



Government
of Canada

Gouvernement
du Canada

Equity Financing Alternatives for Small Business: A Review of Best Practices in the United States



Prepared for Industry Canada,
Small Business Policy Branch
as part of the
Small and Medium-sized Enterprise (SME)
Financing Data Initiative By:
Ted R. Heidrick
Russell R. Keddie
January 2000

Canada 

For additional copies of this publication, please contact:

Publishing and Depository Services
Public Works and Government Services Canada
Ottawa ON K1A 0S5

Tel. (toll-free): 1 800 635-7943 (Canada and U.S.)
Tel. (local): (613) 941-5995
TTY: 1 800 465-7735
Fax (toll-free): 1 800 565-7757 (Canada and U.S.)
Fax (local): (613) 954-5779
Email: publications@pwgsc.gc.ca

This publication is available upon request in accessible formats. Contact:

Multimedia and Editorial Services Section
Communications and Marketing Branch
Industry Canada
Room 252D, West Tower
235 Queen Street
Ottawa ON K1A 0H5

Tel.: (613) 948-1554
Fax: (613) 947-7155
Email: multimedia.production@ic.gc.ca

This publication is also available electronically on the World Wide Web at the following address:
<http://strategis.ic.gc.ca/epic/internet/insbrp-rppe.nsf/en/rd01524e.html>

Permission to Reproduce

Except as otherwise specifically noted, the information in this publication may be reproduced, in part or in whole and by any means, without charge or further permission from Industry Canada, provided that due diligence is exercised in ensuring the accuracy of the information reproduced; that Industry Canada is identified as the source institution; and that the reproduction is not represented as an official version of the information reproduced, nor as having been made in affiliation with, or with the endorsement of, Industry Canada.

For permission to reproduce the information in this publication for commercial redistribution, please email:
copyright.droitdauteur@pwgsc.gc.ca

Cat. No. Iu1-88-9/2006E-PDF
ISBN 0-662-43162-6
53224E

Aussi offert en français sous le titre *Financement par actions pour les petites entreprises : Un examen des meilleures pratiques aux États-Unis.*

TABLE OF CONTENTS

EXECUTIVE SUMMARY	3
1 INTRODUCTION	5
2 OBJECTIVES OF REPORT	6
3 ORGANIZATION	7
4 METHODOLOGY	8
5 FRAMEWORK FOR REVIEW	9
6 SME STAGES OF GROWTH	10
6.1 STAGE 1: SEED	10
6.2 STAGE 2: START-UP	10
6.3 STAGE 3: FIRST EXPANSION	11
6.4 STAGE 4: SECOND EXPANSION	11
6.5 STAGE 5: INITIAL PUBLIC OFFERING	11
7 EQUITY FINANCING AGENTS	13
7.1 PRIVATE INVESTORS	13
7.2 ANGELS	13
7.3 VENTURE CAPITAL	14
7.4 BANKS	15
7.5 CORPORATE INVESTORS	15
7.6 INSTITUTIONAL INVESTORS	15
7.7 THE PUBLIC	15
8 GENERIC FINANCING FLOW INCENTIVES	16
9 FLOW INCENTIVES IN THE US	19
9.1 GOVERNMENT INITIATIVES	19
9.1.1 <i>Small Business Investment Corporation Program</i>	
9.2 TAX INCENTIVES	20
9.2.1 <i>Gains on Qualified Small Business Stock</i>	
9.2.2 <i>Rollover of Gain From Publicly Traded Securities</i>	
9.2.3 <i>The Tax Payer Relief Act of 1997</i>	
10 FLOW SUPPORT SYSTEMS IN THE US	24
10.1 GOVERNMENT INITIATIVES	24
10.1.1 <i>Small Business Development Centers (SBDCs)</i>	
10.1.2 <i>Business Information Centers (BICs)</i>	
10.1.3 <i>Service Corps of Retired Executives (SCORE)</i>	
10.1.4 <i>State and Local Business Development Centres</i>	
10.1.5 <i>Technology Commercialization Centres (TCC's)</i>	
10.1.6 <i>Online Government Resources</i>	

10.2	PRIVATE INITIATIVES	
11	FINANCING FLOW LINKAGE SYSTEMS	26
11.1	GOVERNMENT INITIATIVES	26
11.1.1	<i>Securities Exchange Exemptions</i>	
11.1.2	<i>ACE-Net</i>	
11.2	PRIVATE INITIATIVES	30
11.2.1	<i>Securities Exchanges</i>	
11.2.2	<i>NASDAQ Over the Counter Bulletin Board</i>	
11.2.3	<i>Private Angel Networks</i>	
11.2.4	<i>SCOR and Direct Public Offering Networks</i>	
12	SUMMARY OF EMPIRICAL AND THEORETICAL ANALYSES	34
12.1	EMPIRICAL ANALYSES	34
12.1.1	<i>The Annual Report on Small Business and Competition</i>	
12.1.2	<i>A Survey of High Technology Firms</i>	
12.1.3	<i>Small Business Administration Annual Data Reports</i>	
12.2	QUALITATIVE -THEORETICAL REVIEW	38
12.2.1	<i>Business Environment in the United States</i>	
12.2.2	<i>Understanding the Financing Process</i>	
12.2.3	<i>Newly emerging Forms of Venture Capital</i>	
12.3	SUMMARY	46
13	END NOTES AND REFERENCES	48

EXECUTIVE SUMMARY

This review of best practices of equity financing alternatives for small and medium size enterprises (SME) in the United States has been prepared in order to assist Industry Canada in developing public policy regarding small business financing. The review uncovered a number of programs, policies and processes in place that have allowed the United States to be the world leader in new innovation and entrepreneurial activities.

A simple framework was developed for the investment process. It consists of agents that provide equity financing at different stages in a small business' life cycle, incentives that assist the flow of this investment, programs that support the process, and systems that improve the linkages between those seeking financing and those offering it. And, finally, recent theoretical and empirical processes of the effectiveness of the various elements of this whole system are discussed.

Flow incentives are specific programs and initiatives that facilitate equity financing both in terms of individual decisions to invest and the overall amount of aggregate dollars available for equity investment. The following flow incentives were identified and reviewed:

- Small Business Investment Corporation (SBIC) Program
- Tax incentives for equity investors in small business
- Gains on qualified small business stock
- Rollover of gain from publicly traded securities
- Tax payer relief act of 1997

The SBIC program has increased the overall supply of equity finance capital. The program entices more people to set up venture capital funds. For example an investor with \$10 million might receive another \$30 million from the SBA to form an SBIC. These additional funds are not the only incentives for venture capitalists to form SBICs. Since 1994, many SBICs do not have to make interest payments to the SBA during the first few years of operations. As profits are realized the SBA will take up to 10% in lieu of interest payments. As a result new SBICs are not burdened with high interest payments while they invest in long-term opportunities. This recent regulation has prompted a "mini-boom in SBICs during the past few years.¹

While SBICs provide incentives for investors to increase the aggregate amount of equity investment directly available to small business, general tax incentives affect individual decisions to invest and increase the amount of funds available by reducing the tax burden on equity investors in small businesses. The tax policies and exemptions provide incentives for both individual and corporate investors to invest and reinvest in small business equities.

Flow support systems are initiatives or programs that allow entrepreneurs to access flow incentives in order to improve their chances of receiving equity financing. Support systems such as Small Business Development Centers (SBDCs), Business Information Centers (BICs), and the Service

Corps of Retired Executives (SCORE) were reviewed. These support mechanisms provide much needed training in the area of business planning, financing consultation and other key management areas.

Linkage systems increase the accessibility of investors to entrepreneurs and vice versa. In addition, they increase the aggregate level of equity financing for small business. The larger the number of effective linkage systems in a given investment setting the more accessible risk capital is for entrepreneurs. Linkage systems include both securities exchanges, and also a variety of other entities fostered by innovative securities exchange exemptions.

There are a number of stock exchanges in the United States that serve small businesses. The major incentive for investors is the level of liquidity that is provided. As long as there is a secondary market for a specific stock, investors will be more likely to invest. Stock exchanges have quantitative and qualitative listing and maintenance standards and stringent reporting obligations, which are often deterrents for small businesses. In many cases, a small business simply cannot afford the costs associated with an initial public offering (IPO). However, successful SMEs with high growth potential can often finance IPO's through banks and venture capital companies.

By legislating securities exchange exemptions, many dating back as far as 1933, the US government has functioned as a catalyst in increasing the overall number of linkage systems within the entire equity capital setting. The impetus was provided for investors and entrepreneurs to develop new equity finance markets and networks beyond traditional securities exchanges. Also, many established exchanges now offer new services to small businesses as the level of demand for these investments continues to grow. It is also important to note that these government programs have been proactively adapting to new developments. In particular, Securities Exchange Commission exemptions led to an increased demand by investors for private placements. As a result, the government created ACE-Net to increase the level of interaction between private investors and entrepreneurs beyond the local environment. By adapting to new developments in information technology (i.e the Internet), ACE-net has provided an early model for the many online private investment networks that are now in existence and were reviewed in this report.

Key empirical and theoretical analyses are reviewed. Detailed copies of these, and other articles of potential interest, are provided in the Appendices. The overall conclusion of these reports is that the various programs described above have been instrumental in causing a steady increase in the numbers of small businesses in the United States. In 1997 a record 842,000 new small employers opened their doors and new incorporations hit a record high for the third straight year², and this rate of new business development shows no signs of slowing down in the future.

1 INTRODUCTION

The availability of equity finance for small businesses in Canada has been a topic of interest for policy makers for many years. It is commonly acknowledged that small businesses in the United States have better access to equity financing than their Canadian counterparts. At end of 1998 there were more than 23 million small businesses in the United States accounting for more than half of both the nation's private workforce and its gross domestic product. Small businesses were identified by the US Small Business Administration (SBA) as the primary creator of new jobs in the economy.³

The United States has been extremely proactive in regards to developing public policy with the objective of facilitating the growth of small and medium enterprises (SMEs). In addition, the entrepreneurial culture that permeates most sectors of the economy has also caused numerous programs and processes to be developed that also favour the growth of small business.

The SBA has established size standards for business to qualify as SMEs in most industries. Although there are different standards set for some specific programs and approximately one quarter of all industry associations vary slightly from these numbers, the SBA's most often used standards are as follows⁴:

A small business (SME) has less than or equal to:

- 500 employees for most manufacturing and mining industries
- 100 employees for all wholesale trade industries
- Sales of \$5 million for most retail and service industries
- Sales of \$17 million for most general & heavy construction industries
- Sales of \$7 million for all special trade contractors
- Sales of \$0.5 million for most agricultural industries

One of the most important factors in determining the success of any small business is its ability to access financing. Equity financing, also known as risk capital, is much different from debt financing. Debt has to be repaid over a period of time with accumulated interest, while equity financing is the exchange of growth capital for an ownership share of the business. Equity financing does not constrain short-term cash flows and often the investors provide much needed advice and networking opportunities. Although, the major disadvantage is the dilution of ownership for the founding entrepreneur, equity financing is considered one of the best methods for fueling the growth and potential of small business.

2 OBJECTIVES OF REPORT

The objective of this report is to review best practices in the US related to equity financing for SMEs. This review has been prepared in order to assist Industry Canada in developing public policy regarding small business financing. While the goal of such policy will be to increase access to risk capital for SMEs in the Canadian setting, the following report will detail initiatives in the United States. It is hoped that by analyzing some of these policies and procedures, the Canadian government will gain valuable knowledge in order to continue to proactively improve the flow of equity financing to SMEs in this country.

The report has the following objectives:

- To identify and describe US initiatives that enhance or facilitate the flow of equity financing to small business. This includes:
 - Government programs
 - Tax incentives
 - Network infrastructure
 - Financing community initiatives
 - Investment clubs and networks
- Identify linkages between the various groups and their delivery vehicles
- Summarize recent empirical and theoretical analyses on access to equity financing for start-ups and early stage SMEs.

The review will be organized in the following manner.

Framework for Review

There are many agents that provide equity financing during various stages in the development of a small business. The Framework for Review model provides an overview of the stages of growth and the various financing agents involved in equity financing activities.

SME Stages of growth

In order to understand the flow of financing from different sources, descriptions of generic stages of growth have been defined.

Equity Financing Agents

A detailed list of the types of equity investors has been provided including a short description of investment habits.

Generic Finance Flow Incentives and Flow Support Systems

A broad list of factors and initiatives that facilitate the flow of equity financing to SMEs has been compiled and categorized according to the type of financing agent they affect. Also, the support systems that enable SMEs to possess these incentives are listed. These incentives are evident regardless of industry type or region characteristics.

Flow Incentives

This section lists specific programs and initiatives that facilitate equity financing in the US.

Flow Support Systems

Flow support systems are initiatives or programs that allow entrepreneurs to access and develop flow incentives in order to improve their chances of receiving equity financing.

Flow Linkage Systems

Linkage systems do not positively affect the decision to invest; however, they increase the accessibility of investors to entrepreneurs and vice versa. In effect, linkage systems increase the overall level of equity financing for small businesses. The larger the number of effective linkage systems in a given investment setting the more accessible risk capital will be for entrepreneurs. Angel networks and financing consultants with established networks of investors are two examples of linkage systems.

Summary of Recent Empirical and Theoretical Analyses

4 METHODOLOGY

The information for this review came primarily from online sources; however, printed materials were also used as sources of information.

During the first stage, the researchers conducted themselves “as if they were American entrepreneurs in search of equity financing”. This led to the discovery of numerous sources of information regarding equity financing in the US.

The next stage of research involved the researchers conducting themselves “as if they were investors in search of opportunities”, which led to the identification of many investment incentives programs.

The third stage of research took a more pragmatic approach and simply involved searching for information sources regarding the various elements of the equity financing process (defined in detail later in this document)

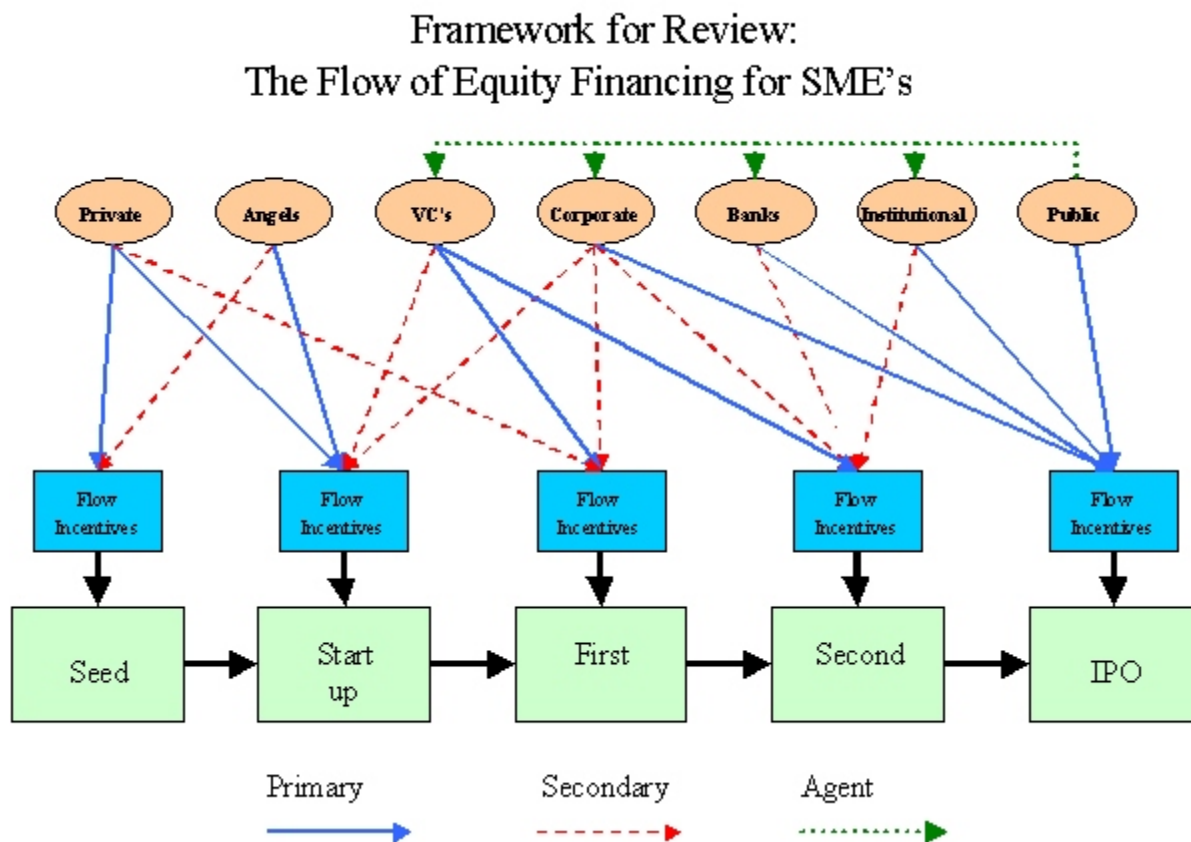
The final stage was more academic and involved a literature review of recent theoretical and empirical analyses. Discussions with members of academia were also conducted.

The final product provides a comprehensive list of factors, programs, parties, and processes that positively affect the flow of equity financing to small business in the United States.

5 FRAMEWORK FOR REVIEW

SMEs in different industries progress along different “financing paths”. For example, a biotechnology firm may progress along a Research-Development-Clinical trials-IPO/Private placement path, while a manufacturing start-up may progress along a Research-Development-Bench-Pilot-Production-Scaleup-IPO path. In both cases, financing options become more readily available in the latter stages when products or services are closer to becoming a commercial reality and/or when positive earnings are evident.

The following generic Framework for Review model, which represents the most usual circumstances for a SME seeking equity financing, has been created to provide a structure of reference for the report. It will allow for the classification of the different forms of equity financing (Finance Agents) as well as the different facilitators, programs, regulations, and policies (Flow Incentives and Flow Support Systems) that affect investment decisions at different stages in an SMEs growth cycle.



6.1 Stage 1: Seed

All businesses start with an idea. The germination of these ideas into a comprehensive vision of a viable company is called the seed stage of a business. During this stage prototypes are built, market opportunities are assessed, ideas are exchanged between trusted friends and family, and the entrepreneur makes a final decision as to whether or not he will dedicate most of his time towards developing the new venture.

Seed stage equity financing primarily comes from the entrepreneur, family, and friends – type I private investors. This type of financing is often called “love money”, as it is seldom invested based on the idea itself but due to the relationship the investor has with the entrepreneur. During the seed stage the majority of expenses will be incurred developing prototypes and conducting market research. However, there are many situations in which seed stage financing requirements are well beyond the means of an entrepreneur and his local network. In these situations the most likely option for equity investment comes from angels and type II private investors, which include past business acquaintances, friends of friends, and others. While both type II private investors and angels will likely be wealthy individuals or business owners with the means to invest in the new venture, angels are different in that they actively seek equity investment opportunities. In fact, with the widespread use of information technology angels are becoming more like Venture Capital firms. The advent of online screening functions, angel networks and the proactive search for high quality investments are three key factors that separate angels from type II private investors. These differences will be discussed further in section 7. Regardless of the type of investor targeted, at this point the entrepreneur will need to have some form of a business plan prepared along with financial projections for the business. Investors outside of the immediate circle of family and friends will require information regarding market size, trends, details of the technology, identification of customers, etc. Most angels will require a comprehensive business plan and executive summary. In addition to a written plan, the entrepreneur will have to possess excellent verbal skills in order to communicate his vision to potential investors.

6.2 Stage 2: Start-up

Once the initial research, idea formulation, and prototypes have been completed then it is time to start the business. During this stage the entrepreneur’s vision will become a functioning organization. The entrepreneur will have to find a home for the business, hire employees (and possibly additional management), order inventories, secure suppliers, commence marketing efforts and so on.

For most entrepreneurs, securing equity financing during this stage is still quite difficult. The company does not yet have a base of customers and has not yet earned a profit. It is a very risky time for a new venture. Similar to the seed stage of growth, angels and private investors will be targets

for investment funds. However, another group of investors, venture capitalists, can now be considered. It will now be more important than ever to have a well developed business plan. In addition, the entrepreneur will likely need the services of an experienced lawyer and an accountant, especially when attempting to the value the company in order to acquire equity financing.

6.3 Stage 3: First Expansion

In this model the first expansion occurs due to the company's rapid growth. The entrepreneur needs additional working capital and/or capital investment to address growing sales of the company. Additional employees are hired, the production process is enlarged and new markets beyond the local setting are targeted. Average investments range from 3 to 5 million. If the entrepreneur can prove positive earnings and an established customer base, the chances for private, angel and venture capital equity investment will be increased dramatically.

6.4 Stage 4: Second Expansion

Second expansion usually involves a company growing at an extremely rapid pace with a robust technology and a rapidly growing potential market. Although not always the case, the entrepreneur may envision transforming the business from a small concern to a large corporation. Additional funds are required to develop new products and/or enter new international markets. Again, production facilities, marketing budgets and other areas of the business may need to be enlarged in order to address the firm's high growth potential, Second expansion investments range from 5 to 20 million. With a successful history and high potential for the future, equity financing options will begin to increase. Banks and corporate investors will also become targets for additional funds.

6.5 Stage 5: Initial Public Offering

A successful SME (although it may no longer be an SME) can finance its growth by acquiring funds from the public through an IPO. However, many companies never reach this stage of growth by choice. The numerous regulations and procedures that must be followed are not appealing to many entrepreneurs. Although business owners will have an opportunity to cash out some of their equity in the secondary markets, they must also be ready to give up some control of the business. Periodic reports of business activities have to be supplied to shareholders, which may affect any perceived competitive advantage associated with the company's private information. Also, other activities such as sales of stock by executives must be reported to a securities exchange commission. The size of the investment may range from 5 million to well over 100 million.

In the United States there are alternatives to "going IPO" in regards to attracting equity investments from the public. Small businesses can access public capital by selling state-registered securities to the general public. This process is called a Direct Public Offering (DPO). DPO's will be discussed in detail in further sections of this report.

Acquisition

In many cases successful SMEs in high growth industries are acquired by larger organizations. While this provides growth capital and an exit strategy for an entrepreneur, in most circumstances the company will cease to be an SME.

7.1 Private Investors

Type I

The first type of private investment comes from friends and family and is often referred to as “love money” The decision to invest does not usually consider the technology or business idea itself, but the investor’s prior relationship with the entrepreneur. It must be assumed that in order to provide funding, the type I investor must first have sufficient financial means to do so. Also, the primary reasons for investing usually do not include such considerations as tax incentives. In many cases the investor simply wants the entrepreneur to succeed while the possibility of high returns is a secondary concern.

Type II

There are two key differences between type I and type II private investors. First, type II investors do not usually do not have a close personal relationship with the entrepreneur. The entrepreneur is usually introduced to these individuals through business transactions and networking, or the private investor may have an interest in the SMEs industry. Second, type II investors are more stringent in their investigation of the opportunity and will have much higher expectations of returns. In most cases formal documentation and periodic reporting will be required. Type II private investors are also often confused with angel investors. While there are indeed some similarities – both are wealthy individuals - the primary difference is that type II investors do not proactively seek to invest in small businesses; however, they are targeted by entrepreneurs due to their financial capabilities and/or credibility in the industry. In addition, angels have differentiated themselves further from type II investors through their increased usage of information technology. With the use of online screening and matching services found in most angel networks, angels are now functioning more like venture capital firms. They now have a larger pool of opportunities to select from and have formalized much of the selection process by requiring entrepreneurs to submit online applications and business plans.⁵

7.2 Angels

As stated previously, angels are individuals or small groups of professionals or business people with an active interest in investing in and assisting new ventures. Most often they focus on local companies. These investors are more formal than the type I private investor, and provide more value than the type II private investor. Angels often provide guidance and contacts for the entrepreneur with such groups as banks, suppliers, industry associations and others. The credibility that a reputable angel can provide to a small struggling business often allows the SME to possess a competitive edge during the vulnerable start-up stage of development. Angels will often look for high returns and an exit strategy for their investments. Similar to formal venture capital, they often tie investments to the achievement of milestones and objectives. The key to garnering angel equity investments will be a well developed business plan, exceptional management, a high growth business idea, and an exit strategy for the angel’s investment.

All of these types of private investors (type I, type II, and angels) are more readily found in the United States due a business culture that rewards entrepreneurial activity and various government sponsored incentive programs. However, these investors can also be found in Canada. Type I and type II private investors have always been a primary function in equity finance for SMEs in Canada. Also, small angel networks have begun to form in some parts of the country increasing the prominence of angels in this country. It should be noted that a critical mass of angel networks has not yet been established in this country and entrepreneurs often find it difficult to locate angel investors.

7.3 Venture Capital

Venture capital firms (VCs) allocate funds from private and institutional investors in order to invest in companies that possess high growth potential. VCs typically invest for short terms of three to seven years and expect pre-tax returns from 20 to 40 percent per annum. Unlike angels, VCs primarily invest in existing companies with the expectation of moving the company towards IPO or acquisition – the exit strategies of choice. However, some VCs will invest in start-ups in special circumstances, such as a business with patented technology and a high growth market, or a very experienced management team that is breaking out on its own. VCs very rarely provide investment during the seed stage of a company.

VCs research potential investments more vigorously than other investors and often specialize in a particular segment or industry. During the past few years, venture capital funds have been flowing primarily towards high technology companies. In the second quarter of 1999 sixty percent of all US venture capital went to two high technology sectors: communication and software, with the majority flowing to Internet related companies. Other areas that received venture capital were: consumer retail (13%), bio/medical (10%), business services (9%), semiconductors (4%), computers/peripherals (3%), and other (1%). During the second quarter of 1999 venture capitalists invested \$7.6 billion; almost 40% of which was invested in the high technology sector of Silicon Valley⁶. Due to the high expenses of venture capital firms, they usually have a minimum investment in order to justify their due diligence costs. Due to the formal structure of the venture capital operation and the more stringent evaluation process, complete business plans and presentations are compulsory. Also, an existing customer base and a minimum number of years with positive earnings will also be closely considered.

The cost of financing through venture capital firms is usually quite high. Often 30 to 50 percent ownership of the company is the price paid for venture capital funds. Although the VC will not typically get involved in the daily management of the company, it will usually occupy a seat on the board of directors once a deal has been closed. The investment itself can take on many different forms. Primarily it is a straight equity investment; however, it can also involve convertible debt or debt with warranties. Similar to the angel investor, a properly chosen VC firm will also provide additional value in the form of consulting and networking.

7.4 Banks

Banks in the United States offer a variety of equity financing options; however, straight equity investments in seed or start-up companies are very rare. At this stage of growth banks primarily provide fee for service consulting to locate potential equity investors. Once a company has experienced successful growth and is deemed ready to move towards the IPO stage, then banks become more involved in equity financing activities.

7.5 Corporate Investors

Corporate investors include large existing businesses with proven track records. Corporate investors will often finance a successful partner, customer or supplier if the risk-return ratios match corporate policies. For more risky ventures, such as start-ups, many corporations have developed incubation facilities. New innovations within the company, often called intrapreneurship, are often spun-off into new businesses through such programs.

7.6 Institutional Investors

Institutional investors, such as mutual and pension funds, primarily invest in SMEs by providing funds to venture capital firms. Start-ups and seed companies will rarely receive funds directly from the institutional investor; however some have set up large funds with the purpose of investing in small business. In most cases these funds are set up similar to venture capital firms.

7.7 The Public

The public is the largest potential pool of capital for small business. Due to securities exchange regulations, the public most often can only invest in publicly traded companies registered with the Securities Exchange Commission (SEC). The investment is realized during the public offering. However, the public also indirectly invests in SMEs through mutual and pension funds. In the US there are exemptions to the Securities Act that allow small companies to solicit equity investments from the public without fully registering with the SEC. There are restrictions on the amount of the total investment and in some cases the type of investor that is eligible.

8 GENERIC FINANCING FLOW INCENTIVES

The numerous factors that influence an investor's decision to invest are known as financing flow incentives. Flow incentives include usual items such as well written business plans, tax incentives, and good management; however there are a number other elements which are not as easily identified yet have a profound affect on both individual new venture investments and aggregate investment within and across different financing agent categories. The following tables describe the most common flow incentives for each of the financing agents described previously. The tables also identify additional support mechanisms required for the incentives to thrive any given setting, and the stage of growth in which the agent is most likely to invest.

Private Investor, Type I		
Flow Incentive	Flow Support Systems	Stages of Growth
Relationship with Entrepreneur	N/A	· Seed · Start-up

Private Investor, Type II		
Flow Incentive	Flow Support Systems	Stages of Growth
Business plan	Local entrepreneur support programs Management Consultants Specialized Lawyers Accountants	· Seed · Start-up · First expansion
Relationship with entrepreneur	N/A	
Knowledge of investment process	Investment education programs Internet resources	
Knowledge of industry	Media attention to industry Personal experiences	
Good management or potential for good management	Pool of capable managers: · Business Schools · Cluster of related businesses	
Credible referral	N/A	
Tax incentives	Government tax policies	

Angels		
Flow Incentive	Flow Support Systems	Stages of Growth
Business plan	Local entrepreneur support programs Management Consultants Specialized Lawyers Accountants	<ul style="list-style-type: none"> · Seed · Start-up · First expansion
Knowledge of investment process	Investment education programs Internet resources	
Knowledge of industry	Media attention to industry Personal experiences	
Good management or potential for good management	Pool of capable managers: <ul style="list-style-type: none"> · Business Schools · Cluster of related businesses 	
Credible referral	Angel Networks	
Tax incentives	Government tax policies	

Venture Capital Firms		
Flow Incentive	Flow Support Systems	Stages of Growth
Business plan	Local entrepreneur support programs Management consultants Specialized lawyers Accountants	<ul style="list-style-type: none"> · Start-up · First Expansion · Second Expansion
Proprietary technology	Intellectual property specialists	
High growth sector	N/A	
Good management or potential for good management	Pool of capable managers: <ul style="list-style-type: none"> · Business Schools · Cluster of related businesses 	
Tax incentives	Government tax policies	
Credible referral	Other VC Firms	

Corporate Investors		
Flow Incentive	Flow Support Systems	Stages of Growth
Business plan	Local entrepreneur support programs Management consultants Specialized lawyers Accountants	<ul style="list-style-type: none"> · Start-up · First Expansion · Second Expansion
Proprietary technology	Intellectual property specialists	
High growth sector	N/A	
Good management or potential for good management	Pool of capable managers: <ul style="list-style-type: none"> · Business Schools · Cluster of related businesses 	
Relationship with entrepreneur	N/A	
Tax incentives	Government tax policies	

Banks		
Flow Incentive	Flow Support Systems	Stages of Growth
Business plan	Local entrepreneur support programs Management consultants Specialized lawyers Accountants	<ul style="list-style-type: none"> · Second Expansion · IPO
Successful business history	N/A	
Proprietary technology	Intellectual property specialists	
High growth sector	N/A	
Good management or potential for good management	Pool of capable managers: <ul style="list-style-type: none"> · Business Schools · Cluster of related businesses 	
Relationship with Entrepreneur	N/A	
Tax incentives	Government tax policies	

Institutional		
Flow Incentive	Flow Support Systems	Stages of Growth
Business plan	Local entrepreneur support programs Management consultants Specialized lawyers Accountants	<ul style="list-style-type: none"> · Second Expansion · IPO
Successful business history	N/A	
Proprietary technology	Intellectual property specialists	
High growth sector	N/A	
Good management or potential for good management	Pool of capable managers: <ul style="list-style-type: none"> · Business Schools · Cluster of related businesses 	
Area of specialty	N/A	
Tax incentives	Government tax policies	

Public		
Flow Incentive	Flow Support Systems	Stages of Growth
<ul style="list-style-type: none"> · Business plan, prospectus · Annual Reports 	Local entrepreneur support programs Management consultants Specialized lawyers Accountants	<ul style="list-style-type: none"> · IPO
Successful business history	N/A	
Recommendation by analyst	Good investor relations	
Positive media attention	Good public relations	
Tax incentives	Government tax policies	

Flow incentives are specific programs and initiatives that facilitate equity financing both in terms of individual decisions to invest and the overall amount of aggregate dollars available for equity investment. While the previous section dealt with generic flow incentives regarding individual investment decisions, this section summarizes federal programs that provide direct incentives for equity investors to increase the amount of investment dollars^{*S} they have available to small businesses.

9.1 Government Initiatives

The United States government has implemented a number of initiatives in order to facilitate the growth of small businesses. In addition to federal programs there are a number of State programs and regulations, also known as Blue Sky laws. There is also a wide diversity of programs county and municipal level; however, only federal laws and a few State regulations will be discussed in this review. In most cases state and municipal programs are extensions or compliments to federal policies.

9.1.1 Small Business Investment Corporation Program⁷

In 1958 the US federal government developed a program in which public venture capital is funneled to privately owned venture capital companies called Small Business Investment Corporations (SBICs). During the past 40 years SBICs have provided \$20 billion in funding to small businesses. Some of the more successful examples include Intel, America Online, Staples, Apple Computer, Federal Express, Sun Microsystems and Callaway Golf.⁸ The SBIC uses a combination of private funds and funds borrowed from the federal government. SBICs provide equity capital, long-term loans and management consulting to eligible small businesses. Loans and securities for less than five years are unusual, while fees, interest rates, and returns are regulated by the Small Business Administration.

An SBIC may receive leverage equal to 300 percent of its private capital. In addition, an SBIC with at least 50 percent of its "total funds available for investment" invested or committed in "venture capital" may receive an additional tier of leverage equivalent to 400 percent of private capital, not to exceed \$ 90 million. A private capital investment of \$5 million is required for most SBICs, while \$10 million is required if an SBIC intends to use securities for its capital base. In some cases SBICs issue debentures, which are guaranteed by the SBA. Pools of these debentures are formed and sold to investors through a public offering. SBA guaranteed participation certificates representing an undivided interest in the pools are provided to investors.⁹

All figures in this document are in US dollars unless otherwise stated.

In essence SBICs function similar to a venture capital firms providing financing for existing growth oriented businesses. However, it is stated in SBA literature that SBICs seldom invest in start-ups in order to limit exposure. SBICs must provide annual financial reports and are subject to onsite evaluations by the SBA. SBA regulations also control investment approval processes and operating procedures. For example, SBICs are not permitted to control any business on a permanent basis. Currently, there are approximately 330 active SBICs in the US.¹⁰

The SBIC program has increased the overall supply of equity finance capital in two ways. First, the SBIC program entices more people to set up venture capital funds. For example, an investor with \$10 million might receive another \$30 million from the SBA. These additional funds are not the only incentives for venture capitalists to form SBICs. Since 1994, many SBICs do not have to make interest payments to the SBA during the first few years of operations. As profits are realized the SBA will take up to 10% in lieu of interest payments. As a result new SBICs are not burdened with high interest payments while they invest in long-term opportunities. This recent regulation has prompted a “mini-boom in SBICs during the past few years.”¹¹

Second, investors (both individual and C corporations) purchasing shares of an SBIC are eligible for tax breaks and rollovers discussed in detail in the next section.

Specialized Small Business Investment Company (SSBICs) operate similar to SBICs, however, they can access additional government financial assistance by focusing their investment activities towards new ventures owned by visible minorities or “economically disadvantaged” entrepreneurs.¹²

Disbursements to small businesses by SBICs were approximately \$1.85 billion in 1996. The increase of \$630 million over 1995 came as a result of new programs to promote the formation of larger SBICs. Investment by SSBICs was \$117 million in 1996.¹³

Further Information: <http://www.sba.gov/INV/overview.html>

9.2 Tax Incentives

While SBICs provide incentives for investors to increase the aggregate amount of equity investment directly available to small business, general tax incentives affect individual decisions to invest and increase the amount of funds available by reducing the tax burden on equity investors in small businesses. The following tax policies and exemptions provide incentives for both individual and corporate investors to invest and reinvest in small business equities.

9.2.1 Gains on Qualified Small Business Stock¹⁴

A qualified small business stock is a stock that meets all the following tests:

- It must be stock in a C corporation* during the time the stock is held.
- It must have been issued after August 10, 1993.

- The corporation must be a *qualified small business***
- The stock must have been acquired at its original issue.
- The corporation must meet the *active business test****
- Within the period beginning 2 years before and ending 2 years after the stock was issued, the corporation cannot have bought more than a “de minimis” amount of its stock from the seller.
- Within the period beginning 1 year before and ending 1 year after the stock was issued, the corporation cannot have bought more than a de minimis amount of its stock from anyone, unless the total value of the stock it bought is 5% or less of the total value of all its stock.

* A C corporation is the most common type of corporation US. Once incorporated the C corporation becomes an entity in itself and its common shareholders do not hold liability for its actions.

** *A qualified small business* is a C corporation with total gross assets of \$50 million or less at all times after August 9, 1993, and before it issued the stock. The corporation's total gross assets immediately after it issued the stock must also be \$50 million or less.

*** *The active business test* attempts to prove that at least 80% of its assets in the active conduct of at least one qualified trade or business, which include:

- Services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services,
- Principal asset is the reputation or skill of one or more employees,
- Any banking, insurance, financing, leasing, investing, or similar business,
- Any farming business (including the business of raising or harvesting trees),
- Any business involving the production or extraction of products for which percentage depletion can be claimed, or
- Any business of operating a hotel, motel, restaurant, or similar business.

All corporations are eligible *except*:

- A Domestic International Sales Corporation (DISC) or a former DISC,
- A corporation that has made, or whose subsidiary has made, an election under section 936 of the Internal Revenue Code, concerning the Puerto Rico and possession tax credit,
- A regulated investment company,
- A real estate investment trust (REIT),
- A real estate mortgage investment conduit (REMIC),
- A financial asset securitization investment trust (FASIT), or
- A cooperative.

Note: All Specialized Small Business Investment Companies (SSBIC) are treated as passing the active business test.

Rollovers

Owners (excluding C corporations) of a qualified small business stock may be able to rollover gains tax-free or exclude part of the gain from their income under the following conditions:

- The stock was issued by a qualified small business after August 10, 1993.
- The stock must be held for more than 6 months prior to rolling it into another qualified small business stock.
- The replacement stock is purchased during the 60-day period beginning on the date of the sale.
- The replacement stock is a qualified small business stock.
- The replacement stock continues to meet the *active business test* for small business stock for at least the first 6 months after it is purchased.

Rollover example: If an investor makes a \$10,000 gain on a qualified business stock, he can avoid capital gains taxes by investing in another qualified small business within 60 days. Only when the investors completely liquidates his investment will he have to claim a capital gain. For example, if the investor decided to liquidate his position in the second small company and made an additional \$30,000 gain on the second investment and then he would have to claim \$40,000 in capital gains. The incentive is delaying the gains as long as possible because the value of any gains is reduced by time. Thus, the present value of the taxes paid is reduced. In other words, the incentive for the investor lies in the fact that he can transfer gains from one investment to the next without being taxed.

Exclusion of Gains

Since 1998, sellers of qualified small business stock have been able to exclude from taxable income one-half of the gain from the sale or exchange of stock held for more than 5 years. While this exclusion is not allowed to C corporations, special rules apply when a partnership, S corporation, regulated Investment Company, or common trust fund holds the stock.

The exclusion of gains from the sale of any one stock is limited the greater of:

- Ten times the basis in all qualified stock sold or exchanged during the year, or
- \$10 million (\$5 million if seller is married and files a separate return) minus the amount of the excluded gain from the stock of the same issuer in earlier years.

For example, an investor sells his position in a qualified business stock held for more than 5 years for a gain of \$20,000. The amount that he would have to pay taxes on would only be \$10,000.

9.2.2 Rollover of Gain From Publicly Traded Securities¹⁵

A rollover of gain from publicly traded securities is a postponement of part or all of a gain from selling securities. The following criteria must be met in order to qualify:

The seller must:

- Sell publicly traded securities (on an established securities exchange) at a gain.
- Purchase replacement property within 60-days of the date of the sale
- Replacement property must be either common stock or a partnership interest in a *specialized small business investment company (SSBIC)*.

The amount of gain postponed is equal to the gain realized on the sale of securities minus the amount invested in the SSBIC. If the amount reinvested is equal to or more than the gain, the full amount of the gain must be used in the rollover. The limits on postponed gains per year are as follows:

The smaller of:

- \$50,000 (\$25,000 if seller is married and files a separate return), or
- \$500,000 (\$250,000 if seller is married and files a separate return), minus the amount of gains postponed for all earlier years.

9.2.3 The Tax Payer Relief Act of 1997

Prior to 1997, individuals paid tax on net capital gains at a maximum of **28%**. The Tax Payer Relief Act of 1997 generally lowered this rate to **20%** and created a new **10%** rate for special circumstances.

The net result of these taxes incentives and other programs has been a steady increase in the numbers of small businesses in the United States. In 1997 a record 842,000 new small employers opened their doors and new incorporations hit a record high for the third straight year.¹⁶ Empirical data will be fully discussed in Section 12 later in this review.

10 FLOW SUPPORT SYSTEMS IN THE US

Flow support systems are initiatives or programs that allow entrepreneurs to access and develop generic flow incentives in order to improve their chances of receiving equity financing. These support mechanisms provide much needed training in the area of business planning, financing consultation and other key management areas.

10.1 Government Initiatives

10.1.1 Small Business Development Centers (SBDCs)

SBDCs are a result of the cooperative efforts of the SBA, the academic community, the private sector, and state and local governments. SBDCs are funded and administered by the SBA. They provide management and technical assistance to small businesses and entrepreneurs. There are also other variations of SBDCs including Women's Business Centres (WBCs) and Tribal Business Information Centres (TBICs)

Additional Information: <http://www.sba.gov/SBDC/index.html>

10.1.2 Business Information Centers (BICs)

BICs are supported by local SBA offices and provide one-stop consultation services and access to computers and software. Most have small business reference libraries to assist entrepreneurs in a number of areas, which include creating business plans, developing marketing strategies, investigating export opportunities, etc.¹⁷ BIC's that are located in economically underprivileged regions are called One Stop Capital Shops (OSCSs) and are partnerships between SBA and a local communities.

Additional Information: <http://www.sba.gov/BI/bics/>

10.1.3 Service Corps of Retired Executives (SCORE)

Created in 1964, SCORE is a nonprofit association comprised of over 12,000 volunteer business counselors. In 1998 there were 389 SCORE chapters throughout the U.S. SCORE members offer free counseling services to entrepreneurs. To date approximately 4 million entrepreneurs have consulted SCORE members.

Additional Information: <http://www.score.org/>

10.1.4 State and Local Business Development Centres

In addition to SBDC's administered by SBA, there are a number of BDC's that are initiatives of state and municipal governments. The primary function of these centres is to provide business planning and other consultation services to small business owners. Although there are some excellent resources for entrepreneurs at the state and municipal level, most of these programs are complimentary to those of the SBA. As a result an in depth review of these programs would not add significantly the information being allocated in this review.

10.1.5 Technology Commercialization Centres (TCC's)

SMEs can utilize numerous technology commercialization centres across the United States to improve their technologies. By developing prototypes in conjunction with reputable technology incubators, entrepreneurs will be able to attract equity investments more easily. In addition to the numerous university TCC's, good examples can also be found at the Austin Technology Incubator located at the IC2 Institute and NASA-sponsored Regional Technology Transfer Centers. These organizations attempt to expedite the transfer and commercialization of technology in order to facilitate economic development through the growth of SMEs.

10.1.6 Online Government Resources

There are a number of government agencies that have detailed information regarding the start-up and effective management of a small business. Although there are some excellent state web sites, the most comprehensive resource for small business owners is the US Small Business Administration web site. There are numerous documents and online tutorials regarding key management issues faced by entrepreneurs. An entire section is devoted to financing issues.

10.2 Private Initiatives

Private initiatives include the services of management consultants, legal professionals and accountants. Although most provide assistance on a fee-for-service basis, many free resources can be found at municipal libraries and on the Internet. Online examples include http://www.quicken.com/small_business, <http://smallbusiness.yahoo.com>, <http://edge.lowe.org/>. Although these private initiatives provide some excellent resources for entrepreneurs, it should be noted that their importance is secondary to that of sources such as the SBA web site. In most cases, SBA materials have simply been summarized or directly hyper-linked to.

11 FINANCING FLOW LINKAGE SYSTEMS

Linkage systems increase the accessibility of investors to entrepreneurs and vice versa. In addition, they increase the aggregate level of equity financing for small business. The larger the number of effective linkage systems in a given investment setting the more accessible risk capital is for entrepreneurs. It is important to note that many flow linkage systems facilitate the creation of other systems. For example securities exchange exemptions for small businesses seeking equity financing has fostered the development of a number of private Angel networks such as **garage.com** (reviewed in more detail in section 11.2.3) and other public networks such as **ACE-net** (section 11.2.1)

11.1 Government Initiatives

11.1.1 Securities Exchange Exemptions¹⁸

The Securities Act generally requires companies to provide full disclosure of all "material facts" investors require to make an informed investment decision. Companies wishing to trade sell securities in the US must register with the SEC. However, there are a number of exemptions that only require limited registration or none at all.

Intrastate Offering Exemption

Section 3(a)(11) of the Securities Act, is known as the Intrastate Offering Exemption. This exemption facilitates the financing of local business operations. The name of the exemption indicates its nature. In order to qualify the company must be incorporated in the state in which it is offering its securities; it must carry out a significant amount of business in and offer and sell securities only to residents of that state. There is no limit on the size of the offering or the number of purchasers. Securities cannot be resold to residents living outside the state for nine months after the offering is complete.

Private Offering Exemption

Section 4(2) of the Securities Act exempts from registration "transactions by an issuer not involving any public offering." This exemption refers to the common type of private investment in equity finance. To qualify for this exemption, the purchasers must be "sophisticated investors" which should not be confused with accredited investors. "Sophisticated" simply means the investor must be able display that they fully understand the risks associated with investing, must be able to understand basic financial calculations and statements and, must be able to bear the risk of investment. They must have access to relevant information and agree not to resell or distribute the securities to the public.

Regulation A

Section 3(b) of the Securities Act authorizes the SEC to exempt from registration small securities offerings. Regulation A is an exemption for public offerings not exceeding \$5 million in any 12-month period. The company must file an offering statement consisting of a notification, offering circular, and exhibits for review. Regulation A offerings are similar to registered offerings (i.e. one that will be freely traded on a stock exchange) in many respects. For example, purchasers must be provided with an offering circular. Also, the securities can be offered publicly and are freely tradable in the secondary market after the offering is complete. However, the exemption has some key differences primarily intended to promote small business financing. For example, the initial financial statements do not need to be audited and there are no reporting obligations after the offering, unless the company has more than \$10 million in assets and more than 500 shareholders. Once the SEC has conducted a brief and informal evaluation, the offering can be advertised prior to filing. This will allow entrepreneurs to determine demand for their securities prior to incurring the legal costs of filing the statement of offering.

Accredited Investor Exemption - Section 4(6)

Offers and sales of securities to accredited investors not exceeding \$5 million are exempt from registration. No general advertising or solicitation is permitted. Financial reporting is not required.

According to the SEC an "accredited investor" is:

- a bank, insurance company, registered investment company, business development company, or small business investment company;
- an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;
- a charitable organization, corporation or partnership with assets exceeding \$5 million;
- a director, executive officer, or general partner of the company selling the securities;
- a business in which all the equity owners are accredited investors;
- a natural person with a net worth of at least \$1 million;
- a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or
- a trust with assets of at least \$5 million, not formed to acquire the securities offered, and whose purchases are directed by a sophisticated person.

Source: Securities Exchange Commission Web site: <http://www.sec.gov>

Regulation D

Regulation D was established primarily to facilitate investment in small business and has three rules.

Rule 504

Companies are exempt for offerings up to \$1 million within a 12-month period. Freely tradable securities can be sold under the following circumstances:

- the offering is registered in one or more states that require a publicly filed registration statement and delivery of a substantive disclosure document to investors;
- the offering is registered in one or more states that require a publicly filed registration statement and delivery of a substantive disclosure document to investors and sold in another state without requirements, as long as the disclosure documents required by the state in which the offering is registered are provided to all purchasers; or,
- the offering is completed according to state law exemptions that permit general solicitation and advertising and securities are sold to “accredited investors” (see v) for SEC definition of accredited investor).

Rule 505

Companies are exempt for offerings up to \$5 million within a 12-month period. Securities may be sold to an unlimited number of “accredited investors” and up to 35 other investors. The issued securities are not freely tradable and general solicitation or advertising cannot be conducted. An independent public accountant must certify financial statements.

Rule 506

Rule 506 is called a "safe harbor" for the SEC's private offering exemptions. This rule is similar to 505 except that an unlimited amount of capital can be raised to an unlimited number of accredited investors and 35 other purchasers. However, the other purchasers must be “sophisticated”, meaning that they must have sufficient knowledge of financial and business matters as to be capable of making sound investment judgments. General solicitation or advertising of securities is not permitted.

California Limited Offering Exemption - Rule 1001

Companies are exempt for offerings up to \$5 million that also satisfy the conditions of section 25102 of the California Corporations Code*. California companies can offer securities to "qualified purchasers" whose characteristics are similar to, but not the same as, accredited investors under Regulation D. This exemption allows some form of general solicitation prior to sales.

* Section 25102 of the California Corporations Code is similar to Regulation D described above and provides the list of exemptions from state securities laws.

Exemption for Sales of Securities through Employee Benefit Plans: Rule 701

Rule 701 exempts sales of securities intended to compensate employees. This exemption is available only to companies that are not subject to SEC reporting requirements. \$1 million in securities can be issued without providing financial statements to employees. Additional securities can be offered according to asset and share ratios set by the SEC. If more than \$5 million in securities are offered

in a 12-month period, employees must be provided limited disclosure documents. Securities are not freely tradable.

Additional Information: <http://www.sec.gov/smbus/qasbsec.htm#eod6>

Summary of Exemptions

By legislating securities exchange exemptions, many dating back as far as 1933, the US government has functioned as a catalyst in increasing the overall number of linkage systems within the entire equity capital setting. The impetus was provided for investors and entrepreneurs to develop new equity finance markets and networks beyond traditional securities exchanges. Also, many established exchanges now offer new services to small businesses as the level of demand for these investments continues to grow. It is also important to note that these government programs have been proactively adapting to new developments. In particular, SEC exemptions led to an increased demand by investors for private placements. As a result, the government created ACE-Net to increase the level of interaction between private investors and entrepreneurs beyond the local environment. By adapting to new developments in information technology (i.e. the Internet), ACE-net has provided an early model for the many online private angel networks now in existence.

11.1.2 ACE-Net

The Access to Capital Electronic Network (ACE-Net) was developed by the U.S. Small Business Administration's Office of Advocacy in order to create a national online network where accredited investors can locate and invest in small businesses. It has only been widely used during the past few years with the proliferation of the Internet. In order to qualify for the database, small businesses must acquire a "no-action letter" issued by the Securities Exchange Commission. This letter states that the company is "in full compliance with the appropriate filing and registration requirements of federal and state securities laws and regulations."¹⁹ A small company can raise up to \$5 million using ACE-Net. However, up to \$1 million can be raised without having to register a securities offering under the SEC's Regulation D, Rule 504, by taking advantage of the Accredited Investor Exemption or similar state variations.²⁰

ACE-Net has been successful in addressing some important obstacles in small business equity finance. First, it has begun to reduce geographical barriers between investors and entrepreneurs. Previously, entrepreneurs found it difficult to identify investors outside of their local area. The Internet allows the "distance" between entrepreneurs and investors to be reduced while direct communications can be established. Ultimately, most parties will eventually have to meet in person before any investments are made; however, the screening process for both parties now includes candidates across the country. Second, the development of an online database of entrepreneurs and business plans saves time for investors. The length of time spent on the initial screening process has been dramatically reduced. Investors (and entrepreneurs) do not have to spend valuable time traveling a meeting in order to determine the attractiveness of an investment. Once a few investments have been determined to fit the requirements of a particular investor, then the traditional presentation process can begin. Time spent attracting investors can also be reduced for the

entrepreneur. Information is created once and accessed by multiple investors from across the country. The end result is that the equity finance process has been rationalized to a certain degree. Investors and entrepreneurs that do commence communications have already been screened which will likely speed up the process of investment.

Additional Information: <https://ace-net.sr.unh.edu/pub/>

11.2 Private Initiatives

11.2.1 Securities Exchanges

Although most assume that Initial Public Offerings (IPO's) are the domain of large corporations, small businesses can often attract large amount of growth capital through IPO's. There are a number of Stock exchanges in the United States that serve small businesses. The major incentive for investors is the level of liquidity that is provided. As long as there is a secondary market for a specific stock, investors will be more likely to invest. Stock exchanges have quantitative and qualitative listing and maintenance standards and stringent reporting obligations (most often to the SEC), which are often deterrents for small businesses. In many cases, a small business simply cannot afford the costs associated with an IPO. However, successful SMEs with high growth potential can often finance IPO's through banks and VCs. This is called mezzanine financing.

American Stock Exchange (AMEX)

AMEX, the second largest floor-based exchange in the US, has the following requirements for listing²¹.

- Size: Stockholders' equity of at least \$4,000,000
- Income: Pre-tax income of at least \$750,000 in its last fiscal year, or in two of its last three fiscal years.
- Distribution: Minimum public distribution of 500,000 shares together with a minimum of 800 public shareholders or minimum public distribution of 1,000,000 shares together with a minimum of 400 public shareholders.

Additional Information: <http://www.amex.com>

National Association of Securities Dealers (NASDAQ)

The Nasdaq Stock Market has two tiers, the Nasdaq National Market and the Nasdaq SmallCap Market. Each tier has its own set of financial requirements and standards of corporate governance.

National Market

- Size: \$6 million in Net Tangible Assets
- Income: \$1 million
- Distribution: 1.1 million shares with a minimum market value of \$8 million and 400 shareholders and a minimum bid price of \$1.

SmallCap Market

- Size: \$4 million in net tangible assets or \$50 million in market capitalization
- Income: \$750,000
- Distribution: 1 million shares with a minimum market value of \$5 million and 300 shareholders and a minimum bid price of \$1.

Additional Information: <http://www.nasdaq.com>

Philadelphia Stock Exchange (PHLX)

The PHLX is the oldest stock exchange in the US. It's Tier 2 listing is especially catered to small business listings.

- Size: \$3 million in net tangible assets
- Income: Net income of \$100,000 in 2 of past three years
- Distribution: 500,000 shares with a minimum of and 800 shareholders.

Additional Information: <http://www.phlx.com>

Boston Stock Exchange

- Size: \$4 million in net tangible assets
- Income: pre-tax income of \$750,000 and net income of at least \$400,000
- Distribution: 750,000 shares with a minimum of and 600 shareholders and a minimum bid price of \$2.

Additional Information: <http://www.bostonstock.com>

Chicago Stock Exchange

Tier 1- Basic

- Size: \$4 million in net tangible assets
- Income: pre-tax income of \$750,000 and net income of at least \$400,000
- Distribution: 500,000 shares with a minimum of and 800 shareholders and a minimum bid price of \$5.

Tier 2

- Size: \$2 million in net tangible assets
- Income: pre-tax income of \$750,000 and net income of at least \$400,000
- Distribution: 250,000 shares with a minimum of and 500 shareholders and no minimum bid price.

Additional Information: <http://www.chicagostockex.com/>

Other Exchanges

There are also other exchanges which meet the needs of small businesses. These include the Cincinnati, San Diego the Pacific stock exchanges.

11.2.2 NASDAQ Over the Counter Bulletin Board

The Over-the-Counter Bulletin Board (OTCBB) is a regulated quotation service for over-the-counter (OTC) equity securities. An OTC equity security generally is any equity that is not listed or traded on a national securities exchange. Issuers of these securities often have no reporting obligations to any federal regulatory authority. OTCBB does not provide issuing services and there are no minimum requirements to be included in the bulletin board. There is no formal relationship between the OTCBB and issuers of stock. However, issuers of securities which began quotation on the OTCBB after January 4, 1999 are subject to minimal periodic filing requirements with the SEC. OTCBB securities are traded by a community of “Market Makers” that enter quotes and trade reports through a closed computer network.

Additional Information: <http://www.otcbb.com/>

11.2.3 Private Angel Networks

Traditional investment clubs have now been transformed into what are commonly known as Angel networks. Local investment clubs now primarily consists of friends pooling funds to invest in publicly traded equities. Angel networks are primarily coordinated by for-profit companies that solicit information from entrepreneurs and investors. This information is then entered into a database and processed in order to find entrepreneur-investor matches. Not all angel networks are automated or operate for a profit. In such cases, angel networks are often informal meetings between potential entrepreneurs and angel investors, however more networks are using information technology to improve efficiency. As stated earlier, online databases have not only reduced the overall time it takes to match investors to entrepreneurs, but it also allows for interactions between geographically dispersed parties.

For-profit angel network companies earn revenues through annual subscription fees charged to entrepreneurs and/or investors in exchange for access to the network. The entrepreneur submits business plans or online forms to the network, while investors prepare a profile of the type of business they wish to invest in. Most often it is left to the investor to contact the entrepreneur and details of investment are left to the two parties. Examples of online Angel Networks include:

www.garage.com
www.rule506.com
www.angelnetwork.com
www.angelinvestorsonline.com
www.business-angels.com

11.2.4 SCOR and Direct Public Offering Networks

The Small Corporation Offering Registration (SCOR) was adopted in 1989 by the North American Securities Administrators Association. It was designed to make the process of equity financing easier for small companies raising less than \$1 million. Although Regulation D eases the process of securities offerings for small businesses, it does possess certain obstacles for entrepreneurs. Specifically, most offerings in excess of \$500,000 are limited to no more than 35 investors, while general solicitation is not permitted. In addition, these securities are not freely tradable until registered with the SEC, which can be extremely costly and time consuming. Thus, many offerings must be discounted to reflect their lack of liquidity.

SCOR eliminates most of the red-tape associated with SEC registration and allows entrepreneurs to raise up to \$1 million. There are no restrictions on trading of these securities, thus, investors obtain much more liquidity resulting in higher prices for the securities. The SCOR has only been widely used since 1992. From 1992 to 1995 approximately 754 companies filed for approval to sell securities under SCOR regulations with state securities commissions. Of the 476 approved applications 110 succeeded in raising capital.²²

Under SCOR, small business owners complete a fifty-question form, called a U-7. It is then submitted for approval to the state where the securities will be sold. Also, a Form D must be submitted to the SEC for reference purposes. Most states require some form of additional information beyond the U-7. The review process is conducted by securities regulators, who will often request clarifications. In addition, certain states evaluate the "merits" of the offering. Once the regulators are satisfied, the company can begin to sell its securities.

Direct Public Offering (DPO) Networks

The rapid growth of SCOR during the past few years has provided an incentive for the creation of networks devoted to matching investors to this type of investment. There is only one well established DPO network, Direct Stock Market, Inc. It is an online service created to facilitate the exchange of information between investors and emerging growth companies with the purpose of increasing equity financing options for entrepreneurs. The Direct Stock Market is very different from Angel networks as it offers both private placements for SCOR and other eligible small business equities, but it also provides a much needed secondary market for these securities.

Additional Information: <http://www.dsm.com>

12 SUMMARY OF EMPIRICAL AND THEORETICAL ANALYSES

In addition to reviewing government and private initiatives, recent empirical and theoretical analyses of small business equity finance in the US were also reviewed. All figures are in US dollars unless otherwise stated.

12.1 Empirical Analyses

12.1.1 The Annual Report on Small Business and Competition²³

Published in December 1998 by the Office of Advocacy for the Small Business Administration, this report details the state of small business in the US during 1996. Of particular importance is the equity financing section in which aggregate financing figures are represented for 1995. A portion of table 2.1 from this document is represented below.

	All Businesses	Large Business	Small Business
Public Markets – All**	532	502	30
IPO's	30	0	30
Secondary Offerings	375	375	0
Venture Capital***	34	0	35

* Most estimates are a stock of financing sources taken in June 1995. Small businesses include all non-corporate businesses (i.e partnerships, sole proprietors, etc.) and businesses with assets of less than \$10 million before offering.

** Total estimated cumulative value of public offerings of common stock for the period 1988 through 1995.

*** Rounding and tabulation of figures may affect total balances.

In addition, the following table displays the growth in Public Offerings of small businesses with less than \$10 million in total assets before the offering over the past few years.

	Number	Value (in millions)
1996	291	5686
1995	187	3129,
1994	190	1975
1993	189	2043

12.1.2 A Survey of High Technology Firms²⁴

This survey was commissioned by the SBA in 1998 and was presented in February 1999. A study of small high technology firms financing habits reveals that almost 40 percent of companies responding to the survey rely on unaffiliated individuals, most likely angels, for equity financing (see 12d). The research summarized in the tables below (12c and 12d) indicates that 56.1% of firms who used equity finance used it to provide at least 76% of all their financing requirements (see 12c). The authors also stated that, although not readily apparent in the tables below, a full 30% of those companies that relied on equity relied on equity for 100 percent of their financing needs. Table 12c reports the mix of financing for small firms between equity, short term and long term debt. It is apparent from table 12c that when small businesses require supplemental financing - that is, when the financing sought is only a small percentage of total funds available to the company – the preferred method is through debt instruments. However, when funds being sought by a small business represent the majority of funds available, the chosen method of finance is often equity .

Table 12c: Mix of Financing						
Percent of Total Funds	Equity		Short-term Debt		Long-term Debt	
	Number	Percent	Number	Percent	Number	Percent
< 25%	20	13.4	55	56.7	34	43.6
26-50%	27	18.1	20	20.6	22	28.2
51-75%	18	12.1	8	8.3	9	11.54
76-100%	84	56.1	14	14.4	13	16.67
Total number of firms responding	149	100	97	100	78	100

Table 12d further summarizes activities for those who have chosen equity to finance their small businesses. The use of “Unaffiliated Individuals” (angels and type II investors) and VCs are summarized. Banks have been included to provide a comparison. In most cases bank financing is debt oriented.

Table 12d: Sources of External Financing						
Percent of Equity	Unaffiliated Individuals		Venture Capital Companies		Banks	
	Number	Percent	Number	Percent	Number	Percent
1-25%	15	31.9	7	31.8	10	22.2
26-50%	11	23.4	8	36.4	10	22.2
51-75%	4	8.5	2	9.1	4	8.9
76-100%	17	36.2	5	22.7	21	46.7
Total number of firms responding	47	100	22	100	45	100

12.1.3 Small Business Administration Annual Data Reports

In regards to SBICs the amount of investment has been growing dramatically since, 1994. The following table represents SBIC and SSBIC investments from 1994 to 1998.

Table 12e: Disbursements to Small Businesses by SBICs and SSBICs (millions)						
	Total		SBICs		SSBICs	
	Number	Amount	Number	Amount	Number	Amount
1998*	3096	4220	N/A	N/A	N/A	N/A
1997	2713	2400	N/A	N/A	N/A	N/A
1996	2302	1849	1343	1732	959	117
1995	2173	1184	1045	1037	1128	148
1994	2375	1121	1070	965	1305	155

*October 1998 through September 1999.

It is interesting to note that the average investment for an SBIC in 1997 was approximately \$880,000 while the SBA estimated that the average venture capital firm's average investment was \$6.8 million. According to the SBA this "demonstrates the SBIC Program's success in addressing the otherwise unmet needs of American small businesses for venture capital in the \$500,000 to \$5 million range."²⁵

The data in the following tables was released in early December 1999. A survey of all SBICs was conducted to review performance over the period of October 1998 through September 1999.

Table 12f: Financing Activities by All SBIC Licensees*				
	Number of Financings	Percentage	Dollar Amount	Percentage
First	1379	44.54	2,925,815,544	69.32
Continuing	1717	55.46	1,295,098,344	30.68
Total Financing	3096	100.0	4,220,993,888	100.0
Straight Debt	1061	34.27	276,525,072	6.55
Debt with Equity	846	27.33	887,419,003	21.02
Equity Only	1189	38.4	3,056,969,813	72.42
Total Financing	3096	100.0	4,220,993,888	100.0
Equity Only				
First	618	51.98	2,166,876,403	70.88
Continuing	571	48.02	890,093,410	29.12
Total Equity Only	1189	100.0	3,056,969,813	100.0

*October 1998 through September 1999.

Table 12g: Financing Activities by All SBIC Licensees				
Type of Business *				
Industry Classification	Number of Financings	Percent	Dollar Amount	Percent
Agric, forestry, fishery	8	0.26	12,748,077	0.30
Mining	15	0.48	71,841,630	1.70
Construction	45	1.45	76,958,933	1.82
Mftg - -Durable	414	13.37	829,372,106	19.65
Mftg – Non-durable	239	7.72	461,038,166	10.92
Trans, Comm, Util.	707	22.74	607,071,093	14.38
Wholesale Trade	151	4.88	361,836,135	8.57
Retail Trade	237	7.66	201,381,560	4.77
Finance, Ins, Real Estate	47	1.52	141,650,986	3.36
Services	1177	38.02	1,384,740,937	32.81
Unclassified	59	1.91	72,294,265	1.71
Total	3096	100.0	4,220,913,888	100.0

*Classified by SIC Code. October 1998 through September 1999.

Table 12h: Financing Activities by All SBIC Licensees				
Age of Business at Time of Financing – Initial Financings Only*				
	No. of Initial Financings	Percent	Dollar Amount	Percent
I year or less	567	41.12	1,181,470,871	40.38
Between 1 and 2 years	138	10.01	233,704,254	7.99
Between 2 and 3 years	121	8.77	210,668,425	7.20
Between 3 and 4 years	115	8.34	250,172,705	8.55
Between 4 and 5 years	52	3.77	125,075,348	4.27
Between 5 and 6 years	51	3.70	121,053,217	4.14
Between 6 and 7 years	33	2.39	32,021,199	1.09
Between 7 and 8 years	21	1.52	17,240,411	0.59
Between 8 and 9 years	31	2.25	86,871,474	2.97
Between 9 and 10 years	23	1.67	27,764,561	0.95
Over 10 years	225	16.32	639,780,989	21.86
Unclassified	2	.015	292,00	0.01
Total	1379	100.0	2,925,815,544	100.0

Table 12i: Funds provided by the SBA to Regular and Specialized SBICs	
	Amount (Millions)
1998	417.1
1997	439.7
1996	400.7
1995	369.2
1994	115.0
1993	86.8
1992	84.4
1991	88.4
1990	75.4

From the information in the above tables it is apparent that the level of financing provided by the government to SBICs is having a dramatic effect on the level of financing available to small business.

12.2 Qualitative -Theoretical Review

This section will summarize and review a number of articles devoted to both the key issues of small business equity financing and the general business environment in the United States that allows capital to flow freely to small businesses in high growth sectors. Sources were selected from government, academic and business periodicals and stand-alone reports.

12.2.1 Business Environment in the United States

While there have been countless articles written about the entrepreneurial culture found in the United States, the following articles were selected as important to this study for two reasons. First they are recent articles about the state of small business in the US, and second, they provide new ideas as to where the business environment is headed in the future.

10. The State of Small Business: A Report to the President.

Small Business Administration
1998

This report presented to President Clinton describes the excellent climate for small business growth in the United States. In terms of financing the report states: “The availability of equity financing, especially for fast-growing firms, continued to expand in the booming economy of 1996. Both initial public offerings and private venture capital reached historically high volumes. The availability of informal equity capital from accredited investors is also believed to have increased significantly”.

10. Models for Success: State Small Business Programs and Policies

Small Business Administration
1999

Again, the fact that state and federal governments have helped to create a positive environment for small business is related; however, there seems to be an urgency to increase efforts to reduce unnecessary regulations on small business activities. Models for Success recommends specific measures for “creating an environment in which all businesses will have the opportunity to compete effectively and expand to their full potential.” This comprehensive document outlines how the states can improve their regulations regarding small business growth and prosperity. Included in the report are suggestions as to how to facilitate the expansion of venture capital activities and government programs to increase the further the financing of seed and start up ventures. Many examples of successful state policies and programs are offered as guides to those states that have not yet adequately addressed the importance of accessible financing and support for small businesses to economic prosperity.

10. The New Economy is Stronger Than you Think

Sahlamn, William A
Harvard Business Review
Nov/Dec 1999

Sahlman states that the American economy is stronger than ever and more likely to continue its dominance in the world economy. The reason that the United States has continued to not only prosper from, but also to create the New Economy is its admiration for entrepreneurs and its extremely high tolerance for failure. In what he calls “the American Way”, the author argues that Americans’ “love affair with entrepreneurs” has created a culture in which failure is not only expected but has become considered by many to be “good experience” for future endeavours. As result, capital flows very easily to new ideas, especially entrepreneurs starting up companies in high growth, high tech areas.

10. Bringing Silicon Valley Inside

Hamel, Gary
Harvard Business Review
Sep/Oct 1999

In 1998 Silicon Valley produced 41 IPOs with a collective market capitalization of \$27 billion. Hamel argues that in the New Economy newcomers are responsible for creating much of the wealth in most industries. Entrepreneurship is beginning to take precedence over stewardship as the primary characteristic of running a business. Silicon Valley’s success should not be attributed to a group of intelligent business people with skills well beyond those found in other regions. The success of these companies should be attributed to the region’s business model. He argues “in Silicon Valley ideas, capital, and talent circulate freely, gathering in whatever combinations are most likely to generate innovation and wealth”. In 1998 each worker in Silicon Valley created \$54,000 in new wealth. Although the main theme of the article is how larger companies can “bring Silicon Valley inside”, its exploration of the innovative and entrepreneurial characteristics of Silicon Valley is an important piece of recent research into the New Economy and how companies (and governments) can adapt. The article is especially important for policy makers as they may take some of the lessons prescribed to big business and project them onto their own circumstances. Understanding the re-emergence of entrepreneurs as the dominating force in business is important for effectively developing policies directed at facilitating a new model of freer flowing capital.

10. A Push for Small Companies

Business Week
May 31, 1999

This short article contends that for the US to maintain its dominance, it must continue to facilitate open markets and loose regulation. Open markets increase competition and give rise to new ideas and new successful businesses. The US culture is one that rewards entrepreneurs, while the lack of government regulation is the primary cause for the rapid expansion of small business. These are also the reasons that capital flows more freely to small businesses than anywhere else in the world.

10. Social Capital and Capital Gains in Silicon Valley

Cohen and Fields

California Management Review

Winter 1999

In short, social capital is the set of elements found in a vibrant civil society that evolve over time due to the interaction of different parties within the systems. On page 2 of the article the author states: “ In Silicon Valley, social capital can be understood in terms of the collaborative partnerships that emerged in the region, owing to the pursuit by economic and institutional actors of objectives related specifically to innovation and competitiveness.” The author argues large amounts of social capital are being amassed in Silicon Valley through the productive interaction between:

- Research Facilities
- US government Policies
- Venture Capital
- Law Firms
- Employee Stock options
- Labour markets – specifically high turnover is a valuable quality, recruitment from a global applicant pool, and good people who leave big companies to form start-ups are deemed “heroic”.
- Business Networks – leaders of most the cohorts above (law, VC, government, etc) all know and interact with each other.
- The Nature of the Industry – Silicon Valley embraces intellectual property and the employment contract, while industries such as steel embrace unions.

The key to any well performing region, particularly those focused on new economy activities such as information technology, is the establishment of a performance-focused trust between its citizens.

10. Power to the People

Nocera, Joseph

Fortune

Oct, 1999

The author argues that the proliferation of a ‘culture of investing’ has been the primary cause of the “Bull” market throughout the 1990s. Investing in stocks and trading salaries for stock options has been a part of the entrepreneurial culture in America for a long time and is one of the major reasons why capital is so easy to access in the US. Although the article simply describes the author’s experience in a Rhode Island town, it clearly displays the attitudes of regular citizens towards investing and the business environment.

Other Notable Articles on the business environment in the US are:

High Velocity

Hormats, Robert
Harvard International Review
Summer 1999

Helping Small Business Succeed: SBA Financial Plan 2000

US Small Business Administration
1999

Financing Small Business

Small Business Administration
Forthcoming in 1999 or 2000

12.2.2 Understanding the Financing Process

Various topics from direct private placements to formal venture capital are summarized

10. Why do Business Angels Say No: a case study of opportunities rejected by an informal investor syndicate.

Mason and Harrison
International Small Business Journal
Jan-Mar 1996

Although the article is a bit dated (1996), it drew on earlier research of angels in the United States. While Angels have a much higher acceptance rate than VCs, they reject the majority of opportunities they investigate. They are different than the type II investor discussed in this review as they are “generally experienced investors that have a fair degree of financial acumen”. Angels tend to invest in sectors in which they have a deep understanding and are motivated first and foremost by high capital appreciation. In the beginning of the investment process the attractiveness of the industry takes precedence, while the focus towards management competency becomes dominant as the relationship proceeds. The top three “deal killers” are: 1) inability of management team; 2) inappropriate marketing plan; and 3) a suspect financial plan.

10. How to Finance Anything

Andresky Fraser, Jill Inc.
March 1999

The author argues that the state of the capital markets is not all positive. She argues that the age of entrepreneurs receiving easy money is gone and although she offers such terms as “overheated” and “dried up” to describe the capital market in the US, she offers 20 tips on raising money. Although

this authors of this review disagree with Fraser's assessment of the capital markets. she makes some good comments and provides a different view of venture capital. As a result of new found reluctance to invest in "anything dot com". Venture capitalists and Angels are scrutinizing their investments more closely than before. The result has been better deals for venture capital as entrepreneurs compete with each other for less funds. Fraser contends that the VCs will likely continue this process and that it will become internalized into the industry. Included in her 20 tips to raising capital are guaranteed loans from the SBA, private equity from friends and family, private equity from Angels, online equity markets, corporate investors, international investors, and others.

3. SCORE's Impact on Small Firms

Broome Jr., JT
Nation's Business
Jan 1999

The Service Corps of Retired Executives (SCORE) has a network of 389 chapters with over 12000 active volunteers. The impact on small businesses has been dramatic. The article offers a few testimonials in which SCORE mentors have not only readied entrepreneurs to open for business but have assisted them in acquiring financing.

10. Financing for Do-It-Yourselfers

Reynes, Robert
Nation's Business
May 1998

Small Company Offering Registrations (discussed in section 11.2.4 in this review) have become more popular after their slow start in 1990. SCORs take advantage of Rule 504. The author argues that affinity groups, groups with similar interests, should be the target market for SCOR marketing. Such groups include customers, suppliers and others. In many cases the SCOR can function as a Direct Public Offering (DPO) or can become the catalyst to a much wider DPO through other newly forming channels.

10. Fragmentation in the Market for Venture Capital

Fiet, James
Entrepreneurship Theory and Practice
Winter 1996

Although it is an older article is it relevant to the current review as it outlines the concept of competition between Angels and VCs for equity investment opportunities. The article recognizes that there is a lack of market intermediaries responsible for: 1) documentation of investment opportunities; 2) introducing entrepreneurs to investors; and 3) providing an aura of fairness and responsibility to the investor (screening and credibility). It is interesting to note that the article was written in 1996 and that these intermediaries have been growing in number due primarily to improvements in information technology. Traditionally, VCs received the best investment

opportunities because they have the best information systems. However, angels are now improving their information channels and are gaining access to better opportunities. Now VCs and Angles often compete for the same deals. Although the article is bit technical in its description of the two market players, its note on the importance of fragmentation to the competitive nature of equity finance markets is relevant to the topic at hand.

10. Easier Access to Equity Capital

Evanson, David
Nations' Business
Jan 1998

Another article discusses SCOR as a great “starter” to acquiring equity financing. SCORs are often overlooked as inexpensive methods of acquiring financing. One important point of the article is that the SCOR can provide the impetus for large scale financing. Once a SCOR has been successfully floated the stock then can be traded on various DPO markets and the NASDAQ over the counter bulletin board. If this is stated as part of the plan, investors will be more likely to invest given its increased liquidity in the future.

10. How Venture Capital Works

Zider, Bob
Harvard Business Review
Nov/Dec 1998

The author argues that the majority of venture capital does not flow towards new innovations but to follow up funding and technology commercialization. Venture capital firms invested \$10 billion in 1997 while only 6% went to start-ups. One different viewpoint of the article is that VCs do not invest in people as much as they do in chosen industries. The article details how VC investment deals can be structured differently. He also outlines the benefits and risks for both parties of an equity finance arrangement. Because venture capital is such a small part of the over all financing picture (i.e. debt is by far the largest component) it has the potential to grow exponentially in the future.

10. Inside the Silicon Valley Money Machine

Warner, Melanie
Fortune
Oct 26, 1998

The article reviews the practices of the most successful venture capital firm in Silicon Valley. Kleiner Perkins was the founder of the VC industry in California and invested in early ventures such as Netscape, AOL, Amazon, and others. The relevance of the article is not the company's success in securing equity financing deals, but in how it networks all of its investment companies together to increase the likelihood of a successful venture.

10. Dollars from Heaven: A choir of angels bedevils the VCs

Karlgaard, Richard
Forbes
June 1998

Due to the success of IPOs and the equity markets there are now more Angels than ever before. Microsoft, for example, has created at least 5000 millionaires. The author reports that in 1997 “angels” invested \$50 billion into new ventures in the US. Family and friends invested \$40 billion while \$10 billion was invested by “serious” angels. The author argues that angels are most compatible with seed capital and that the growth of angel investing is creating much needed competition with VC firms. This trend is likely to continue considering the growth of the American IPO market. Angels and VCs are now vying for the best investment opportunities and are creating more efficient capital markets.

10. Three Keys to Obtaining Venture Capital

PricewaterhouseCoopers LLC
<http://www.pwc.com/moneytree>

This is an important document for entrepreneurs to review when seeking venture capital. In order to effectively tap VC funds, entrepreneurs must first understand the process.

Other exceptional articles regarding the investment process in the US are:

Angels in the Valley

Malone, Michael
Upside
Apr 1997

Another Face for Venture Capitalism?

Fox, Loren
Upside
Oct 1999

Small Wonders: Many of today’s hot growth companies received early financing from SBICs, “ the best kept secret in Washington”.

Korn, Donald
Financial Planning
Aug1, 1999

Capital Ideas for Financing

Nelton, Sharon
Nation’s Business
Sep 1996

12.2.3 Newly emerging Forms of Venture Capital

1. Private Equity Turns Inside Out

Korn, Donald
Financial Planning
Nov 1999

The article reports the new trend by the mass market of investors to invest earlier than the IPO stage to take advantage of massive returns being accumulated by VCs. “Online private equity marketplaces” are being erected at an alarming rate where informal (yet accredited) investors not previously involved in VC or Angel activities, are now getting more involved in the equity financing of start-up companies. This new development in equity finance in the US is primarily a result of analysts forming online networks where people can buy directly into SMEs. By providing quarterly valuations of the private stock, not only do investors receive more information than ever before, but the stock also become eligible for IRA investments, which is the equivalent of RRSPs in Canada. In effect, this new trend is bringing private equity investing to the masses of accredited investors who would otherwise only be active in public markets.

2. Community Development Venture Capital: creating a viable business model for the future.

Jegen, David
Nonprofit Management and Leadership
Winter 1998

Community Development Venture Capital firms (CDVC) are a rapidly growing trend in the US. These companies must balance financial and social returns in their investment activities. In effect, the nonprofit sector has borrowed a successful model from the private sector. By making profit oriented decisions investments in communities can be self-sustainable in the long term. In 1998 there was approximately \$299 million in CDVCs. Most target their funds towards particular geographical areas, while other target primarily minorities. The investment challenges of 9 CDVCs are chronicled. Although it is apparent that CDVCs do not get choose from the more attractive opportunities, they are filling an important role by providing profit oriented equity finance to undeserved areas.

3. BankBoston Development Co. Strikes a Chord in Urban America

Lau, Deborah
Venture Capital Journal
May 1999

This article details how one Bank’s venture capital fund has been successfully addressing the policies of the 1997 Community Reinvestment ACT which encourages banks to invest in the communities in which they operate. This bank is employing traditional venture capital techniques while seeking traditional venture capital returns. This “no handouts” type of investment has been quite successful

to date. For those businesses that do receive funding and have high growth potential there is an immediate link between the Bank owned VC and it's larger partner The Bank of Boston.

4. Venture Capital

Duffy, Tom
Computerworld
Oct 11, 1999

The article outlines the new trend of large corporations to enter into the VC market. Not only are they looking for the high returns found in the industry, but more importantly they are looking to secure access to new technologies. There are approximately 500 VC firms in the US managing over \$330 billion worth of investments. Notable large companies to recently enter the market are GE capital, Motorola, and the Central Intelligence Agency (CIA). The author points out that most VCs want to provide more than just investment dollars, and as a result must have a local presence in the economic cluster of choice.

5. Can Big Companies Nurture Little Companies

Fazio, Regina
Harvard Business Review
May/June 1999

The author argues that new corporate VC "units" are a welcome addition to the venture capital industry as yet another equity finance option for is available to entrepreneurs. The study reviews the success of corporate venture capital and compares it to traditional firms that are smaller and more flexible. She concludes that corporate VCs have fewer but lengthier review process, deeper managerial experience to transfer to the new venture, and better networks to ensure initial success of its investments. Entrepreneurs who use large corporate venture capital must be aware of these factors and the likelihood of the business being acquired in the future.

12.3 Summary

The preceding empirical and theoretical review examined not only some of the results of various government and private initiatives but also reviewed some of the US's top academic opinions regarding these policies and the state of small business. The general opinion is that the United States has developed an environment that provides ample equity investment funds for growing small businesses. Although the existence of the numerous programs and policies summarized in this review has allowed small businesses to flourish in the US, there also seems to be a continued demand to see even more policies that facilitate freely flowing funds from investors to small business with little or no government intervention.

While access to financing is one of the most important factors in determining the success of small business growth in any country, equity financing is arguably the most important form of funding for businesses with high growth opportunities. A direct result of its entrepreneurial business culture, the

United States has been extremely proactive in developing policies that facilitate the flow of equity financing to small businesses. The continuous high growth in both the numbers of small businesses and their contributions to employment, GDP and the tax base in the US has provided ample proof that SMEs are thriving south of the border.

13 END NOTES AND REFERENCES

- ¹ Korn, Donald Jay. Small Wonders: Many of today's hot growth companies received early financing form SBICs, "the best kept secret in Washington. Financial Planning. New York. Aug 1999.
- ² The State of Small Business a Report of the President. Small Business Administration.1998.
- ³ U.S. Small Business Administration. The SBA & America's Entrepreneurs: A Partnership for the 21st Century. SBA. 998.
- ⁴ U.S. Small Business Administration. The SBA & America's Entrepreneurs: A Partnership for the 21st Century. SBA. 1999.
- ⁵ Doyle, Denzil. Doyletech Corporation. 1999.
- ⁶ Silicon Valley Web site. <http://www.mercurycenter.com/svtech/companies/moneytree/>
- ⁷ Small Business Administration Website: <http://www.sba.gov/INV/> November 1999.
- ⁸ Korn, Donald Jay. Small Wonders: Many of today's hot growth companies received early financing form SBICs, "the best kept secret in Washington. Financial Planning. New York. Aug 1999.
- ⁹ Small Business Administration Website: <http://www.sba.gov/INV/overview.html> November 1999.
- ¹⁰ Korn, Donald Jay. Small Wonders: Many of today's hot growth companies received early financing form SBICs, "the best kept secret in Washington. Financial Planning. New York. Aug 1999.
- ¹¹ Korn, Donald Jay. Small Wonders: Many of today's hot growth companies received early financing form SBICs, "the best kept secret in Washington. Financial Planning. New York. Aug 1999.
- ¹² Small Business Administration Website: <http://www.sba.gov/INV/overview.html> November 1999
- ¹³ The State of Small Business a Report of the President. Small Business Administration.1998
- ¹⁴ Material excerpts taken from the IRS Website: Internal Revenue Service: http://www.irs.treas.gov/prod/forms_pub/pubs/p5500410.htm. November 1999
- ¹⁵ Internal Revenue Service: http://www.irs.treas.gov/prod/forms_pub/pubs/p5500409.htm. November 1999.
- ¹⁶ The State of Small Business a Report of the President. Small Business Administration.1998.
- ¹⁷ Small Business Administration Web site: <http://www.sba.gov/BI/bics/> November 1999
- ¹⁸ Securities Exchange Commission Web site: <http://www.sec.gov> November 1999.
- ¹⁹ ACE-Net Web site: <https://ace-net.sr.unh.edu/pub/ent/efaq.htm> November 1999.
- ²⁰ ACE-Net Web site: <https://ace-net.sr.unh.edu/pub/ent/efaq.htm> November 1999.
- ²¹ American Stock Exchange: <http://www.amex.com/>. November 1999.
- ²² Frollini, Nick. What's the SCOR? An Analysis of the Small Corporation Offering Registration and its use in the United States 1992-1995. Enterprise Corporation of Pittsburgh. February 1996.
- ²³ The State of Small Business a Report of the President. Small Business Administration.1998
- ²⁴ Cordes, Joseph, Hertzfeld, Henry, Vontoras, Nicholas, A survey of High Technology Firms. Small Business Administration. 1999.
- ²⁵ Small Business Administration 1997Annual Report. <http://www.sba.gov/INV/1997/>. 1998.