

Congress of the United States

U.S. House of Representatives

Committee on Small Business

2361 Rayburn House Office Building

Washington, DC 20515-6515

Memorandum

To: Members, Subcommittee on Investigations, Oversight and Regulations
From: Committee Staff
Date: September 19, 2013
Re: Hearing: Access to Capital in Arizona

On Monday September 23, 2013 at 1:00 p.m., the Subcommittee on Investigations, Oversight and Regulations of the Committee on Small Business will hold a field hearing in the Enterprise Room at SkySong, the Arizona State University Scottsdale Innovation Center, 1475 North Scottsdale Road, Scottsdale, AZ. This hearing will examine the local environment for small businesses seeking to raise capital; the regulatory impediments to investors providing funds to entrepreneurs, especially those in high-growth fields; and the effect of the Jumpstart Our Business Startups Act of 2012¹ (JOBS Act) on Arizona enterprises seeking capital.

I. Introduction

As of 2010, there were 99,232 businesses in Arizona with less than 500 employees. In addition, there were 395,995 businesses with no employees.² In 2010, small businesses were represented in all sectors with the highest concentrations in professional, scientific and technical services (14.7 percent), followed by healthcare and social assistance (12.8 percent) and construction (11.8 percent).³

¹ Pub. L. No. 112-106, 126 Stat. 306 (2012), codified at scattered sections of Title 15, United States Code [hereinafter JOBS Act].

² OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, ARIZONA SMALL BUSINESS PROFILE 1 (2013), available at <http://www.sba.gov/sites/default/files/az12.pdf>. The statistics should not be used as an accurate measure of the small businesses located in Arizona. Due to the way the Small Business Administration (SBA) calculates size standards, the categories used in the text may be over- or underinclusive of small businesses in Arizona.

³ *Id.* at 2.

Helping to finance Arizona small businesses, banks in 2011 made over 81,400 loans under \$1 million amounting to about \$2.8 billion.⁴ In fiscal year 2012, the SBA guaranteed 1,065 loans to small businesses for over \$478 million.⁵ Although banks have made significant efforts in providing capital in Arizona, this hearing will focus on the availability of equity capital for Arizona small businesses.

II. Equity Financing

Equity finance involves selling a portion of a business in return for capital without having to make periodic payments, as would occur with a bank loan.⁶ One avenue is to obtain equity capital from friends or family.⁷ Other options involve obtaining funds from investors – angel investors and venture capital funds. Alternatively, a new mechanism, crowdfunding, allows business to obtain funds from non-professional investors with whom the business owner is not familiar.

A. Angel Investing

An angel investor is a high-net worth individual⁸ who chooses to invest in businesses either as an individual or as part of a group of angels.⁹ There are currently over 250,000 individuals making

⁴ OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, SMALL BUSINESS LENDING IN THE UNITED STATES 2012 TABLE 4D, at 110 (2013), available at http://www.sba.gov/sites/default/files/files/sbl_12study.pdf. It is not possible to state whether all of the loans under \$1 million are made to small businesses. The data used by the Office of the Chief Counsel for Advocacy was obtained from call reports provided by banks to the Federal Deposit Insurance Corporation (FDIC). Those call reports require the banks to specify the total number of loans of less than \$1 million. However, those call reports do not require the specification of whether the business is large or small under definitions established by the SBA. As a result, the total number of loans made under \$1 million may be either over- or underinclusive of the total number of small businesses receiving loans from banks subject to federal regulation. In addition, the call report data excludes commercial lending from credit unions since they do not provide call reports to the FDIC. Finally, the SBA loan programs offer loans in excess of \$1 million to small businesses. Despite these caveats, the call reporting data represent the best, albeit flawed proxy, for overall (as opposed to lending through SBA guaranteed loans) small business lending by commercial banks.

⁵ UNITED STATES SMALL BUSINESS ADMINISTRATION, 7(a) AND 504 LENDING ACTIVITY FOR ARIZONA, FISCAL YEAR 2012 (2013) (on file with the Committee).

⁶ R. HISRICH, M. PETERS & D. SHEPHERD, *ENTREPRENEURSHIP* 346 (7th ed. 2008).

⁷ *Id.* at 349.

⁸ The term “high-net worth” generally describes any individual that qualifies as an accredited investor in regulations developed by the Securities and Exchange Commission. See Tanya Prive, *Angel Investors: How The Rich Invest*, *FORBES*, March 12, 2013, available at <http://www.forbes.com/sites/tanyaprive/2013/03/12/angels-investors-how-the-rich-invest/>. An individual qualifies as an accredited investor if the person has a net worth of \$1 million (exclusive of the value of their primary residence) or had annual income in excess of \$200,000 during the preceding two years. 17 C.F.R. § 230.501(a)(5)-(6).

⁹ W. BYGRAVE & A. ZACHARAKIS, *ENTREPRENEURSHIP* 390 (2d ed. 2011).

angel investments each year and over eight million investors qualified to be angel investors.¹⁰ The average angel investment can range from less than \$10,000 to as much as \$500,000.¹¹

In 2012, angel investors provided \$22.9 billion in financing to over 67,000 companies.¹² Angel investment led to the creation of 274,800 jobs in the United States.¹³ In the first quarter of 2013, angel groups located in the Southwest¹⁴ region of the country completed 12.9 percent of angel deals and were responsible for 18.1 percent of dollars invested in the United States.¹⁵

B. Venture Capital

Venture capital firms are private, professionally managed funds raised from institutional investors such as pension funds, hedge funds, mutual funds and wealthy individuals. The venture capital firm uses these funds to invest in high-growth companies with the ultimate aim of selling the company to another firm, or having the investment sold to the public in an initial public offering.¹⁶

According to the National Venture Capital Association rankings of venture capital investment, these firms invested \$212 million in Arizona in 2012.¹⁷ By contrast, California businesses received \$14.1 billion in venture capital investment during the same time period.¹⁸ Despite this ranking, public companies headquartered in Arizona that were once venture-backed account for 80,471 jobs and \$17 billion in revenue.¹⁹

1. Pitch Events

For small businesses to find angel investors or venture funds, they can attend so-called pitch events. These events enable an individual business owner to present their business ideas to a

¹⁰ *JOBS Act Implementation Update: Hearing Before the Subcomm. on Investigations, Oversight, Investigations and Regulations of the H. Comm on Small Business*, 113th Cong. (statement of Jean Peters, Managing Director, Golden Seeds), available at http://smallbusiness.house.gov/uploadedfiles/4-11-2013_peters_testimony.pdf.

¹¹ R. HISRICH, M. PETERS & D. SHEPHERD, *ENTREPRENEURSHIP* 376 (7th ed. 2008).

¹² J. SOHL, CENTER FOR VENTURE RESEARCH, *THE ANGEL INVESTOR MARKET IN 2012: A MODERATING RECOVERY CONTINUES 1* (2013), available at http://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/2012_analysis_report.pdf.

¹³ *Id.*

¹⁴ The Southwest region includes angel activity in the states of Arizona, Colorado, New Mexico, Nevada, Texas and Utah.

¹⁵ ANGEL RESOURCE INSTITUTE, ET. AL., *HALO REPORT ANGEL GROUP UPDATE: Q1 2013*, at 14, 16 (2013) available at http://www.angelresourceinstitute.org/~media/ARI/Files/Research/HaloReport/Q1_2013_Halo_Report.pdf.

¹⁶ R. HISRICH, M. PETERS & D. SHEPHERD, *ENTREPRENEURSHIP* 377 (7th ed. 2008).

¹⁷ NATIONAL VENTURE CAPITAL ASSOCIATION 2013 YEARBOOK Fig. 3.06, at 31 (2013), available at http://www.nvca.org/index.php?option=com_content&view=article&id=257&Itemid=103.

¹⁸ *Id.*

¹⁹ NATIONAL VENTURE CAPITAL ASSOCIATION, *VENTURE CAPITAL AND ENTREPRENEURSHIP IN ARIZONA 2* (2001), available at http://www.nvca.org/index.php?option=com_content&view=article&id=321&Itemid=586.

single or group of investors depending on the type of event.²⁰ One such event occurs annually in Scottsdale, AZ – Invest Southwest.²¹ At this event, a group of small business owners seeking between \$1 and \$5 million are selected at a “Get Ready” seminar to present their business plans to potential, prescreened investors ready and willing to invest in small businesses.²² Since 1992, more than \$250 million has been invested in businesses that have presented at Invest Southwest.²³

C. Crowdfunding

Crowdfunding entails obtaining small amounts of money from large numbers of individuals, generally through Internet portals.²⁴ Crowdfunding sites can be organized to allow for donations, rewards and pre-purchases of good in exchange for funding.²⁵ This type of crowdfunding has been used by artists, movie producers and the like to raise funds for their projects.²⁶ In 2012, crowdfunding projects raised \$2.7 billion and funded over one million individual campaigns.²⁷ However, due to regulatory restrictions, businesses are extremely limited in their ability to use crowdfunding for raising equity capital.²⁸

III. Current Issues

Angel investors and venture capital funds have provided substantial amounts of capital to small businesses in Arizona. However, the regulatory regime designed to protect the public from unscrupulous promoters of equity investment also imposes significant transactions costs on legitimate small businesses attempting to obtain equity financing.

These costs, which may exceed \$1 million,²⁹ make no sense for small businesses trying to raise the amounts that might be available from investors attending Invest Southwest, for example. As a result, Congress created exemptions (that have been expanded upon by the Securities and Exchange Commission (SEC)) to reduce regulatory burdens for businesses trying to raise small

²⁰ L. CUNNINGHAM, A LINGUISTIC ANALYSIS OF THE ENTREPRENEURIAL PITCH I (2010) (unpublished master’s thesis), available at http://etd.lib.clemson.edu/documents/1285784211/Cunningham_clemson_0050M_10801.pdf.

²¹ www.investsouthwest.org.

²² *Id.*

²³ *Id.*

²⁴ C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5 (2012).

²⁵ *Id.* at 14-27.

²⁶ Thomas Hazen, *Social Networks and the Law: Crowdfunding or Fraudfunding?*, 90 N.C.L. REV. 1735, 1736 (2012).

²⁷ Chance Barnett, *Top 10 Crowdfunding Sites for Fundraising*, FORBES, May 8, 2013, available at <http://www.forbes.com/sites/chancebarnett/2013/05/08/top-10-crowdfunding-sites-for-fundraising/>.

²⁸ See Joan Heminway & Shelden Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 906-07 (2011).

²⁹ PRICEWATERHOUSECOOPERS, CONSIDERING AN IPO? THE COSTS OF GOING PUBLIC MAY SURPRISE YOU 2 (Sept. 2012), available at http://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf.

amounts of capital from sufficiently sophisticated investors who are able to assess the risk of investment without full disclosure. Collectively, these exemptions are referred to as “Regulation D.”³⁰

However, even these exemptions have proven problematic for many small businesses trying to raise equity capital. Moreover, these exemptions were developed long before the Internet and the possibility of crowdfunding to raise equity capital. Given these developments, Congress enacted the JOBS Act with the expectation that it would improve the environment for small businesses to raise equity capital.³¹

A. Eliminating the Ban on General Solicitation and General Advertising

As a general proposition, businesses seeking to use Regulation D exemptions to raise money were prohibited from advertising or otherwise openly soliciting for investment. Congress, in the JOBS Act, required the SEC to promulgate rules to lift these restrictions on advertising and solicitation for businesses utilizing Regulation D. The SEC did not meet the statutory deadline but promulgated a final rule on July 24, 2013.³²

To engage in general solicitation under the SEC’s rule, businesses are required to inform the SEC of the businesses’ intent to use general solicitation.³³ The rule also provides a non-exclusive list of methods that businesses may use to determine whether the steps taken to verify that purchasers are accredited investors are reasonable.³⁴

B. Crowdfunding and the JOBS Act

The JOBS Act creates an exemption to allow the public to buy shares in a small business through crowdfunding websites. To qualify for this exemption, an issuer’s offering may not exceed \$1 million and there are various limits on the amount an individual can invest, based on their net worth.³⁵ These offerings must be conducted through an intermediary, who must register with the

³⁰ 17 C.F.R. §§ 230.500-.508.

³¹ For a more detailed explication of the need for the JOBS Act and its goals, see the Memorandum prepared for the Subcommittee hearing entitled “JOBS Act Implementation Update” held on April 11, 2013 and available at http://smallbusiness.house.gov/uploadedfiles/4-11-2013_hearing_memo.pdf.

³² Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771 (July 24, 2013).

³³ *Id.* at 44,783.

³⁴ *Id.* at 44,778.

³⁵ An investor whose income or net worth is below \$100,000 may invest up to \$2,000 or 5% of the investor’s annual income or net worth, whichever is greater. An investor whose income or net worth is greater than \$100,000 may invest up to \$100,000 or 10% of the investor’s annual income or net worth, whichever is less. JOBS Act, § 302, 126 Stat. at 315.

SEC as either a broker-dealer or as a funding portal.³⁶ The restrictions are Congress' effort to balance business access to capital with appropriate protections for the public.³⁷ To date, the SEC has not proposed rules to implement crowdfunding of equity investments, thereby reducing the ability of Arizona small businesses to use new technological innovations to raise needed capital.

C. Regulation A

Although most small issuers utilize the exemptions in Regulation D, the SEC developed an additional exemption to the conventional disclosure requirements when selling equity to the public. The SEC exempts from full disclosure equity offerings of \$5 million or less and is denominated as Regulation A.³⁸ The JOBS Act raises the limit for Regulation A offerings from \$5 million to \$50 million.³⁹ To date, the SEC has not promulgated regulations to implement this provision, which would allow Arizona small businesses needing more than \$5 million can do so by selling to the public without incurring transaction costs normally associated with a public offering.

IV. Conclusion

The goal of the JOBS Act was to increase the flow of investment capital to businesses by reducing regulatory burdens associated with raising equity capital. The full benefits have not been realized because the SEC has failed to implement the JOBS Act in the manner mandated by Congress. Arizona equity investors and, more importantly, small businesses should begin to see benefits as the SEC grudgingly completes implementation of the JOBS Act.

Witnesses at this hearing will discuss the current environment for raising equity capital in Arizona and the potential impact the regulatory changes associated with the JOBS Act will have. Witnesses also will offer additional recommendations, including further regulatory changes that will help small businesses raise capital.

³⁶ *Id.* Broker-dealers have been regulated by the SEC since the Great Depression. Crowdfunding portals, to the extent they are used to obtain equity capital for small businesses, are subject to SEC regulation as a result of the JOBS Act.

³⁷ <http://www.crowdsourcing.org/editorial/making-it-legal-crowdfunding-bills-navigate-critics/10077>.

³⁸ 17 C.F.R. §§ 230.251-.263. Colloquially, Regulation A is sometimes referred to as a "limited public offering."

³⁹ JOBS Act, § 401(a), 126 Stat. at 324-25.