectives outlined earlier. An 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). Under that rule, a LISBIC would be deemed to be a resident of the state where its principal place of business is located. And as long as the issuer's employees are based in such state or territory, it would also be deemed to be doing business in that state. Relying on the exemption, the LISBIC would be able to sell securities without registration to investors whose principal residence is located in that same state. However, since Rule 147A is not available to an investment company registered or required to be registered under the ICA, the availability of this exemption would hinge on the treatment of the LISBIC under the ICA or an enabling modification to Rule 147A.

2. **Investment Company Act Considerations**

The use of LISBICs would raise issues under the Investment Company Act of 1940 and the Investment Advisors Act of 1940. Investment companies

---

284 See supra notes 248-251 and accompanying text.

285 17 C.F.R. §230.147A(c)(1).

286 17 C.F.R. §230.147A(c)(2)(iv).

287 17 C.F.R. §230.147A(d)(2).

288 17 C.F.R. §230.147A(a).

289 See infra Part III.B.2. Integration of a Rule 147A offering with a Rule 506 offering (targeted at institutional investors) that takes place less than months after completion of the Rule 147A offering could raise additional issues. 17 C.F.R. §230.147A(g).


are subject to a number of registration and periodic disclosure requirements under the ICA. Under the act, an investment company is “any issuer which is … engaged primarily… in the business of investing, reinvesting, or trading in securities,” the latter term being broadly construed. LISBICs would certainly appear to fall under this definition. An exemption from registration under the ICA might be necessary for LISBIC’s to qualify for some of the Securities Act exemptions.

There are a number of exemptions available under the ICA, the most common being the “private investment company” exemptions under Section 3(c)(1) and Section 3(c)(7). 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. 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].”

These exemptions cover investment advisors providing advise to private funds (such as hedge funds) or to SBICs. 15 U.S.C. §§ 80b–3(b)(1), (7)(a).


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 no applicable. 15 U.S.C. § 80a–3(a)(2).

See supra notes 277, 288 and accompanying text.

See SEC ICA FAQs, supra note 292.

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. 15 U.S.C. § 80a–3(c)(1). This is the most commonly used exemption by SBICs.

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. 15 U.S.C. § 80a–3(c)(1). The term “qualified purchaser” is defined in Section 2(a)(51) of the ICA. 15 U.S.C. § 80a–2(a)(51).

3. Protecting Retail Investors

Unlike existing SBICs which 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 to ensure that these are not engaging in self-dealing transactions and are staying true to the fund’s purpose. ²⁹⁹

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. ³⁰⁰ LISBIC’s managers will also have the incentive to protect their reputational capital with these institutional actors with whom they repeatedly interact. ³⁰¹ In addition, state law might impose additional disclosure and fiduciary requirements on the LISBICs and those managing them. ³⁰² LISBICs will need to be organized under state law as a corporation, limited liability company or limited partnership. ³⁰³ This organizational choice will determine the default legal rights of investors and define the obligations and duties of the LISBIC manager. ³⁰⁴ As many of these provisions are default rules that can contracted around in an LISBIC’s organizational documents, regulatory provisions could

²⁹⁹ See Marco Becht, Patrick Bolton and Ailsa Roell, Corporate Governance and Control in HANDBOOK OF THE ECONOMICS OF FINANCE 1, 1-2 (2002) (explaining how dispersed shareholders with small equity interest have little incentive to incur management monitoring costs).


³⁰² See supra note 291 and accompanying text.

³⁰³ See supra note 132 and accompanying text.

mandate that LISBICs provide for a menu of statutorily mandated rights in these organizational documents to facilitate investor protection.\footnote{See id.}

A second set of agency problems revolve around a LISBIC’s goal of investing in minority-owned businesses and providing these 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.\footnote{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 (2011) (describing this dynamic which they refer to as “agency capitalism”).} This can be true even when the investors funding the intermediary would better off with the intermediary exercising its governance rights.\footnote{See id.} This dynamic is unlikely to characterize a LISBIC’s management of its portfolio companies. 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 free riding on its mentoring and assistance of a portfolio company. Another set of concerns relate to the selection process of a 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 pursue effectively social goals heightens this concern.\footnote{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 a new legal forms that with key structural elements that give managers the incentives and competence to accomplish such goals).}

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.\footnote{13 C.F.R. §107.630(a).} 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. 310 For each reporting period, SBICs must also prepare a valuation report that provides an estimate of the value of their loans and investments. 311 Periodically, for each financing of a small business, SBICs submit a portfolio financing report. 312 The SBA’s Office of Examinations reviews on an annual basis SBICs’ financial health and regulatory compliance and monitors the performance of SBICs through key metrics. 313 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 have the incentive to verify that the LISBIC is fulfilling such goals. 314

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 inherent in developing a new market and incentivize private equity funds to incur the initial expenses necessary to successfully enter this niche. The current socio-economic climate and will to address racial economic disparities make outlays of this type more politically feasible than in the past. 315 This section describes two possible forms of public financial support.

---

310 13 C.F.R. §107.630(a).
311 13 C.F.R. §107.650.
312 13 C.F.R. §107.640.
313 See OCC Report, supra note 130 at 1.
314 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 308, at 978-981 (describing the certification process for community development financial institutions).
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. 316 LISBICs should be afforded the regulatory flexibility and predictability that SSBICs never had. 317 More importantly, debt should not be the primary levering mechanism. 318 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.

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. 319 Though these programs entail greater risk for the SBA, the amount could be capped and managed. Pursuing this alternative takes us close 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 (which the author also supports and proposes as an alternative to the LISBICs contemplated in this Article), there is value to having small investors participate and set the tone as to the social and financial expectations of LISBICs’ investments, something that would be missing from such a pure hybrid SBA program.

316 See Bates & Bradford, supra note 191, 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.”).

317 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. 13 C.F.R. §107.620.

318 See supra notes 181-204 and accompanying text.

319 See supra notes 141-148 and accompanying text.
2. **Preferential Tax Treatment**

Providing tax deductions based on amounts invested in LISBICs or a lower tax rates 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. 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. 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. An association of online platforms has recently proposed a similar tax exemptions for investors participating in crowdfunding investments as a way to maximize the potential of crowdfunding to fuel business and economic growth.

---

320 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 308, at 978-980 and 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 et al., *NEW MARKETS TAX CREDIT (NMTC) PROGRAM EVALUATION: FINAL REPORT*, Urban Institute (April 2013), https://www.urban.org/sites/default/files/publication/24211/412958-New-Markets-Tax-Credit-NMTC-Program-Evaluation.PDF.


322 See SEC CF Report, supra note 230, at 17.

323 See AOIP Paper, supra note 231, at 3 (proposing reasonable tax credits or deductions to encourage private investments in small businesses).
Some groups have proposed a more general tax credit specifically targeted to promote venture capital investments in minority businesses.324

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.325 Under Supreme Court precedent, strict scrutiny review applies to all preference programs that are based on racial classifications, thus requiring that such classifications be narrowly tailored to further compelling governmental interests.326 This section outlines two strategies to address such potential legal challenge.

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.”327 This statutory definition of “socially disadvantaged individuals” in the SBA Act has survived constitutional challenges.328 The SSBIC Program, which was designed for small business entrepreneurs “whose participation in the free enterprise system is hampered

---


325 U.S. CONST. amend. XIV, § 1.


327 See supra notes 107-110 and accompanying text.

because of social or economic disadvantage,” followed a similar strategy in targeting minority-owned small businesses.329

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. This type of “place-based incentive programs” are used by local governments to revitalize economically depressed communities by providing investors preferential tax treatment or financial assistance through low interest rate loans.330 Such designations have also been employed under the Community Reinvestment Act and the Impact Investment SBIC program.331 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, i.e., a community designated by the Internal Revenue Service (IRS) as being “economically-distressed.”332 Though there has been criticisms on the implementation of this program,333 it provides an example

329 See supra note 149 and accompanying text.


331 See supra notes 153-159 and accompanying text.


333 See, e.g., Simon, supra note 332 (discussing “impact washing” and the low multiplier effects of investments in low income communities); Alan Sage, Mike Langen and Alex Van de Minne, Where Is the Opportunity in Opportunity Zones? Early Indicators of the Opportunity Zone Program’s Impact on Commercial Property Prices (mimeo Oct. 15, 2019) (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 & Lorena Roque, Opportunity Zones Bolster Investors’ Bottom Lines Rather than Economic or Racial Equity, Institute of Taxation and
of a politically viable “place based incentive program” at the federal level used to
target investors to help the development of minority communities.334

CONCLUSION

Removing the financial barriers faced by minority entrepreneurs is more
crucial than ever in light of recent political and economic events. Promoting the
growth of minority-owned business is also sound policy, as it would have a
considerable impact both at the local and national level. 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 longstanding racial inequities.335 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.336

The problem examined in this Article has been widely acknowledged; the
body politic and market participants are more willing than ever to act. That past
programs have been relatively unsuccessful should not be discouraging.
Understanding why past programs have come short helps up design ones better

---

334 See Scott Eastman and Nicole Kaeding, Opportunity Zones: What we Know and What We

335 See Angela Blackwell & Michael McAfee, Banks Should Face History and Pay Reparations,
reparations-racism-inequality.html; Porter, supra note 60, at 55;

336 See Applewhite, Founders and Venture Capital, supra note 99; Austin, supra note 324, at 3.
suited to solve the problem at hand. Finding the right approach, however, requires identifying specific processes that drive disparities. This Article starts this 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 can be great, but the benefits are immeasurable.