United States General Accounting Office

GAO

Report to the Chairman, Committee on Small Business, U.S. Senate

September 2000

SMALL BUSINESS

Efforts to Facilitate Equity Capital Formation

GAO

Accountability * Integrity * Reliability

GAO/GGD-00-190

GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, D.C. 20548

General Government Division

B-283890

September 29, 2000

The Honorable Christopher S. Bond
Chairman, Committee on Small Business
United States Senate

Dear Mr. Chairman:

As you requested, this report discusses U.S. small businesses'[1] access to equity capital financing.[2] According to the Small Business Administration (SBA), in 1998, the small business sector generated about half of the private gross domestic product. The development and survival of many of this country's fastest growing small businesses depend on equity capital financing. Because of the vital role that small businesses play in our economy, you asked that we study recent trends in small business equity capital financing and the potential effects of market practices and securities law regulations on such financing.

The specific objectives of this report are to (1) provide an overview of the major sources of external equity capital for U.S. small businesses and describe SBA's Office of Advocacy (SBA-OA) estimate of their perceived needs for equity capital financing, (2) determine trends for the period of 1994-99 in small business equity capital financing, (3) describe how market practices and securities law regulations for equity capital-raising activities could affect small businesses, and (4) describe any efforts undertaken by federal and state agencies to facilitate small businesses' access to equity capital.

Results in Brief

Markets that provide equity capital financing to U.S. small businesses include informal, unregulated markets and regulated securities markets. The primary providers of private equity capital in informal, unregulated markets are

[1]For the purpose of our study, a business is "small" if it has $25 million or less in annual revenues or 500 or fewer employees. We define a business as "large" if it has more than $25 million in annual revenues and more than 500 employees.

[2]Equity capital is money raised by a business by selling shares of ownership, or potential ownership, of the business. According to SBA's Associate Administrator for Investment, subordinated debentures with equity features are the common investment vehicle for many of SBA's Small Business Investment Companies (SBIC) and are considered by SBA to be the functional equivalent of convertible preferred stock financing used by venture capital funds. Therefore, we include such SBIC investments as equity in this report.

- “business angel” investors—wealthy individuals who provide private equity financing to early-stage, high-growth small businesses and
- venture capital funds (which include Small Business Investment Companies (SBIC))—private partnerships that provide private equity financing to early- and later-stage, high-growth small businesses.

Small businesses that raise equity capital in regulated securities markets do so through

- Private placement of securities—an offering of securities exempt from federal registration, which is limited in distribution to certain types of investors.
- Public offering of securities—an offering of stock to the general public. For a small business, this could take the form of an initial public offering (IPO)—a private business’ first offering and sale of securities to the general public (i.e., going public). Another type of public offering is a direct public offering (DPO)—a business’ attempt to raise capital in the public markets without the aid of a securities underwriter.[3]

In 1996, SBA-OA sponsored a study to estimate the need of small businesses for equity capital. From the results of this study, SBA-OA estimated that about 10 percent of the businesses started in a year (i.e., start-ups) would need equity capital, as well as about 25 percent of faster growing small businesses. Therefore, in 1996, about 50,000 start-ups and about 75,000 fast-growing businesses were estimated to need equity capital financing. Partly on the basis of focus group results, SBA-OA also stated that the greatest equity capital financing need of small businesses was for amounts in the range of $250,000 to $5 million. SBA-OA estimated that for 1996, the total unmet need for early-stage equity financing for small businesses was about $60 billion annually.

Available data are insufficient for updating the estimate of small businesses’ equity capital needs, but indicate for the 1994-99 period that the level of small business equity financing increased dramatically. Data indicate that the total of small business equity capital financing provided in 1999 by venture capital funds, SBICs, IPOs, and private placements of securities was about $107 billion. This amount represents almost a six-fold increase from the amount in 1994 (about $18 billion) and an increase of

[3]An underwriter is a brokerage firm, securities dealer, or investment banking firm that sells company securities to investors, other brokerage firms, securities dealers, and investment banking firms. The selling of securities to investors can occur either through a private placement or public offering.

about 270 percent over the total estimated amount from those sources in 1996 (about $29 billion).

However, the extent to which the recent increases in equity financing have helped to fill the unmet need suggested by SBA-OA’s 1996 estimate is not clear. The average amount of a venture capital investment has increased, suggesting that, in general, venture capital funds may have become a less likely source of equity financing in the $250,000 to $5 million range. In addition, venture capital investments tend to be concentrated in certain geographical areas and certain industries, raising questions about whether unmet needs in different parts of the country and industries are being addressed. Furthermore, business start-ups have also increased. Finally, business angel investors, for whom financing data are not available, are considered an important source of equity capital funds for small businesses. SBA-OA officials we interviewed continue to believe that, despite the growth in the total dollar volume of venture capital fund investments, available evidence supports their assessment that a major equity financing shortage persists for small businesses in the amounts of $250,000 to $5 million.

In the 1994-99 period, high-tech companies had the widest use of venture capital, IPO, and private placement financing. According to some market participants we interviewed, many small businesses have difficulty attracting venture capital financing because of the selection criteria used by venture capitalists in deciding where to invest their funds. Some market participants also told us that many small businesses are restricted in issuing equity securities by the high costs and complexities resulting from state and federal securities law regulations and by the inability to attract underwriters to market their securities. According to an investment banker we interviewed, small business issues are viewed unfavorably by underwriters because they are too small in size to be profitable.

Equity capital formation in the unregulated equity capital market is affected by market practices, which reflect efforts of investors and other market participants to maximize returns and manage risks on investments. In the regulated securities markets, market practices as well as federal and state securities laws and regulations, which are designed to protect investors and the integrity of the securities markets, affect equity capital formation of both large and small businesses. In general, however, equity capital is widely viewed as less accessible and more costly per dollar raised for small businesses compared with large businesses.

The results of our analysis of IPO offerings indicate that the average total cost to conduct a small business IPO during 1994-99 was about 10 percent of total offering proceeds, while the average total cost for a large business IPO was about 8 percent. Federal securities regulators have simplified federal registration of securities offerings and exempted certain small business securities offerings from several requirements to reduce the regulatory burden and costs for small businesses in equity capital formation. However, some market participants we interviewed believed more can be done, including, for example, increasing dollar limits on securities offerings allowed under certain exemptions and encouraging greater commonality in certain federal and state registration requirements.

In addition to simplified registration and exemption initiatives, states and the federal government have initiated actions to help reduce the regulatory burden and costs for small businesses seeking equity capital financing in the regulated securities markets. They have also initiated actions to help increase the availability of information about small businesses' seeking to raise equity capital in the informal, unregulated equity capital markets. Most state governments have also initiated actions to help encourage business angel investment in small companies through training programs and a variety of events intended to introduce entrepreneurs and potential investors. These initiatives alone have not solved the perceived problem of the equity capital gap.

SBA; the Securities and Exchange Commission (SEC); the North American Securities Administrators Association, Inc. (NASAA); and the National Venture Capital Association (NVCA) provided technical comments on this report that were incorporated where appropriate. NVCA and SBA-OA also provided written comments and generally commended the information in the report.

Background

SBA estimated that there are about 25.5 million small businesses operating in the United States today that differ widely in size, industry, and rates of growth. They also differ in their needs for external financing, including equity capital financing. In the early years of most companies, capital tends to come from the entrepreneur; friends; family members; and cash from operations, if any. A business' opportunities for external capital in the form of a business loan will depend on its ability to meet commercial lenders' requirements for collateral or personal guarantees. For many companies, including "mom and pop" businesses, debt financing can be a viable external financing business option. Moreover, we were told that many owners of small businesses prefer debt financing because they want to retain total control of the business.

The cash needs of a rapidly growing small business might exceed funds from the entrepreneur and his or her family and friends as well as the business' borrowing capacity. For example, small businesses might have difficulty qualifying for substantial bank loans because they may lack the necessary collateral. When this occurs, the business may seek to sell shares of ownership, or securities convertible into shares of ownership, in the business to raise needed cash to be used in operations. Equity capital investors may be willing to take on such risk if they expect relatively larger returns on their investment than on less risky investments. By bolstering a business' overall capital, equity capital financing can also help facilitate future bank loans as a source of financing.

SBA-OA undertakes research, conducts and participates in conferences, and engages in other activities to promote the role of small businesses in the U.S. economy. While SBA-OA is part of SBA, its actions and positions are independent of the Administrator of SBA.

SBA operates the SBIC program. SBICs are privately organized and managed for-profit investment businesses that are licensed and supported by SBA. SBICs provide equity capital and management assistance to qualifying small businesses. Most SBICs differ from private venture capital firms in that they supplement their investment capital with funds raised by issuing SBA-guaranteed debt or equity securities. This "leverage" allows them to invest in businesses with more modest growth targets and still generate competitive financial returns for their private investors.

The Securities Act of 1933 (Securities Act) requires companies that are publicly offering securities for investment to register the securities with SEC and to provide investors with all material information relating to the purchase of a business' securities. The Securities Exchange Act of 1934 (Exchange Act) contains antifraud provisions that provide civil recovery rights to investors who purchase or sell securities on the basis of materially inaccurate information. All states also have established securities registration and review requirements to protect purchasers of securities.

Scope and Methodology

To provide an overview of major sources of external equity capital financing for small businesses and to describe the perceived needs in such financing for U.S. small businesses, we interviewed knowledgeable governmental and private sector officials and academicians and reviewed relevant studies.

To determine trends in equity capital for the 1994-99 period, we analyzed cost and industry data for domestic companies regarding venture capital, SBIC, IPO, and private placement financing.[4] We obtained data on IPO, private placement, and venture capital financing from databases maintained by Thomson Financial Securities Data (TFSD) and data on SBIC financing from SBA's Investment Division. Difficulties in obtaining data about business angel investments prevented us from including these in our analysis. SBIC financing data that we gathered relates solely to small businesses. From available data, we treated venture capital financing as small business financing. We excluded later stage and buyout investments because, according to the NVCA's Director of Research, these investments are not made in small businesses.

Information on the size of the business receiving financing was not available on each of the IPO and private placement data records we obtained. Therefore, we had to estimate the total dollar amount raised for small business IPOs and private placements.[5] To do this, we compared the ratios of total dollar financing among businesses known to be small with the total dollar financing among all of those businesses, large or small, in which size was known, and we applied that ratio to the total dollar financing among records in which size was unknown. The validity of this estimate depends upon the assumption that the distribution of total financing for small and large firm IPOs and private placements among the businesses with missing size information was similar to the distribution among businesses whose size was known. Many of the IPO and private placement records were missing size information, so our estimate has some unknown amount of error. We did not verify the reliability of these data.

To describe how market practices and securities law regulations could affect small businesses and to describe differences in the potential effects of these practices and regulations on small businesses, we obtained both qualitative and quantitative information on investment volume and costs for both small and large businesses, for the 1994-99 period, from a variety of public and private sources. Specifically, to identify market practices and costs for IPOs, private placements, and venture capital financing, we obtained the views of officials from the SEC's Division of Corporation

[4]We excluded from our trend analysis foreign companies and domestic companies in foreign countries.

[5]The TFSD IPO database had 3,292 records, of which 1,511 had business size information. These 1,511 businesses comprised 1,053 small businesses and 458 large businesses. The TFSD private placement database had 1,969 records, of which 257 had business size information. These 257 businesses comprised 160 small businesses and 97 large businesses.

Finance—Office of Small Business Policy; the National Association of Securities Dealers Regulation, Inc. (NASDR); and SBA's Office of Advocacy and Investment Division. We also obtained the views of officials from NVCA; the National Association of Small Business Investment Companies; and NASAA. In addition, we interviewed officials from various industry participants, including investment bankers, securities lawyers, venture capital firms, business angels, business incubators,[6] and small businesses. Lastly, we reviewed information from various Internet Web sites.

To determine the respective authorities of federal and state securities regulators and to investigate the effect of that division on small businesses, we interviewed federal securities regulators at SEC and NASDR; state securities regulators for Washington and Maryland; officials at NASAA; and securities lawyers. We also reviewed federal and state securities statutes, rules, and regulations and assessed their effects on small and large businesses' capital formation. In addition, we attended several conferences on small business financing and reviewed available literature on Web sites and in print, including reports, studies, articles, and published proceedings.

To describe the efforts undertaken by federal and state agencies to facilitate small businesses' access to equity capital, we interviewed officials of SBA-OA, SEC's Division of Corporation Finance—Office of Small Business Policy, NASAA, and Maryland and Washington securities divisions. We also interviewed securities lawyers and the President of the National Association of State Seed and Venture Funds and reviewed material on relevant Web sites.

We conducted our work mostly in Washington, D.C., and San Francisco, CA, between August 1999 and September 2000 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the heads, or their designees, of SEC, NVCA, SBA, and NASAA. All four entities provided technical comments, which were incorporated in this report where appropriate. NVCA and SBA-OA also provided written comments that are discussed at the end of this letter and reprinted in appendixes V and VI.

[6]Business incubators are entities that help young businesses to survive and grow during their first few years of existence by providing them with aids such as hands-on management assistance, access to financing, and exposure to critical business or technical support services (e.g., office space and telephones).

Small Businesses Have Four Major Sources of External Equity Capital and Are Perceived to Mostly Need $250,000 to $5 Million in Equity Capital

Small businesses have four major sources of external equity capital: wealthy individuals, known as business angels; venture capital funds; private placement of securities; and public offerings of securities. These sources of external equity capital tend to be relevant at different stages of a business' growth. The need for, and the availability of, external equity capital can change with economic conditions that affect such factors as the number and wealth of investors in capital markets and the number and type of start-up companies.

In 1996, SBA-OA sponsored a study to estimate small businesses' need for equity capital.[7] According to SBA-OA officials, the results of this study indicated that the businesses needing equity capital included about 10 percent of the business start-ups each year and about 25 percent of the mostly small businesses growing faster than 20 percent annually. Therefore, in 1996, SBA-OA estimated that about 50,000 start-ups and about 75,000 fast-growing businesses, which was a total of about 125,000 businesses needed equity capital financing. In addition, partly on the basis of the results of several focus groups that it conducted in 1996, SBA-OA identified the greatest equity capital financing need of small businesses as financing in the amounts of $250,000 to $5 million.[8] SBA-OA estimated the total unmet need for early-stage equity financing for small businesses to be about $60 billion annually.

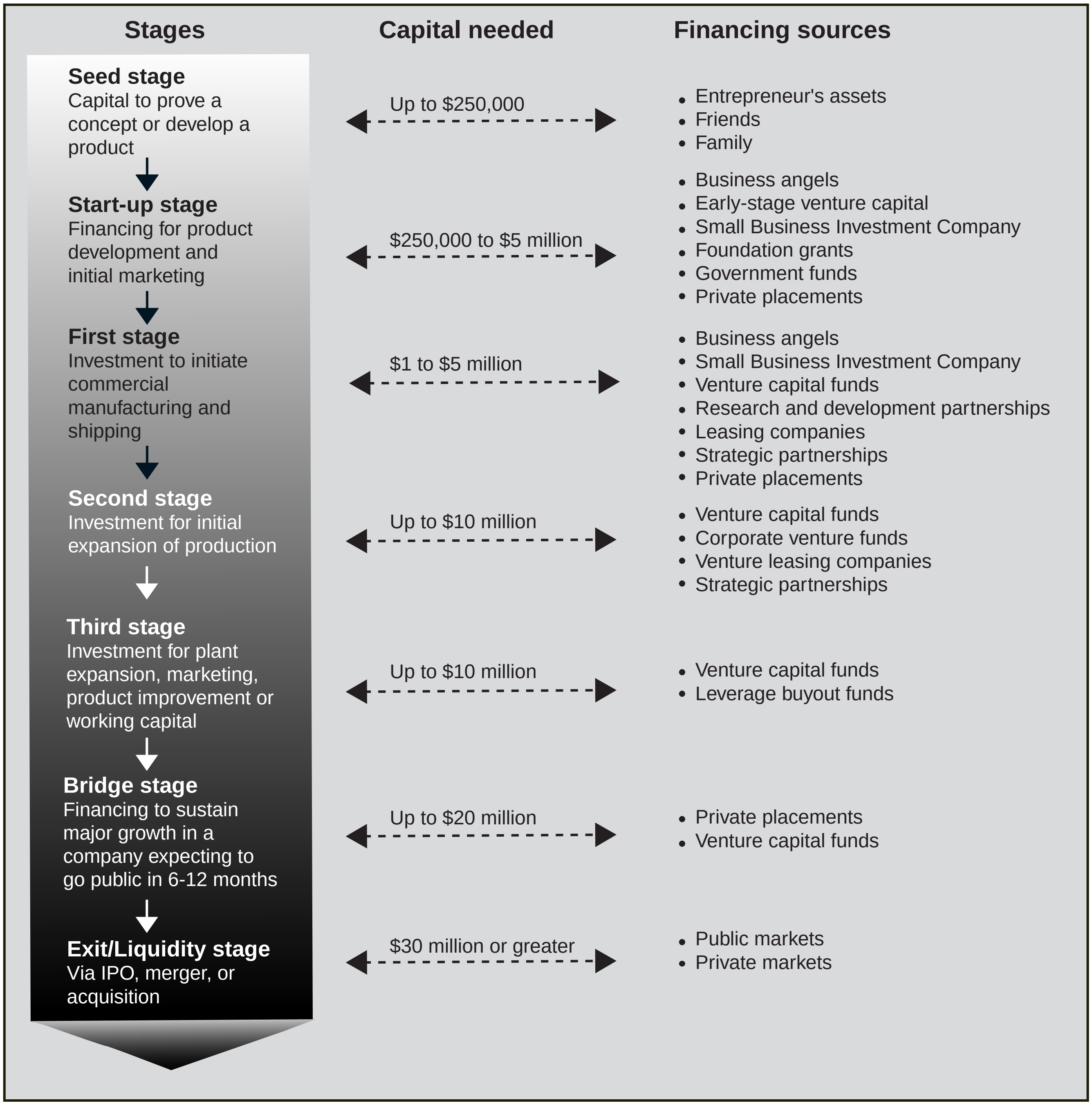
Small Businesses Have Four Major Sources of External Equity Capital Financing

Small businesses have the following four major sources of external equity capital financing: business angel investors, venture capital funds, private placement of securities, and public offerings of securities. These sources tend to be relevant at different stages of a business' growth, as illustrated in figure 1.

[7]Cognetics, Inc., which is a New Jersey consulting firm, conducted the study, according to an SBA-OA official. Also, see the June 1996 SBA-OA-sponsored study entitled Creating New Capital Markets for Emerging Ventures, which was done by the Center for Venture Research at the University of New Hampshire.

[8]The Process and Analysis Behind ACE-Net, SBA-OA, October 1996.

Figure 1: Possible Stages of Business Growth and Sources of Financing



Note: This illustration shows stages of growth and financing sources relevant to many, but not all, small businesses.

Source: GAO analysis of SBA, NVCA, and California Bureau of Research data and available articles.

Business Angels

Business angels are important participants in the informal, unregulated market for small business equity capital. Entrepreneurs typically first seek early-stage, external equity financing from business angels. Business angels

- invest their own funds in small businesses;
- provide incremental financing to small businesses on the basis of the business' achievement of specific financial and nonfinancial milestones;
- typically provide early-stage funds, which may range from $25,000 to several million dollars per deal;
- generally seek high-growth, high-return investment opportunities, although some invest more for social good, with high returns being of secondary importance;
- take 10 percent or more of a firm's ownership and generally look for the ability to liquidate the investment in about 5 to 10 years through a merger, acquisition, or IPO;
- advise and may manage the firm or be passive investors; and
- may act independently, but increasingly are organizing to share information about possible investments and pool resources with other business angels.

Venture Capital Financing

According to an industry representative, venture capital funds, which are private partnerships that provide private equity financing, generally consist of about 6 to 12 general partners and associates. These funds generally are structured as 10-year limited partnerships with venture capitalists acting as the general partners and outside investors serving as limited partners.[9] Venture capital funds generally

- invest the money of others, including pension funds, university endowments, insurance companies, and wealthy investors;
- provide incremental financing to small businesses on the basis of the business' achievement of specific financial and nonfinancial milestones;
- tend to fund high-growth, high-return deals at later stages and in larger amounts than business angels;
- take about 20 to 40 percent ownership of a firm, depending on the amount of capital provided and their valuation of the firm;
- look for the ability to liquidate the investment in about 3 to 5 years through a merger, sale, or IPO;

[9]A limited partnership is a form of business organization that is made up of a general partner—who manages a project—and limited partners—who invest money but have limited liability, are not involved in the day-to-day management, and usually cannot lose more than their capital contribution. The limited partnership structure is the dominant structure used by venture capital businesses to raise money.

- advise and manage the firm by taking seats on the firm's Board of Directors; and
- may invest in a business with other venture capital funds to reduce risks through diversification.

NVCA, which is a trade association for the venture capital industry, reported that 620 venture capital firms in the United States were managing 1,237 funds in 1999. In its technical comments to our draft report, NVCA noted that although most venture investments are $20 million or less (in 1999, 86 percent of venture deals), in recent quarters, venture capital funds have made increasingly large investments, ranging from $30 million (e.g., Internet-related companies needing capital to establish national brand awareness) to $200 million or more (which often involves huge infrastructure investment, such as communication satellites or extensive wiring).

SBICs, a further source of venture capital financing for small businesses,[10] generally

- provide equity financing in amounts of $250,000 to $5 million and management assistance to a wide variety of companies and
- include Specialized SBICs, which are to provide financing and management assistance to economically or socially disadvantaged persons.

Specialized SBICs typically make smaller investments than SBICs. The average equity amount that Specialized SBICs invested per deal in 1999 was $350,554; while for SBICs, the average equity amount was $2.05 million. As of December 31, 1999, the number of licensed SBICs was 295, and the number of licensed Specialized SBICs was 61.

Private Placements of Securities

A small business can raise equity capital in the regulated securities markets through a private placement of equity securities. Private placements—an offering of securities that are exempt from federal registration requirements and limited in distribution to certain types of investors—can provide financing to sustain rapid growth of a business and may be a lower-cost alternative to an IPO. Private placements are generally less expensive than public offerings because they (1) must be offered in a limited manner to a limited audience of participants, (2) are exempt from

[10]In 1999, SBA proposed the creation of the New Markets Venture Capital Program to stimulate economic development in low- and moderate-income communities. SBA expects equity investments made by the new venture capital companies to range from $50,000 to $300,000.

SEC registration requirements, and (3) are usually sold without the assistance of an underwriter. However, private placements may not be exempt from state registration requirements.

Public Offerings of Securities

Small businesses also can raise capital in the regulated securities markets through the public offerings of securities. For the purposes of this report, a public offering can be

- an IPO—a private business' first offering and sale of securities to the general public (i.e., going public) or
- a DPO—in which the issuer attempts to raise capital in the public markets without the aid of a securities underwriter.

IPOs are subject to federal and state securities laws designed to protect investors and the integrity of securities markets, and an underwriter usually assists in IPOs. Underwriters play an important role throughout the IPO process by helping companies in their efforts to market and sell the IPO to the investment community.

DPOs can be a lower-cost alternative to underwritten public offerings because DPOs are not assisted by an underwriter and, therefore, have no underwriting expense. However, DPOs do entail costs, such as regulatory filing, accounting, printing, legal, and marketing costs, since DPOs have to be registered with SEC and go through its traditional registration review process. According to NASAA officials, DPOs stand little chance of success without an existing client base or other affinity group. See appendix I for the chronology of a small business' attempt to raise capital via a DPO.

Small Businesses' Greatest Perceived Need for Equity Capital Is for Financing in the Range of $250,000 to $5 Million

At the 1995 White House Conference on Small Business, small businesses' need for equity capital was identified by participants as a high-priority issue. As a follow-up to that concern, SBA-OA sponsored a study in 1996 to estimate small businesses' need for equity capital. According to SBA-OA officials, the results of this study indicated that businesses in need of equity capital include about 10 percent of business start-ups each year and about 25 percent of the small businesses growing faster than 20 percent annually. Therefore, in 1996, SBA-OA estimated that about 50,000 start-ups and about 75,000 fast-growing businesses, or a total of 125,000 businesses needed equity capital financing. In addition, partly on the basis of the results of several focus groups that it conducted, SBA-OA identified that the greatest equity capital financing need of small businesses was financing in the amounts of $250,000 to $5 million. SBA-OA estimated for 1996 that the total unmet need for early-stage equity financing for small businesses was about $60 billion annually. Although acknowledging that these numbers were soft, an SBA-OA official told us that he considered all of these findings valid today.

Several business officials and academicians that we interviewed were familiar with SBA's effort to define the perceived need of small businesses for equity capital. Although they recognized the difficulty associated with defining the need of small businesses for equity capital, several of them stated that many small companies face difficulties raising equity capital in amounts from $250,000 to $5 million. Part of this difficulty was perceived as arising from upward movement in the average minimum amount that venture capital funds were investing per deal.

Several business officials we interviewed also said that the cost of conducting an IPO of securities could limit small businesses' access to the equity capital market. In addition, some market participants we interviewed acknowledged that equity-financing difficulties exist for companies in industries that are not the current "favorite" of the investment community. For example, some said that companies in such technologies as renewable energy, have difficulty attracting venture capital financing because these companies are perceived as offering lower investment returns than some other investment opportunities (most recently, Internet-related companies) and also as having a relatively long investment horizon of 20 to 25 years.

Small Business Equity Capital Financing Increased In 1994-99

To better understand the current environment and recent trends in small business equity capital financing, we analyzed available industry data for domestic companies receiving equity capital financing during 1994-99 from venture capital funds, SBICs, IPOs, and private placements of securities. We found a dramatic increase in the estimated overall level of small business equity financing in the study period and also since 1996, which was the year of SBA-OA's effort to estimate small businesses' needs for equity capital financing. While the estimated level of small business equity capital financing increased, so did the number of start-up companies. In the study period, high-tech companies had the widest use of venture capital, IPO, and private placement financing. We also observed that recent increases in the average amount of equity capital invested in small businesses by venture capital funds could make these funds a less likely source of financing for amounts of less than $5 million than they had been previously.

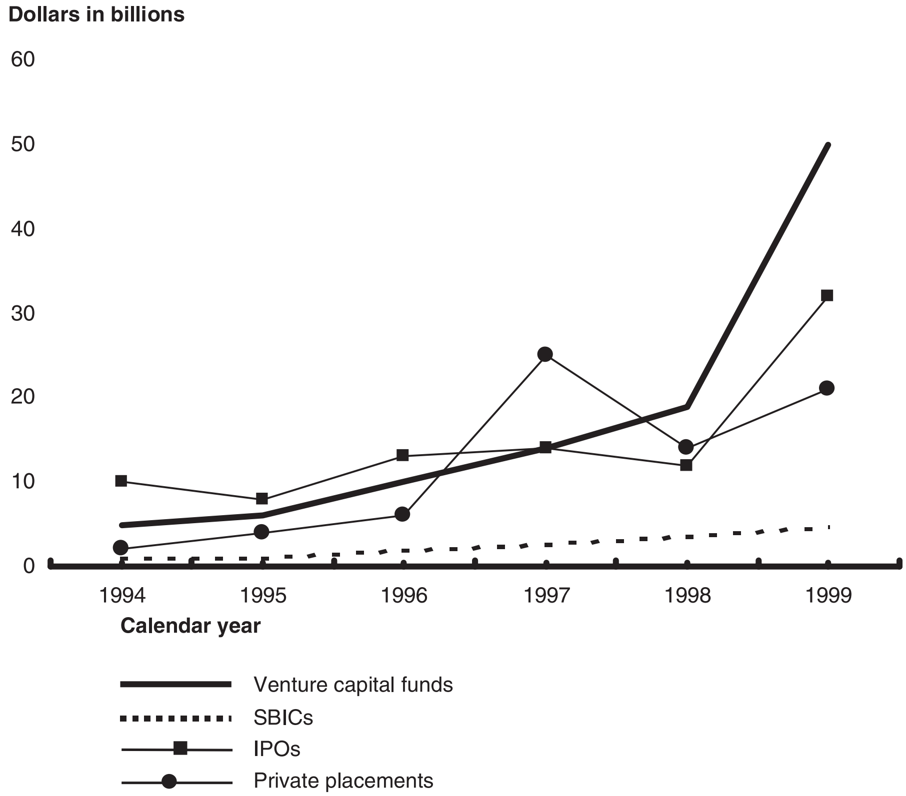
Total Amount of Small Business Equity Capital Financing Increased Almost Six-Fold in 6 Years

The estimated level of financing for small businesses from venture capital funds, SBICs, private placements of securities, and IPOs increased almost six-fold in the 1994-99 period, from about $18 billion in 1994 to about $107 billion in 1999. Of the sources we analyzed, venture capital funds provided the greatest amount of small business equity capital financing; also, the greatest annual increase in financing was from that source in 1999. The $107 billion estimate of small business equity capital financing from those sources in 1999 represents an increase of about 270 percent over the estimated amount from those sources in 1996 ($29 billion).

We did not attempt to account for financing from business angels because of difficulties in obtaining industry data. According to SBA-OA and others, approximately 30,000 companies a year receive about $20 billion in equity capital from about 250,000 business angel investors. Many industry representatives we interviewed told us that the business angels often provide financing in the $250,000 to $5 million range.

During the 1994-99 period, estimated venture capital, IPO, SBIC, and private placement equity financing for small businesses increased, as shown in figure 2. Venture capital financing of small businesses dramatically increased in 1998 and 1999. IPO financing also had significant growth in 1999. SBIC equity financing increased from approximately $1 billion in 1994 to $4.6 billion in 1999.

Figure 2: Estimated Financing Provided to Small Businesses by Venture Capital Funds, SBICs, IPOs, and Private Placements, 1994-99



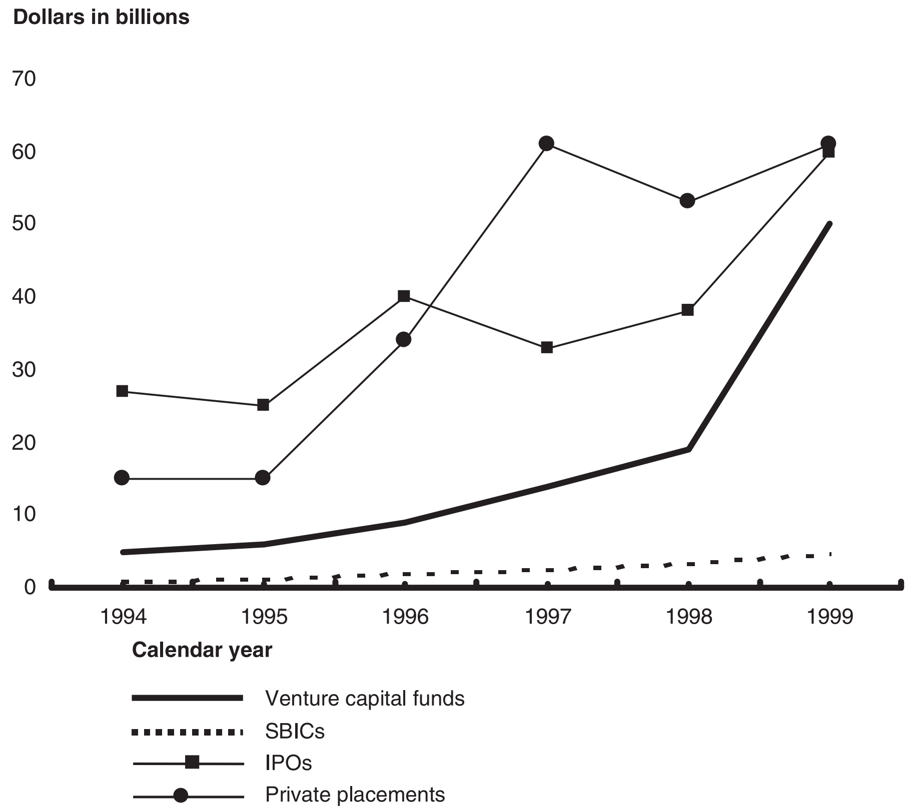
Note: IPO and private placement amounts have been adjusted to account for missing business size information. See the scope and methodology section of this report for adjustment calculation.

According to SBA's Associate Administrator for Investment, subordinated debentures with equity features are the common investment vehicle for many of SBA's SBICs and are considered by SBA to be the functional equivalent of convertible preferred stock financing used by venture capital funds. Therefore, we included such SBIC investments as equity in this report.

Source: GAO analysis of data provided by TFSD and SBA.

The amounts of equity capital financing that venture capital funds, SBICs, IPOs, and private placements provided to all businesses (large and small) are shown in figure 3.

Figure 3: Equity Capital Financing Provided to All Businesses by Venture Capital Funds, SBICs, IPOs, and Private Placements, 1994-99



Note: All reported statistics are based on all records of domestic equity financing available from TFSD and SBA.

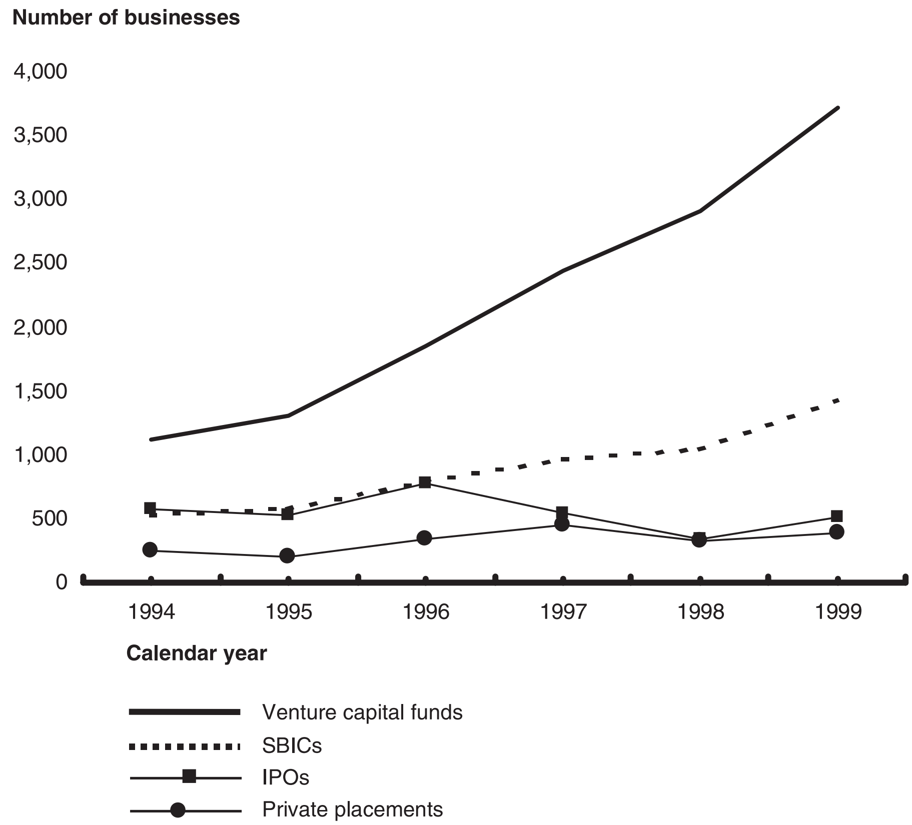
According to SBA's Associate Administrator for Investment, subordinated debentures with equity features are the common investment vehicle for many of SBA's SBICs and are considered by SBA to be the functional equivalent of convertible preferred stock financing used by venture capital funds. Therefore, we included such SBIC investments as equity in this report.

Source: GAO analysis of data provided by TFSD and SBA.

Because SBICs only fund small businesses, and we generally treat venture capital financing as small business financing, the amounts for these sources are identical in figures 2 and 3. Over the stated period, as shown in figure 3, the amount of equity capital financing provided to large and small businesses grew significantly for the private placement, IPO, SBIC, and venture capital markets. In 1999, the private placements and IPO markets accounted for the majority of financing to large and small businesses from these equity sources. Venture capital financing showed the greatest percentage increase for 1998 and 1999.

Figure 4 shows the number of businesses (large and small) receiving equity capital financing from venture capital funds, SBICs, IPOs, and private placements in the study period. The figure also shows that during 1994-99, the number of businesses financed by venture capital increased steadily and that venture capital financed the greatest number of businesses. Venture capital funds financed 1,178 businesses in 1994 and 3,638 businesses in 1999. SBICs financed 534 businesses in 1994 and 1,426 businesses in 1999. The number of businesses financed by IPOs and private placements remained relatively constant over the period.

Figure 4: Number of Businesses Receiving Equity Capital Financing From Venture Capital Funds, SBICs, Private Placements, and IPOs, 1994-99



Note: All reported statistics are based on all records of domestic equity financing available from TFSD and SBA. Also, the number of businesses receiving private placement financing may be overstated because it represents the number of financings and a business may have received more than one financing.

Source: GAO analysis of data provided by TFSD and SBA.

High-Tech Companies in Specific States Had Widest Use of Venture Capital Financing

Results from our review of trends in the equity capital financing for small and large businesses during 1994-99 indicate that high-tech companies in particular states had the widest use of venture capital, IPO, and private placement financing. California, Massachusetts, New York, and Texas were the four states with the largest amounts of venture capital financing from 1994-99. In 1999, California businesses received $16.87 billion in venture capital investments—nearly 3 times the amount they received in 1998. Additional industry data show that of the total amount invested in the computer software, computer networking/equipment, and telecommunications industries in 1999, Silicon Valley businesses received 46.0 percent, 45.5 percent, and 31.0 percent, respectively.

Venture Capital Firms May Be Less Likely to Provide Financing in the $250,000 to $5 Million Range

As shown in table 1, the average amount of investment in small business by venture capital funds more than doubled in 1999 to $13.3 million, up from $6.6 million in 1998. Although overall financing has increased, this suggests that, in general, venture capital funds may have become a less likely source of equity capital financing in the $250,000 to $5 million range. Based on the increase in the average investment to $13.3 million, SBA-OA officials believe that, the increased level of venture capital financing will be less likely to serve the unmet needs of small businesses.

Table 1: Average Dollar Amount of Equity Capital Disbursed to Small Businesses by Venture Capital Firms, 1994-99

Dollars in millions

Calendar year	Average amount of equity capital disbursed
1994	$4.32
1995	4.36
1996	5.38
1997	5.75
1998	6.61
1999	13.34

Source: GAO analysis of data provided by TFSD.

Market Practices of Private Equity Providers and Regulatory Requirements Affect Small Business Equity Capital Formation

For large and small businesses, equity capital formation is affected by (1) market practices of private equity capital providers, which reflect their efforts to maximize returns and manage risks, and (2) costs associated with federal and state securities market regulations, which are designed to protect investors and the integrity of securities markets. Private equity capital providers generally view small businesses as high-risk investments because small businesses have a high, historical rate of failure and information that is often helpful in assessing risks and returns is typically limited. Therefore, to manage risks in small business investing, private equity capital providers have strict criteria for the selection of businesses in which they will invest.

In the formal, regulated securities market, regulations that protect investors and help to ensure the integrity of equity capital markets can facilitate information disclosures that can improve investor confidence. However, the costs of compliance with these regulations can be a limiting factor for small businesses. Certain regulatory costs for small issues of securities tend to be higher per-dollar-raised compared with costs for large issues, partly because certain costs are not proportionate to the size of the offering. Small businesses may also be subject to potentially costly state requirements in their capital-raising activities, while large businesses often are not. This is because large issues, such as nationally traded securities, are exempt from state registration and review requirements, while small issues are not.

Because state registration requirements differ, a small business making a multistate offering can find complying with the varying state laws complex, costly, and time-consuming. Federal and state securities regulators have adopted several reforms to streamline the capital formation process for small businesses and reduce their regulatory burden. Some market participants we interviewed believed that more could be done to reduce regulatory burden to small businesses. For example, some suggestions were aimed at attracting more investors to small business investment, increasing the dollar limits on securities offerings allowed under certain exemptions, and encouraging greater commonality in certain federal and state registration requirements.

Investment in New, Rapidly Growing Businesses Is Viewed as High Risk by Equity Capital Providers

According to literature we reviewed, equity capital providers view new and rapidly growing companies generally as high-risk investments because such companies have a high, historical failure rate. In addition, these companies often lack a record of performance that investors can use to evaluate potential risk and returns.[11] Some research indicates that approximately 80 percent of new businesses will either fail or no longer exist within 5 to 7 years of formation due to a lack of financial depth, a lack of management expertise, an unworkable business idea, or some combination of these factors. The perceived high risk associated with new and rapidly growing companies is also borne out by the past performance of venture capital investments in the informal, unregulated equity capital market. According to a recent study by the National Association of Seed and Venture Funds, only about 10 percent of venture capital investments meet their expected rate of return.[12] This statistic is particularly striking in light of venture capital funds' strict processes for selecting investments and their active monitoring of the companies in which they invest.

[11]By way of contrast, information about the performance of companies whose stocks are publicly traded is available from a variety of sources, such as Standard & Poors.

[12]Growing New Businesses with Seed and Venture Capital: State Experiences and Options, Robert G. Heard and John Sibert, National Association of State Seed and Venture Funds, Year 2000.

Stringent Investment Selection Criteria Designed to Maximize Returns and Manage Risks

According to market participants we interviewed and literature we reviewed, to maximize returns and help manage risk, providers of equity capital in the informal, unregulated equity capital market require small businesses in which they invest to meet highly selective financing criteria. Venture capital funds, for instance, typically look for businesses with

- a marketable business idea with widespread appeal;
- an estimated minimum annual internal rate of return[13] in the range of 30 to 50 percent;
- an experienced management team; and
- an opportunity to liquidate the investment in about 3 to 5 years through a merger, a sale, or an IPO.

These and other criteria limit the companies deemed eligible for financing. Although venture capital investments have increased dramatically, only about 1 percent of all business plans[14] submitted to venture capital funds typically has received financing in recent years and historically, according to an NVCA official and the venture capitalists that we interviewed.

Some Criteria Designed to Minimize the High Cost of Obtaining Information

Providers of private equity capital may also impose investment selection criteria that serve to minimize the high cost of obtaining information to evaluate potential risk and return. For example, those providers may consider only businesses that are located in a specific geographical area or only businesses of a specific type in which they have expertise. Regarding location, providers of private equity capital often prefer to make their investments within a reasonable commuting distance due to their need for firsthand information about the small businesses they fund and to participate in management tasks.[15]

The type of business may play a role in the selection process of venture capital funds because some providers prefer to specialize in a particular industry to achieve economy in their research efforts. The costs of due

[13]Internal rate of return is the discount rate (i.e., interest rate) at which the "present value" of the future cash flows of an investment equals the cost of the investment. Present value is the value today of a future payment, or stream of payments, discounted at some appropriate interest rate.

[14]A business plan is generally supposed to be a concise, complete, and easy to understand document that describes the company, its products, business methods, financial condition, and financing needs. Business plans, usually prepared by a firm's management, are written to clarify company purposes, plan new directions, and raise capital from private investors.

[15]According to some industry participants we interviewed, some geographic areas may also be attractive to investors—and start-up companies—because they offer a supportive infrastructure that includes ready access to patent and securities attorneys; a workforce willing to work for limited salaries in exchange for stock options, warrants, and the like; research and development activity; investment bankers; and accountants.

diligence[16] efforts of private providers of equity capital can be substantial. According to a business angel investor group we interviewed, the investigation of a finalist company alone can cost up to $25,000.

The size and developmental stage of a business can also play a role in the investment selection process. Small businesses seeking larger amounts of capital (most often at later stages) may be at an advantage since venture capital funds are increasingly less likely to make early-stage investments of less than $5 million, according to industry officials. According to NVCA, in 1999, about 55 percent of venture capital investments in companies were for expansion financing, compared with 22 percent for early-stage financing, 18 percent for later-stage financing, and 5 percent for buyouts or acquisitions. Market participants noted that venture capitalists are limited in the number of investments they can actively oversee, and that managing a small investment takes as much time and effort as managing a larger one. They also stated that given that larger sums of money invested in venture capital have been available, venture capitalists have been leaning toward larger investments.

According to venture capital literature and the market participants that we interviewed, once investment decisions are made, venture capital funds typically impose further requirements that help protect the investment. Such requirements can include

- incremental financing from the venture capital fund on the basis of the business' achievement of specific financial and nonfinancial milestones;
- the business' adoption of incentive-related compensation schemes, such as smaller cash salaries, which are offset by issuance of stock options;
- involvement of venture capitalists in a wide range of the business' activities; and
- preferences in stock liquidation for the venture capital fund or priority in receiving proceeds from a liquidation of assets.

IPO Market Has Strict Criteria for Selecting Investments

As in the informal, unregulated equity markets, practices in the regulated equity securities markets can be restrictive for small businesses in need of equity capital. Market requirements in regulated securities markets are imposed partly by securities underwriters to compensate them for risks involved in the marketing of the offering. According to an investment banker we interviewed and literature reviewed, large underwriters generally like IPO candidates to have, at a minimum,

[16]Due diligence examinations usually include a review of books and records, discussions with members of the management team, and an in-depth financial analysis of the company.

- annual revenues of $20 million,
- net income of $1 million, and
- the potential to achieve and sustain significant annual growth rates (i.e., 20 percent or greater in revenues) for the next 5 to 10 years.

However, in recent times, astronomical growth expectations have enabled some Internet and Internet-related companies to go public with minimal revenues and no profits. Also, according to investment bankers we interviewed, businesses doing IPOs of less than $50 million generally are having a difficult time attracting large investment banking firms (e.g., Merrill Lynch and Goldman Sachs) to underwrite their public offerings. The investment bankers said this is the case partly because of high, fixed costs, including high, after-market monitoring costs and the need to make large-size investments. Therefore, these IPOs are commonly distributed by third- and fourth-tier investment banks rather than prestigious first-tier investment banks. Investors are less inclined to invest in small offerings placed with lower-tier investment banks because such firms often do not have the same market recognition that the large firms command. Further, we were told that another problem for these small issues is finding a securities analyst to cover the stock. In addition, investment bankers said that economies of scale typically make IPOs under $50 million uneconomical for larger investment banking firms.[17]

Securities Laws and Regulations Facilitate Information Disclosure

Securities laws and regulations to protect investors and help ensure the integrity of equity markets facilitate information disclosures that can improve investor confidence. Unless subject to a specific exemption, a business selling its securities is required by the Securities Act to file a registration statement with SEC that includes a prospectus, that describes the business' operations, financial condition, security offering, risk factors, and management. A company cannot sell its securities until SEC declares the registration statement effective.

The Securities Act requires that all information provided to investors in connection with the offer or sale of the company's securities is to be materially complete and accurate. NASAA officials representing state securities' regulators told us that small businesses issuing securities may be especially vulnerable to loss of investor confidence if some issuers "poisoned the well" with material misstatements.

[17]Economies of scale occur when cost per dollar of issuance declines as issuance volume increases.

Regulatory Costs Per Dollar of a Public Offering Tend to Be Higher for Small Issues Than Large Issues

In analyzing estimates of IPO costs, we found that the estimated average total cost needed to conduct a small business IPO during 1994-99 was about 10 percent of the total offering proceeds, while the average total cost for a large business IPO was about 8 percent.[18] Implementation of securities law regulations results in costs that are greater per dollar raised for smaller issues compared with larger issues subject to the same requirements because certain costs are not proportional to the size of the offering. Examples of these costs include legal and accounting expenses. Table 2 presents the estimated average costs for an IPO that raised $25 million.

Table 2: Estimated Initial Costs of Becoming a Public Company

Cost category[a]	Estimated average costs for a $25 million underwritten IPO
Securities and Exchange Commission registration fee	$9,914
National Association of Securities Dealers, Inc., filing fee	3,375
State (Blue Sky) filing fees and expenses	15,000
Accounting fees and expenses	160,000
Legal fees and expenses	200,000
Printing and engraving expenses	100,000
Transfer agent and registrar fees	5,000
Miscellaneous expenses	34,200
Nasdaq entry listing fees	63,725
Nasdaq annual fees	11,960
Underwriting discounts and commissions	1,750,000
Total	**$2,353,174**

[a]The figures presented in this table were calculated by Nasdaq and are based on the mean value of each cost category from a number of illustrative examples of IPOs of about $25 million. It should be noted that all aspects of business relationships involved in an IPO, including underwriting, can be negotiated.

Source: Nasdaq's Going Public, 4th Edition, 1999.

As represented in table 2, underwriting expenses represents the largest single cost of an IPO, partly due to the complexity of the federal and state securities laws and risks of the offering. According to a SEC official we interviewed and literature we reviewed, because of the complexity of these laws and liability issues, companies typically use underwriters, along with securities lawyers and certified public accountants, to assist them in registering and processing IPOs with SEC, NASDR, and state securities regulators. According to the securities professionals we interviewed, underwriting expenses consist of a discount or commission[19] of about 6 to

[18]The average cost is for businesses where the size was known.

[19]The underwriting discount or commission is the fee paid by the company to the underwriter for purchasing or selling the company's securities.

10 percent of an offering's value for small issues (typically 7 percent) compared with 4 to 6 percent for large issues. According to investment bankers and securities attorneys we interviewed, underwriting expenses are generally lower for large issues than for small issues because large issues involve less risk and work per dollar of offering. We found this difference in underwriting expense for our subset of small and large IPO offerings: the average cost of the underwriting discount or commission for small offerings was 7.5 percent and, for large offerings, 6.7 percent. According to the securities professionals we interviewed and literature we reviewed, underwriters typically determine their fee on the basis of several factors, including the size, quality, and underwriting type of the offering.[20]

We also received average cost figures calculated by NASDR from several IPOs of about $5 million and $10 million. According to a NASDR official, the methodology used by NASDR was consistent with that used by Nasdaq. For a $5 million IPO, the average total cost was 14.4 percent of the total offering proceeds, with 9.4 percent of the proceeds representing underwriting discounts and commissions. For a $10 million IPO, the respective figures were 9.8 and 7.3 percent.

Other expenses of the underwriter can include

- an expense allowance to cover the underwriter's legal, due diligence, travel, and other expenses;
- warrants to purchase stock in the business for the underwriter's own account;
- right of first refusal on subsequent offerings; and
- financial consulting fees.

In addition to the underwriting compensation, the business usually incurs legal, accounting, printing, and other marketing costs; also incurred are filing fees for SEC, NASDR, stock exchange, and state registration, as shown in table 2. The amounts of these costs can vary, depending on several factors, including the size of the offering. Offering expenses generally are paid out of proceeds at the closing of the offering.

[20]The underwriting types are firm commitment and best-efforts basis. In a firm commitment offering, the underwriter can purchase some or all of the newly issued shares to resell to other investors, thereby assuming financial risk for the issuance of the shares. In a best-efforts offering, the underwriter acts as an agent for the company and assumes no financial risk for the sale of the new shares since the company retains ownership of the shares.

Large, Nationally Traded Issues Are Exempt From State Registration Requirements, Although Small Issues Generally Are Not

Although most small securities offerings are subject to state registration requirements, large, nationally traded issues are not. The National Securities Markets Improvement Act of 1996 (NSMIA) preempts state registration and review requirements of nationally traded securities.[21] Unless exempt by state statute, securities not preempted by NSMIA are subject to state registration requirements.

The three methods of registration at the state level are notification, qualification, and coordination. As described more fully in appendix II, notification is a method of registration that requires a notice filing with the state. Registering a nonexempt security at the state level is known as registration by qualification. The registration requirements under this option are similar to a registration at the federal level in which the issuer must file a registration statement satisfying requests for approximately 16 categories of information.

Registration by qualification frequently includes a merit review by state securities regulators of the securities being offered. A merit review is an analysis of the offering using substantive standards (e.g., the disparity in the price paid by promoters for their shares and the price paid by public investors). According to NASAA officials, the purpose of merit review is to align the interests of the issuer with those of the public investors. Although this process can improve investor confidence in small, locally sold securities, it can be costly and time-consuming for businesses seeking to raise capital.

Registration by coordination is a method of registration that is available to issuers who have registered their offering with SEC. Although the content of the registration and the procedure by which it becomes effective is streamlined, it is still subject to merit review and according to NASAA officials, is the registration method most often used for equity offerings. Appendix II shows state registration-filing fees, which vary by state.

Congress and Securities Regulators Have Sought to Ease Regulatory Requirements for Small Businesses

Balancing the need to assist small businesses in capital formation with the need to protect investors, Congress and securities regulators have simplified the registration process and provided small businesses with exemptions from federal registration requirements on the basis of the dollar size of the offering, location of the offering, and number and type of investors. However, offerings exempt from federal registration requirements are not always exempt from state registration requirements.

[21]As discussed in a later section of this report, NSMIA also preempts state registration and review requirements of offerings under SEC rule 506 of Regulation D.

For this reason, businesses offering such securities may have to register their securities offerings in each state in which they are sold. In addition, certain offerings by small businesses subject to federal registration requirements must register with state regulators. Several market participants we interviewed supported further efforts by federal and state regulators to reduce the regulation of securities offerings by small businesses, including increasing dollar limits on securities offerings allowed under certain federal and state exemptions. Several market participants also suggested encouraging greater commonality in certain federal and state registration requirements.

To minimize the regulatory costs of raising equity capital, SEC allows small business issuers (those with less than $25 million in revenues in the last fiscal year and outstanding stock of $25 million or less) to use simplified small business forms (SB-1 and SB-2) in filing registration statements (see table 3 below).

Table 3: Simplification of SEC Registration Requirements for Securities Offerings for Small Businesses

Requirement	Form S-1	Form SB-1	Form SB-2
Type of disclosure	Extensive narrative discussion of disclosure	Disclosure can be presented in a question-and-answer format	Less extensive narrative disclosure than S-1
Audited financial statements required	Yes, for last 3 fiscal years	Yes, for last 2 fiscal years	Yes, for last 2 fiscal years
Capital that can be raised	Unlimited amount	$10 million every 12 months	Unlimited amount

Source: GAO analysis of SEC regulations and forms.

The SB-1 and SB-2 forms require audited financial statements for 2 fiscal years. In contrast, the regular registration form available to all issuers (S-1) requires more detailed audited financial statements for 3 fiscal years. According to a securities law article, forms SB-1 and SB-2 are estimated to save an issuer up to approximately $125,000 for an average offering. However, regardless of which form is used, according to an investment banker we interviewed, small business issues are viewed unfavorably by many investment bankers because they are too small in size to be profitable. He further noted that small offerings are commonly distributed by smaller investment banks that lack market recognition, which can be a hindrance to attracting investors.

Exemptions From Federal Registration Requirements Reflect Efforts to Balance Small Businesses' Needs With Protections for Investors and Market Integrity

In response to concern that the expense of SEC registration restricts small businesses' access to equity capital markets, federal securities laws provide certain securities offerings with exemptions from federal registration requirements. (The registration requirements and exemptions summarized in this section, and others, are discussed in greater detail in app. III.) Generally, such exemptions apply when issues are relatively small in dollar size or purchasers of the securities are wholly or largely restricted to investors' meeting certain standards of wealth or business sophistication.

Regulation D is designed to (1) eliminate any unnecessary restrictions that SEC rules place on small business issuers and (2) achieve uniformity between state and federal exemptions to facilitate capital formation consistent with protecting investors. Regulation D establishes three separate but interrelated exemptions—rules 504, 505, and 506—as summarized in table 4. The exemptions differ regarding the size of the offerings to which they apply and/or the number and type of investors to which offerings may be made. These exemptions were a focus of interest for several market participants that we interviewed, who are affected by these exemptions, and they had suggestions for streamlining these exemptions. These suggestions could thereby increase small businesses' access to equity capital.

Table 4: Summary Characteristics of SEC Regulation D Exemptions

Characteristic	Rule 504 exemption	Rule 505 exemption	Rule 506 exemption
Number and type of investors who may invest	Unlimited number of any type of investors	An unlimited number of accredited investors[a] and up to 35 nonaccredited investors	An unlimited number of accredited investors and up to 35 nonaccredited, sophisticated investors
Maximum dollar size of securities offering	Up to $1 million in any 12-month period	Up to $5 million in any 12-month period	Unlimited dollar amount may be sold
Restricted securities resales	Yes, unless certain conditions are met[b]	Yes	Yes
Disclosure documents required to be delivered to investors	Under state law requirements pursuant to certain conditions[b]	Yes	Yes
Restrictions on general solicitation and advertising for investors	Yes, unless certain conditions are met[b]	Yes	Yes
Subject to federal and state antifraud provisions	Yes	Yes	Yes
Preexisting relationship requirement	Yes, unless certain conditions are met[b]	Yes	Yes
SEC form D filing required	Yes	Yes	Yes
State registration required	Yes, unless there is a state exemption	Yes, but most states have state exemptions, such as the Uniform Limited Offering Exemption	No, preempted from state registration by NSMIA
Type of issuers that cannot use exemption	Blank check companies,[c] investment companies, or SEC reporting companies	Investment companies	None

[a]Accredited investors include, among others, individuals whose net worth is more than $1 million and whose individual income exceeds at least $200,000 for the most recent 2 years and certain institutional investors, such as insurance companies, banks, and endowments.

[b]To deter micro-cap stock fraud, rule 504 of Regulation was amended in April 1999 by SEC to restrict the resale of securities and prohibit general solicitation and advertising unless specified conditions permitting a public offering are met. These conditions are that (1) the transactions are registered under a state securities law requiring public filing and delivery of a substantive disclosure document to investors before sales; (2) for sales to occur in a state without this sort of provision, the transactions must be registered in another state with such a provision, and the disclosure document filed in the state must be delivered to all purchasers before sale in both states; or (3) the securities are issued under a state law exemption that permits general solicitation and advertising, so long as sales are made only to accredited investors, as that term is defined in Regulation D.

[c]A blank check company is a development stage company that has no specific business plan or purpose or its business plan is to merge with an unidentified company.

Source: GAO analysis of SEC Regulation D.

Rule 504 provides an exemption from the federal registration requirements for small offerings (up to $1 million in any 12-month period) that would be state regulated because of the small amount of the offering and the likelihood that sales would occur in a limited geographic area. The purpose of rule 504 is to provide small companies attempting to raise seed capital through the sale of securities with the ability to do so without being hampered by the expense of federal registration. According to statistics provided to us by SEC's Office of Small Business, rule 504 offerings have steadily increased, rising from 2,357 in 1994 to 3,407 in 1999.

Issuers relying on the rule 504 exemption must register in every state in which the securities are offered, absent a state exemption. Since most states do not have exemptions for 504 offerings, an issuer with a multistate offering will likely have to comply with differing individual state filing requirements. Some industry participants suggest that rule 504 filings be exempt from state registration requirements to avoid the burden of state-by-state registration. However, NASAA officials believe that because these offerings are local in nature and have been exempt at the federal level, states have an interest in regulating these securities offerings. Others suggest that the state securities laws (also known as blue-sky laws) be simplified and made uniform. One registration form used at the state level to ease this burden is the Small Company Offering Registration (SCOR) form. SCOR is a simplified question-and-answer registration form accepted by 49 states, which also can be used as the disclosure document for investors in rule 504 offerings. A NASAA official believes that the use of the SCOR form makes registration at the state level more uniform.

Rule 505 allows an exemption for private offerings up to $5 million in a 12-month period. Its purpose is to unify the state and federal exemption for offerings up to $5 million that meet certain criteria. As such, a parallel initiative to rule 505 was adopted at the state level of NASAA's Uniform Limited Offering Exemption (ULOE), which contemplates a uniform rule exempting offers and sales if offered or sold in compliance with rule 505.

More disclosure is required for rule 505 offerings than for rule 504 offerings because of the increased dollar amount of the offering. Rule 505 allows an issuer to sell its securities to an unlimited number of "accredited investors" and up to 35 other persons who need not satisfy a business sophistication or wealth standard. Investors cannot resell the issued securities unless the issuer registers the securities or an exemption exists at both the federal and state level. The issuer may not use general solicitation or advertising to sell the securities, and SEC has stated that the demonstration of a preexisting relationship with any offeree to whom the issuer sells is evidence of freedom from general solicitation. Furthermore, unless there is a state law exemption, rule 505 offerings must be registered at the state level.

Since the passage of NSMIA, rule 505 offerings have declined. According to SEC statistics, rule 505 offerings have decreased since 1994, dropping from 2,163 offerings that year to 1,016 offerings in 1999. Industry participants we interviewed told us that because offerings must be registered at the state level and because of the prohibition of general solicitation and advertising, rule 505 offerings are rarely used. Thus, it has been suggested by such participants that SEC eliminate the restriction on advertising and general solicitation for rule 505 offerings. In addition, industry participants suggest that rule 505 offerings be preempted from state registration requirements. According to an SEC official, SEC takes a posture of neutrality regarding the preemption of the state securities laws. As discussed in the next paragraphs, SEC is not inclined to eliminate the general solicitation and advertising restrictions on rule 505 offerings because the restrictions on solicitation are among the attributes that distinguish a private placement offering from a public offering. According to an SEC official, SEC supports the general solicitation restrictions in part as a demonstration of the limited nature of the offering, which is a reason not to require registration under the Securities Act.

Rule 506 allows a business of any size to raise an unlimited amount of capital through offerings to an unlimited number of accredited investors and up to 35 other financially sophisticated purchasers without having to register with SEC. Rule 506 offerings have been preempted by NSMIA from state registration requirements. According to SEC statistics, rule 506 offerings have increased dramatically since 1994, growing from 5,414 in that year to 13,112 in 1999.

Industry participants believe that the restriction on general solicitation and advertising impedes small businesses' ability to search for investors. Some securities attorneys have suggested that rule 506 be amended to permit general solicitation and advertising. In June 1995, SEC solicited comments on an amendment to Regulation D that would eliminate the prohibition against general solicitation for rules 505 and 506 offerings. Although SEC deferred action on the general solicitation question, it indicated that it would consider comments in connection with a future initiative. According to an SEC official, one rationale for the prohibition on general solicitation and advertising is to distinguish a rule 506 offering, which is a private offering with no federal or state oversight, from a public offering, which requires significant oversight due to its wide distribution. The prohibition on general solicitation and advertising is what keeps the offering "private" and helps minimize the risks of widespread fraud. Another SEC concern regarding lifting the general solicitation ban is the potential for participation of unsophisticated investors who may need the protection provided by registration under the Securities Act.

Regulation A provides further exemption for offerings under $5 million. Although Regulation A is termed an "exemption," it actually provides a simplified SEC registration form, which does not require audited financial statements for public offerings of securities not exceeding $5 million. SEC has stated that its primary purpose in adopting Regulation A was to provide a simple and relatively inexpensive procedure for small business use in raising limited amounts of needed capital. A business that relies on Regulation A must (1) file with SEC for review an offering circular, which may be in a question-and-answer format, that contains unaudited financial statements and (2) provide the offering circular to investors. Like registered offerings, the securities can be offered publicly and are freely tradable in the secondary market. According to SEC statistics, on average, 83 Regulation A offerings have been filed each year since 1994. Some of the reasons given for Regulation A's limited use is that it is rare for an issuer to attract an underwriter for an offering under $5 million. In addition, although Regulation A does not require audited financial statements at the federal level, most states require audited financial statements for a Regulation A offering. Notwithstanding the benefits provided by the SEC exemption, because most states do not offer the same regulatory relief, the issuer receives little benefit from a Regulation A exemption.

Unlike traditional public offerings, Regulation A offerings enable companies to "test the waters"—that is, to determine if adequate investor interest in the securities exists before incurring the expense of filing with SEC. Thus, if certain conditions are met, a business may issue written or oral statements asking whether investors would be interested in purchasing its securities. If there is insufficient interest, the business is spared the expenses associated with filing with SEC. Another advantage of Regulation A is that issuers can use SCOR and regional reviews in the states where they are available.[22] (SCOR and regional reviews are discussed in detail in the next section of this report.) Also, like certain Regulation D offerings, Regulation A offerings can be made over the Internet.

Market participants we interviewed stated that the requirement to register issues under $5 million with both SEC and the states is burdensome for small businesses. One state regulatory official told us that one of the problems in coordination between state regulators and SEC is inconsistency in time periods for comments and eligibility requirements

[22]Regional review is a program in which several states from a given region coordinate their regulatory review of a filing and issue one comment letter to the issuer within a standard agreed-upon time frame.

for testing the waters. Another problem with Regulation A offerings that were identified by several interviewees is that the under $5 million offering size is often too small to attract broker-dealers who can distribute the securities to investors. Some interviewees recommended that the Regulation A threshold be increased from $5 to $10 million. A securities lawyer we interviewed suggested that Regulation A offerings be exempt from SEC and state registration requirements.

Steps Taken to Reduce Regulatory Burden and Increase the Availability of Small Business Information

In addition to the various exemptions from federal registration requirements, the states and others have taken steps to reduce the regulatory complexity and cost that small businesses face in multistate offerings of securities. The states have also made efforts to increase the availability of information about small businesses seeking to raise equity capital. Various state-level programs coordinated by NASAA focus on simplifying the preparation of state-required disclosure documents and streamlining state-level reviews of multistate securities offerings. In addition, SBA-OA has established an Internet-based service to increase the availability of information about small companies seeking equity capital from business angels and venture capital funds. Appendix IV presents additional efforts of state and federal agencies to increase small businesses' access to equity capital markets.

State Programs Are Designed to Simplify and Streamline Processes in Multistate Securities Offerings by Small Issuers

Through NASAA, state securities regulators have developed model regulations and legislation that states can adopt to simplify state registration requirements for small issuers planning to raise capital in more than one state. Virtually all states have adopted SCOR, an initiative developed by NASAA in conjunction with the American Bar Association. SCOR is designed to simplify and reduce the costs of registration of securities for small businesses seeking to raise seed capital and is available to issuers relying on exemptions found in Regulation A, rule 504, or the intrastate offering exemption. SCOR offers a simplified question-and-answer registration form (form U-7) that also can be used as the disclosure document for investors in rule 504 offerings.

According to a 1999 NASAA written statement, SCOR has been used by more than 1,000 companies to raise capital since its 1989 inception. SCOR appears to work best for companies that have an existing client base or a well-defined affinity group for marketing purposes. According to an industry source, the success rate (i.e., raised minimum offering dollar amount) of raising money via SCOR offerings varies widely by state but averages about 35 percent for the businesses that initiate the process. The estimated average cost of a SCOR offering is about $30,000, according to an industry source. However, some market participants we interviewed thought that raising capital via SCOR had limited credibility among brokers and investors. A NASAA official said that it is not the SCOR form on which the offering is registered that limits the credibility of the offering but the size of the offering, which cannot attract investment bankers to distribute the securities.

The Regional Review Program Streamlines State Review of SCOR Forms

Many states use the Regional Review Program, established in 1996, in their review of state registrations using the SCOR form. A regional review of a security offering streamlines the review process, thereby potentially saving issuers time and money. Under the Regional Review Program,

- the issuer files a registration application in the states in which it intends to sell securities and requests a coordinated review;
- participating states forward comments on the initial application to the designated lead state, and the designated lead state forwards one comment letter to the issuer, generally within 3 to 4 weeks of application receipt;
- the issuer responds and the response is communicated to the designated lead state; and
- by prior agreement, all participating states clear the comments when the designated lead state clears comments, generally within 5 business days of receiving issuer’s response.

Each state participating in the Regional Review Program agrees to apply uniform standards regarding such matters as the time frame for issuing comments and the type of comments to be issued in reviewing registration applications.[23] According to NASAA officials, 5 regional review programs have been established in which 36 states are participating, and a 6th program is being established to cover the southeastern part of the country. Also, 75 offerings have been attempted under the Regional Review Program to date.

CER Program Coordinates Multistate Review for Offerings Over $5 Million

The Coordinated Equity Review (CER) Program, initiated in 1997, is designed by NASAA to lower the cost associated with equity offerings by providing for a coordinated state review process for offerings of equity securities registered at the federal level and in multiple states. Under the CER Program, as under the Regional Review Program, the participating states coordinate to produce one comment letter to an issuer that addresses both substantive, “merit,” and disclosure matters. Pennsylvania is the administrator for the CER Program. According to NASAA officials, under the CER Program’s protocol, the comment letter must be issued no

[23]Participating states in the Regional Review Program follow NASAA’s Statements of Policy, which are uniformity guidelines for state securities regulators to follow in the review of registrations.

later than 19 days after the filing is received in Pennsylvania. NASAA officials note that 39 of the 42 states that review offerings registered at the federal level are participants in the CER Program, and 54 offerings have been filed, with 24 becoming effective under CER.[24] According to a state regulator, 54 does not appear to be a large number of filings in comparison to the number of offerings that are eligible to use the CER Program.[25] However, he said that NASAA is continuously trying to educate issuers, underwriters, and securities attorneys about the availability of the program and its potential benefits.

Market Participants Support Coordination Programs

According to market participants we interviewed and feedback that SEC and NASAA have received from issuers and securities attorneys, the coordinated review programs are steps in the right direction for promoting greater uniformity in and streamlining the state securities registration process. Market participants we interviewed would like to see more states participating in the programs and greater coordination among regional review programs regarding the time frames for issuing comments.

SBA's ACE-Net Program Is Designed to Increase the Availability of Information for Investors in Unregulated Equity Capital Markets

SBA-OA created ACE-Net in 1996 in response to the perceived needs of small businesses for equity capital in amounts of $250,000 to $5 million. ACE-Net (Access to Capital Electronic Network) is a secure, password protected, Internet-based listing service that is designed to link institutional and individual accredited investors with fast-growing businesses seeking equity capital. As of July 2000, about 40 states had agreed to a uniform set of disclosure documents and to a model accredited investor exemption. Investors in those states can use ACE-Net to electronically access information about deals nationwide.

SBA-OA has recruited over 60 state- or university-based network operators to work with entrepreneurs and business angel investors as a means of increasing the amount of equity capital to the underserved areas of the country. SBA-OA officials and a director of an ACE-Net site we interviewed told us that ACE-Net operators administer the management of the program by providing mentoring and counseling to entrepreneurs and business angel investors on various issues relating to running a small

[24]Eight states (Colorado, Florida, Georgia, Hawaii, Illinois, Louisiana, New York, and Wyoming) and the District of Columbia do not require state-level review of this type of filing and, therefore, are not included in the CER Program.

[25]An average of 430 registration statements, using the form SB-2, have been filed with SEC annually between 1994 and 1999. According to an SEC official, most issuers that file their registration statements on form SB-2 must also register their offerings at the state level and, therefore, would be eligible for the CER Program if the states where they expect to sell the securities also participate in CER.

business and seeking equity capital. As of 1999, ACE-Net had listed 162 businesses in a variety of industries and was processing another 150 applications for listing. However, the number of companies listed falls short of the critical mass of about 500 companies that the SBA's Chief Counsel for Advocacy says the program needs to be recognized by investors as a viable service. Negotiations are under way to privatize ACE-Net.

Investors we interviewed stated that they were concerned about the investment quality of the companies listed on ACE-Net and believed that SBA should do a better job of screening companies. Entrepreneurs we interviewed expressed concerns regarding the lack of information about ACE-Net's financing successes. However, according to the Chief Counsel for Advocacy, the "no-action" letter granted by SEC—which allows ACE-Net to operate without being registered as an exchange, broker-dealer, or investment advisor—does not allow SBA-OA to analyze, advertise, or release information about the merits of particular investment opportunities and is not permitted to screen companies.

State Governments Have Made Efforts to Encourage Small Business Investment

State governments have also initiated a variety of efforts to encourage small business capital formation. These efforts include, among others, training business angels in how to make investments and organize themselves; training entrepreneurs how to obtain equity financing for their ventures; and underwriting visibility events, such as venture fairs or venture networks, to link entrepreneurs to investors. For example, Iowa sponsored an 1-day event in Des Moines in which a selected group of business angels from around the state gathered to learn how to evaluate and make investments and organize themselves. The participants were expected to share this knowledge with other angel investors.

Conclusions

In 1996, SBA-OA sponsored a study, which was based in part on the results of several focus groups that it conducted, to estimate the equity capital need of small businesses. The study identified unmet needs for equity capital. Estimates from our analysis of available industry data indicated that the total of small business equity capital financing provided in 1999 by venture capital funds, SBICs, IPOs, and private placements of securities was about $107 billion. This amount represents almost a six-fold increase from the amount in 1994 (about $18 billion) and an increase of about 270 percent over the total estimated amount from those sources in 1996 (about $29 billion). However, the extent to which the recent increases in equity financing have helped to fill the unmet need identified by SBA-OA's 1996 estimate is not clear. The average amount of a venture capital fund investment has increased suggesting that, in general, venture capital funds may have become a less likely source of equity financing in the $250,000 to $5 million range.

In addition, venture capital fund investments tend to be concentrated in certain geographical areas and certain industries, raising questions about whether unmet needs in different parts of the country and industries are being addressed. Furthermore, business start-ups have also increased. Finally, business angel investors, for whom financing data are not available, are considered an important source of equity capital funds for small businesses. SBA-OA officials we interviewed continued to believe that, despite the growth in the total dollar volume of venture capital fund investments, available evidence supports their assessment that a major equity financing shortage persists for small businesses needing amounts of $250,000 to $5 million.

The extent to which equity capital is well suited to meet the needs of small businesses is associated with several interrelated factors. First, many small business owners do not want to issue external equity capital because they want to retain control of the business. Second, market practices, which reflect the efforts of investors and other market participants to maximize returns and manage risk on investments, serve to limit equity investments in small businesses. For example, investors perceive small business investment to be high risk and so require high potential returns to compensate for that risk. In addition, the cost of obtaining information on small businesses can be high, and investors require some control of the businesses to help manage the risk of their investment. Third, although securities laws and regulations facilitate information disclosures that can improve investor confidence, they impose disproportionate costs on small businesses because IPOs are more costly for small businesses compared with large businesses. The results of our analysis of IPO offerings indicate that the average total cost to conduct a small business IPO during 1994-99 was about 10 percent of total offering proceeds, while the average total cost for a large business IPO was about 8 percent.

Market participants we interviewed identified perceived obstacles faced by small businesses in gaining access to equity capital. Federal securities regulators have simplified federal registration of securities offerings and exempted certain small business securities offerings from several requirements in an attempt to reduce the regulatory burden and costs for small businesses in equity capital formation. State governments have also taken steps in an attempt to reduce the regulatory burden and costs for small businesses seeking equity capital financing in the regulated securities markets. However, some market participants we interviewed believe more can be done, including, for example, increasing dollar limits on securities offerings allowed under certain exemptions, encouraging greater commonality in certain federal and state registration requirements, and encouraging commonality among state registration requirements. These suggested changes merit future consideration and should be analyzed within the context of enhancing small business access to equity capital while ensuring that securities laws foster investor protection and confidence.

Agency Comments

We requested comments on a draft of this report from the heads, or their designees, of SEC, NVCA, SBA, and NASAA. All four entities provided technical comments, which we have incorporated where appropriate. NVCA and SBA-OA provided written comments that are reprinted in appendixes V and VI, respectively.

NVCA generally commended our work and expressed its views on several related topics including the need to increase the number of small businesses eligible to use forms SB-1 and SB-2 registration; governmental and non-governmental actions that have increased the barriers to accessing capital markets or increased the cost of capital for small businesses; and the effect that the elimination of pooling of interests accounting would have on venture capital financing.

SBA-OA complimented our draft report as providing valuable information for policymakers on what is occurring in the equity markets. SBA-OA also expressed views on 1) the difficulty of documenting the equity capital needs of small businesses due to a lack of precise data; 2) market barriers and regulatory requirements that hinder small business access to equity capital; 3) the limited number of small businesses receiving equity financing; and 4) the need to further study small businesses' ability to access the equity capital markets.

As agreed with your office, unless you announce the contents of this report earlier, we plan no further distribution until 30 days from the date of this letter. At that time, we will send copies of this report to Senator John F. Kerry, Ranking Minority Member, Senate Committee on Small Business; Senator Phil Gramm, Chairman, and Senator Paul S. Sarbanes, Ranking Minority Member, Senate Committee on Banking, Housing and Urban Affairs; Representative Jim Leach, Chairman, and Representative John J. LaFalce, Ranking Minority Member, House Committee on Banking & Financial Services; Representative James M. Talent, Chairman, and Representative Nydia M. Velazquez, Ranking Minority Member, House Committee on Small Business; the Honorable Aida Alvarez, Administrator, SBA; the Honorable Arthur Levitt, Chairman, SEC; Mr. Mark G. Heesen, President of NVCA; Mr. Marc Beauchamp, Executive Director of NASAA; and other interested parties. Copies will also be made available to others upon request.

The major contributors to this report are acknowledged in appendix VII. If you have any questions about this report, please call me or William Shear at (202) 512-8678.

Sincerely yours,

Richard J. Hillman

Richard J. Hillman
Associate Director, Financial
Institutions and Markets Issues

Contents

Abbreviations

ACE-Net	Access to Capital Electronic Network
Amex	American Stock Exchange, Inc.
CER	Coordinated Equity Review
DPO	direct public offering
HL	Hahnemann Laboratories, Inc.
IPO	initial public offering
MAIE	model accredited investor exemption
NASAA	North American Securities Administrators Association, Inc.
NASDR	National Association of Securities Dealers Regulation, Inc.
NSMIA	National Securities Markets Improvement Act
NVCA	National Venture Capital Assocation
NYSE	New York Stock Exchange, Inc.
SBA	Small Business Administration
SBA-OA	SBA-Office of Advocacy
SBIC	Small Business Investment Company
SCOR	Small Company Offering Registration
SEC	Securities and Exchange Commission
TFSD	Thomson Financial Securities Data
ULOE	uniform limited offering exemption

A Small Business Goes Public Via a Direct Public Offering

This appendix presents a chronology discussion of a small business attempting to raise equity capital by directly selling securities to investors without the assistance of an investment banker. Hahnemann Laboratories, Inc. (HL), provided this information.

Birth of Hahnemann Laboratories, Inc.

January 1985 to April 1994

The company, a retail pharmacy, was founded in 1985 in conjunction with a medical clinic (a separate corporation), which was formed by homeopathic physicians as a teaching clinic for promoting classic homeopathic medicine. Homeopathy is a 200-year-old natural system of using nontoxic medicines to relieve symptoms and cure disease. In 1986, Mr. Quinn, the company's founder, undertook a separate effort to compound homeopathic medicines. The new company was incorporated in 1992 as Hahnemann Medical Clinic Pharmacy, Inc. This name was changed to Hahnemann Laboratories, Inc., in 1994. Mr. Quinn, HL's President, Chief Executive Officer, and Chief Financial Officer, is a pharmacist.

HL packages medicines in kits that supply a range of commonly requested homeopathic medicines. In the spring of 1993, the company developed the Quinn Dispensing Kit Program. Each kit contains 240 homeopathic medicines. Later, Mr. Quinn established a goal of marketing 100 kits to homeopathic practitioners and these kits were to be produced at a cost of $2,500 each. To expand, HL estimated that it would need about $400,000 to cover the costs of U.S. Food and Drug Administration registration, accounting, printing, construction of a manufacturing laboratory, initial production, marketing, and working capital.

Search for Financing

April 1992 to September 1992

HL entered into merger discussions with other homeopathic firms but could not reach an agreement on the direction of the companies. Merging with another company would have given HL access to more sales representatives and additional funds.

May 1993

HL applied for a loan from the Small Business Administration but was denied due to a lack of collateral.

December 1993	Two business angel investors, one in August and the other in December, rejected HL.
August 1994	Mr. Quinn contacted a lawyer and a consultant who were engaged in (1) assisting small businesses to identify investors interested in particular products and (2) providing advice on making initial direct public offerings (DPO).
September 1994 to December 1994	Mr. Quinn prepared the prospectus on HL and documents necessary to make a Regulation A offering[1] on HL. Mr. Quinn submitted the documents to the Securities and Exchange Commission (SEC), including pro forma financial estimates for the next 5 years, and to the California Department of Corporations.

Satisfying SEC Requirements

July 1994 to December 1994	HL converted its accounting system to meet SEC requirements. The DPO consultant gave Mr. Quinn guidance on converting the system. HL hired a certified public accountant to perform the conversion. SEC approved HL's Regulation A offering.
March 1995	HL updated financial statements for SEC to obtain an extension to raise funds.

First Financing: Hahnemann Laboratories, Inc., Goes Public

January 1995 to August 1995	HL mailed letters to potential investors that HL had targeted as having an interest in its products. HL made contact with potential investors.
June 1995 to October 1995	HL made an initial public offering of 50,000 shares of common stock at $10 per share. From this offering, HL raised about $470,000. Twenty percent ($94,000) of the funds were used to pay fees and costs of printing and mailings. The remainder was spent on building a laboratory, equipment, production costs, staffing, materials, and outside consultants.

[1] A Regulation A offering allows a company to raise up to $5 million annually.

Methods and Fees for Registering Offerings of Securities Under State Blue-Sky Laws

Each state regulates the sale of securities within its borders. These regulations, generally referred to as the blue-sky laws, prescribe three methods of registering securities offered for sale within the state. These registration methods are notification, qualification, and coordination.

The notification method requires a notice filing[1] with the state and is reserved for mature issuers that satisfy a certain net earnings test. The qualification method is used for any security not exempt from the state registration requirements. Registration by qualification, like registration at the federal level, requires the issuer to file a registration statement satisfying requests for approximately 16 categories of information, and the state administrator is given a wide range of authority to deny the effectiveness of a registration statement. This method frequently includes merit review of the securities being offered. According to NASAA officials, the coordination method is most often used in equity offerings and is available to issuers who have registered their offerings with SEC. These issuers can file copies of the SEC registration statement and any amendments with the state administrator. The registration typically becomes effective at the state level the moment it becomes effective at the federal level. Registration by coordination streamlines the content of the registration statement and the procedure by which it becomes effective, but not the substantive standards governing its effectiveness. Thus, registration by coordination is subject to merit review.

Table II.1 describes the fees charged by state for each method of registration (see table note). Fees paid by small business issuers vary, depending on the state where the issuer registered the securities. As shown in this table, under the qualification method, a small business issuer seeking to secure $3 million would pay a minimum of $2,500 to qualify in California, $1,500 in Georgia, $300 in Idaho, and $500 in Virginia.

[1]The notification filing contains a description of the security being offered, the offering price, any underwriter's discounts or commissions, finder's fees, selling expenses, a copy of the underwriting agreement, a description of stock options to be offered, a copy of the prospectus, and any other information circulated in connection with the offering.

Table II.1: Fees for Registration of Initial Offerings Under State Blue-Sky Laws

	Method of registration		
State	**Notification**	**Coordination**	**Qualification**
Alabama	$40 and 1/10 of 1% of AOP, $1,000 maximum	$40 and 1/10 of 1% of AOP, $1,000 maximum	$40 and 1/10 of 1% of AOP, $1,000 maximum
Alaska	$100 nonrefundable fee and $500 refundable if for 1 year; or $100 nonrefundable and $1,100 refundable, if automatic extension for 1 year	$100 nonrefundable fee and $500 refundable if for 1 year, or $1,100 refundable if automatic extension for 1 year	$100 nonrefundable fee and $500 refundable if for 1 year or $1,100 refundable if automatic extension for 1 year
Arizona	1/10 of 1% of AOP, $200 minimum, $2,000 maximum	N/A	1/10 of 1% of AOP, $200 minimum, $2,000 maximum
Arkansas	1/10 of 1 % of maximum AOP, $150 minimum, $2,000 maximum; sales over 105% of AOP, $200 penalty	1/10 of 1% of maximum AOP, $150 minimum, $2,000 maximum; sales over 105% of AOP, $200 penalty	1/10 of 1% of maximum AOP, $150 minimum, $2,000 maximum; sales over 105% of AOP, $200 penalty
California	$200 and 1/5 of 1% of aggregate value of securities proposed to be sold, $2,500 maximum	$200 and 1/5 of 1% of aggregate value of securities proposed to be sold, $2,500 maximum	Small company qualification by permit: $2,500 and additional fee in certain circumstances, not to exceed $1,000.
Colorado	N/A	$200	$100 qualification fee; $200 for amendment
Connecticut	N/A	1/10 of 1% of maximum AOP, $300 minimum, $1,500 maximum	1/10 of 1% of maximum AOP, $300 minimum, $1,500 maximum
Delaware	N/A	½ of 1% of maximum AOP, $200 minimum , $1,000 maximum for small company offering	½ of 1% of maximum AOP, $200 minimum, $1,000 maximum for small company offering
Florida	$1,000 nonrefundable application fee	$1,000 nonrefundable application fee	$1,000 nonrefundable application fee
Georgia	1/20 of 1% of maximum AOP, $250 minimum	N/A	1/20 of 1% of maximum AOP, $250 minimum
Guam	5/100 of 1/5 of maximum AOP, $25 minimum, $500 maximum	5/100 of 1/5 of maximum AOP, $25 minimum, $500 maximum	5/100 of 1/5 of maximum AOP, $25 minimum, $500 maximum
Hawaii	1/20 of 1% of AOP, $500 maximum	N/A	1/10 of 1% of AOP, $250 minimum, $2,500 maximum
Idaho	$300 flat fee	$300 flat fee	$300 flat fee
Illinois	N/A	1/20 of 1% of defined maximum AOP, $500 minimum, $2,500 maximum	If registered under the Securities Act of 1933, 1/20 of 1% of defined maximum AOP, minimum $500, maximum $2,500 + $300 examination fee; If not registered with SEC, $250 filing fee, $150 examination fee, and $25 amendment examination fee
Indiana	N/A	1/20 of 1% of maximum AOP, $250 minimum, $1,000 maximum; $25 amendment fee	1/20 of 1% of maximum AOP, $250 minimum, $1,000 maximum; $25 amendment fee
Iowa	N/A	1/10 of 1% maximum AOP, $50 minimum, $1,000 maximum	1/10 of 1% maximum AOP, $50 minimum, $1,000 maximum

	Method of registration		
State	**Notification**	**Coordination**	**Qualification**
Kansas	.05% of AOP, $100 minimum each statement, $1,500 maximum; $100 application fee for amendment	.05% of AOP, $100 minimum each statement, $1,500 maximum; $100 application fee for amendment	.05% of AOP, $100 minimum each statement, $1,500 maximum; $100 application fee for amendment
Kentucky	$125 exam fee and 3/50 of 1% of AOP, $60 minimum, $1,200 maximum	$125 examination fee and 3/50 of 1% of AOP, $60 minimum, $1,200 maximum	$125 examination fee and 3/50 of 1% of AOP, $60 minimum, $1,200 maximum
Louisiana	1/10 of 1% of AOP; $100 minimum, $1,000 maximum, and $250 expense charge	N/A	1/10 of 1% of AOP, $100 minimum, $1,000 maximum and $250 expense charge
Maine	$500 for registration statement for each class of security registered	$500 for registration statement for each class of security registered	$500 for registration statement for each class of security registered and $300 where total raised does not exceed $1 million
Maryland	1/10 of 1% of maximum AOP, $500 minimum, $1,500 maximum	1/10 of 1% of maximum AOP, $500 minimum, $1,500 maximum	1/10 of 1% of maximum AOP, $500 minimum, $1,500 maximum
Massachusetts	N/A	1/20 of 1% of aggregate amount of offering, $300 annual minimum, $1,500 annual maximum	1/20 of 1% of aggregate amount of offering, $300 annual minimum, $1,500 annual maximum
Michigan	1/10 of 1% of maximum AOP; $100 minimum, $1,250 maximum; $10 certificate of existence and status of issuer	1/10 of 1% of maximum AOP, $100 minimum, $1,250 maximum; $10 certificate of existence and status of issuer	1/10 of 1% of maximum AOP, $100 minimum, $1,250 maximum; $10 for certificate of existence and status of issuer
Minnesota	$100 and 1/10 of 1% of maximum AOP, combined $300 maximum; $25 amendment; if increase in selling price, additional fee	$100 and 1/10 of 1% of maximum AOP, $300 combined maximum; $25 amendment, additional fee if increase in selling price	$100 and 1/10 of 1% of maximum AOP, $300 combined maximum; $25 amendment, additional fee if increase in selling price
Mississippi	$300	1/10 of 1% of amount registered, $150 minimum, $1,000 maximum	1/10 of 1% of amount registered, $150 minimum, $1,000 maximum
Missouri	$100 for up to $100,000; over $100,000, 1/20 of 1% of amount by which maximum AOP registered securities offered in state exceeds $100,000; $900 maximum and $100 filing fee	$100 for up to $100,000, over $100,000, 1/20 of 1% of amount by which maximum AOP registered securities offered in state exceeds $100,000, $900 maximum, $100 filing fee	$100 for up to $100,000; over $100,000, 1/20 of 1% of amount by which maximum AOP registered securities offered in state exceeds $100,000; $900 maximum and $100 filing fee
Montana	$200 for first $100,000 or portion and 1/10 of 1% for excess over $100,000, $1,000 maximum; excess sales where amendment is not filed requires payment of 3 times the normal fee	$200 for first $100,000 or portion and 1/10 of 1% for excess over $100,000, $1,000 maximum; excess sales where amendment not filed require payment of 3 times normal fee	$200 for first $100,000 or portion; 1/10 of 1% for excess over $100,000; $1,000 maximum; excess sales where amendment not filed requires payment of 3 times normal fee
Nebraska	1/10 of 1% of AOP, $100 minimum	1/10 of 1% of AOP, $100 minimum	1/10 of 1% of AOP, $100 minimum
Nevada	1/10 of 1% of AOP, $350 minimum, $2,500 maximum	1/10 of 1% of AOP, $350 minimum, $2,500 maximum	1/10 of 1% of AOP, $350 minimum, $2,500 maximum
New Hampshire	2/10 of 1% of offering value, $1,050 maximum and $200 examination to qualify	2/10 of 1% of offering value, $1,050 maximum and $200 examination fee to qualify	2/10 of 1% of offering value, $1,050 maximum and $200 examination fee to qualify
New Jersey	$1,000 nonrefundable fee	$1,000 nonrefundable fee	$1,000 nonrefundable fee

	Method of registration		
State	**Notification**	**Coordination**	**Qualification**
New Mexico	1/10 of 1% of AOP, $525 minimum, $2,500 maximum	1/10 of 1% of AOP, $525 minimum, $2,500 maximum	1/10 of 1% of AOP, $525 minimum, $2,500 maximum
New York	$75 state notice; $75 for further state notices; intrastate offerings: 1/2 of 1% of maximum AOP, $25 minimum, $1,500 maximum	N/A	N/A
North Carolina	$2,000 initial and renewal fees; $50 additional securities filing fee	$2,000 initial and renewal fees; $50 additional securities filing fee	$2,000 initial and renewal fees; $50 additional securities filing fee
North Dakota	1/20 of 1% of AOP, $100 minimum, $500 maximum	N/A	1/10 of 1% of AOP on first $750,000; 1/20 of 1% of amount over $750,000; $100 minimum for each class of securities
Ohio	1/10 of 1% of AOP, $100 minimum, $1,000 maximum; for certain securities, flat fees as prescribed	$100 and 1/10 of 1% of AOP, $100 minimum, $1,000 maximum	$100 and 1/10 of 1% of AOP, $100 minimum, $1,000 maximum
Oklahoma	$200 examination fee and 1/10 of 1% of AOP, $200 minimum, $2,500 maximum; Oklahoma issuers: $200 and 1/20 of 1% of amount registered; $100 minimum, $2,500 maximum	$200 examination fee and 1/10 of 1% of AOP, $200 minimum, $2,500 maximum; Oklahoma issuers: $200 and 1/20 of 1% of amount registered; $100 minimum, $2,500 maximum	$200 examination fee and 1/10 of 1% of AOP, $200 minimum, $2,500 maximum; Oklahoma issuers: $200 and 1/20 of 1% of amount registered; $100 minimum, $2,500 maximum
Oregon	N/A	Examination: $1 per $1,000 of AOP on first $100,000 or fraction; $.50 per $1,000 on next $200,000 or fraction; $25 for each additional $100,000 or fraction; $25 minimum, $500 maximum; sales in excess of quantity registered $25 minimum	Examination: $1 per $1,000 of AOP on first $100,000 or fraction; $.50 per $1,000 on next $200,000 or fraction; $25 for each additional $100,000 or fraction; $25 minimum, $500 maximum; sales in excess of quantity registered $25 minimum
Pennsylvania	N/A	$500 based on maximum AOP less than $10 million; $750 for $10 million or more	$350 and 1/20 of 1% of maximum AOP, $2,150 maximum
Rhode Island	1/10 of 1% of max AOP, $300 minimum, $1,000 maximum	1/10 of 1% of maximum AOP, $300 minimum, $1,000 maximum	1/10 of 1% of maximum AOP, $300 minimum, $1,000 maximum
South Carolina	$500 fee; $25 fee for prospectus or offering circular accompanying registration application	$500 fee; $25 fee for prospectus or offering circular accompanying registration application	$500 fee; $25 fee for prospectus or offering circular accompanying registration application; $50 fee for review of prospectus or offering circular to determine eligibility of securities for registration
South Dakota	N/A	$1 per $1,000 on first $500,000 of sale price; $500 and $.75 per $1,000 of excess over $500,000; $100 minimum; $25 amendment fee plus fees described above	$1 per $1,000 on first $500,000 of sale price; $500 and $.75 per $1,000 of excess over $500,000; $100 minimum; $25 amendment fee, plus fees described above

	Method of registration		
State	Notification	Coordination	Qualification
Tennessee	N/A	1/10 of 1% of offering price, $300 minimum, $1,000 maximum; $300 for limited offering; $25 late registration fee	1/10 of 1% of offering price, $300 minimum, $1,000 maximum; $300 for limited offering; $25 late registration fee
Texas	Examination, 1/10 of 1% offering price of securities sold in state and $10 filing for original application fee; sales in excess of registration 3 times difference in fees, plus $10	Examination: 1/10 of 1% offering price of securities sold in state and $10 filing for original application; sales in excess of registration 3 times difference in fees, plus $10	Examination: 1/10 of 1% offering price of securities sold in state and $10 filing for original application; sales in excess of registration 3 times difference in fees, plus $10
Utah	$300	$750	$300
Vermont	.50% on each $1,000 par value stock (no-par stock, or par less than $100, offering price), $20 minimum, $200 maximum	N/A	1/10 of 1% ($1 each $1,000 of AOP), $400 minimum (covers up to $400,000), $125 maximum
Virginia	1/20 of 1% of maximum AOP, $100 minimum, $250 maximum	1/20 of 1% of maximum AOP, $200 minimum, $700 maximum	1/10 of 1% of maximum AOP, $250 minimum, $500 maximum
Washington	N/A	$100 on first $100,000 and 1/40 of 1% for excess for 12-month period; $100 for each additional 12 months	$100 on first $100,000 of offering price and 1/20 of 1% for excess.
West Virginia	1/20 of 1% of maximum AOP, $50 minimum, $1,500 maximum	1/20 of 1% of maximum AOP, $50 minimum, $1,500 maximum	1/20 of 1% of maximum AOP, $50 minimum, $1,500 maximum
Wisconsin	N/A	$750	$750
Wyoming	1/50 of 1% of total offering amount in Wyoming, $200 minimum, $600 maximum	1/50 of 1% of total offering amount in Wyoming, $200 minimum, $600 maximum	1/50 of 1% of total offering amount in Wyoming, $200 minimum, $600 maximum

Note: These registration fees are only one of several types of fees that states can charge business issuers. This table does not include a description of the other types of fees since the focus is to describe the initial fees that can be charged to small business issuers.

Legend: AOP aggregate offering price
N/A not applicable

Source: Blue Sky Law Reporter, CCH Paragraph 6501, October 1999. Reproduced with permission from BLUE SKY LAW REPORTER published and copyrighted by CCH INCORPORATED 2700 Lake Cook Road, Riverwoods, Illinois 60015.

Federal and State Agencies Have Taken Some Actions to Help Small Businesses Raise Capital While Protecting Investors

Companies intending to raise capital by selling securities to the public generally are required to file a registration statement with SEC and state regulators and to supply investors with an offering document. Federal and state securities laws aimed at protecting investors prohibit false and misleading statements in connection with the offer or sale of securities. Such statements include communications and documents supplied to investors and documents filed with SEC and state regulators. In an attempt to assist small businesses in capital formation while balancing the need to protect investors, Congress and the securities regulators have simplified the registration process and provided small businesses with exemptions from federal registration requirements on the basis of the dollar size of the offering, location of the offering, and number and type of investors. However, offerings exempt from federal registration requirements are not always exempt from state registration requirements. If no state exemptions exist, a company may have to register its securities offerings in each state where they are sold and must register some offerings with both federal and state regulators.

Federal Securities Laws Protect Investors by Requiring Disclosure of Material Information

Companies selling securities to the public must comply with the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act). The Securities Act requires companies to provide investors with the information that an investor would find important in deciding whether to purchase a company’s securities, and it prohibits material misrepresentations in the sale of securities. The Securities Act also requires companies to file a registration statement with SEC, which includes an offering document or prospectus to be supplied to investors. In a process known as disclosure review, SEC is to review the registration statement to determine whether it contains the required information. SEC does not evaluate whether the offering is fair to investors or whether statements in the offering documents are accurate. The purpose of these requirements is to ensure that investors have access to certain basic facts about securities before buying them. Furthermore, the antifraud provisions of the Exchange Act provide civil recovery rights to investors who purchase or sell securities on the basis of inaccurate public filings and suffer losses. The purpose of the antifraud provisions is to ensure that information provided to investors is accurate.

Federal Securities Laws Specify Registration Requirements

Before offering securities for sale to the public, issuers are required to file a registration statement with SEC. A company cannot sell its securities until SEC declares the registration statement effective. Registration statements must contain a prospectus that describes, among other things, the company’s business operations; financial condition; and management. Companies must give the prospectus to all investors that purchase its securities. Companies registering securities are required to use certain forms specified by SEC. If a company is a small business issuer (as described below), it can file its registration statement using a simpler, less costly form than the ones larger issuers can use.

Antifraud Provisions Provide Legal Remedies for SEC and Private Investors

Companies selling securities to the public to raise capital are also subject to sanctions outlined in the securities laws for fraudulent conduct in connection with securities sales. Material misstatements and omissions may result in SEC civil suits or administrative proceedings under the general antifraud provisions of the Securities Act and the Exchange Act. Private investors can also sue a seller of securities for material misstatements or omissions in connection with securities sales, and purchasers of securities can bring action when a registration statement contains material misstatements or omissions. The Exchange Act's antifraud provisions prohibit misstatements and omissions of material facts in connection with the purchase or sale of a security, even if the security is exempt from registration requirements. Under provisions of the Exchange Act, an investor may bring a claim against a company for material misstatements or omissions in any of its public filings for any losses incurred as a result of securities purchases or sales that are based on such misrepresentations or omissions.

Federal Exemptions and SEC Initiatives Expand Small Business Access to Equity Capital

To facilitate small businesses' access to equity capital, SEC allows small businesses to use a simplified registration form. The securities laws and SEC rules also contain several exemptions from SEC's registration requirements for small business issues. In addition, SEC allows issuers to save significant underwriting costs by issuing securities directly over the Internet.

Special Forms for Small Business Issuers Are Available

To minimize the costs of raising equity capital, SEC makes available streamlined registration processes for small business issuers with less than $25 million of revenues in the previous fiscal year and that also have outstanding stock of less than $25 million in value. SEC allows such small business issuers to file their registration statements using one of the two simplified small business forms. Small business issuers offering up to $10 million worth of securities in any 12-month period can use the form SB-1, which allows issuers to provide information in a question-and-answer format. Form SB-1 also requires audited financial statements for only the preceding 2 fiscal years, rather than for the 3 previous years, which is otherwise required by the regular S-1 registration form that applies to all issuers. Form SB-1 is used infrequently, according to SEC staff members. Issuers have used an average of 12 form SB-1s each year between 1994 and 1999, according to SEC data.

Another simple form available to small business issuers (form SB-2) allows an issuer to register an unlimited dollar amount of securities using a less extensive narrative than the regular form S-1. Form SB-2 also lets issuers provide audited financial statements for only 2 fiscal years. Issuers use form SB-2 more frequently than form SB-1. According to data provided by SEC staff, an average of 430 registration statements have been filed annually using the form SB-2 between 1994 and 1999.

The forms SB-1 and SB-2 have been estimated to save an issuer as much as $125,000 for an average offering. However, although these forms make it easier for small business issuers to register securities, an investment banker we interviewed told us that small business issues are viewed unfavorably because they are too small in size to be profitable to many investment banks. He further stated that such offerings are commonly distributed by third- and fourth-tier investment banks that lack market recognition, which can hurt in attracting investors.

The Internet Can Be Used for Initial Public Offerings by Small Businesses

The Internet provides an alternative to the traditional method of offering stock to the public that can eliminate some underwriting costs for companies of all sizes. The Internet especially enables smaller companies to raise capital through self-managed initial public offerings known as DPOs, which are generally not distributed by an underwriter and, therefore, are much less expensive. Underwriter fees, which are normally the largest cost involved in conducting a public offering, can range from 6 to 10 percent of the total dollar amount being raised. These fees can commonly total $300,000 to $500,000 for a typical public offering seeking to raise $5 million. The same securities laws govern securities offerings made over the Internet as traditional offerings distributed by underwriters, and the registration process is the same as the ones used for traditional securities offerings.

In an offering, during the period when a company decides to file a registration statement, a company is prohibited from making any communication that “conditions the market” for the securities it intends to offer. In an Internet offering during this period, for instance, hyperlinks to analyst reports and financial forecasts; projections; or other indications of the company’s value contained on a company’s Web page may be considered an impermissible communication.[1] During the date between the filing of the registration statement and the date that it becomes effective, only certain types of written offers are permitted and electronic communications must conform to SEC rules governing written offers.

[1]Such a communication, which is called “gun-jumping,” violates section 5(c) of the Securities Act.

Once the registration statement becomes effective, an issuer may deliver the final prospectus and any additional sales literature electronically only if the investor has consented to its delivery in electronic form. SEC has also stated that there is adequate delivery of the prospectus electronically if the investor has access to both the prospectus and the sales literature in close proximity to each other and, if the investor is able to view the sales literature, the investor must also able to view the final prospectus.

SEC Registration Exemptions Are Intended to Assist Small Businesses

Concerns have been and continue to be expressed by industry participants that the expense of registering with SEC for certain small business offerings impedes small businesses' ability to use the public capital markets for financing. In an attempt to ease this potential impediment, federal securities laws exempt certain securities offerings from registering with SEC, which saves certain issuers the expense of federal registration as well as other associated costs, such as certain accounting and legal fees.

Regulation D Represents an Attempt to Reduce Burdens Imposed by Federal Securities Laws

Regulation D was one of the results of SEC's evaluation of the impact of its rules and regulations on the ability of small business to raise capital, which revealed a concern that the registration requirements of the Securities Act imposed disproportionate restraints on small business issuers. Regulation D is designed to eliminate unnecessary restrictions that SEC rules place on small business issuers. While preserving protections for investors, Regulation D also was intended to promote uniformity between state and federal exemptions to facilitate capital formation for small businesses. Regulation D establishes three separate but interrelated exemptions, rules 504, 505, and 506.[2]

<u>Rule 504.</u> The first exemption, rule 504, provides an alternative to SEC registration for public or private offerings of up to $1 million. Rule 504 provides that a company offering up to $1 million of securities in a 12-month period does not have to file a registration statement with SEC. Rule 504 was designed to provide an exemption from federal registration requirements for small offerings by small issuers that are presumed to be regulated by the states because of the modest amount of the offering and the likelihood that sales will occur in a limited geographic area.

Like the other Regulation D exemptions, an issuer may not use public solicitation or advertising to market the securities, and purchasers receive "restricted" securities, meaning that they may not sell the securities without registration or an applicable exemption. However, unlike the other

[2]A notice of exempt sales (i.e., form D) is required to be filed with SEC within 15 days of the first sale of Regulation D securities.

Regulation D exemptions, under rule 504, (1) the company can issue its securities publicly using general solicitation[3] and advertising to market the securities and (2) purchasers can resell their securities, if the following conditions are met:

- the company registers its offering in a state that requires it to file a registration statement and to deliver a prospectus to investors before sale;
- the company registers and sells its securities in a state that requires registration and disclosure delivery and also sells its securities in a state without those requirements, as long as the company provides investors with the prospectus that is required by the state where the securities are registered; or
- the company can sell its securities according to state law exemptions that permit general solicitation and advertising, as long as it sells only to certain financially sophisticated investors known as "accredited investors."[4]

Rule 504 benefits small businesses because it allows them to avoid the significant costs they would otherwise incur in registering their securities with SEC. Another benefit is that an issuer can sell rule 504 securities to an unlimited number of investors. Other rule 504 benefits are the lack of a sophisticated investor requirement, which is required for certain other Regulation D exemptions, and the lack of a prohibition on general solicitations and advertising if the previously listed conditions are met.

However, issuers using the rule 504 exemption must register in every state in which the issuer offers the securities, unless there is an available state exemption. Since the majority of the states do not have exemptions for rule 504 offerings, an issuer choosing to sell securities in more than one state has to comply with each state's filing requirements. Additionally, states often have different filing and disclosure requirements for rule 504 offerings.

[3]"General solicitation" refers to the public dissemination of information regarding an anticipated or pending private offering. A series of SEC no-action letters indicates that a preexisting relationship between an offeror and the investor is an indication that general solicitation did not occur.

[4]An "accredited investor" is defined as: a bank, insurance company, registered investment company, business development company, or small business investment company; an employee benefit plan; 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 of 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 2 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 that is not formed to acquire the securities offered and whose purchase is directed by a sophisticated person.

Rule 504 offerings have steadily increased since 1994, when 2,357 offerings were made, through 1999, when 3,407 offerings were made, according to SEC data. Corporate attorneys and industry participants expressed a variety of views about rule 504 offerings. Some industry participants suggested that rule 504 offerings should be altogether exempted from state registration requirements to allow issuers to avoid the burden of having to register in each state. Others suggested that state blue-sky laws need to be simplified and made uniform to enable small businesses to access capital more readily.

The North American Securities Administrators Association, Inc. (NASAA) officials have stated that the development of the Small Company Offering Registration (SCOR) initiative eases the burdens created by state registration requirements for rule 504 offerings. NASAA, in conjunction with the American Bar Association, developed the SCOR initiative in 1988, which allows issuers to use a simplified “question-and-answer” registration form that also can be used as the disclosure document for investors for rule 504 offerings. According to NASAA officials, it costs an average of about $30,000 to do a SCOR offering. Further, many of the 49 states that recognize SCOR filings coordinate such filings through the Regional Review Program, which provides a uniform state registration procedure for coordinating and expediting the registration process in all states in the region in which the issuer seeks to sell its securities. According to one state regulatory official, an important feature of SCOR and regional review is that states involved in the programs have agreed to uniform registration standards in the review and issuance of comments.

Rule 505. A second Regulation D exemption, rule 505, is an option for issuers who wish to make private offerings of securities of up to $5 million in a 12-month period. The purpose of this exemption is to provide a uniform federal and state exemption as Congress directed in section 19(c) of the Securities Act. Indeed, in 1983, a parallel initiative to rule 505 was the adoption at the state level of NASAA’s Uniform Limited Offering Exemption (ULOE). According to NASAA officials, ULOE is available in approximately 45 states.

Under rule 505, an issuer may sell to an unlimited number of accredited investors[5] and up to 35 other persons who do not need to satisfy a sophistication or wealth standard. The issued securities are restricted and cannot be resold by investors unless the issuer registers the securities or

[5]Regulation D provides that regarding the purchaser’s qualifications, all that is required is that the issuer reasonably believes that the purchaser’s qualifications and limitations have been met.

there is an available exemption. In addition, the company may not use general solicitation or advertising to sell the securities. An indication that an offer is free from general solicitation is that an offeror has a preexisting relationship with the offeree that it solicits. Unlike rule 504, regarding the unaccredited investors, the company must provide an offering document similar to the document that is required in a registered offering, which includes financial statements that are certified by an independent public accountant.

One commentator noted that rule 505's more extensive disclosure requirement (as compared with rule 504) is appropriate because of the increased size of the transaction, which would necessitate more investor protection.[6] Like rule 504, rule 505 exempts offerings from federal registration. However, such securities are required to be registered in each state in which they are offered, unless a state exemption is available. Although ULOE is available in 45 states, the requirements are not necessarily uniform among the states. According to SEC data, rule 505 offerings have dramatically decreased from 2,163 offerings in 1994 to 1,016 offerings in 1999.

Industry participants complain that the prohibition against general solicitations and advertising further lessens the appeal of rule 505 offerings to issuers. For that reason, some participants have suggested that SEC eliminate the restriction on advertising and general solicitation for rule 505 offerings, and other industry participants have suggested that rule 505 offerings be exempt from state registration requirements. However, according to an SEC official, SEC is not inclined to eliminate the general solicitation restrictions on rule 505 offerings, because such restrictions are among the attributes of a private placement that distinguishes it from a public offering.

<u>Rule 506.</u> A third Regulation D exemption, rule 506, tends to be used more frequently than the other exemptions. Issuers, especially those raising more than $5 million in a private offering, find the rule 506 exemption particularly attractive because it allows a company to raise an unlimited amount of capital from an unlimited number of accredited investors and up to 35 other sophisticated purchasers. Issuers also view the rule 506 exemption favorably because rule 506 offerings are exempt from state

[6]In a rule 505 offering, the issuer and its officers and directors must not be disqualified under certain "bad person" provisions (i.e., a pending indictment; a criminal conviction within the last 10 years; an injunction; stop order and suspension proceedings; postal fraud; and disciplinary orders issued by SEC, a securities exchange, or other securities organization, in each case, resulting from some aspect of the securities business).

registration requirements. According to SEC data, rule 506 offerings have increased dramatically from 5,414 offerings in 1994 to 13,112 rule 506 offerings in 1999.

As with rule 505, rule 506 prohibits companies from using general solicitation or advertising to market the securities. Moreover, with both rules 505 and 506, the offeror generally has a preexisting relationship with any offeree that it solicits. Differences between rules 505 and 506, however, are that under rule 506, all nonaccredited investors must be sophisticated and they must have sufficient knowledge and experience in financial and business matters as well as access to sufficient information to be capable of evaluating the investment. The company must also give nonaccredited investors disclosure documents that generally are the same as those used in registered offerings. Rule 506 financial statement requirements are the same as those for rule 505. In addition, purchasers under rule 506, as with rule 505 offerings, receive restricted securities, which means that unless the issuer registers the securities or the investor obtains an exemption at the federal and state level, the investor may not freely sell the securities.

Unlike offerings made under rule 504 and 505 exemptions, offerings made pursuant to the requirements of rule 506 are automatically excluded from state registration requirements because of the National Securities Markets Improvement Act (NSMIA). However, industry participants complain that the restriction on general solicitation and advertising impedes small businesses that need to search for investors through solicitation or advertising. Some securities attorneys have suggested that rule 506 be amended so that general solicitation and advertising are permitted. In June 1995, SEC sought comments on an amendment to Regulation D that would eliminate the prohibition against general solicitation for rules 505 and 506 offerings. Although SEC deferred taking action on the general solicitation question, it indicated that it would consider comments regarding the question in connection with a future initiative.[7]

Another complaint by industry participants is that rule 506 is only available for issuer transactions and that it cannot be invoked for subsequent sales by accredited investors. Thus, an investor must find an exemption from the federal and state registration requirements or the issuer must register the securities. Regarding exemptions, at the federal level, SEC rule 144 permits the resale of unregistered securities by individuals if certain requirements

[7]Furthermore, NASAA officials believe that the bad person provisions should be extended to rule 506 offerings so that violators of the securities laws do not have an avenue to commit fraud again.

are met. Rule 144 requires that adequate information concerning the issuer must be available, that the individual must have held the securities for at least 1 year, and that only a limited number of shares may be sold. Industry participants also cited as a problem the lack of uniformity at the state level in exemptions for the resale of unregistered securities. They said that a small business' ability to raise capital is ultimately affected since it is difficult to sell securities initially when a secondary market for the securities is lacking.

Exemptions Are Available for Offerings Under $5 Million in an Effort to Reduce Costs for Small Offerings

Other exemptions that are available for offerings under $5 million are the Regulation A offering exemption, the accredited investor exemption, the California Limited Offering Exemption,[8] the employee benefit plans, and the intrastate offering exemption. Each is described below.

Regulation A. Although Regulation A is termed an "exemption," it actually provides a simplified registration form with SEC for public offerings of securities not exceeding $5 million. SEC has stated that the primary purpose of Regulation A is to provide a simple and relatively inexpensive procedure by which small businesses could raise limited amounts of needed capital. SEC has also stated that Regulation A can be an effective tool for a developing company, which may not be able to justify the significant costs of registration. Unlike the companies that use Regulation D exemptions, a company that relies on Regulation A for an exemption must file an offering circular with SEC for review and provide the circular to investors.[9] However, the company can use a simplified question-and-answer format. Like registered offerings, the securities can be offered publicly and are freely tradable in the secondary market. Among the principal advantages of Regulation A offerings, as opposed to full registration, are that the financial statements are simpler and do not need to be audited. This difference can cut an issuer's costs because the issuer can avoid hiring an outside accounting firm in connection with the offering. According to SEC data, an average of 83 Regulation A offerings have been filed each year since 1994.

Unlike traditional public offerings, in Regulation A offerings, companies may "test the waters" to determine if there is adequate interest in the securities before going through the expense of filing with SEC. Thus, if certain conditions are met, a company may issue written or oral statements asking whether investors would be interested in purchasing its

[8]The California Limited Offering Exemption can be found in SEC rule 1001.

[9]Regulation A offerings also have a bad person provision that prevents an issuer who has violated the securities laws in the past 10 years from conducting a Regulation A offering.

securities. If insufficient interest is indicated, the company can avoid the cost of preparing an offering statement, filing it with SEC, and delivering it to investors. The ability to test the marketplace before incurring the costs of an offering can be a tremendous advantage for small businesses.

However, a drawback of Regulation A filings is their lack of exemption from state law registration filing requirements. This lack of an exemption makes them more expensive than Regulation D offerings since an offering statement must be prepared, filed, and reviewed by SEC before any securities can be sold. Market participants complain that it is a burden for them to have to register with SEC and each state where they offer their securities for sale. A state regulatory official told us that one problem encountered in trying to coordinate the filing process between state regulators and SEC is that periods for comments are not consistent between the states and SEC. For example, in many states, the turnaround period for initial comments is about 15 business days, while the SEC turnaround period is about 30 calendar days. Like rule 504 offerings, in Regulation A offerings, issuers can (1) use SCOR and regional review in the states where they are available and (2) make offerings over the Internet.

A solution suggested by one securities lawyer that we talked to for lessening the burden of requiring registration at the state and federal level for Regulation A offerings is to eliminate the requirement that Regulation A offerings be filed and reviewed by SEC. Another suggested solution is to preempt states from regulating Regulation A offerings so that only SEC would prescribe the requirements with which an issuer must comply to qualify for the ability to test the waters.

Another problem with Regulation A offerings cited by a state securities regulator official is that the offering size of under $5 million is often too small to attract broker-dealers, who can distribute the securities to investors. This official recommended that the Regulation A threshold be increased from $5 to $10 million.

The accredited investor exemption. Under the accredited investor exemption,[10] sales of securities to accredited investors[11] with an offering

[10]Section 4(6) of the Securities Act.

[11]The definition of accredited investors is the same as that used in Regulation D. However, unlike the Regulation D exemptions, the exemption is lost if any investor is not accredited. Whereas, with the other Regulation D exemptions, the issuer need only have a reasonable belief that the investors are accredited.

price under $5 million are exempt from Securities Act registration requirements. Like the exemptions in rules 505 and 506, this exemption does not permit any form of advertising or public solicitation, and the resales of securities are restricted. The issuer is not required to provide investors with an offering document, and the offering is required to be registered in each state where the securities are being sold. Commentators have suggested that the accredited investor exemption is rarely used since the exemptions offered under Regulation D are easier to use and offer the same relief.

The California Limited Offering Exemption. Another exemption available for offerings that total less than $5 million, is known as the California Limited Offering Exemption, which provides an exemption from the registration requirements of the Securities Act for offers and sales of securities that satisfy the conditions of section 25102(n) of the California Corporations Code. This exemption was designed to facilitate the ability of small companies to raise capital to finance their growth. By wrapping a federal exemption around a state's exemption, SEC believed that other states might follow suit for the benefit of small issuers. According to NASAA officials, the states followed suit when in 1997, NASAA drafted and many states thereafter adopted the Model Accredited Investor Exemption (MAIE). NASAA adopted MAIE with the expectation that SEC would adopt a corresponding exemption similar to SEC rule 1001. To date, no such federal exemption has been adopted.

The California law provides an exemption from California state law for registration offerings made by California companies to "qualified purchasers" who are defined as similar to accredited investors. Unlike Regulation D offerings, this exemption allows some methods of general solicitation before sales, such as general announcements of the proposed offering to be widely published and circulated, so long as they contain only specified information. Like Regulation D offerings, the securities are restricted and cannot be resold unless there is an available exemption for the resale.

Employee benefit plans. Small businesses have available to them an exemption for offerings pursuant to certain compensatory benefit plans or compensation contracts. In addition to obtaining financing through securities issuances, small businesses may also use their securities to compensate employees and other personnel. Securities-based plans or arrangements often constitute an essential part of the compensation structure of nonpublic companies, especially start-up ventures in which the ability to share in equity appreciation is often a powerful inducement available to attract employees. Offering securities to employees in compliance with the federal securities laws, however, is very costly for nonpublic companies because of the costs associated with SEC filings. Thus, in an effort to enable small businesses to provide securities to employees as an incentive in a cost-effective manner, SEC promulgated rule 701, which exempts the sale of securities that were made to compensate employees by companies meeting certain requirements. The company can sell at least $1 million of securities under this exemption and can sell more securities if it satisfies certain formulas that are based on its assets or on the number of its outstanding securities. If the company sells more than $5 million in securities in a 12-month period, it must provide limited disclosure documents to its employees. Like the securities in rules 505 and 506, under rule 701, employees receive “restricted securities.”

The Intrastate offering exemption. The intrastate offering exemption allows a company to sell its securities to the public within a single state without registering with SEC.[12] The purpose of this exemption is to facilitate the financing of local businesses by local sales. The rationale is that if the offering is local, the federal government can appropriately rely on the states to regulate such securities sales. To qualify for the intrastate offering exemption, a company must be incorporated in and conduct a significant amount of its business in the state in which it is offering the securities. There is no fixed limit on the size of the offering or the number of purchasers. However, the company only can sell its securities to the residents of the state in which it is incorporated. Although exempt from federal registration, a company obtaining the intrastate offering exemption must register its securities pursuant to state law. According to officials from NASAA and a securities attorney, the intrastate offering exemption is viewed unfavorably by issuers concerned that this exemption can be easily lost due to the inadvertent noncompliance with the residency requirement of investors that purchase the securities. For this reason, this exemption is rarely used.[13]

Certain Exempt Offerings Can Be Made Over the Internet

To assist issuers in conducting such offerings over the Internet, the Small Business Administration’s Office of Advocacy (SBA-OA) established ACE-Net (Access to Capital Electronic Network), which is an Internet site where small companies may list their rule 504 and Regulation A offerings. Several industry participants told us that ACE-Net does not have a great reputation in the investment community because companies listed on

[12]Section 3(a)(11) of the Securities Act; 17 C.F.R. 230.147 (1999).

[13]Under this exemption, even one offer to, or securities transfer to a nonresident within 9 months from the sale may make the entire intrastate offering subject to registration.

ACE-Net are considered low-quality companies that could not otherwise get funding. Industry participants suggested that as a solution to this problem, SBA should better screen the quality of the companies that are listed on ACE-Net to ensure better quality investment opportunities for investors. However, according to a SEC no-action letter, ACE-Net is not legally permitted to screen the quality of the companies that are listed on its site.

Companies Must Register Securities in Each State in Which Their Securities Are Offered for Sale

States require securities to be registered before they can be offered for sale within the state unless a state law exemption is available or federal law preempts state registration requirements. As discussed in appendix II, these requirements prescribe three methods of registering securities—notification, qualification, and coordination.

Like SEC, some states perform a disclosure review of small businesses' securities offerings to ensure that companies disclose to investors all information needed to make an informed investment decision. NSMIA preempts state registration and review requirements of nationally traded securities and offerings under SEC rule 506 of Regulation D. Unless exempt by state statute, securities that are not preempted by NSMIA are subject to state registration requirements. Certain initiatives have been developed to assist companies that are exempt from SEC registration, but these companies must register in all states in which their securities are offered.

State Securities Regulators Conduct Merit Reviews and Focus on Unproven Entities With Local or Regional Impact

The state blue-sky laws are aimed primarily at new and unproven concerns and speculative ventures that often have local or regional impact. States require securities to be registered before they can be sold, unless a state law exemption is available or, as discussed below, state registration requirements are preempted by federal law. The primary purpose of state securities laws is to protect purchasers of securities. Omissions of material facts and fraud or deception regarding both the purchase and the sale of securities are prohibited.

Historically, most state legislatures have followed one of two approaches in regulating public securities offerings, or a combination of the two approaches. Some states review small businesses' securities offerings to ensure that companies disclose all information investors need to make an informed investment decision. This is known as disclosure review. Other states also analyze public offerings using substantive standards to ensure that the terms and structure of the offerings are fair to investors, in addition to the focus on disclosure. This analysis is known as merit review. One of the concerns voiced by securities attorneys and market participants is that merit review standards are not uniform among the states. Different states look at different factors to determine if a registration statement contains sufficient information and if the offering terms and structure are fair to investors. Although difficult to implement, one securities attorney proposed that merit review standards be consistent among the states or that states conduct disclosure reviews such as SEC does at the federal level. However, NASAA officials note that under the Coordinated Equity Review (CER) Program, 39 of the 42 states that review offerings registered at the federal level have agreed to apply a uniform set of merit standards in the form that is described in NASAA's Statements of Policy.

NSMIA Preempts State Registration and Review Requirements for Covered Securities

NSMIA[14] preempts state registration and review requirements of securities offerings known as "covered securities." These securities are defined by NSMIA to include "nationally traded," —that is, securities traded on the New York Stock Exchange, Inc. (NYSE); the American Stock Exchange, Inc. (Amex); the NASDAQ National Market System; Tier I of the Pacific Exchange, Inc.; Tier I of the Philadelphia Stock Exchange, Inc.; or the Chicago Board Options Exchange, Inc.—as well as securities that are offered under rule 506 of Regulation D.[15] Securities that are not within the definition of covered securities, remain subject to state registration requirements. These securities include those quoted on the NASDAQ SmallCap market, securities traded on the over-the-counter Bulletin Board; securities quoted on the over-the-counter "pink sheets," and securities listed on securities exchanges other than those exchanges listed above under covered securities. Unless subject to an exemption, securities that are covered securities must be registered with SEC and with each state in which they are offered for sale.

Even though NSMIA exempts covered securities from state registration requirements, NSMIA preserves the authority of state securities regulators to enforce actions that arise out of fraud regarding securities sold in their states. The purpose of NSMIA is to enhance capital formation and the competitiveness of the economy by eliminating regulatory overlap

[14]Securities Act 18(a)(3), 15 U.S.C. 77r(a)(3).

[15]Section 18(b) defines covered security to include:

a. A security listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed, or authorized for listing, on the National Market System of the NASDAQ Stock Market;

b. A security listed, or authorized for listing, on a national securities exchange that has listing standards that the Commission determines by rule (on its own initiative or on the basis of a petition) are substantially similar to the listing standards applicable to securities described in item a. above.

between the states and the federal government, thus simplifying the way that securities are regulated.

Exemptions Are Also Available at the State Level

The state blue-sky laws set forth numerous exemptions from their registration requirements. The exemptions under state acts often contain significant variations. As is true with federal law, state blue-sky laws provide for types of securities and transactions that are exempt from state registration requirements, such as securities issued by certain charitable, educational, or religious organizations.

Most state statutes also exempt certain types of transactions from state registration requirements. For instance, most states have adopted some form of an exemption for transactions that involve an offer to sell securities to not more than 10 persons within the state in any 12-month period. The purchasers usually must be buying for investment and not resale. Another common state law registration exemption covers offerings made only to institutional investors[16] that acquire the security for investment only and not resale.

Model Acts Have Been Proposed in an Effort to Coordinate State Registration and Exemptions

The Uniform Securities Act of 1956 and the Revised Uniform Securities Act of 1985 represent key efforts to make the states' registration and exemption processes more uniform. Specifically, both acts incorporated model rules developed by the American Law Institute to increase uniformity among the states' registration and exemption processes. Although certain provisions of the Uniform Acts have been adopted by certain states, there are significant departures in many states. In 1983, a parallel initiative to SEC's Regulation D led to the adoption at the state level of NASAA's ULOE, which contemplates a uniform rule exempting offers or sales if offered or sold in compliance with Regulation D's rules 505 and 506 that satisfy certain conditions. However, regarding rule 506, NSMIA preempts the states from requiring anything more than a notice filing and, although the rule 505 counterpart exemption remains relevant, it seldom comes into play because rule 505 is used infrequently.

In April 1997, NASAA approved the Model Accredited Investor Exemption (MAIE), which provides an exemption from state securities registration requirements to small businesses offering securities to accredited investors. This exemption is based on the premise that accredited investors, which are wealthy individuals or institutional investors, can do their own due diligence and risk assessment. According to NASAA, 33

[16]Although the statutes define institutional investor differently, they generally include insurance companies, banks, and savings institutions.

states, Puerto Rico, and the District of Columbia have adopted a form of this exemption, and 7 more states have bills providing for such exemptions pending in their legislatures.

Exemptions From State Registration for IPOs and DPOs Conducted Over the Internet

NASAA has addressed the issue of conducting initial public offerings (IPO) and DPOs over the Internet to provide a uniform standard after which each state could model its own regulations. NASAA's resolution, which was adopted on January 7, 1996, encourages states to exempt Internet offers from their state registration requirements if certain conditions are met. States that follow the NASAA resolution exempt Internet offerings in which the Internet offer specifies that (1) the securities are not being offered to residents of a particular state and (2) the offer is not specifically directed to any person in a state. According to NASAA, 32 states have adopted the NASAA Internet Resolution.

A Uniform State Registration Process Assists Issuers in Coordinating State Registration

To assist companies conducting IPOs that are not sold on a national securities exchange but that are required to be registered with both SEC and all of the states in which the company offers securities, a coordinated review procedure (i.e., the CER Program) has been developed. The CER program streamlines the process for such firms by providing a uniform state registration procedure designed to coordinate the blue-sky registration process in all of the states in which the issuer seeks to sell its equity securities. NASAA notes that 39 states are participants in the CER Program.

The CER Program offers issuers registration efficiencies by creating a uniform scheme of review. The program also simplifies the blue-sky registration process for issuers by simplifying the process for resolution of comments. The CER Program Protocol establishes compulsory periods for review and generation of comments.

Special SEC, SBA, and NASAA Activities to Facilitate Small Business Access to Equity Capital

SEC, the Small Business Administration (SBA), and NASAA have activities to help small businesses raise equity capital. Table IV.1 highlights some of these small business activities. To aid the small business capital formation process, all three of these entities have Internet Web sites dedicated to small business issues; have toll-free telephone numbers; provide a small business ombudsman; and provide outreach efforts through forums, conferences, and Web sites.

Table IV.1: Activities by SEC, SBA, and NASAA to Help Small Businesses Raise Equity Capital

Organization	Activity	Activity description
U.S. Securities and Exchange Commission (SEC)	Annual Conference on Uniformity of Federal-State Securities Regulation	SEC and the North American Securities Administrators Association, Inc., (NASAA) conduct an annual conference designed to increase uniformity and cooperation between the federal and state regulatory systems so that capital formation can be made easier and at less cost while at the same time maintaining investor protections. This conference was first held in 1984.
	Small Business Regulations	Simplified registration regulation to reduce costs and regulatory burden on small business issuers by requiring less extensive registration and disclosure requirements for small issuers.
	Annual SEC Government-Business Forum on Small Business Capital Formation	The conference focuses on the capital formation concerns of small businesses. It provides a platform for those involved in raising small business capital (e.g., small business owners, venture capitalists, and small business advocates) to highlight perceived unnecessary impediments to the process of raising capital. Recommendations are developed and voted on by participants as to importance. This conference was first held in 1982.
	Town Hall Meetings	Since 1996, SEC has periodically held town hall meetings with small businesses. These meeting allow small businesses owners to learn about the basic federal securities law requirements for selling securities in the public markets. They also allow SEC staff to learn about small business concerns in raising capital so that initiatives and programs can be designed to meet these concerns. Town hall meetings are conducted throughout the United States.
	Plain English Disclosure	To improve the readability of disclosure documents, it is required that they be written simply and in plain English. According to a SEC official, the small business disclosure area was the first area to which plain English was applied.
	Office of Small Business, Division of Corporation Finance	A centrally located headquarters unit that specializes in small business filings and the needs of small business issuers.
	Public and Private Placement Exemptions	These exemptions at the federal level ease the regulatory cost and burden on small business capital formation by providing exemptions from federal securities registration requirements for securities offerings up to $5 million if certain conditions are met.
U.S. Small Business Administration (SBA)	Office of Advocacy	This office was created as an independent entity within SBA in 1976. It acts as the advocate for small business in the federal government.
	Small Business Investment Company (SBIC) Program	Licensed and regulated by SBA, SBICs are privately owned and managed firms that provide venture capital and start-up financing to small businesses.
	Access to Capital Electronic Network (ACE-Net)	Created in 1996, ACE-Net is a secured Internet service where small companies may list their equity offering for review by accredited investors that are looking to invest $250,000 to $5 million.

Organization	Activity	Activity description
North American Securities Administrators Association (NASAA)	Coordinated Review Programs	The two registration and review programs are Coordinated Equity Review (CER) and Regional Review. The CER program provides for a coordinated state review process for offerings of equity securities registered with SEC. Thirty-eight states participate in the program. The Regional Review program provides for a coordinated regional state review process for offerings in certain regions of the country. State registrations under this program use the Small Company Offering Registration form, which is a simplified question-and-answer-offering document that is provided to investors. Thirty-six states located in 5 regions participate in the program. The participating states in both programs coordinate with each other to produce one comment letter to an issuer that addresses both merit and disclosure matters.[a] These programs came into existence only a few years ago and are intended to create uniformity in and expedite the registration and review process and thus save small business issuers time and money.
	Model Accredited Investor Exemption (MAIE)	Approved by NASAA in 1997, the MAIE exempts offers and sales of securities from state registration requirements if the securities are sold only to persons who are accredited investors. MAIE is based on the premise that accredited investors, defined by SEC as wealthy individuals or institutional investors, are capable of undertaking their own due diligence and gauging the risks involved before making an investment.
	Model Internet Exemption	Adopted in 1996, the model rule exempts offers and sales of securities over the Internet from state registration requirements if certain conditions are met.

[a]Merit (or Substantive) review is a review of issuers and their securities offerings to prevent promotion of fraudulent or inequitable issues. According to NASAA officials, merit review of securities offerings generally addresses (1) disparity in the price paid by promoters for their shares and the price paid by the public investors, (2) whether the issuer has provided for an impound of proceeds in a best efforts offering until sufficient funds have been raised to implement a bare bones business plan, and (3) the terms of material transactions affiliates have entered into with the company. NASAA officials told us that the purpose of merit review is to align the interest of the issuer with those of the investing public. According to NASAA officials, about 27 states follow the merit review approach to registration review of securities offerings. Disclosure review is a review of securities offerings to ensure that adequate disclosure of all material information is made to potential investors.

Source: GAO review of agencies' Web sites and interviews of agency officials.

Comments From the National Venture Capital Association

NVCA
National Venture Capital Association

August 31, 2000

Richard J. Hillman
Associate Director,
Financial Institutions and Markets Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Hillman:

On behalf of the National Venture Capital Association, I thank you for the opportunity to comment on the GAO report to the Chairman of the Senate Small Business Committee entitled Small Business: Actions Taken to Facilitate Equity Capital Formation.

In general, we commend the work the GAO has done to catalogue the various governmental efforts to ease the filing and paperwork burdens of accessing capital markets. Importantly, the report also notes the shortcomings of these efforts and, in some cases, points out specific problems that could be addressed by the regulators. For instance, the report notes that the size limits in Reg D offerings are too small to interest most broker dealers in selling the stock to investors. It also shows that the burden of state registration requirements for small offerings often grossly outweighs any benefit from exemption from federal registration requirements.

A specific issue that we wish to highlight relates to the section in the report regarding the availability of short-form (SB-1 or SB-2) registration for small business offerings. It is worth noting that in 1999, as part of its sweeping "aircraft carrier" proposed regulation, the SEC proposed raising the "current revenues" ceiling from $25 million to $50 million and eliminating the "public float" test for use of the SB forms. In so doing, the SEC noted that the number of companies that qualified as small businesses had fallen since the small business test was set at $25 million in 1992. It noted that increasing the ceiling to $50 million would bring the number of companies qualifying back to the original level. This part of the proposal received wide support. However, the aircraft carrier received very mixed reviews based on unrelated aspects of the proposal. There has been no new effort by the SEC (of which we are aware) to raise the small business limit.

While it is apparently beyond the scope of this report to review governmental (and non-governmental) actions that have increased the barriers to accessing capital markets or increased the cost of capital for small business, we believe that an evaluation of the challenges faced by small businesses cannot be completed without such an appraisal. For instance, paperwork and filing burdens are not the only ways in which the government influences the equity financing climate for small businesses. For example, regulatory actions by the National Association of Securities Dealers (under pressure from the SEC) to raise its standards for continued listing on its Nasdaq NMS, Small Cap and Electronic Bulletin Board have impacted the secondary market for publicly traded small business. Those who work in these markets say that this loss of market "credibility" has a ripple effect on the ability of companies without huge growth prospects for getting investment capital in the first place.

In addition, new listing standards involving the audit committees of companies going public on the three major exchanges increase the cost and burden of accessing the public equities markets.

1655 North Fort Myer Drive • Suite 850 • Arlington, Virginia 22209 • 703.524.2549 • Fax 703.524.3940 • www.nvca.org

Actions taken by non-governmental organizations such as the Financial Accounting Standards Board (FASB) also affect the equity financing environment. The current FASB proposal to eliminate the use of pooling of interests accounting, if approved, will send a signal to venture investors that achieving liquidity from their investments via mergers or acquisitions may no longer be as viable an option as in the past. In such a climate, venture financing may not be available to as wide an array of small businesses as it currently is since consideration of an "exit strategy" (i.e., their plan for achieving liquidity) is a critical component to making investment decisions.

Again, I thank you for the opportunity to review this study and to provide our comments.

Sincerely,

Mark Heesen
President

Comments From the Small Business Administration's Office of Advocacy

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY

September 13, 2000

Mr. Richard J. Hillman, Associate Director
Financial Institutions and Market Issues
General Accounting Office
Washington, D. C. 20548

Dear Mr. Hillman:

The Office of Advocacy wishes to compliment the General Accounting Office on its study *SMALL BUSINESS Efforts to Facilitate Equity Capital Formation.* The report provides valuable information for policy makers on what is happening in equity markets. The report is particularly valuable since it identifies where precise data is lacking both on actual small business needs for equity capital and the level of actual venture fund investments in small business versus in large business.

As the report points out, the Office of Advocacy has tried, with some difficulty, to document what the actual equity needs are of small start-up and growth companies; what the barriers or inefficiencies are in the marketplace, including regulatory requirements, that make it difficult for small firms to find investors; and what the investment patterns are for various sources of equity such, as venture capital funds. Precise data is difficult to obtain because there simply is no centralized database. "Angel" investors, for example, guard their anonymity and have no organization, such as the National Venture Capital Association, which could provide such data. In an effort to measure need and actual investment levels, Advocacy has had to use surrogate information from sources such as individual small business people (e.g. delegates to the 1995 White House Conference on Small Business) and the SBA's Small Business Investment Companies (SBICs). SBICs openly admit to not having the resources to fund all the well-documented business plans they review. We also know that venture funds are investing in increasingly larger deals and concentrating their investments both in specific industries that seem to promise very high returns and in certain geographical areas of the country. From this can be inferred certain inefficiencies in the marketplace that make it difficult for small firms to find investors.

Readers of this report should be cautioned not to assume that the marketplace is awash in money or that the recent economic boom is meeting the needs of small business. The number of millionaires created by the recent boom in the economy, who may be seeking investment opportunities, or the enormous influx of money into the stock market does not necessarily mean that a significant benefit is accruing to small business. Data suggest that this boom has been concentrated in certain industries and many of the recent IPOs are multi-million dollar ventures, e.g. the AT&T Wireless IPO for $10+ billion. As the

FEDERAL RECYCLING PROGRAM PRINTED ON RECYCLED PAPER report points out, only 5,025 U. S. businesses – large and small – received institutional venture capital in 1999, a number far less than the estimated 125,000 start-up and fast growing small companies in need of equity capital each year. How small business may actually be benefiting from this boom remains an issue deserving further study.

Thank you for this report. It makes a major contribution to the literature on this subject and implicitly points to areas for ongoing inquiry.

Respectfully,

Jere W. Glover
Chief Counsel for Advocacy

Cc: Wm. B. Shear

GAO Contacts and Staff Acknowledgments

GAO Contacts

Richard J. Hillman, (202) 512-8678
William B. Shear, (202) 512-8678

Acknowledgments

In addition to those named above, Joe E. Hunter, Sindy R. Udell, Desiree W. Whipple, Janet Fong, Gerhard Brostrom, Jerry T. Sandau, Carl M. Ramirez, Elizabeth A. Olivarez, May M. Lee, and Christopher C. Henderson made key contributions to this report.

Glossary

Accredited investor	As defined in rule 501 of Regulation D, an accredited investor means any person who comes within any of the following categories, or who the issuer reasonably believes comes within the following categories at the time of the sale of securities to that person: a bank, insurance company, registered investment company, business development company, or small business investment company; an employee benefit plan; 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 of 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 2 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.
Business angel investor	A business angel investor is a high net worth individual with an interest and knowledge in a particular business sector, often because that is where he or she gained personal wealth. Business angels can help a start-up company with their considerable experience. They can also cause considerable harm if they are naïve about the needs of the business. An angel will frequently become an active advisor to the company and often take a seat on the board.
Blue-sky laws	Each state has statutory laws governing the distribution and sale of securities. These state statutes, which vary widely in their terms and scope, are commonly referred to as blue-sky laws, an appellation with several suggested origins.
Bridge financing	Financing that is usually provided by private investors or venture capital firms to a company that is expecting to go public usually within 6 months to 1 year or is initiating its next stage of financing. It is often structured so that it can be repaid from proceeds of a public underwriting.
Direct public offering	A direct public offering is the offering of new securities to the public directly by an issuer without the assistance of an investment banking firm.
Early-stage venture	Firms that have a substantial risk of failure, because the technology behind their production method or the logic behind their marketing approach has yet to be proven. The objective of an early-stage venture is to grow fast enough so that it will be able to go public or be sold to another company.

Equity	Ownership interest in a company or corporation that is represented by the shares of common or preferred stock held by the investors.
Equity stake	An equity ownership position in the company that is provided to a funding source, usually a venture capital firm, but also lenders or other investors, as compensation for providing management consulting, financing, or miscellaneous services.
First stage	A stage of development in which the company has expended its initial capital and requires funds, often to initiate commercial manufacturing and sales.
Follow-on/Later stage	A subsequent investment made by an investor who has made a previous investment in the company, generally a later-stage investment in comparison to the initial investment.
Form S-1	The most comprehensive registration statement to be filed with SEC by companies that do not qualify for any of the abbreviated registration statement forms. It requires complete registration and transaction information to be provided in the prospectus.
Initial seed	A relatively small amount of capital provided to an investor or entrepreneur, usually to prove a concept. It may involve product development, but rarely involves initial marketing.
Initial public offering	A company's first offering of stock for sale to the public (i.e., going public). Selling stock to the public is a way for the company to raise money.
Intra-state offering	An offering of the sale of securities within the borders of a state in which the company is registered.
Internal rate of return	An internal rate of return is the discount rate (or interest rate) at which the present value of the future cash flows of an investment equals the cost of the investment. Present value is the value today of a future payment, or stream of payments, discounted at some appropriate interest rate.
Investment bank	An investment banking firm acting as underwriter sells securities from the issuing corporation to the public. A group of firms may form a syndicate to pool the risk and ensure successful distribution of the issue. There are two types of underwriting arrangements—best efforts and firm commitment. With best efforts, the underwriters agree to purchase only as many new securities as they can either successfully resell or serve only as brokers and assist in the search for investors. This arrangement is more common

with speculative securities and with new companies. With a firm commitment, the underwriters purchase outright the securities being offered by the issuer.

Later-stage investment

A fund investment strategy for financing the expansion of a company that is producing, shipping, and increasing its sales volume.

Later-stage venture

Firms with a proven technology behind their product and a proven market for it. Their risk is based on a myriad of uncertainties that affect small business, including the feasibility of their business concept. They have a proven technology and a proven market for their product, are growing fast and generating profits, and need private equity financing to add capacity or to update their equipment to sustain their fast growth. As with early-stage ventures, their objective is to grow fast enough that they will ultimately be able to go public or be sold to another company.

Limited partnership

A form of business organization that offers limited liability to the investors who become limited partners and, in certain cases, also offers tax benefits. Limited partnerships are often used for certain types of investments, such as those in research and development and real estate. Limited partners enjoy limited liability for the debts of the firm and this liability is limited to the amount of the limited partner's investment in the business. Limited partners have no voice in the management of the partnership. They merely invest money and receive a certain share of the profits. There must be one or more general partners who manage the business and remain liable for all of its debts. A limited partnership is organized under state statutes, usually by filing a certificate and publishing a notice in the newspaper. The statutes, codified in many states as the Uniform Limited Partnership Law, must be strictly observed. As in a general partnership, the death, adjudication of insanity, or bankruptcy of any one of the general partners dissolves the limited partnership.

Private placement

An offering of securities that is exempt from federal registration and limited in distribution to certain types of investors.

Prospectus

A disclosure document prepared to provide potential investors with detailed information regarding the purchase of securities, including debt or equity offerings, or limited partnership offerings. As it pertains to a registered offering, the prospectus is part 1 of the registration statement. The prospectus must be delivered before the consummation of any sale pursuant to a registered offering.

Registration statement	The disclosure document filed with SEC in accordance with the registration requirements of the federal securities laws. The registration statement is divided in two parts. The first part is the prospectus, which describes the business and how the proceeds of the offering will be used and includes some background on the principal executives, audited financial statements, and other pertinent data. The second part consists of additional information that is not sent out in the prospectus but is available in the SEC files for inspection.
Restricted shares	Shares of a company's stock generally obtained in a private placement that cannot be sold to the public without registration of the shares or an applicable exemption.
Second stage	A second stage of development in which working capital is provided for the initial expansion of a company that is producing and shipping and has growing accounts receivable and inventories. Although the company has clearly made progress, it may not yet be showing a profit.
Securities Act of 1933	An act passed by Congress, which has been amended, that has two objectives to (1) require that investors receive financial and other significant information concerning securities being offered for public sale and (2) prohibit deceit, misrepresentations, and other fraud in the sale of securities.
Securities and Exchange Commission	The U.S. governmental agency that regulates the securities industry and that is responsible for the administration of U.S. securities laws, including the 1933 Act and the 1934 Act. The primary mission of SEC is to protect investors and maintain the integrity of the securities markets.
Securities and Exchange Act of 1934	An act passed by Congress, which has been amended, that empowers the SEC with broad authority over all aspects of the securities industry. This includes the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self regulatory organizations. The act also identifies and prohibits certain types of conduct in the markets and provides SEC with disciplinary powers over regulated entities and persons associated with them and empowers SEC to require periodic reporting of information by companies with publicly traded securities.
Seed stage	Companies at the seed stage have not yet fully established commercial operations, and may involve continued research and product development.

Small business issuer	A small business issuer is a company incorporated in the United States or Canada that had less than $25 million in revenues in its last fiscal year, and whose outstanding publicly held stock is worth no more than $25 million.
Third stage	The stage of business development in which funding is provided for the major growth of a company whose sales volume is increasing and that is beginning to break even or turn profitable. These funds are typically for plant expansion, marketing, working capital, or development of an improved product.
Underwriter	An underwriter is a brokerage firm, securities dealer, or investment banking firm that sells company securities to investors, other brokerage firms, securities dealers, and investment banking firms. The selling of securities can occur either through a private placement offering or public offering.
Venture capital	Venture capital is money invested or available for investment at considerable risk of loss in small businesses with exceptional growth potential and potential of high return on investments. Managerial and technical expertise are often also provided.
Venture capital firm	Venture capital firms are venture capital and private equity firms organized into a limited partnership which pools capital for the purpose of investing in companies that represent an opportunity for a high rate of return within 5 to 7 years. Venture capital firms foster growth in companies through their involvement in the management, strategic marketing, and planning of their portfolio companies.

Ordering Copies of GAO Reports

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Order by mail:

U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000 or by using fax number (202) 512-6061, or TDD (202) 512-2537.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touch-tone phone. A recorded menu will provide information on how to obtain these lists.

Viewing GAO Reports on the Internet

For information on how to access GAO reports on the INTERNET, send e-mail message with “info” in the body to:

info@www.gao.gov

or visit GAO’s World Wide Web Home Page at:

http://www.gao.gov

Reporting Fraud, Waste, and Abuse in Federal Programs

To contact GAO FraudNET use:

Web site: http://www.gao.gov/fraudnet/fraudnet.htm
E-Mail: fraudnet@gao.gov
Telephone: 1-800-424-5454 (automated answering system)

United States
General Accounting Office
Washington, D.C. 20548-0001

Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100

Official Business
Penalty for Private Use $300

Address Correction Requested

[redacted]

(233620)