January 2014

Funding Innovation: Regulating Seed Financing

Kevin Laws
Zeb Zankel

Follow this and additional works at: http://digitalcommons.law.scu.edu/chtlj

Recommended Citation
Available at: http://digitalcommons.law.scu.edu/chtlj/vol31/iss1/1

This Article is brought to you for free and open access by the Journals at Santa Clara Law Digital Commons. It has been accepted for inclusion in Santa Clara High Technology Law Journal by an authorized administrator of Santa Clara Law Digital Commons. For more information, please contact sculawlibrarian@gmail.com.
FUNDING INNOVATION: REGULATING SEED FINANCING

Kevin Laws† & Zeb Zankel††

Unlike traditional regulatory approaches applied to Wall Street-style transactions, seed financing in Silicon Valley has developed with benign neglect from lawmakers; meaning that securities laws were out-of-sync with the financings but regulators ignored enforcement of violations. Meanwhile, seed investors have achieved fraud prevention, a smoothly functioning market, and other policy objectives in different ways. Now that the explosion of startup financing has garnered the attention of the SEC, we argue that regulating seed financing should differ from the methods used in larger, traditional financings, otherwise compliance costs will severely impede financial activity without improving investor protections. Although the federal government made a great leap forward in passing the JOBS Act and issuing no-action letters beneficial to seed financing, a host of regulatory barriers and ambiguities still remain. This article does not recommend specific regulations, but does recommend seven principles that are important in funding innovative-technology markets, where the markets are defined by high levels of asymmetric information and small transaction amounts. These principles should guide regulators and lawmakers as they consider how to encourage more small-scale financing of innovation, without introducing new opportunities for fraud or creating bad experiences for investors and companies.*

† Kevin Laws is Chief Investment Officer for AngelList. He received his computer science degree from Dickinson College, and MBA from the Massachusetts Institute of Technology’s Sloan School of Management.
†† Zeb Zankel is a newly minted attorney. He received a B.A. with Honors from Wesleyan University, and a J.D. from Santa Clara University School of Law.
* Abstract provided by Brian Wood, J.D. Candidate at Santa Clara School of Law and Associate on the Santa Clara High Tech. Law Journal.
INTRODUCTION

People often forget that, less than a decade ago, the ubiquitous Facebook raised its first small round of investment—$600,000.¹ The first round of financing a company raises is generally called a seed round or a seed financing, where the round is so small that individuals, including wealthy investors, nicknamed angels, can invest.² While the numbers are debated, the typical total amount of capital raised during a seed round can range from a few hundred thousand dollars to a couple million dollars.³

¹. TOM TAULLI, HOW TO CREATE THE NEXT FACEBOOK: SEEING YOUR STARTUP THROUGH, FROM IDEA TO IPO 52 (2012).
³. Id.; see also David H. Freedman, The Great Funding Flameout, INC. MAG., Oct. 2013,
Seed financing represents a small, but very important, portion of financing activity in the United States. This area of finance is characterized by small transactions and extreme information asymmetry on both sides of the deal. The seed-stage market developed its own methods for dealing with these challenging characteristics—methods that have been very effective at preventing fraud and protecting both investors and companies. This market has emerged with benign neglect from the regulators (whether intentional or not). However, now that seed-financing activity is becoming much more public and growing so dramatically, regulators are getting more involved.

Traditional regulatory approaches do not protect investors or help companies raise money in seed-stage markets nearly as well as the mechanisms that have emerged naturally. In fact, some existing regulatory approaches, if imposed, could severely impede activity without improving investor protections at all. The law in this area of financing has developed significantly in recent years to account for these issues, which is a step in the right direction. However, the Securities and Exchange Commission (SEC) is currently wrestling with the details of investor protection—some of which could have a major impact on seed financing. What would be considered modest legal and compliance costs in a large Wall Street transaction can actually prevent smaller transactions from occurring at all.

This article generally addresses how seed financing is different from traditional financing and suggests principles for government agencies to use when regulating seed-financing markets. In Part I, this
article explores the importance, characteristics, size, and methods of seed financing of technology startups. Part II focuses on the history of regulatory dysfunction surrounding seed financing. In Part III, this article reviews the Jumpstart Our Business Startups (JOBS) Act and SEC No-Action Letters and their effect on seed financing. Part IV addresses the unwarranted concerns about fraud and over-promised results in seed financings. Finally, Part V announces seven principles to inform appropriate regulation of seed financing and innovation in general.

I. SEED FINANCING OVERVIEW

A. Seed-Stage Technology Startups Matter

The amount of money invested in seed-stage technology startups is miniscule in proportion to other types of investments in the United States. Venture capital (VC) seed-stage investments totaled nearly $1 billion in 2013.\textsuperscript{15} To put that in context, the entire seed-stage portfolio from 2013 would represent approximately .022% of the assets of a single Wall Street firm (Black Rock).\textsuperscript{16}

However small, seed-stage investments generate an outsized impact on the economy. According to the Kauffman Foundation,\textsuperscript{17} all net job creation from 1999–2011 in the United States’ private business sector came from firms under five years of age.\textsuperscript{18} The technology startups of roughly the last fifteen years include some of the largest companies in the world today—household names like Google and Facebook.\textsuperscript{19} Because these technology startups have already had such
a positive impact on the United States economy, it would seem that creating more of these companies would benefit workers, innovators, and consumers alike.

B. Characteristics of Seed Deals

In theory, the seed-stage market probably should not exist at all. Entrepreneurs know far more about their motivations, business progress, and abilities than do investors. On the other hand, sophisticated investors often better understand the current market prices, terms, and financial arrangements. Thus, the market is characterized by asymmetric information on both sides of the transaction. Moreover, the size of the financing prevents the exchange of that knowledge in a cost-effective manner; in that it would not make financial sense for extensive due diligence on such a small deal. Instead, entrepreneurs and investors may use simple rules to guide their decision-making, such as an investor using heuristics to invest in a company where the founding engineering team is from MIT, or where the other investor in that deal has a strong track record.

Take for example Jeremy Orlow, who used AngelList to raise financing for Apptimize, a company that helped developers test changes in mobile applications.20 When investors looked at his profile, they did not see a full Wall Street-style private-placement memorandum (PPM). Instead, they saw a founder who attended Purdue University, a video of the product in action, and a summary of the terms.21 Often times this is all that is needed to obtain financing.

Based on the experience of author Kevin Laws,22 the following are key characteristics of how seed deals are formed and closed:

- **Screening is based on trust.** With nothing to diligence or take if the entrepreneur is wrong, the investment becomes in large part about judging the credibility and skills of the founders. Intermediaries get in the way of the direct relationships needed for good judgment.

- **Networks rule.** The original idea of “friends-and-family” money was to raise funding from a few people who knew the founders.23 That is not an option for the large number of companies raising these days,

---

22. In his decades in Silicon Valley, founding and serving on the board of several technology companies, and investing in dozens more companies, he has developed strong expertise in the area of seed financing.
nor for the amounts they need (it would require a very rich uncle to close a $1 million round). As a result, most of the investments are done via trust networks—one investor forms the relationship with the company, and the others bet on that investor’s judgment. Social networks online have allowed these previously small trust networks to extend another degree of separation, dramatically increasing the reach of the trust network.

- **The transactions are small, so diligence and governance are informal.** A standard checklist used in a later-stage venture financing would overwhelm a seed-round transaction, eating up a large portion of the financing raised. Instead, seed-stage investors use their experience to decide which items are critical and ignore the rest. Governance is done in the same way—with primarily informal updates and meetings between a few investors and the founding team.

- **Friction is deadly.** The best seed-stage investors are typically founders and operators of other startups. These people are already plugged into entrepreneurs and know what makes for a successful company. However, they have demanding day jobs, which means that the financing process must be easy for them to participate. They can bring great value—like making a well-placed call or providing advice at the right time—so long as they are not overloaded with paperwork demands. VC firms have large and expensive offices dedicated to dealing with all the regulatory and legal issues. Most angels do not.

These characteristics push seed investing towards trust networks of individuals who manage their own money to avoid middlemen and execute quick deals. A seed-stage technology company using a broker would be shunned by many investors because the cost of the broker eats into the costs that should be used to help the company grow. Beyond that, a seed-stage company who produces a formal PPM would be accused by savvy investors of wasting time that could be spent building a better product or attracting new customers.

C. Declining Costs, a Startup Explosion, and Seed Financing

The cost of starting a new technology company has declined dramatically. Startups no longer require the trappings of a larger company in order to launch: accounting, back office, and human

---


resources are outsourced (Backops, Trinet);26 marketing is carried out by social- and viral-platforms (Facebook, Twitter);27 distribution is handled by app stores (Apple, Android);28 and data storage is rented on cloud-based systems (Amazon, Rackspace).29

As costs decline, the same deal price can potentially take a company much further with the same influx of cash, but with less costs. Further, the declining costs have, in part, led to an explosion of new startups. Ludwig Siegele, in a special report on tech startups for the Economist, calls this age an “entrepreneurial explosion,” likening it the “Cambrian Explosion” of ecological diversity that occurred 540 million years ago.30 Where there has been an explosion of technology startups that rely on seed financing, it is increasingly important to appropriately regulate seed financing and ensure this explosion does not hurt investors or entrepreneurs along the way.

D. Seed Financing Methods Have Changed

The amount of funding required to launch a new company has dropped so quickly that traditional financing mechanisms have failed. Conducting a traditional full diligence, reviewing an entire Wall Street-style PPM, negotiating a financing round, and drafting custom legal documents to register the company all comprise only a small percentage of a large financing round (Series A and above).31 But the same costs during seed financing can be a significant portion of the financing,32 which makes the deal less appetizing for companies and investors alike.

31. See Christina Desmarais, 3 Ways to Shrink Your Start-Up Legal Costs, INC. (Feb. 13, 2012), http://www.ince.com/christina-desmarais/3-ways-to-shrink-your-start-up-legal-costs.html. Since Series A financing costs $52,000 in legal fees on average, id., which would be 1% of the financing if raising the average Series A round of roughly $5 million in capital. Freedman, supra note 3.
32. Since legal costs prior to Series A can be around $25,000, Desmarais, supra note 31, and seed round size can range from few hundred thousand dollars to a couple million dollars, Freedman, supra note 3, the math works out to roughly 2%–10% of the financing round. These
The seed-financing market is still adjusting in many ways. Large traditional venture firms like Andreessen Horowitz are pulling back significantly on the number of investments they are making in the seed market. Law firms representing startups are, for example, deferring fees until after the closing date of the next financing round. However, these trends place startup-focused law firms in the exact venture-investor position that thrived in the dot-com era, putting lawyers in a position to decide which companies are most likely to be successful. As the name indicates, lawyers are experts in law and not necessarily the technology business, so, logically, investment by lawyers instead of technology business experts can lead to economic inefficiencies. At the same time, even experienced venture companies have shifted away from seed funding.

A new breed of investor specializing in seed-stage investments has filled the gap: experienced founders of other tech seed companies. On AngelList, over 70% of accredited investors have founded or run at least one company or invested in more than two startups. These investors have made a large impact in the seed finance world, and include businesspeople like Gil Penchina (former CEO of Wikia), Evan Williams (founder of Twitter), and Jeremy Stoppelman (founder of Yelp).
Most of the remaining investors on AngelList are seed funds of one form or another. Each of these funds and investors has found a way to navigate the new landscape of small financing rounds. However, regulations have not yet caught up to the way that modern seed financings function.

II. A HISTORY OF REGULATORY DYSFUNCTION

A. The SEC’s Benign Neglect and Overregulation

Until recently, the SEC’s approach to the seed-financing market was what securities lawyer Sam Guzik called a “combination of benign neglect and overregulation.” On one hand, the securities laws veered towards overregulation and were increasingly out-of-sync with the nature of the financings. For example, prior to the JOBS Act, general solicitation rules dictated that a company could not tell the public of a company’s financing unless it was a public offering, so Wall Street firms were justifiably paranoid about any news of an ongoing private-company financing being leaked to the press. On the other hand, SEC practiced benign neglect where Silicon Valley was concerned. Startups would regularly announce their intent to raise financing at demo days, events where startups pitched their business plans to investors. The tech-press attended demo days, focusing attention on the startups, the lawyers closed the financings, and the demo days continued along unabated without SEC enforcement of general solicitation rules.

Wall Street firms that arranged for meetings between investors and fundraising companies had to register as broker–dealers with the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization (SRO). Every web page was considered a broker advertisement and was subject to approval by FINRA, while the Silicon Valley firms did not register with any entity. On Wall Street, brokers

44. Id.
46. See FINRA Rule 2210 (2014) (“Communications with the Public”); see also Primack, supra note 43.
thoroughly vetted each company in which they considered investing.47 Theoretically these same rules applied in Silicon Valley, however, in practice the investors had to fend for themselves—and, in the experience of the author, preferred it that way, since they wanted direct founder relationships and resented any broker interference. On Wall Street, the broker had to carefully screen each investor for suitability.48 In Silicon Valley, investors were implicitly screened, since companies only wanted value-added investors.49 Seed investors, who were used to closing deals on a handshake, would be scared away if entrepreneurs presented them with stacks of papers to fill out and sign before striking a deal.50 In other words, the standard securities regulations remained in effect for the typical Wall Street investor—regulations that would shut down the nascent seed-financing market if enforced in their heaviest form—but were not enforced as a practical matter in Silicon Valley, in a manner of benign neglect.

The benign neglect continued as long as the number of seed investments was small, done behind closed doors, and not announced too loudly outside the tech-press. As soon as a firm would crossover into the more public eye, it would have to step into the Wall Street form of regulation. For example, before Garage Technology Ventures (formerly Garage.com), an incubator, filed to go public in February of 2000, they registered with the National Association of Securities Dealers (later renamed FINRA) as a broker.51

However, a decade into the twenty-first century, the Internet and the explosion of startups and angel investors changed everything. Suddenly, the Silicon Valley method was playing out very publicly. Major publications like the New York Times covered the demo days where startups raising money presented their companies.52 Other entities justifiably wanted a part of the Silicon Valley-style market,}

47. See FINRA Rule 2111 (2014) (“Suitability Obligations”).
51. See Garage.com, Inc., Registration Statement (Form S-1), Registration No. 333-30174 (Feb. 11, 2000).
leading to governments hosting demo days—even the U.S. Small Business Administration (SBA) hosted one in 2013.\footnote{See, e.g., Natale Goriel, Blog, \textit{Accelerator Demo Day Comes to Washington, DC}, SMALL BUS. ADMIN. (July 2, 2013), http://www.sba.gov/community/blogs/accelerator-demo-day-comes-washington-dc-learn-how-you-can-participate.}

In 2010, Internet startups emerged to automate and scale all of these activities. The primary author’s own company, AngelList, was among them. Financing was now completely visible, and was working the way Silicon Valley did, not Wall Street. The strategy of benign neglect could not continue.

In 2011, AngelList received a letter from the SEC’s Enforcement Division as part of an inquiry into financing portals and platforms.\footnote{Letter from SEC Enforcement Division to AngelList Regarding Financing Portals and Platforms (2011) (on file with author).} The company’s Wall Street securities lawyers suggested that this was just the beginning and to dig in for the long haul.\footnote{The SEC’s inquiry ended several months later without action on the part of the SEC. Thankfully, the Wall Street securities lawyers were wrong.}

\subsection*{B. Other Regulatory Challenges for Seed Financing}

Applying the old philosophy to these small financing transactions simply does not work. In the technology-financing world, there were at least two methods of financing: friends-and-family rounds, and large institutional rounds.\footnote{See Graham, \textit{How to Fund a Startup}, supra note 23.} The first was intended for raising small amounts of money to get the idea off the ground—but smaller than necessary to actually build a company and product with real traction.\footnote{Id.}

When moving to institutional rounds, companies would either tour VC firms or use a broker to raise money.\footnote{See id.} The ban on general solicitation\footnote{General solicitation is undefined in the statute but may include: (1) any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television and radio; and (2) any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. See 17 C.F.R. § 230.502(c)(1)–(2) (2014).} created an environment where VC firms could raise large pots of money and announce to the world that they were open for business—so that companies needing funding would seek them out.\footnote{See Ryan Caldbeck, \textit{How General Solicitation Will Change Private Equity and Venture Capital Forever}, FORBES (Sep. 23, 2013, 12:16 PM), http://www.forbes.com/sites/ryancaldbeck/2013/09/23/how-general-solicitation-will-change-private-equity-and-venture-capital-forever/ (companies could not go straight to investors, so the venture capital and private equity firms served as an intermediary connector).}
But startup companies were forbidden from doing the same by the rules surrounding general solicitation.61

As a result, startup companies would often tour Sand Hill Road in Menlo Park, California, where seemingly every venture firm office is located.62 Alternatively, they would hire a broker to tap into existing investor networks to raise capital.63 Both methods inserted large costs into the system. Most of the costs were borne by the investor in the case of venture funds (in the form of fees and carry paid to the fund managers). Alternatively, the costs were borne by the company in the case of a broker (where a percent of the fee raised was paid by the company). Along with those additional costs, VC firms and brokers became less common in first rounds as the cost of starting a company and correlating investment amounts dropped.64 Incubators and accelerators have stepped in to help connect young companies with capital.65 At the same time, where traditional VC firms have moved into later-stage funding,66 private seed-stage investors have become more prevalent and filled the gap.67

As shown above, the limitations on seed-stage companies when seeking capital has played a role in triggering unnecessary additional costs, and later limiting the pool of investors active in the seed stage. As regulators attempt to resolve these economic inefficiencies without upending traditional regulations on other sorts of financing, several major questions remain unanswered.

The first question is whether demo days or press breaking news of a financing are considered general solicitation. On September 23, 2013, the Securities Exchange Commission began to allow companies to use

61. See supra note 59.
63. See J.J. Colao, In the Crowdfunding Gold Rush, This Company has a Rare Edge, FORBES (June 5, 2013), http://www.forbes.com/sites/jjcolao/2013/06/05/in-the-crowdfunding-gold-rush-this-company-has-a-rare-edge/.
64. See 2014 MONEYTREE REPORT, supra note 36.
65. Verne Kopytoff, The Number—and Variety—of Business Incubators is on the Rise, BLOOMBERG BUSINESSWEEK (Nov. 5, 2012), http://www.businessweek.com/articles/2012-11-06/the-number-and-variety-of-business-incubators-is-on-the-rise. Incubators select startups, mentor participants about business basics, make introductions to potential customers and partners, and help find investors and financing. Id. Accelerators are similar to incubators yet the primary distinguishing characteristic is that accelerators are brief programs, lasting at times for three months. Id.
67. See Slade, supra note 49.
general solicitation to raise funds only if: (1) taking money from accredited investors (e.g., high net worth individuals), and (2) taking reasonable steps to verify that the investors in the company are accredited investors. Many investors likely do not want to share their credit reports, tax returns, and other personal financial documents with the companies they invest in or spend the money on lawyers or accountants to verify that investors are accredited. Hence, the question remains whether a pitch competition, demo day, or other entrepreneur event constitutes a general solicitation violation, especially when even government agencies themselves are hosting demo days.

The second question is whether incubators are brokers. Under the Securities Exchange Act of 1934, a broker is defined as any person engaged in the business of effecting transactions in securities for the account of others. Incubators arrange meetings between the companies and investors, take a strong hand setting terms, and receive benefits from doing so (in the form of ownership).

The final question is how do companies find and meet investors that are outside their direct circle without using a broker. Demo days and extensive networks have traditionally been the way this is accomplished. While the JOBS Act offers a provision for conditional general solicitation, this tool has rigorous requirements that might deter investors, so the issue of seed-stage companies accessing capital remains.

The presence of these lingering questions has led to many forms of dysfunctional behavior. As mentioned earlier, large VC funds can reach out to companies while seed-stage companies cannot talk publicly about needing money. This creates many inefficiencies. For example, it is generally known inside the technology-startup industry which funds actually have capital to spend and which are taking meetings just to stay plugged-in. But companies do not know this information, so they can waste their time pitching the wrong funds as a result. This legally sanctioned imbalance between investor and company can be detrimental to encouraging our technology innovation companies because of the barrier to accessing capital.

---

69. See Goriel, supra note 53.
71. Kopytoff, supra note 65.
72. Goriel, supra note 53.
73. JOBS Act § 501.
74. See supra text accompanying note 60.
III. THE JOBS ACT AND SEC NO-ACTION LETTERS

Regulators face an extremely difficult challenge. How should they craft rules that allow the new financing methods to continue without accidentally opening up loopholes that upend the status quo elsewhere? Put more simply—how would they let a seed-stage company meet a sophisticated investor in Silicon Valley without allowing a scammer to call a retiree in Boise?

The initial steps were promising. The JOBS Act passed with bipartisan support through Congress and was signed into law in 2012. This legislation contained a number of amendments to federal securities regulations that made capital formation easier for startups:

- **Shareholder Numbers.** The number of investors a company with over $10 million in assets can have without being registered with the SEC was raised from 500 to 2,000.

- **Solicitation.** Companies can now publicly announce financings, so long as the ultimate investors are accredited and the company took reasonable steps to verify accreditation. Before the JOBS Act, companies could not publicly advertise or solicit investments.

- **Accredited Platforms.** Platforms that allow accredited investors and companies to meet may perform a number of functions (including diligence services and standardized documents) without registering as a broker-dealer with FINRA.

- **Crowdfunding.** A new exemption permits fundraising from a large number of small investors, provided that all purchases are made through a registered broker or funding portal. Investors may only invest limited amounts, which vary according to annual income or net worth of the investor.


76. JOBS Act § 501; SEC STAFF, JOBS ACT SECTION 504 REPORT ON AUTHORITY TO ENFORCE EXCHANGE ACT RULE 12g5-1 AND SUBSECTION (B)(3), at 6 (2012).

77. JOBS ACT § 201(a)(1).

78. 17 C.F.R. § 230.502(c) (2014).


80. Id.; see also SEC Proposed Crowdfunding Regulation, Securities Act Release No. 9470, Exchange Act Release No. 70741, 78 Fed. Reg. 66428 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pt. 200, 227, 232, 239, 240, 249). Crowdfunding, raising many small amounts of money from large amounts of people, may yet play a role, but at the time of this article, the SEC has proposed regulations that make it significantly more costly and difficult than raising from accredited investors. Id. Since accredited platforms like AngelList exist, we believe it is
The JOBS Act contained many other provisions, though those have less impact on seed financings—for example, the provisions relating to initial public offerings for emerging growth companies, which only applies to companies that have been around for at least two years, and not brand new companies.81

Beyond the clear startup focus evident in the title of the JOBS Act, the SEC staff has been active in drawing distinctions between different types of financing in their enforcement of the law. The SEC’s Division of Trading and Markets issued a statement clarifying the rules for accredited platforms such as AngelList, which made very clear their intent to try to keep the Wall Street and Silicon Valley rules separate: “As a practical matter, we believe that the prohibition on compensation makes it unlikely that a person outside the venture capital area would be able to rely on the exemption from broker-dealer registration.”82

After the JOBS Act passed, the SEC Division of Trading and Markets issued two no-action letters, one to AngelList,83 and one to FundersClub.84 The no-action letters have three practical effects:

- **The creator of a single-security fund is not a broker.** If an intermediary creates a fund that invests in a single security, the intermediary is not a broker; it is an advisor to the fund, and only needs to register as an investment advisor or exempt reporting investment advisor.85

- **The advisor can charge carried interest.** The advisor cannot receive compensation for closing the transaction but it can receive compensation in the form of carried interest for its services.86

- **An angel can receive carried interest from the fund.** Anybody paid to effectuate or arrange a transaction in securities generally has to be unlikely that the tech community will use equity crowdfunding much in its currently proposed form.

85. See AngelList No-Action Letter, supra note 83, at 3.
86. See id.; FundersClub No-Action Letter, supra note 84, at 3.
regulated as a broker. But since carried interest is payment based on the funded company’s success and not on the success of the transaction, an angel investor advising a Rule 506-compliant fund can receive carried interest without registering as a broker.

The combination of permissive JOBS Act provisions and seed-friendly SEC No-Action letters has allowed seed financings to come out of the shadows and provides a strong foundation for the growth of the seed-financing market.

IV. UNWARRANTED CONCERNS OF FRAUD AND OVERPROMISED RESULTS

Investors have expressed valid concerns that issuers would perpetuate criminal fraud and would take advantage of the rules and try to fool investors, or exuberant companies overpromising results to investors. Interestingly, traditional angel groups have seen very little fraud according to Marianne Hudson, the Executive Director of Angel Capital Association. AngelList features a similar phenomenon—thousands of companies that investors have funded after finding them on AngelList with zero reports of fraud to date.

There are two reasons for this lack of fraud. First, it is much harder to commit fraud out in the open. AngelList profiles get attention because founders and investors are linked to others in the network. Thus, startups that get wider distribution are those connected to many points of the existing network. The end result is that fraudulent issuers would have to fool many people and conduct their business where everybody could see who they were talking to, and where there is also a record of the communication.

The second reason for the lack of fraud is that the cost of fraud can be well-diversified. Given the rarity of fraud in angel investing, it represents a very small drag on returns. The danger of being completely overexposed in one investment is significantly lower than with investment management, where many investments may all be

88. See AngelList No-Action Letter, supra note 83, at 3.
90. Mark Sullivan, SEC May Make it Harder for Angels to Get Their Wings, VB NEWS (May 20, 2014, 1:16 PM), http://venturebeat.com/2014/05/20/sec-may-make-it-harder-for-angels-to-get-their-wings/.
91. Id. (remarks of ACA Exec. Dir. Marianne Hudson).
under the control of one potentially fraudulent or incompetent manager. That of course does not mean that outright fraud will never occur. However, it remains a much smaller concern in the universe of seed investing than it does elsewhere in the investing for the reasons stated above.

The concern of an exuberant company overpromising results is actually more relevant given that seed-stage startups are—by definition—raising money for the first time and therefore less able to assess the chances for success than a company with lengthy experience running a company. The technology-startup seed financing market avoids the risk of over-exuberant companies by relying on experienced investors who generally know that a founder may have a misplaced belief in his or her own success.92

As seed financing expands, additional mechanisms have grown to address the issues of fraud and overpromised results. First, platforms educate issuers. The incubators, accelerators, and online platforms often provide guidance to the startups about not making overstated claims about future performance or misleading about current results. Second, lead investors are more experienced. There is usually an experienced investor in each deal (AngelList has formalized that requirement for any online closing).93 That investor evaluates where the company fits in the landscape and makes an assessment as to whether the deal terms are within current market norms. These mechanisms do not obviate the problems entirely, but reputable platforms like incubators and accelerators are motivated to uphold their reputation in the investment community to stay competitive, thereby developing structures to avoid unnecessary risks to investors.

V. SEVEN PRINCIPLES FOR REGULATING INNOVATION FINANCING

The federal government has made tremendous progress in passing legislativing and clarifying enforcement to account for seed financing. Nevertheless, room for growth remains as the seed financing markets expand to foster the growth of innovative technology businesses. The following seven principles offer guidance to regulators and lawmakers on how to encourage more small-scale financing of innovation without introducing new opportunities for fraud or bad experiences for investors and companies.

92. The background of AngelList investors shows a high level of experience among angel investors. See Investors, ANGELIST, supra note 38.
A. Put Regulatory Costs as Late in the Process as Possible

Only 5%–10% of startups succeed in attracting investors.\textsuperscript{94} Often the parties with the information advantage are investors, not companies.\textsuperscript{95} Putting regulatory costs up-front, with the idea of providing a hurdle that only good companies can jump, would just dampen seed financing activity and not provide actual protection. Even small costs—say, $5,000 for legal fees to comply with a regulation—get multiplied many times over for every successful financing since each company pays the regulatory fees but only a few succeed. In a market where companies are the best judges of their own success, up-front costs might be a very useful regulatory tool. Unfortunately, in innovation-intensive industries like technology, investors are actually in a better position to judge whether the market will accept the startup. Consequently, up-front costs are no longer a good filter; they are simply a huge cost and a drain on the system.

B. Encourage Investor Transparency

In seed-financing markets, the more investment activity that happens in the public eye, rather than behind-closed-doors, the better. In today’s world, investors review a company’s information online before investing, just as consumers check online reviews before purchasing something that looks too good to be true. Fraudulent companies preferred a private world, where fraud could happen outside the view of the perceptive public and regulators. Laws that place costs on communications—by restricting communications, requiring additional filings rather than just maintaining records, forcing companies into a particular format, or requiring companies to publicly disclose sensitive information—would logically reduce investor protection by pushing communication behind closed doors (and making it verbal rather than written) without the opportunity for public vetting of the company.

\textsuperscript{94} See Video Interview by Jonathan Sandlund, \textit{Diving into Equity Crowdfunding with Jeff Lynn, CEO of Seedrs}, CROWD CAFE (Dec. 17, 2012), \url{http://www.thecrowdcafe.com/equity-crowdfunding-with-jeff-lynn} (discussion at 1:44); see also CANADIAN MEDIA FUND, \textit{Crowdfunding in a Canadian Context, Facts and Stats, How Likely is Your Crowdfunding Campaign to Succeed} (Jan. 21, 2014), \url{http://crowdfunding.cmf-fmc.ca/facts_and_stats/how-likely-is-your-crowdfunding-campaign-to-succeed}.

\textsuperscript{95} See supra Part I.B.
C. Encourage Investor Diversification by Reducing Individual Investment Transaction Costs

Since most startups fail, lawmakers and regulators should encourage investors to invest in many startups. Increasing transaction costs on each startup is counterproductive; regulators should encourage mechanisms that allow investors to diversify across many deals. By some calculations, at the new highly skewed returns, investors should have at least seventy investments for a sufficient chance of doubling their money. If the amount of each investment were $25,000, this would translate into a total allocation to seed financing of $1.75 million. Since startup investments should comprise less than 10% of an investor’s personal portfolio, that would require a net worth of well over $15 million, combined with the time and inclination to invest and monitor many seed-stage startups. This would reduce the pool of angels to only a handful of people in Silicon Valley who enjoy the sport of investing rather than create the type of robust market that is needed. Regulators should encourage mechanisms that allow accredited investors to invest $2,500 instead of $25,000.

D. Encourage Automation

The authors believe automation is the secret sauce that can increase compliance and make compliance with the rules less onerous and costly. The securities regulation rules could be built into the user interface of automated systems like AngelList. Unfortunately, regulations are rarely written with automation in mind. For example, the word reasonable is anathema to automators because computer programming more easily solves yes–no problems than abstract problems, like “what is reasonable?”

Accredited investor status queries provide an easy opportunity for automation. If it were easy to verify an investor’s status as accredited, like a single check of a system run by the IRS, then everybody could be checked for accreditation with no cost to the system. This type of streamlined regulatory system might fail to screen out a recently unemployed investor after the initial check, but such a limited


drawback would be less costly to the seed financing system than a robust accredited investor status requiring checks at every point in the process. As regulators set regulations, figuring out whether they can be coded in automated systems will help greatly in making the regulations instantly effective, ubiquitous, and cheaper to implement.

E. Be Mindful of Costs and Benefits

Cost-benefit analysis is crucial in crafting rules and regulations. For example, there are steps that are very expensive for legitimate accredited investors and honest companies but do little to actually screen-out unaccredited investors. The accredited investor net worth test requires investors to have over $1 million in net worth (excluding their primary residence). The verification of assets for an accredited investor participating in a 506(c) offering requires issuers to get documents dated in the last three months. This means that a letter showing accredited status can’t be valid for more than 3 months at a time if the issuer wishes to use the so-called “safe harbors” in the regulation; if it’s been longer than 3 months, the issuer needs to ask the investor to re-prove assets to the issuer or one of the parties identified in the regulation (lawyer, investment advisor, CPA, or broker). As a result of this rule, a lawyer once asked AngelList to track down an investor to personally verify that he still had over $1 million in assets. That investor was a billionaire, and one of the richest people in America. This verification process added costs to a legitimate financing where the verification was unnecessary given the investors vast known wealth. This rule could be easily improved, by allowing issuer to default to an annual verification where an investor exceeds the net worth standard by double ($2 million in net worth). When dealing with such wealthy investors, annual verification provides just as much protection, but would be far less costly and onerous to automate. A proper cost-benefit analysis, could greatly improve this rule, and such analysis is essential for crafting future laws and regulations governing seed financing.

F. Align the Intermediary Interests with Investors

The AngelList and Funders Club no-action letters the SEC issued in March 2013 are invaluable to seed financing by allowing platforms to accept carried interest. That allows platforms stay funded and continue serving this crucial role as a connector. If a company fails, or

100. Id. § 230.506(c)(2)(ii).
even if it slides sideways and does not increase in value, then the platform earns nothing. Only when the company becomes more valuable after the investment does the platform get any reward, which favors investors because the intermediaries benefit when investors benefit. This differs from proposed crowdfunding regulations, which would ban any co-investment or equity compensation for intermediaries and instead requires transaction fees. The regulation would align the intermediary interests with the volume of companies, which does not benefit investors because intermediaries are compensated purely on volume of transactions rather than on the growth of each financed company. Instead, by ensuring intermediaries have a stake in the success of each financed company, the intermediary will be incentivized to ensure only high-quality companies are financed. Financing high-quality companies is good for those companies and good for investor protection.

G. Allow the Intermediaries to Exercise Judgment

In the experience of author Kevin Laws, one of the main functions of platforms is helping investors focus. Because there are hundreds of thousands of startups on AngelList, simply presenting all startups in a list would be useless to investors. Instead, platforms like AngelList have criteria for ranking or featuring certain opportunities so that investors can narrow focus to opportunities of their liking.

As long as conflicts are disclosed by the platform, this calculated presentation of data to users serves a critical function to educate market participants. The platform knows more than anyone about the underlying data about investors, companies, and investments, and is incentivized to push the marketplace towards more credibility.

While the added-value that platforms bring may seem obvious, the JOBS Act bans crowdfunding platforms for unaccredited investors from providing “investment advice or recommendations.” The SEC’s draft regulations go so far as to ban platforms from turning down startups; crowdfunding platforms would have to accept all startups, bad or not, because doing anything else would constitute a “recommendation.” Banning judgment in a business where

102. Id.
105. Regulation Crowdfunding, 78 Fed. Reg. at 66556 (proposed rule 227.300(c)(2)(i)–
transactions are based on trust simply increases friction with no investor protection benefit.

CONCLUSION

The massive expansion of seed-stage investment capital has been great for the economy and for innovation. However, the methods that grew organically in seed-stage investment differ from those methods used by the SEC in their regulation of larger-financing activity. Both are aimed at achieving fraud prevention, a smoothly functioning market, and other policy objectives, but accomplish those goals in different ways.

Although the federal government made a great leap forward in passing the JOBS Act and issuing no-action letters beneficial to seed-stage investment, a host of regulatory barriers and ambiguities remain. If regulators and lawmakers take into account the unique characteristics of what it takes to facilitate seed-stage activity, then it is possible we could regulate this market well without accidentally killing it.

After all, it was not that long ago that an entrepreneur raised $92,000 for an idea he and his partner had to create a better computer—they named their company Apple.¹⁰⁶ Let us support more of that activity in the world today.