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United States House of Representatives
Committee on Financial Services
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RANKING MEMBER

June 27, 2022

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: June 30, 2022, Task Force on Financial Technology Hearing entitled, "Combatting Tech Bro Culture: Understanding Obstacles to Investments in Diverse-Owned Fintechs"

The Task Force on Financial Technology will hold a virtual hearing entitled, "Combatting Tech Bro Culture: Understanding Obstacles to Investments in Diverse-Owned Fintechs" on June 30, 2022, at 12:00 p.m. on the virtual meeting platform Cisco Webex. The single-panel hearing will have the following witnesses:

- **Jenny Abramson,** Founder & Managing Partner, Rethink Impact
- **Sallie Krawcheck**, CEO and Co-Founder, Ellevest
- **Marceau Michel**, Founder, Black Founders Matter
- **Wemimo Abbey**, Co-Founder and Co-CEO, Esusu
- **Maryam Haque**, Executive Director, Venture Forward

Introduction

The proliferation of financial technology companies (fintechs) that are leveraging new technologies to provide financial services and products in recent years has been made possible by large-scale investments, especially by venture capital (VC) funding. VC is a form of private equity and a type of early financing for startup companies and small businesses. VC firms target companies with high growth potential in exchange for equity in the company. VC firms often assume high risks on a portfolio that includes several startups with the expectation that many will fail, but if a few reach the targeted returns, VC investors will be generously rewarded. According to some researchers, the top quartile of VC funds "have an average annual return ranging from 15% to 27% over the past 10 years, compared to an average of 9.9% S&P 500 return per year for each of those ten years."[1]

VC firms have demonstrated a strong interest in technology-based companies, including fintechs. In 2021, VC investments in the fintech industry reached $35 billion.[2] However, the majority of that investment has been directed towards White and male-founded companies, with a small minority directed at companies founded by women (2%) and people of color (23%),[3] with Black founders receiving only 1% of investments and Latinx founders receiving just 1.8%.[4] This hearing will investigate the lack of diversity in the VC ecosystem, challenges faced by diverse fintech founders in raising capital, the impact of diverse-owned fintechs and diverse-owned VC funds on communities of color, and what policy tools could be considered to help promote greater VC funding for fintechs founded by women and people of color.

[1] SERAF, Dividing the Pie: How Venture Fund Economics Work [Part II] (accessed June 27, 2022).
[2] S&P Capital IQ; see also Appendix Figure 1.
[3] See also Appendix Figure 2.
[4] RateMyInvestor, *Diversity in U.S. Startups* (2017).

Overview of Venture Capital

Although the size of VC investments appears relatively small when compared to the overall size of the global capital markets (which exceed $100 trillion), VC plays an important role in promoting entrepreneurship, innovation, and invention.[5] Startups funded by VC may form the pipeline for future transformative companies that become drivers of economic growth. For example, many well-known publicly traded technology companies, including Alphabet, Apple, Meta, and Amazon, were once VC funding recipients.[6]

Some VC firms have made efforts to diversify their portfolios; however, critics have noted that these efforts have been mainly limited to "impact investment" portfolios that are often motivated by reputational pressure.[7] Many fintechs espouse the main focus of their companies as reaching consumers who are underserved by traditional financial institutions, including women and people of color,[8] so the lack of VC available to diverse-founded fintechs is potentially troubling as it could hinder innovation that would benefit underserved consumers.

In aggregate, the size of VC investments in the fintech industry nearly doubled between 2020 and 2021 to reach $35 billion, according to S&P Capital IQ.[9] S&P Capital IQ breaks down the U.S. private fintech investments into broad categories of investment and capital markets technology, payments, insurance technology, digital lending, banking technology; financial media; and data solutions, and found that VC investments increased in all categories between 2020 and 2021.

VC investment firms have varying levels of size, expertise, and depth of financial strength. Individual startups, depending on the stage of their funding needs, can receive VC investments ranging from $10,000 in the seed stage to over $1 billion in later stages. For example, according to S&P Capital IQ, insurance technology company Integrity Marketing Group, banking technology company Chime Financial, and investment and capital markets technology company New York Digital Investment Group all received more than $1 billion in VC funding in 2021.[10] Examples of VC firms with different operational styles include the following:

- **Y Combinator** is an incubator and technology accelerator that invests in seed-stage startups and provides the startups with training and resources as they develop their business concepts.[11] Y Combinator routinely hosts three-month training programs for startups and provides $500,000 seed capital for each participating startup. Y Combinator famously invented the Simple Agreement for Future Equity (SAFE) framework that became a popular method of venture fundraising.[12]
- **Sequoia** is a large, mostly later-stage VC investor that is behind many well-known technology companies including Apple, FTX, Airbnb, DoorDash, LinkedIn, Zoom, PayPal, and Alphabet.[13] Sequoia has been in existence since 1972. Sequoia invests internationally and works with approximately 250 portfolio companies at any given time. As of June 2022, Sequoia has raised $20 billion across 31 funds.[14]

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[5] Securities Industry and Financial Markets Association, Research Quarterly: Equities (accessed June 27, 2022).
[6] *Venture Capital Flooding Into Technology Companies At Record Levels*, Investor's Business Daily (Apr. 30, 2021).
[7] Impact Frontiers, Investor Contribution (last visited June 27, 2022).
[8] *See e.g. Fintech works to elevate minority leaders as users diversify*, TechXplore (Nov. 18, 2020).
[9] *See* Figure 2; S&P Capital IQ.
[10] *Id.* CRS used data downloaded from S&P Capital IQ. Because private securities markets face terminology and data collection challenges, CRS does not review or guarantee the accuracy of the source data.
[11] Y Combinator, What Happens at YC (accessed June 14, 2022).
[12] Y Combinator, *Announcing the Safe, a Replacement for Convertible Notes* (Dec. 6, 2013).
[13] Sequoia, Our Companies (accessed June 14, 2022).
[14] Crunchbase, Sequoia Capital (accessed June 24, 2022).

- **Andreessen Horowitz** (also known as "a16z") has an industry focus on digital assets, cryptocurrency, and web3 (i.e., the third generation of the internet) startups. It has raised around $7.6 billion in funds, including a $4.5 billion fund announced in May 2022. Despite the downturn in digital asset pricing at the time, a16z plans to deploy $1.5 billion in web3 seed investments and $3 billion in venture investments at different funding stages.[15]

Racial, Ethnic, and Gender Disparities in VC Investments

Race & Ethnicity - VC-backed founders are estimated to be 77.1% White, 17.7% Asian, 2.4%, Middle Eastern, 1.8% Latinx, and 1% Black.[16] Of the $424.7 billion that has been invested in technology companies since 2009, 0.0006% has been invested in Black women-owned companies, and 0.4% in Latinx women.[17] Because investors are believed to be 21% more likely to back founders of the same ethnicity, some capital markets experts have argued that a VC workforce with more diverse representation may lead to increased VC capital flow for diverse founders.[18] Founders of color appear underrepresented in VC leadership positions, and notably, Black and Latinx founders were funded at a much lower level as compared to the demographic profile of the total U.S. population, with the Black population estimated at 12.4%, and the Latinx population estimated at 18.7% in 2020.[19]

Gender - Multiple sources indicate a gender funding gap in funding by VC. Data provided by PitchBook, which provides research on private capital markets, shows that even though VC capital investments and the number of deals by VC have both increased substantially for female-founded and female co-founded companies in recent years,[20] the female-only founded companies consistently received around 2% of total VC funding per year.[21] This contrasts with the fact that 20% of all U.S. firms that employ people are female-owned,[22] and that 22% of startups were founded by women in 2018.[23]

Many observers attribute the relatively low female-founder VC support to the fact that the VC industry itself lacks female representation. Research repeatedly indicates that investors tend to invest more in founders of the same gender, race, and ethnicity.[24] At the same time, female VC investors have a much higher tendency to invest in female founders.[25] Some studies show that women are increasingly taking professional and leadership roles at VC firms, but that a significant gender gap remains. According to one estimate, the percentage of female investment partners increased to 16% in 2020 from 11% in 2016,[26] signifying that there is some improvement in female participation in senior VC firm leadership, but that there is still a lack of representation of women at the leadership level at VC firms.[27] Additionally, a study by consulting firm Deloitte and two interest groups similarly indicated that, while women made up

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[15] Andreessen Horowitz, We Back Bold Entrepreneurs Building the Next Internet (accessed June 24, 2022).
[16] RateMyInvestor, *Diversity in U.S. Startups* (2017).
[17] *Diversity As $uperpower: The (Well-Known) Data Against Homogeneous Teams In Venture Capital*, Forbes (Sept. 22, 2020); *see also* Digital Undivided, The State of Latina & Black Women Founders (accessed June 14, 2022).
[18] Bengtsson, O., & Hsu, D. H., *Ethnic matching in the U.S. venture capital market*, Journal of Business Venturing (Mar. 2015); The Kenan Institute, Frontiers in Entrepreneurship: 2020 Trends in Entrepreneurship (accessed June 14, 2022).
[19] See U.S. Census Bureau, Improved Race and Ethnicity Measures Reveal U.S. Population Is Much More Multiracial (Aug. 12, 2021); *see also The Nation Is Diversifying Even Faster Than Predicted, According to New Census Data*, Brookings (July 1, 2020); *see also* Appendix Figure 4, which illustrates the VC workforce racial composition as of 2018.
[20] Chart 3 of PitchBook, *The US VC Female Founders Dashboard* (June 2, 2022).
[21] See Appendix Figure 2.
[22] Andrew Hait, *Number of Women-Owned Employer Firms Increased 0.6% From 2017 to 2018*, United States Census Bureau (Mar. 29, 2021).
[23] *Data Show that Gender-Inclusive Founding Teams Have Greater Success in Fundraising and Innovation*, Kauffman Fellows (Oct. 3, 2019).
[24] *See The Other Diversity Dividend*, Harvard Business Review (July-August 2018); *see also Race influences professional investors' financial judgments*, Proceedings of the National Academy of Sciences (PNAS) (May 9, 2019).
[25] *Women VCs Invest in Up to 2x More Female Founders*, Kauffman Fellows (Mar. 25, 2020).
[26] *Id.*
[27] *More Women Are Top VC Decision-Makers, But Parity Is A Long Way Off*, Axios (July 21, 2020).

approximately 45% of the VC workforce, they are still less represented in professional and leadership roles.[28]

Research on Diversity and Company Performance

Studies and publications have repeatedly demonstrated that companies founded by diverse teams outperform those with less diversity.[29] Companies with diverse founders earn 30% higher multiples on invested capital (MOIC) when they are acquired or go public.[30] 69.2% of top-performing US funds and angel groups included females in decision-making roles, while only 30.8% had all-male leadership.[31] One researcher noted that "[t]eams of diverse founders (more than one gender and/or more than one race or ethnicity represented) create more innovation and, on average, better financial outcomes at venture-funded startups. Much of the available data focuses on gender-diverse investing teams, which are two times more likely to invest in gender-diverse founding teams, 2.6 times more likely to invest in women-led entrepreneur teams, and more than three times more likely to invest in a female CEO."[32] Therefore, constraining "investment to a single-gender and single race damages innovation and risks limiting outcomes."[33]

Researchers have also found that companies with gender-diverse executive teams with 30% or more women in leadership are almost 50% "more likely to financially outperform the least diverse teams (those with less than 10% or fewer women) as measured by earnings before income and taxes margin and as compared to the national industry median … [with] the more gender-homogeneous the executive team, the greater the likelihood of underperformance on profitability."[34] Ultimately, as capital shifts from traditional companies to an "innovation" dominated the market, gender, racially, and ethnically-diverse teams generate significantly higher returns than homogeneous teams.[35]

Capital Formation and Investor Protection

To raise capital, many start-up companies issue private securities, also called unregistered securities offerings, that are exempt from registration with the U.S. Securities and Exchange Commission (SEC),[36] and are therefore not obligated to make regular disclosures related to the financial health or revenue prospects of the company. Given these heightened risks due to unavailability of public and audited disclosures, and their higher-than-normal probability of complete loss, these securities can only be marketed and sold to investors that meet certain regulatory thresholds, including *accredited investors, accredited institutional investors,* and *qualified institutional buyers.*[37] Some have argued that one way to increase the availability of funding for start-ups is to allow more investors to invest in this manner.[38] However, others have argued that this would harm retail investors and members of the public, with one advocate arguing that the "Accredited Investor" rule is one of the SEC's "most important retail investor protection methods. . . [allowing the SEC] to effectively draw a line between investors who have the financial means and financial knowledge to fend for themselves and those who lack such sophistication or wherewithal. This clear demarcation has helped the [SEC] to better protect those who need such

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[28] See Appendix Figure 3.
[29] *Diversity As $superpower: The (Well-Known) Data Against Homogeneous Teams In Venture Capital*, Forbes (Sept. 22, 2020).
[30] *Id*.
[31] *Id.*; *see also* PitchBook and All Raise, *All In: Women in the VC Ecosystem* (2019).
[32] *Diversity As $superpower: The (Well-Known) Data Against Homogeneous Teams In Venture Capital*, Forbes (Sept. 22, 2020).
[33] *Id*.
[34] *See* West River Group, *The Power Of Diversity: Why Homogeneous Teams In Venture Capital Are Bad For Business* (Sept. 21, 2021); *see also* McKinsey & Company, Diversity wins: How Inclusion Matters (May 19, 2020).
[35] *Diversity As $superpower: The (Well-Known) Data Against Homogeneous Teams In Venture Capital*, Forbes (Sept. 22, 2020).
[36] *See* CRS, Private Securities Offerings: Background and Legislation (Oct. 5, 2017).
[37] *See* SEC, Capital Raising: Building Blocks (accessed June 17, 2022).
[38] *See e.g.,* Let's Not Backtrack on Loosening 'Accredited Investor' Rules, Cato Institute (Jan. 29, 2021).

protection, and has allowed market participants, including broker-dealers, underwriters and companies to more effectively target their solicitations and offerings."[39]

Regulatory Environment

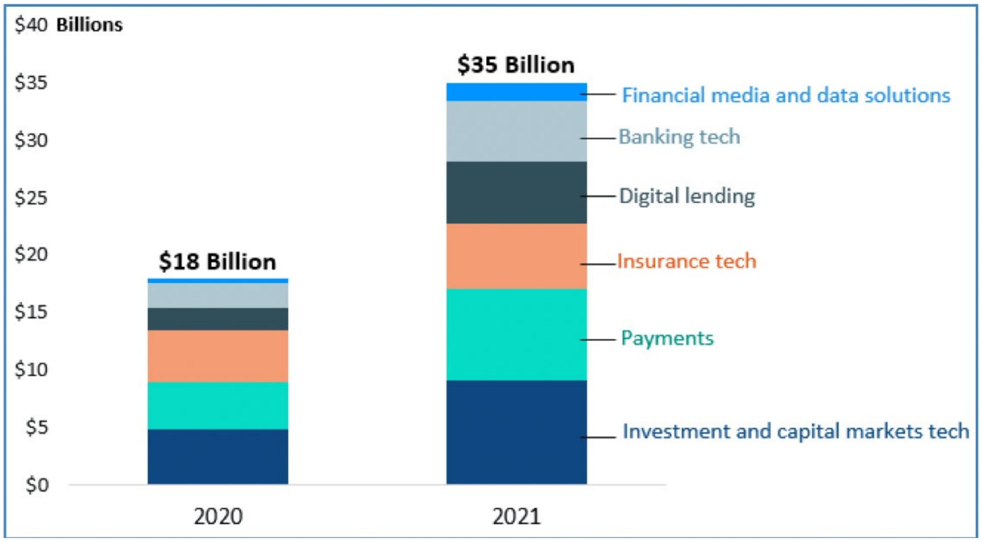
Under the Dodd-Frank Act, the Securities and Exchange Commission (SEC) established a legal definition for VC funds for the first time in 2011.[40] Entities that meet the legal definition of a VC fund are granted certain regulatory exemptions. Under the Dodd-Frank Act definition, a VC fund must (1) represent itself as pursuing a venture capital strategy to its investors and prospective investors; (2) hold no more than 20% of its aggregate capital contributions and uncalled committed capital in nonqualifying investments, other than short-term holdings; (3) not borrow, provide guarantees, or otherwise incur leverage, other than limited short-term borrowing; (4) not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and (5) not register under the Investment Company Act of 1940 and not be elected to be treated as a business development company.[41]

Although VC funds could be exempted from the Investment Company Act of 1940[42] and are not required to register with the SEC or provide related public disclosure and other compliance at the fund level,[43] much of the regulation of VC applies to VC advisers. Section 202(a)(11) of the Investment Advisers Act of 1940 (IAA)[44] defines an "adviser" as any person or firm that, for compensation, is engaged in providing advice to others or issuing reports or analyses regarding securities. VC fund managers, for example, would usually qualify as advisers. VC fund advisers could be subject to SEC or state registration and oversight if they have more than $150 million in assets under management. The IAA provisions and related agency rules specify many VC adviser obligations.[45] The SEC has increasingly engaged on the lack of diversity in the VC ecosystem. For example, the SEC's Small Business Capital Formation Advisory Committee recommended that the SEC Commission take action to reduce barriers to entry for underrepresented founders and their investors, stating, "the country is at an inflection point with respect to confronting matters of racial equity and inclusion, and access to capital is a powerful tool to help achieve racial and economic equity. Inclusion in the development of new business and economic growth is important to our national well-being, particularly for minorities and women.[46]

[39] *See* Better Markets, *Letter to SEC Amending the "Accredited Investor" Definition* (Mar. 16, 2020).
[40] Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203).
[41] 17 C.F.R. §275.203(l)-1.
[42] Investment Company Act of 1940 (P.L. 76-768)
[43] *See* Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940.
[44] Investment Advisers Act of 1940 (IAA; P.L. 76-768).
[45] Staff of the SEC's Division of Investment Management and Office of Compliance Inspections and Examinations, *Information for Newly-Registered Investment Advisers* (Nov. 23, 2010).
[46] *See* SEC, Recommendations of the SEC Small Business Capital Formation Advisory Committee (SBCFAC) (Aug. 26, 2020); *see also* SEC, *Investing in Underrepresented Founders*, Presentation to the SBCFAC (Aug. 4, 2020).

Appendix – Figures

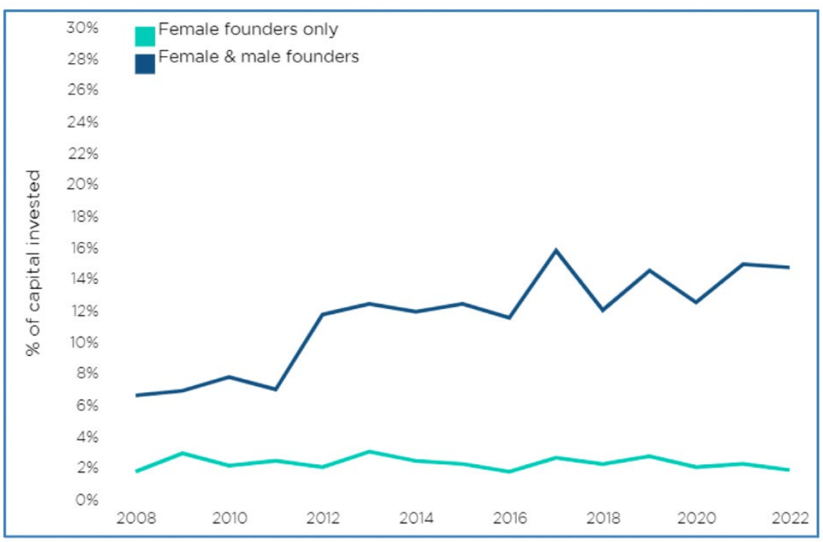
Figure 1: Venture Capital Investments in U.S. Private Fintech



Source: Data from S&P Capital IQ.

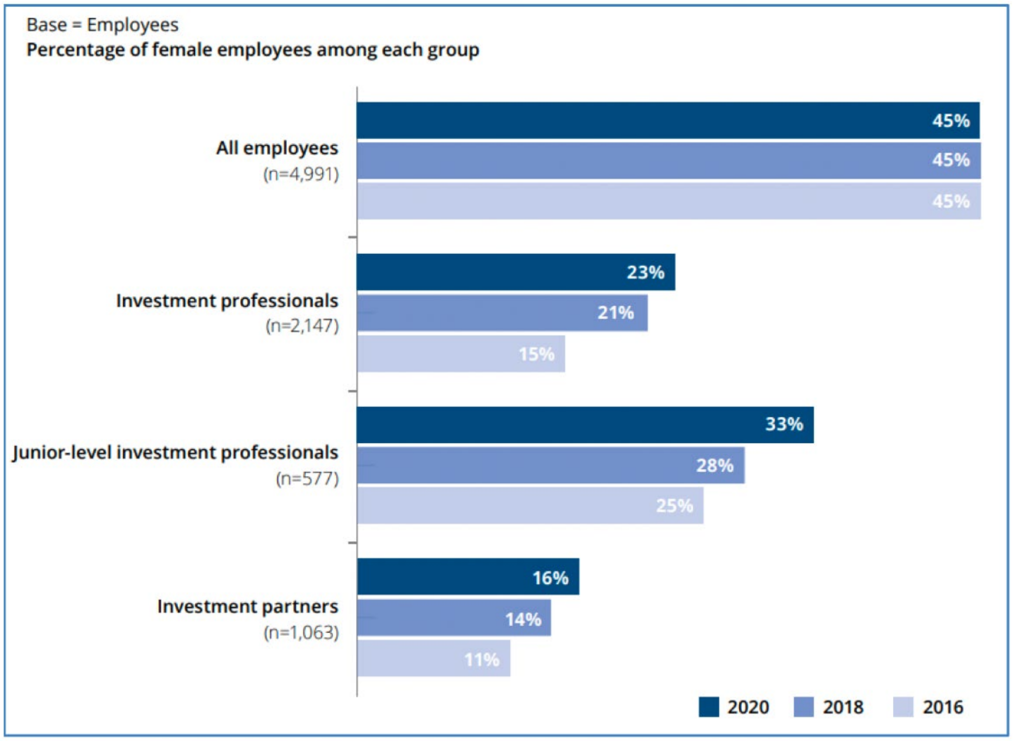
Notes: The chart reflects private placements completed by private, U.S.-based fintech companies. Debt transactions are excluded. This analysis is limited to offerings that were completed in the time period shown and captures only the portion of the offerings that were raised during that time period, excluding tranches that closed prior to the period.

Figure 2: Percentage of Venture Capital Received by Female-Founded and Female Co-Founded Startups



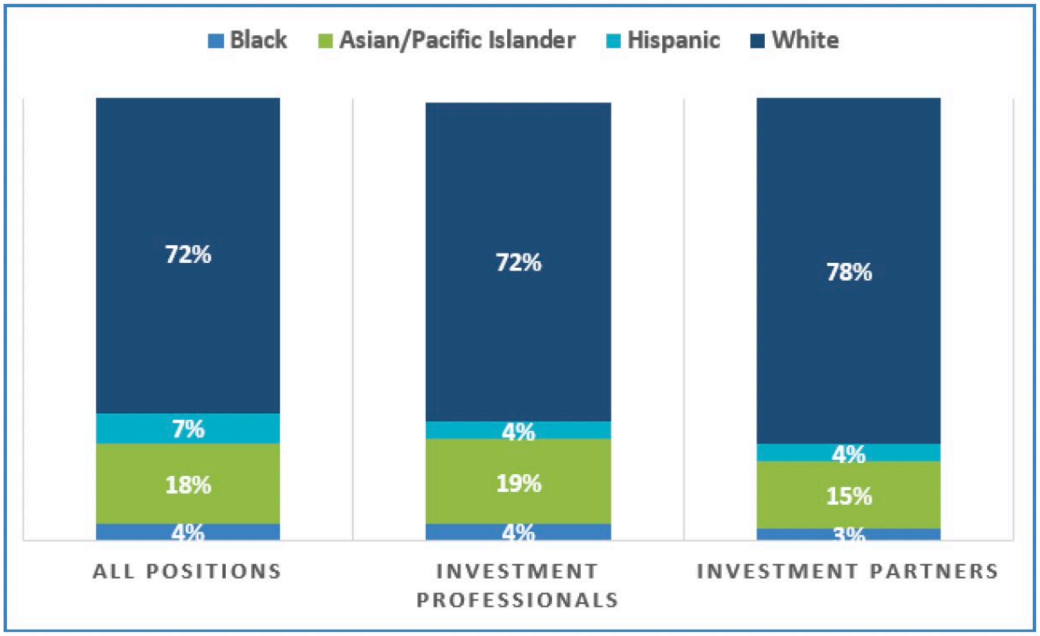
Source: PitchBook.

Figure 3: Gender Diversity at Venture Capital Firms



Source: NVCA, Venture Forward, and Deloitte, *VC Human Capital Survey* (March 2021).

Figure 4: Racial Diversity of the VC Workforce



Source: CRS using data from NVCA, Venture Forward, and Deloitte, *VC Human Capital Survey* (March 2021).

Notes: Percentage of the workforce as reported in survey sample in 2020. Racial categorization as defined by the source.