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Congress of the United States

U.S. House of Representatives
Committee on Small Business

2361 Rayburn House Office Building
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To:	Members, Subcommittee on Economic Growth, Tax and Capital Access
From:	Small Business Committee Staff
Subject:	Subcommittee Hearing: "Equity Finance: Catalyst for Job Creation"
Date:	April 16, 2012

On Thursday, April 19, 2012, at 10:00 am, in Room 2360 of the Rayburn House Office Building, the Committee on Small Business Subcommittee on Economic Growth, Tax and Capital Access will meet for the purpose of examining the current state of equity financing for small businesses including recent legislative changes and other regulatory impediments. Witnesses include Mary Dent, General Counsel, Silicon Valley Bank, Palo Alto, California; Jason Best, Co-founder, the Startup Exemption, San Francisco, California; and Tony Shipley, Founder, Queen City Angels representing the Angel Capital Association, Cincinnati, Ohio and Angela Jackson, Managing Director, Portland Seed Fund, Portland, Oregon.

Equity financing is a funding method where a business owner sells a percentage of their company in exchange for an ownership stake. This ownership stake provides the investor with the right to a percentage of future profits of the company and a share of the management responsibility. Because many small businesses do not have fixed assets to pledge as collateral to secure a traditional loan from a bank or other lending institution, equity finance is an important alternative funding source. Besides providing needed financing at an early stage, equity finance also offers high-growth businesses access to strategic partners. Witnesses will discuss the current environment for equity finance and ways to strengthen the entrepreneurial funding ecosystem.

Introduction

Starting a business can present challenges for all entrepreneurs, and many cite funding as the primary obstacle they face.[1] Bank loans, an important source of capital for small business, have

[1] KAUFFMAN FOUNDATION REPORT, HIGH GROWTH ENTREPRENEURS PLAN TO CONTINUE GROWING, September 11, 2011, *available at* http://www.kauffman.org/newsroom/high-growth-entrepreneurs-plan-to-continue-growing.aspx.

declined markedly since the recession began.[2] That reduction in lending has been attributed to changes in the supply of credit and the tightening of credit standards by banks.[3] When bank loans are unavailable, entrepreneurs turn the four Fs: founders, family, friends, and foolhardy investors.[4]

While many entrepreneurs either self-fund their business or obtain capital from friends and family, some are able to access capital from outside investors. The four Fs refer to these investors as "foolhardy" because of the risk involved in startup small businesses. According to research by the Kauffman Foundation, approximately fifty percent of new firms do not survive past five years.[5] Given the volatility in the survival rate of new firms and their lack of collateral, most banks are unwilling to lend to a startup business.[6] Equity investors on the other hand are willing to take on risk because of the upside potential if a business becomes successful.

Equity Finance Overview

A benefit of equity financing over debt financing is that it allows a business to obtain funds without having to repay a specific amount of money in a particular time period. Unlike debt financing (e.g., bank loans) that require the business to make a monthly payment, which can restrict cash flow at a time when the business might be struggling to turn a profit, an equity investment typically does not require a fixed monthly payment.[7] Rather, the business owner receives funding in exchange for an ownership stake in the company. This ownership stake guarantees the investor a percentage of future earnings. While there is the potential to profit from the growth of a firm, if the endeavor fails, equity investors will not see a return on their investment.[8] Along with receiving an injection of capital, an advantage of an equity investment to a small company is that the investor has a stake in the business's success. So, investors are usually willing to offer strategic advice and management assistance to the entrepreneur, as well as introduce the entrepreneur to the investor's network of business contacts. This is extremely valuable to nascent entrepreneurs who do not have experience growing a company. The main drawback to this kind of investment is that the entrepreneur must give up a share of their

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[2] BURCU DUYGAN-BUMP, ALEXEY LEVCOV AND JUDIT MONTORIAL-GARRIGA, FINANCING CONSTRAINTS AND UNEMPLOYMENT: EVIDENCE FROM THE GREAT RECESSION 1 (DECEMBER 14, 2011), QUANTITATIVE ANALYSIS UNIT, FEDERAL RESERVE BANK OF BOSTON, *available at* http://www.bos.frb.org/bankinfo/qau/wp/2010/qau1006.pdf (hereinafter "Financing Constraints").
[3] Financing Constraints, *supra* note 22 at 1.
[4] William Bygrave and Andrew Zacharakis, ENTREPRENEURSHIP, at 340 (2ND ED 2011).
[5] DANE STANGLER AND PAUL KEDROSKY, NEUTRALISM AND ENTREPRENEURSHIP: THE STRUCTURAL DYNAMICS OF STARTUPS, YOUNG FIRMS AND JOB CREATION, KAUFFMAN FOUNDATION, *available at.* http://www.kauffman.org/uploadedfiles/firm-formation-neutralism.pdf.
[6] ROBERT D. HISRICH, MICHAEL P. PETERS & DEAN A. SHEPHERD, ENTREPRENEURSHIP, 347 (7th ed. 2008).
[7] R. HISRICH, M. PETERS & D. SHEPHERD, ENTREPRENEURSHIP, at 346.
[8] The ownership stake in the company will allow the investor to recover a percentage of the remaining business assets after debt creditors are repaid.

business to an investor who may not share the same vision on how the company should be managed.

The stage at which the investor becomes involved[9] in the business and how they seek a return on their investment are two factors used to distinguish the type of equity investment sought. For small businesses, the most common forms of equity finance are: angel investment, venture capital and (potentially) crowdfunding.[10]

Angel Investors

The most common equity investment (not coming from a founder, family, or friend of the entrepreneur) for startup businesses comes from high net worth individuals know as angel investors.[11] Angel investors are typically successful entrepreneurs who reinvest the gains they received from starting their own company. Along with seeking a return on their investment, angel investors also want to share their expertise and experience with a new crop of entrepreneurs.[12]

An angel investment comes from either an individual angel or a group of individual angels who have joined together to invest.[13] The average angel investment can range from less than $100,000 to as much as $2 million,[14] which is usually smaller than an investment from a venture capital firm.[15] Angel investments typically include a more hands-on approach with respect to the management of a company and a willingness to accept a smaller return or greater risk.[16] Since angel investors are using their personal funds and not raising money from outside investors, they have the flexibility in terms of the length and the structure of their investment.[17] Further, angels can invest in seed-stage and early-stage firms that are seeking a smaller investment that may not be cost effective for larger investors, including venture capitalists.[18] Angel investors typically have the resources and skill necessary to bring a company to the point where they become eligible for an investment from a venture capital company.

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[9] Venture capital investors are more likely to become involved with a small business during the early stage of product development; whereas angel investors are usually high net worth individuals or small groups as opposed to management teams with multiple investors.
[10] Since crowdfunding was only recently legalized by the JOBS Act, the true impact on small business remains unknown.
[11] FINANCING HIGH-GROWTH FIRMS: THE ROLE OF ANGEL INVESTORS, OECD PUBLISHING 29 (2011), *available at* http://dx.doi.org/10.1787/9789264118782-en.
[12] *Id.* at 72.
[13] William Bygrave and Andrew Zacharakis, ENTREPRENEURSHIP, 390, (2nd ed. 2011).
[14] *Id.* at 390.
[15] FINANCING HIGH-GROWTH FIRMS: THE ROLE OF ANGEL INVESTORS, OECD PUBLISHING 34 (2011), *available at* http://dx.doi.org/10.1787/9789264118782-en.
[16] *Id.*
[17] FINANCING HIGH-GROWTH FIRMS: THE ROLE OF ANGEL INVESTORS, OECD PUBLISHING 31 (2011), *available at* http://dx.doi.org/10.1787/9789264118782-en.
[18] William Bygrave and Andrew Zacharakis, ENTREPRENEURSHIP, 388, (2nd ed. 2011).

Venture Capital

Venture capital firms are professionally managed funds raised from institutional investors such as pension funds, hedge funds and mutual funds. The venture capital firm uses these funds to invest in growing companies in exchange for an ownership stake.[19] Venture capital companies exercise control over the management of the business by taking seats on the company's board of directors so they can actively participate in management decisions.[20] The goal of most venture capitalists is to grow the company to the point where it can either be acquired, or the company can be taken to an Initial Public Offering (IPO). IPO's occur when an ownership stake in a company is available for purchase on a public market. This event can raise a large amount of capital and allow investors the ability to harvest the value of their ownership stake.[21] These exit events allow the venture capital company to realize the gains needed to return money to their investors. The typical venture capital fund is organized to last ten years.[22] Given this structure, venture funds look for companies that they can grow quickly within this time period.

When choosing a company to invest in, venture capital firms look for companies with rapid growth potential so their money is not tied up for an extended period of time and there is potential for greater profit. Because of these investment criteria, venture capital companies typically invest in specific high growth industries and companies where the venture capital firm has a core competency of expertise. The most common industries for venture capital investment are biotechnology, medical instruments and devices, and computer-based technology.[23] In fact, 80 percent of venture capital invested in the United States has gone to high technology companies.[24]

As a percentage of total startup businesses, venture capital firms fund very few companies. Venture funding is typically reserved for companies that are already in business and have previously received their first round of funding from another source.[25] Despite this, venture funding is key to company growth and job creation. According to a 2011 Global Insight Study, venture-backed companies accounted for nearly 12 million jobs and $3.1 trillion in revenue in the United States in 2010.[26]

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[19] R. HISRICH, M. PETERS & D. SHEPHERD, ENTREPRENEURSHIP, at 377.
[20] FINANCING HIGH-GROWTH FIRMS: THE ROLE OF ANGEL INVESTORS, OECD PUBLISHING 23 (2011), *available at* http://dx.doi.org/10.1787/9789264118782-en.
[21] Bygrave and Andrew Zacharakis, ENTREPRENEURSHIP, 353, (2nd ed. 2011).
[22] *Id.*
[23] *Id.* at 348.
[24] *Id.* at 350.
[25] *Id.* at 347.
[26] National Venture Capital Association Home Page, *available at* http://www.nvca.org/index.php?option=com_content&view=article&id=339&Itemid=653.

Crowdfunding

Under the recently signed Jumpstart Our Business Startups (JOBS) Act (Pub. L. No. 112-105), small businesses now have the ability to offer an equity share of a company directly to the public via a networking site on the Internet. This method of raising capital is known as crowdfunding.

Prior to the recent change in the law, crowdfunding was available as a tool for non-profits and small businesses to receive donations from the general public, but an ownership stake in the organization was not permitted. Rather, the investor donated money to a company in exchange for a product or service available only to investors.[27] One of these platforms is kickstarter.com.[28] On kickstarter.com, entrepreneurs must apply to have their project accepted, and the funding is collected by Amazon Payments, a third party payment processor. There are estimates that over 250 similar sites are now actively seeking investors.[29]

The change to the law made by the JOBS Act was necessary because since the 1930's, federal securities laws regulating the sale of company stock were enacted to protect investors[30] from fraudulent practices, such as unsophisticated investors being lured into illegal investments. Most equity investors are exempt from this restriction because they are considered to be "accredited investors." Accredited investors are high-net worth individuals who the SEC has determined have the knowledge and skill to invest in startup businesses.[31]

Under the JOBS Act, companies will now be able to seek equity investment from the general public. Despite allowing this method of funding, there are still significant restrictions on the amount of money a company can raise through crowdfunding and the amount that a non-accredited investor can invest. These restrictions are in place to address concerns that the law continue to include comprehensive investor protections, education about risk and the opportunity for due diligence.[32] Supporters of crowdfunding cite the required disclosure and communication

[27] David Pogue, *Embracing the Mothers of Invention*, N.Y. TIMES, Jan.25, 2012, *available at* http://www.nytimes.com/2012/01/26/technology/personaltech/financing-the-stuff-of-dreams-through-kickstarter-state-of-the-art.html?_r=1&ref=venturecapital.

[28] http://www.kickstarter.com/.

[29] Editorial, Crowdfunding: *Many Scrappy Returns*, THE ECONOMIST, Nov. 21, 2011, *available at* http://www.economist.com/node/21538770.

[30] R. HISRICH, M. PETERS & D. SHEPHERD, ENTREPRENEURSHIP, at 359.

[31] The term "accredited investor" is defined in Regulation D of Rule 501(a). In December 2011, the Securities and Exchange Commission adopted a final rule which amends the definition of "accredited investor." The revised definition was required by the Dodd-Frank Act. Under the revised definition, an accredited investor is one with a net worth of $1 million excluding the value of one's primary residence. Net Worth Standards for Accredited Investors, Final Rule, 17 C.F.R. pts. 230, 239, 270 and 275 (December 2011), *available at* http://www.sec.gov/rules/final/33-8518.pdf.

[32] See Crowdfunding editorial, *supra* note 41. *See also* Editorial, *Making It Legal: Crowdfunding Bills Navigate Critics*, Crowdfunding.com website, *available at* http://www.crowdsourcing.org/editorial/making-it-legal-crowdfunding-bills-navigate-critics/10077.

as adequate investor protections.[33] The Securities and Exchange Commission (SEC) has been tasked in the law with developing rules that are *necessary and appropriate* for the protection of investors.[34] This rulemaking must take place 270 days after enactment of the Act.[35]

Conclusion

Equity finance is an important source of capital for small businesses, particularly high-growth small businesses with the greatest potential for growth and job creation. Because of recent changes to the laws governing equity investment, small businesses will have increased opportunities to access capital from investors. As these legislative changes are implemented, the Committee will continue to monitor their effect on small business financing and job creation. This hearing will provide Members the opportunity to hear testimony about the current regulatory environment for equity investment and how the recent changes will impact this funding ecosystem.

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[33] Kevin Lawton, *Crowdfunding 101: What You Need to Know To Make an Informed Decision,* Startup Exemption, *available at* http://www.startupexemption.com/archives/category/kevin-lawton#axzz1jNE5fAG1.
[34] Pub. L. No. 112-105 § 302(c).
[35] *Id.*