Center for American Entrepreneurship

To Get More Capital to Women Founders and Entrepreneurs of Color, Amend Section 3(c)(1) of the Investment Company Act of 1940

The Issue: Launching a new business requires money. Entrepreneurs need money to pay expenses, develop their product or service idea, research the marketplace, develop and implement a strategy for identifying and targeting customers, and, hopefully, begin paying initial employees. Because such costs typically arrive long before the first dollar of revenue, capital and credit are the lifeblood of any new business. Many new businesses – particularly businesses that have the potential or intent to grow very quickly – rely on investors who provide early-stage capital in exchange for an equity stake in the company. Unfortunately, the overwhelming share of equity capital goes to entrepreneurs who are white and male. In recent years, women entrepreneurs have received only about 2 percent of total venture capital and entrepreneurs of color have received less than 1 percent.

The Solution: The inequitable distribution of equity capital is attributable to both explicit bias on the part of some investors, but also to unintentional bias. Recent research has documented a phenomenon known as "homophily" – investors tend to invest in entrepreneurs who look like them, have similar backgrounds and life experiences, and who are launching companies that investors can relate to. At present, most startup investors are white and male, with the predictable result that most of the startups in which they invest are launched and run by white male entrepreneurs. Getting more capital to women entrepreneurs and entrepreneurs of color, therefore, requires greater diversity among those who invest in startups.

Indeed, research published in 2022 by Harvard economist Josh Lerner concluded that Black-led investment funds are three to four times more likely to invest in Black entrepreneurs.

Section 3(c)(1) Funds: The Investment Company Act of 1940 establishes the legal framework for the establishment, operation, and regulation of investment funds. Most private investment funds are organized under section 3(c)(1) of the Act, which exempts investment funds not making a public offering of securities from registration as an investment company with the Securities and Exchange Commission and from the filing of costly disclosure requirements associated with registration – provided that all fund participants are accredited investors and that the number of participating investors is 100 or fewer.

The 100-investor limit has the effect of reinforcing deficiencies in diversity among startup investors – and, therefore, among entrepreneurs who successfully secure funding – because it keeps the average contribution from each investor, except for very small funds, very high. For example, in the case of a $30 million fund – quite small by industry standards – the average investment is $300,000, too large for many accredited investors, particularly many women investors and investors of color.

In 2018, Congress passed and President Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act, the principal purpose of which was to modify certain aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Act also amended section 3(c)(1) of the Investment Company Act to allow funds smaller than $10 million to have up to 250 investors.

The increase in the number of permitted investors improved circumstances for 3(c)(1) funds in two ways. First, it helped get more capital to new companies. Second, it allowed more accredited investors to allocate smaller amounts of capital to a potentially lucrative asset class.

But the $10 million fund cap is highly problematic. Funds less than $10 million are simply too small to have a meaningful impact on the diversity of entrepreneurs who secure financing. Moreover, funds larger than $10 million remain subject to the 100-investor limit.

The Expanding American Entrepreneurship Act: On November 16, 2023, after more than a year of work with the Center for American Entrepreneurship, Senators Jerry Moran (R-KS), Tim Scott (R-SC), and Mark Warner (D-VA) introduced the Expanding American Entrepreneurship Act. The legislation would raise the cap on funds organized under the 2018 sub-category of section 3(c)(1) from $10 million to $50 million, and double the number of permitted investors from 250 to 500.

Together, these changes will enable emerging fund managers to raise larger funds – a "bigger bat" to swing at the current inequitable distribution of equity capital – and facilitate greater participation by accredited women investors and investors of color, diversifying the investor base and thereby directing more equity capital to women founders and entrepreneurs of color. Using the same example of a $30 million fund, under the terms of the legislation the average investment from 500 accredited fund participants would be just $60,000 rather than $300,000. It should also be pointed out that smaller required investments mean smaller risk exposures, promoting investor protection.

Mac Conwell, founder and Managing Partner of RareBreed Ventures in Baltimore, MD, made the following comment regarding the introduction of the Act:

"I thank Senators Jerry Moran (R-KS), Tim Scott (R-SC), and Mark Warner (D-VA) for their leadership in introducing the **Expanding American Entrepreneurship Act**. I launched RareBreed in response to the lack of access to capital for founders of color and founders outside the major investment hubs of Silicon Valley, New York, and Boston. Current rules price out many accredited investors of color from participating in investment funds, which limits capital to drive innovation, economic growth, and job creation, and restricts capital invested in founders of color. We know this because research has shown that Black-led funds are four times as likely to invest in a Black-led company. The **Expanding American Entrepreneurship Act** will provide accredited investors of color more opportunities to participate in venture capital at lower minimums, helping to reduce risk, better diversify investments, and create wealth in communities of color. As someone who has spent my entire career in venture capital as an advocate for reducing barriers and expanding participation, I applaud this legislation and look forward to supporting its passage any way I can."