ANNUAL REPORT FOR FISCAL YEAR 2019

Office of the Advocate for Small Business Capital Formation

U.S. SECURITIES AND EXCHANGE COMMISSION
ABOUT THIS REPORT + ACKNOWLEDGEMENTS


Pursuant to Section 4(j)(6)(D) of the Exchange Act, this Report is provided directly to the committees of Congress without any prior review or comment from the Commission, any Commissioner, any other officer or employee of the Commission, or the Office of Management and Budget. It does not necessarily reflect the views of the Commission, the Commissioners, or staff of the Commission.

The work of the Office is possible only through the support of a talented and passionate team. While the Office has been supported by many colleagues across the agency during its first year in operation, we recognize the following team members who worked in the Office during FY2019:

Emerald Greywoode Boston-Mammah  Jessica W. McKinney
Colin A. Caleb  Jennifer Riegel
Julie Zelman Davis  Malika Sullivan

Special thanks to our colleagues within the SEC for providing resources for this Report, including the Division of Economic and Risk Analysis for providing SEC data to quantify the state of small business capital formation and contextualize issues, and the Office of Public Affairs for making our written product for this report visually engaging. We particularly thank the following individuals: Daniel Bresler, Vlad Ivanov, Andy Kim, Anzhela Knyazeva, Wei Liu, Chris Onrubia, Narahari Phatak, Zehra Sikandar, and John Zheng.
Message from the Advocate

“Small businesses are the backbone of our economy” is a statement so often repeated that it has become a standard line used almost ubiquitously by leaders, both political and apolitical.1 Rightly so, given the role smaller companies play in our economy—from being the primary job creators over the past two decades, to the innovators of new technologies that change lives, to the generators of wealth for many investors. Yet small businesses are often underrepresented here in Washington, DC, where laws and rules impacting their operations are made.

I have the opportunity of a lifetime to serve as the U.S. Securities and Exchange Commission’s (SEC) first Advocate for Small Business Capital Formation after being appointed in December 2018 and beginning to build the SEC’s newest office starting in January 2019.2 During our formative first year of operation, I approached building our Office with the only frame of reference I had coming from the private sector: like a start-up. We crafted a business plan3 to communicate with the public our mission, vision, and approach for supporting small businesses’ capital formation needs, just like many start-ups do before pitching to investors. Knowing that we needed to scale pragmatically and efficiently, we defined our minimum viable product (or MVP) and documented the steps we would take to achieve full scale programming, along with a timeline to provide visibility of what you could expect from us and when.

At almost every event we host, we simultaneously engage with businesses and their investors, recognizing that the success of businesses is interwoven with the success of their investors. In speaking with new audiences, I often analogize our Office to a megaphone, explaining that we take the ecosystem’s voices and make them louder within the SEC and the broader regulatory landscape to positively impact policy. It is my hope that this inaugural report will do just that: take the many voices that we hear, distill them into a concise summary, and communicate in a compelling manner what small businesses and their investors tell us that they need from our capital markets.

Looking back at FY2019 and our first nine months, I am proud of what we have accomplished to date, and I look forward to working collaboratively with the Commission, Congress, and our agency partners to deliver meaningful solutions to support the backbone of our economy; small businesses. We are proud to be, as many a small business storefront sign says, “Open for Business.”

MARTHA LEGG MILLER
Advocate for Small Business Capital Formation
An independent office housed within the U.S. Securities and Exchange Commission, created by Congress via special legislation.

One called to use your voice for others, derived from Medieval Latin.

Office of the Advocate for Small Business Capital Formation

From start-ups to small cap, “small” is relative for the SEC’s newest Office, which supports emerging, privately-held companies up to small public companies.

The deployment of productive capital by informed investors to create economic growth.
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Congress created the Office to provide a dedicated champion to smaller companies accessing critical capital to build, grow, and thrive. The Office operates pursuant to sections 4(j) and 40 of the Securities Exchange Act of 1934 (15 U.S.C. §§ 78d and 78qq), as added by the SEC Small Business Advocate Act of 2016 (P.L. 114-284) and amended by the Small Business Access to Capital after a Natural Disaster Act (title IX of division S of Public Law 115-141) (collectively, the Small Business Advocate Act).

The Office officially commenced operations in January 2019. As an independent office reporting directly to the Commission, the Office is statutorily charged with the following functions:

- Assisting small businesses and their investors in resolving significant problems they may have with the SEC or with self-regulatory organizations (SRO);
- Identifying areas in which small businesses and their investors would benefit from changes in SEC regulations or SRO rules;
- Identifying problems that small businesses have with securing access to capital;
- Analyzing the potential impact on small businesses and their investors of proposed SEC regulations and SRO rules;
- Conducting outreach to small businesses and their investors to solicit views on capital formation issues;
- Proposing appropriate regulatory and legislative changes to the SEC and Congress to mitigate problems identified with small business capital formation and to promote the interests of small businesses and their investors; and
- Consulting with the Investor Advocate on such regulatory and legislative changes and other small business issues.

The Office also proactively works to identify any unique challenges faced by minority-owned small businesses, women-owned small businesses, and small businesses affected by natural disasters.
The Office hosted a round table in Little Rock, AR at the Venture Center, a nonprofit fintech accelerator focused on solutions for community banks.

Scope of Small Businesses

The Office supports a spectrum of small businesses and their investors, from emerging, privately-held businesses to publicly traded companies with less than $250 million in public market capitalization. Based upon commonalities in sources of capital and issues faced, the Office has segmented its target market into three categories of businesses and their corresponding investors:
Our Mission

The Office’s mission is to advocate for small businesses and their investors to foster better access to capital markets, strengthening the voice of small business within the SEC and the broader regulatory landscape.

- Work with small businesses to understand their capital formation issues through education and outreach
- Analyze the potential impact of proposed rules and regulations likely to significantly affect small businesses
- Help small businesses resolve issues with the SEC and SROs by recommending policy changes

Core Tenets

The Office adheres to the following core tenets in approaching its delivery of services and solutions to small businesses and their investors:

- Small businesses are job creators, generators of economic opportunity, and fundamental to the growth of the country.
- One size does not fit all for small businesses.
- Good work has been done by the SEC, but we are not done and should continue to evolve as the market demands.
- Small business policy should facilitate trust and confidence in capital markets to encourage efficient allocation of investment dollars.
- We serve as a collaborator with, and contributor to, other SEC divisions and offices and SROs, not as an auditor.

Values

The Office is guided by four core values:

- ACCESSIBILITY — We engage with both small businesses and their investors, as well as with the SEC, SROs, Congress, and other agencies on a regular basis through a variety of channels.
- TRANSPARENCY — We are visible and open in our approach to supporting small businesses and their investors.
- PRAGMATISM — We approach problems with a solution-oriented mindset by making practical, market-driven recommendations.
- EFFICIENCY — We operate like a lean start-up, maximizing resources and focusing activities where the Office can have a measurable impact.
Inaugural Year of the Office in Review

LAUNCH OF THE SEC’S NEWEST OFFICE

**JANUARY 31**
Martha Legg Miller was sworn in as the first Advocate for Small Business Capital Formation, with initial team members joining shortly thereafter.

**MARCH 18-20**
Office hosts first external engagement events with entrepreneurs and investors in Kansas City, MO and KS.

**APRIL 8**
Publication of Foundational Business Plan and roll out of plans for 2019 activities at SEC Speaks.

**MAY 6-10**
National Small Business Week, including Small Business Roundtable with Commissioners, inaugural meeting of the Small Business Capital Formation Advisory Committee, and celebration of the 100th day of the Office.

**JULY 22**
Advisory Committee hosts first out of DC meeting in Omaha, NE, making recommendations on open rulemakings.

**AUGUST 13**
Office hosts the 38th Annual Government-Business Forum on Small Business Capital Formation in Omaha, NE at Creighton University.

**AUGUST 14**
Office hosts the SEC’s newest office.
Business Plan

Throughout the first year of our Office, we have often referred to ourselves as a “start-up within the government,” challenged with operationalizing and delivering solutions to our “customers”—small businesses and their investors—starting from a blank slate. We began building out the Office by engaging in the same work that thousands of startups across the United States engage in each year: developing a business plan. Starting with our enabling legislation as guideposts, we crafted a statement of our Office’s mission to guide each decision we would make, keeping small businesses’ and their investors’ needs first of mind. Just as businesses do, we followed that by defining our target market and began identifying the capital formation needs of different small business market segments. With the mission and target market established, we outlined the products, programs, and services our Office would deliver, established projected launch dates, and began identifying critical components of each deliverable to ensure that we scale in a lean and efficient manner, again adopting a business-oriented mindset to solutions tailored to our target market. We created the business plan as a compass to guide decisions internally, as a pacesetter to keep us on track, and as a roadmap to guide expectations externally. Because of the premium we place on transparency, we put the business plan on our website to be open about our thought process and plan of action.

Outreach Activities
Highlighted Engagements in Fiscal Year 2019

In addition to hundreds of meetings, phone calls, emails, and cups of coffee shared with individuals across the small business ecosystem, we have sought out opportunities to engage with diverse groups of small business thought leaders—our Office’s customers—through events, speaking engagements, and networks of potential beneficiaries of our Office’s products, programs and services. Some of the events in which we have engaged this year include:

- **March 19, 2019**
  - **Overland Park, KS**
  - Panel discussion alongside individuals from the public and private sector, hosted by the U.S. Department of State.

- **April 8, 2019**
  - **Washington, DC**
  - Launch of the Office’s Foundational Business Plan and plans for inaugural year of the Office.

- **April 30, 2019**
  - **Washington, DC**
  - Solicitation of investor input from smaller funds and investment companies.

- **May 3, 2019**
  - **Denver, CO**
  - Roundtable discussion with small business owners and investors on pressing capital formation issues.

- **March 20, 2019**
  - **Kansas City, MO**
  - Town hall meeting with small business owners, investors, and aspiring entrepreneurs.

- **April 9, 2019**
  - **Washington, DC**
  - Discussion of the creation of the Office and role at the SEC with international securities regulators.

- **May 3, 2019**
  - **Denver, CO**
  - Discussion of legal issues in small business capital formation in the Rockies.

- **May 6, 2019**
  - **Washington, DC**
  - Roundtable focused on experiences of businesses and investors raising capital and investing outside of coastal “hot spots.”
**National Association of Women Business Owners’ Advocacy Day**

**June 4, 2019**
**Washington, DC**

Collaboration with female entrepreneurs on their national advocacy day.

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**38th Government-Business Forum on Small Business Capital Formation**

**August 14, 2019**
**Omaha, NE**

Hosted forum, gathering members of the public and private sectors to craft suggestions for securities policy.

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**U.S. Black Chambers 10th National Conference**

**August 20, 2019**
**National Harbor, MD**

Panel discussion on the art of capital raising and deal activity.

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**Rural RISE 2019 Summit**

**Sept. 18, 2019**
**Pine Bluff, AR**

Panel discussion highlighting government resources to empower rural communities to foster entrepreneurship.

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**National Small Business Association**

**June 10, 2019**
**Washington, DC**

Discussion with NSBA’s Leadership Council on their top issues.

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**Maha Discovery Festival**

**Aug. 15, 2019**
**Omaha, NE**

Pitched the Office like an entrepreneur at the largest Midwestern entrepreneurship conference.

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**The Venture Center Roundtable**

**Sept. 17, 2019**
**Little Rock, AR**

Roundtable discussion with the Little Rock startup and fintech community.

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**NYSE American Emerging Companies Summit**

**Sept. 19, 2019**
**New York City, NY**

Fireside chat discussing issues faced by small reporting companies and their investors, and Inside the IceHouse podcast episode recording.
Launch of Video Content

Small business owners and their investors often do not engage with the SEC (or other federal government agencies) for many reasons, including lack of time and resources. In an effort to increase engagement in the regulatory process, the Office piloted four videos in FY2019 that, in 3-5 minutes, provide a high-level, plain English overview of a rulemaking topic, how it affects small business interests, and how the viewer can engage and provide feedback. These videos are a reflection of growing trends in information consumption, with 80% of all internet traffic in 2020 projected to be video.21

The FY2019 videos included.22

- How to Comment: Engage in the Rulemaking Process
- Harmonization of the Exempt Offering Framework
- Accelerated Filer Proposed Amendments
- Simplifying the M&A Accounting Rules

The videos reflect the changing nature of how people are consuming information and prioritizing visual content. External audiences have been far more willing to stream a short video about a securities law topic that they see on social media than to dig into a lengthy PDF on SEC.gov to find out if is relevant to them. Going forward, the Office will continue exploring video and other forms of media to better engage with and inform small businesses and investors.

Small Business Forum

The Office hosted the SEC’s 38th annual Government-Business Forum on Small Business Capital Formation on August 14, 2019 in Omaha, Nebraska at the Heider College of Business at Creighton University, continuing the SEC’s three-year tradition of taking the Forum outside of Washington, DC. The Forum is a unique event where members of the private and public sectors converge to identify and highlight issues they experience in accessing capital and investing in small businesses and then formulate solutions on which the government can take action. The Office assumed responsibility for the Forum beginning in FY2019 under the Small Business Advocate Act. A separate report has been delivered to Congress summarizing the proceedings and recommendations of the participants.23
[Top] “Capital Formation Success Stories from the Silicon Prairie” panelists and SEC Commissioners engage in a thoughtful dialogue about capital raising.

[Center] SEC Commissioners and “Harmonization: What a Concept!” panelists.

[Bottom left] Commissioner Rob Jackson visits with business owners and investors.

[Bottom right] Commissioner Allison Herren Lee talks with panelists and participants.
The data provided in this Report is derived from a combination of public filings with the SEC, as analyzed by the SEC’s Division of Economic Research and Analysis (DERA), and is supplemented with figures and findings from third parties. In doing so, we hope to provide a snapshot view of the state of U.S. small business capital formation, amalgamating many important pieces of the capital formation story into one resource to aid in evaluating the current flow of investment capital between small businesses and investors. The data supplements anecdotal evidence and helps quantify the successes and challenges in small business capital formation nationwide. Using data, we can better identify what tools, strategies, and approaches would be most helpful in crafting policy solutions. Unless otherwise indicated, the data period utilized for DERA data is July 1, 2018 to June 30, 2019.

What regulatory pathways are companies using to raise capital?24

<table>
<thead>
<tr>
<th>Private Offerings</th>
<th>Public Offerings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Regulation D</strong></td>
<td></td>
</tr>
<tr>
<td>Rule 506(b)</td>
<td>Initial Public Offerings</td>
</tr>
<tr>
<td>Private Placements</td>
<td><strong>Other Registered Offerings, including Secondary Offerings</strong></td>
</tr>
<tr>
<td>Accredited Investor Crowdfunding</td>
<td></td>
</tr>
<tr>
<td>Rule 506(c) Limited Offerings</td>
<td></td>
</tr>
<tr>
<td>Regulation A Mini IPOs</td>
<td></td>
</tr>
<tr>
<td>Regulation CF Crowdfunding</td>
<td></td>
</tr>
</tbody>
</table>

- **Rule 506(b)**: Private Placements - $1.4T median
- **Rule 506(c)**: Accredited Investor Crowdfunding - $210B median
- **Rule 504**: Limited Offerings - $260M median
- **Regulation A**: Mini IPOs - $800M median
- **Regulation CF**: Crowdfunding - $54M median

- **Initial Public Offerings**: $50B median
- **Other Registered Offerings, including Secondary Offerings**: $1.2T median
What are the primary types of offerings and what companies are using them?

<table>
<thead>
<tr>
<th>OFFERING TYPE</th>
<th>IN A NUTSHELL</th>
<th>TYPICAL CO. PROFILE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Crowdfunding</td>
<td>Raising up to $1.07 million from many investors online.</td>
<td><img src="image1.png" alt="Image" /></td>
</tr>
<tr>
<td>Limited Offerings</td>
<td>Raising up to $5 million from investors, often with whom the company has a relationship.</td>
<td><img src="image2.png" alt="Image" /></td>
</tr>
<tr>
<td>Intrastate Offerings</td>
<td>Raising capital locally according to state law exemptions, which generally cap the offering at between $1 million to $5 million, depending on the state.</td>
<td><img src="image3.png" alt="Image" /></td>
</tr>
<tr>
<td>Private Placements</td>
<td>Raising unlimited capital from higher net worth investors with whom the company has a relationship.</td>
<td><img src="image4.png" alt="Image" /></td>
</tr>
<tr>
<td>Accredited Investor Crowdfunding</td>
<td>Raising unlimited capital from higher net worth investors, often online, using general solicitation.</td>
<td><img src="image5.png" alt="Image" /></td>
</tr>
<tr>
<td>Mini Public Offering</td>
<td>Raising up to $50 million from many investors online.</td>
<td><img src="image6.png" alt="Image" /></td>
</tr>
<tr>
<td>Registered Offerings (including Initial Public Offerings)</td>
<td>Raising large amounts of capital through “IPOs” or secondary offerings through a registration statement filed with the SEC.</td>
<td><img src="image7.png" alt="Image" /></td>
</tr>
</tbody>
</table>

**Small, Emerging Businesses**

**Mature and Later-Stage Businesses**

**Small Public Companies**
How are companies using the offering types in the industries that raise the most capital (excluding pooled funds)?

- **BANKING**: $397B in registered offerings, $39B in Regulation D, and $163M in Regulation A.
- **TECHNOLOGY**: $138B in registered offerings, $12M in Regulation D.
- **MANUFACTURING**: $129B in registered offerings, $48M in Regulation D.
- **REAL ESTATE**: $58B in registered offerings, $486M in Regulation D, $67B in Regulation A.
- **ENERGY**: $105B in registered offerings, $19B in Regulation D, $5M in Regulation A.
- **HEALTH CARE**: $92B in registered offerings, $49M in Regulation D, $23B in Regulation A.

The Office joined over 300 rural capacity builders in Pine Bluff, Arkansas at Rural RISE, highlighting government resources to empower rural communities fostering entrepreneurship.
Where are companies raising capital?34

The maps included in this section illustrate the concentration of estimated total capital raised under various different offering types by issuers that report a primary location in the U.S., with the number of offerings conducted indicated on each state.
Small, Emerging Businesses

Companies within this segment of the market generally raise capital through some combination of bootstrapping, self-financing, bank debt, friends and family, crowdfunding, angel investors, and seed rounds. This funding is commonly used to get companies off the ground and through early prototypes.

How are early stage small businesses accessing capital?

Small businesses often bootstrap and self-finance to overcome access to capital challenges, including using the following overlapping resources:

- **PERSONAL FUNDS**: 69%
- **RETAINED BUSINESS EARNINGS**: 69%
- **LOAN OR LINE OF CREDIT**: 55%
- **CREDIT CARDS**: 52%
- **EQUITY FROM INVESTORS**: 7%

Notably, funding operations using retained business earnings is generally an option only available to established companies.

How are small business loans and lines of credit typically collateralized?

- **PERSONAL GUARANTEE**: 58%
- **BUSINESS ASSETS**: 49%
- **PERSONAL ASSETS**: 31%
- **PORTIONS OF FUTURE SALES**: 8%
- **NONE**: 16%

Young small businesses are more likely to tap into informal sources of credit such as funding from owners or family and friends, while older firms are more likely to receive funding from more traditional sources.

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Young small businesses are more likely to tap into informal sources of credit such as funding from owners or family and friends, while older firms are more likely to receive funding from more traditional sources.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
How have community banking trends impacted emerging businesses?

Banks are moving away from smaller-dollar loans, which are less profitable at scale. The following figures illustrate that pain point for smaller companies:39

Neither term loans based upon cash flow or commercial revolving lines of credit are available for companies that are not yet revenue-producing or that are temporarily choosing to accelerate growth at the expense of profitability.40

“Capital is the lifeblood of small businesses, who depend on credit to start, operate, and grow. Historically, small businesses relied on banks to access capital. But during the 2008 financial crisis, credit markets froze, and banks temporarily stopped lending even to businesses with good credit. This crisis hit small businesses hard and credit conditions have been slow to recover.”

KAREN G. MILLS, FORMER SBA ADMINISTRATOR41
What is the role of angel investors?

“Angel investors” are generally high net worth individuals who provide financial backing for early-stage businesses, often coming from among an entrepreneur’s friends and family. Angel investors typically invest their own funds directly in a business located in close proximity, often using convertible debt.

What is the scale of angel investing in early-stage companies in 2018?

- **334,565** active angel investors
- **$23.1 billion** in total angel investments
- **66,110** entrepreneurial ventures received angel funding
- **$349,620** average angel funding round

The average angel’s individual investment is between: $5,000 and $100,000

What does the pool of accredited investors look like?

Angel investors are generally “accredited investors,” meaning that they meet certain requirements for income or net worth set forth by the SEC and are eligible to participate in many offerings that are not available to non-accredited investors.
How does household income and net worth vary by region of the U.S.?\(^49\)

<table>
<thead>
<tr>
<th>Region</th>
<th>Mean Household Income</th>
<th>Median Household Income</th>
<th>Mean Household Net Worth</th>
<th>Median Household Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>West</td>
<td>$108,500</td>
<td>$57,500</td>
<td>$873,700</td>
<td>$114,300</td>
</tr>
<tr>
<td>South</td>
<td>$100,000</td>
<td>$51,500</td>
<td>$636,900</td>
<td>$87,000</td>
</tr>
<tr>
<td>Midwest</td>
<td>$102,000</td>
<td>$54,700</td>
<td>$658,800</td>
<td>$103,200</td>
</tr>
<tr>
<td>Northeast</td>
<td>$136,500</td>
<td>$64,400</td>
<td>$851,300</td>
<td>$154,500</td>
</tr>
</tbody>
</table>

What role do non-accredited investors play?

While there are pathways for non-accredited investors to participate in exempt offerings, the vast majority of small businesses are still limiting their offerings to accredited investors.\(^50\) From 2015-2018, non-accredited investors participated in only:\(^51\)

\[6\% \text{ of Rule } 506(b) \text{ transactions}
\]

\[2\text{-}3\% \text{ of total capital raised in transactions under Rule } 506(b)
\]

“\[S\]o much of entrepreneurship happens at the local level. Entrepreneurs raise money from local investors, hire from the local market, and found companies with the people who live in the same area.\]

EWING MARION KAUFFMAN FOUNDATION\(^52\)
How costly is it for early-stage companies to navigate compliance with securities laws?
Companies spend significant money on legal fees in raising early-stage capital, in some cases amounting to the cost of an additional employee’s salary. One 2019 start-up guide quotes the costs as:

- $5,000 TO $20,000 for very early stage
- $20,000 TO $40,000 for a venture capital raise

The age at which companies raise capital has matured:

While in 2014 a 3-year old company was commonly raising Series A, in 2019 that same age company is raising angel and seed-financing.

“[T]he nature of startups receiving financing is fundamentally changing as investors continue to concentrate capital in fewer yet larger deals. At the seed stage, startups historically have been pre-product, but today’s investors tend to prefer a more mature company at this stage, which typically means the startup should at least have a minimum viable product.”

PITCHBOOK
Mature and Later-Stage Businesses

Companies within this segment of the market are generally growing and looking for larger amounts of capital that can fund operations of scale, ventures into new verticals, and preparation for public markets. Most often these investors are institutional in nature, whether syndicate groups, venture capital, private equity, or even public funds.

What is the role of venture capital (VC) in funding mature and later-stage businesses?

VC funds a small portion of the overall number of small businesses (approximately 0.5%), but those businesses tend to have outsized growth trajectories. VCs tend to fund companies with significant return on investment multiples, realizing profit at the company’s initial public offering or sale. A few statistics illustrate VC’s scale and impact on small business capital formation:

- 18,228 VC deals in 2018, up from 6,876 in 2009
- 1,087 VC-backed IPOs from 2009-2018

Increases in the availability of VC funding in metro areas have been correlated with job growth:

- 10% increase in VC in a metro area
- 2.6% increase in the number of small employers
- 2.9% increase in employment at small employers
- 3.9% increase in total payroll
What is the role of private equity (PE) in funding mature and later-stage businesses?

PE funds tend to back companies with return prospects following restructuring, realized through dividends and/or sale of the target company, often funded by a combination of investor equity and debt. A few statistics illustrate PE’s scale and impact on small business capital formation:

10,000
average PE yearly deal count for the past 5 years

1,043
PE-backed IPOs from 2009-2018

Some studies have found that PE returns have recently outperformed the public market (12% for PE vs. 8% for the S&P), while others have noted a greater return dispersion from private equity than from the public market, and mutual funds in particular.

When do mature and later-stage businesses enter the public markets following VC and PE investments?

HISTORICALLY
venture-backed tech companies raised $100 million in total private funding

NOW
>90% of unicorns raise at least $100 million in a single private financing
In what ways do VC-and PE-backed companies enter the public markets?

13,695
Companies backed by PE and late stage VC

700
of which are estimated to become the next immediate generation of public companies\textsuperscript{66}

44.8%
of companies currently listed on the NASDAQ were formerly backed by PE or VC\textsuperscript{67}

From 2009 to 2018, public companies acquired

11,000+
PE and VC-backed companies for over $3 trillion

to serve various growth, intellectual property, talent and strategic needs\textsuperscript{68}
Small Public Companies

Companies can access broad pools of investors when they conduct public offerings, allowing companies to raise large amounts of capital to fund activities such as research and development, capital expenditures, or debt service. Public offerings also provide liquidity to early-stage investors and publicity for the company’s products and services.

How has the prevalence of publicly traded companies changed over time?69

Companies are increasingly going public at a later stage in their lifecycle after raising more capital from the private markets, providing for less growth following their IPO. In other words, companies are generally choosing to enter the public markets after maturing beyond the smaller reporting company thresholds.71
IPOs from July 1, 2018 through June 30, 2019:

<table>
<thead>
<tr>
<th>204</th>
<th>$243 Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>IPOs</td>
<td>Average Proceeds</td>
</tr>
</tbody>
</table>

IPOs and other registered offerings by small public companies from July 1, 2018 through June 30, 2019:

<table>
<thead>
<tr>
<th>294</th>
<th>$47 Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Offerings</td>
<td>Average Proceeds</td>
</tr>
</tbody>
</table>

The Fortune 500 has changed dramatically since 1955:

- Only 12% remain on the list in 2014
- The other 88% have gone out of existence, merged, or fallen off the list

Small companies struggle for attention:

- 61% of exchange-traded companies with <$100 million market capitalization have no research coverage

The old pattern was that small companies raised small amounts of speculative capital from venture capitalists at speculative valuations, and then the ones that worked out went public at much higher valuations. The new pattern is that large companies raise large amounts of not-particularly-speculative growth capital from mutual funds at mature-company valuations, and then eventually they sort of quietly slip into being public.

MATT LEVINE, BLOOMBERG

""
Women-Owned Businesses

Women are founding more start-ups:77

21.6% of start-ups in 2018

4% of start-ups in 2001

Women constituted 25.9% of entrepreneurs seeking capital in 2018...

Capital used at start-up varies by gender:78

$54,375 for women

$80,285 for men

and had an investment yield rate of 17.5%

compared to a baseline rate of 23.2%

Women are less likely to apply for bank loans, despite research finding no differences in approval rates.79
In 2018, women founding teams received less VC funding than their male peers of the approximately $130 billion reportedly invested.\textsuperscript{81}

One study found that companies founded or co-founded by women generate more revenue:\textsuperscript{82}

Per $1 of investment...

- male-only teams create 31¢ of revenue
- female teams create 78¢ of revenue

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\textsuperscript{81} For more information, see: [Source Link]

\textsuperscript{82} For more information, see: [Source Link]
What effect does sexual orientation have on access to capital?

Research by StartOut found that gender had a far greater effect on startup funding levels than sexual orientation of the founders.\(^83\)

Women Investors in Small Businesses

29.5% of angel investors are women\(^84\)

only 11% of VCs across the industry are women\(^85\)

71% of VC firms have no female partners\(^86\)
Minority-Owned Businesses

The most recent estimates show that 8 million businesses are minority owned, or 29.3% of U.S. firms. Since 2007, there has been a 38% increase in the number of minority-owned businesses.

Numbers of Minority-Owned Businesses

- Native Hawaiians and other Pacific Islanders: 54,749
- Latinx: 3,305,873
- Asian: 1,917,902
- Black: 2,584,403
- American Indians and Alaska Natives: 272,919

Numbers of Minority-Owned Businesses by State

The map shows the number of minority-owned businesses in each state, categorized by the number of businesses per range:
- 1–2 million
- 500,000–999,000
- 100,000–499,000
- 50,000–99,000
- 10,000–49,000
- 1,000–10,000
What challenges do minority-owned businesses face in accessing capital?

Minority-owned businesses face challenges in accessing loans from banks, including:

- **3X** more likely to be denied loans
- **7.8%** average interest rate (vs. 6.4% for non-minority)

New black-owned businesses start with almost three times less in terms of overall capital compared with new white-owned businesses:

- **$35,205**
- **$106,720**

Minorities constitute **10.7%** of entrepreneurs seeking capital in 2018 and had an investment yield rate of **22%**, compared to a baseline rate of **23.2%**.
Minority entrepreneurs report profitability is disproportionately impacted by lack of access to capital.

What challenges do Latinx business owners report in accessing debt financing?

<table>
<thead>
<tr>
<th>Minority Group</th>
<th>Application Rate for Financing</th>
<th>Likelihood of Funding Shortfalls</th>
</tr>
</thead>
<tbody>
<tr>
<td>African American</td>
<td>22%</td>
<td></td>
</tr>
<tr>
<td>Latinx</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>Asian-American</td>
<td>13%</td>
<td></td>
</tr>
<tr>
<td>White</td>
<td>9%</td>
<td></td>
</tr>
</tbody>
</table>

47% of Latinx business owners compared to 40% of Non-Latinx report a lower application rate for financing. Similarly, 28% of Latinx report a higher likelihood of funding shortfalls compared to 49% of Non-Latinx.
Only 5.3% of angel investors are minorities. 

Minority Investors in Small Businesses
VC Workforce Representation

Employees

Investment positions

Investment partners

Black  Asian/Pacific Islander  Latinx  White
When natural disasters strike communities, they often impact the survival prospects for small business, who may have fewer resources to weather the challenges to rebuild the business and reinvigorate its customer base.

Impact of Natural Disasters on Small Businesses

Immediate: 40% will not reopen
1 Year Later: 25% will close
3 Years Later: 75% without a business continuity plan will fail

Reported Small Businesses Losses Following Natural Disasters

<table>
<thead>
<tr>
<th>Assets</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1-$25,000</td>
<td>45%</td>
</tr>
<tr>
<td>$25,000+</td>
<td>19%</td>
</tr>
</tbody>
</table>
How does the percentage of the population affected by natural disasters compare to the amount of capital being raised?

27% of the US population lives in an area that was affected by a natural disaster over three years ending June 30, 2019.

However, businesses in areas affected by natural disasters over that three year time period are generally raising less capital relative to the affected population.

Counties hit by severe disasters experienced greater out-migration, lower home prices and higher poverty rates.

NATIONAL BUREAU OF ECONOMIC RESEARCH"
Rural Communities & Capital Formation

Much of entrepreneurship happens at a local level, particularly in early stages of company formation and growth. The importance of local ecosystems can exacerbate company challenges in rural communities facing population declines, impacting access to potential angel investors, talent, and customers.

How does the rural population compare to the amount of capital being raised?

19% of the U.S. population lived in rural areas\textsuperscript{105}.

17% of small employer firms are located in rural areas\textsuperscript{106}.

However, businesses in rural areas\textsuperscript{107} are raising less capital over three years ending June 30, 2019 relative to affected population:

In recent decades, startup activity has declined in rural areas\textsuperscript{108}. 

\begin{itemize}
  \item 20% of small employer firms are located in rural areas in 1977.
  \item 12% of small employer firms are located in rural areas in 2017.
\end{itemize}

Compared to 19% of affected population.
The decline in community banks in rural areas is crippling access to early-stage debt for small businesses. As of 2017 in the U.S.’s 1,980 rural counties:

- 115 have just one community bank branch
- 625 do not have a locally-owned community bank
- 35 have no bank

Many angel groups are working to find investment opportunities outside of the “four hour drive radius” rule of thumb, such as through state-wide networks.

For venture capital, the data indicate that while the average deal size and concentration of deals (inputs) in rural geographies may be less than that of urban regions, there is little difference in the performance of a rural investment in terms of multipliers, jobs, or exit types (outcomes).

PATRICIA SCRUGGS, WAYNE EMBREE AND ROB WILT BANK
Over the course of the first year in operation, the Office has received feedback on various issues encountered by small businesses and their investors from start-up to small cap, from coast to coast, and across industries. The recommendations set forth in this report are proposed as pragmatic and principles-based solutions to the most serious issues raised with the Office. Our general experience has shown that where an issue affects a broad segment of the market, the magnitude of the issue’s impact is often greater for minority-owned and women-owned small businesses and investors, as well as on small businesses and investors in areas affected by natural disasters or in rural areas.

Our Office is generally supportive of the current initiatives and rulemakings underway at the SEC as they relate to small business capital formation. We present these recommendations as an opportunity to distill specific marketplace calls for action that are either not a part of the current regulatory or congressional agenda or that are complimentary to ongoing efforts. These recommendations provide a focused set of five critical challenges expressed by the market, with corresponding background discussion, summary of issues raised, and proposed solutions.
Modernize, Clarify, and Harmonize Exempt Offering Framework

Background
Access to capital markets is critical for much of small business financing, with investor capital playing separate and complimentary roles to financing from the banking sector. In meeting with businesses and their investors across the country about capital formation, one of the most consistent critiques expressed has been that the current exempt offering framework is complex and confusing. While the current rules contain a relatively broad “menu” of tools to raise capital, the requirements for each differ and in some cases conflict. This challenging regulatory puzzle is understandably difficult to navigate, with each puzzle piece originating at different times and in response to different policy demands, with origins all the way back to 1933 with the Securities Act’s passage. A complex path to capital to grow, scale, and mature makes it all the more challenging for companies to fulfill our collective expectation of new entrants joining the public markets to supplant the past two decades’ approximate 50% drop in listed companies. It is imperative that companies and investors have navigable and functional tools for the exchange of capital in early, pre-IPO stages to build the pillars of tomorrow’s public markets.

Issues Raised
To understand securities law compliance, marketplace participants tend to need either a law degree or access to sophisticated counsel who can help them navigate the rules, both of which carry a significant price tag and can be a barrier to entry. This issue is exacerbated for those without broad networks or without excess funds to hire counsel in the midst of raising capital (which naturally tends to occur when capital is at its scarcest). While the “menu” of exemptions contains many options, regulatory uncertainty or confusion often incents companies and their investors to avoid using certain exemptions in favor of the most common and well understood pathways. For example, the integration doctrine is used to determine when more than one transaction should be “integrated” and considered a single offering, and it entails a facts and circumstances analysis dating back to 1933. Although it has been modernized and clarified over the years, companies and investors, as well as their counsel, struggle when trying to raise money using different offering exemptions that do not all allow general solicitation. When the rules confuse not only the actors who are directly impacted by the rules—namely, businesses and investors—but also counsel on whom they rely for expert advice, capital formation is negatively affected.

A small business owner in Pine Bluff, Arkansas shares her perspectives with the Office over coffee.
Proposed Solution: Harmonization

The SEC’s recent Harmonization Concept Release\(^{120}\) sought unprecedented feedback on the areas in which the exempt offering framework works effectively, as well as where it can be improved to support efficient flow of capital while maintaining appropriate investor protections. Many ideas have been proposed to modernize, clarify, and streamline the regulations on the offer and sale of securities, and we have overwhelmingly heard support from marketplace participants for implementing many of the ideas suggested. In doing so, we would prioritize the following guiding principles:

- The rules, as well as how we at the SEC communicate compliance obligations, should be accessible to both companies and their investors, regardless of legal acumen.\(^{121}\)
- The rules should allow companies to progressively and efficiently raise capital at each stage of the company life cycle as they grow, scale, and mature.
- The internet and technology have revolutionized communication since the Securities Act of 1933, including how businesses reach customers and operate. Any changes to the rules should incorporate an understanding of current communication practices, while also providing flexibility for the inevitable evolution of tomorrow’s tools.
- To the extent that dollar amount caps are incorporated,\(^{122}\) they should be tied to expressed marketplace needs for capital and provide flexibility for future review and adjustment. Caps should also take into consideration the varying demands for capital depending upon industry, geography, and life cycle stage.
- In evaluating the capital formation tools and investor protective measures, Congress and the Commission should reexamine the principles underlying regulation of capital raising transactions in light of the changing needs of the market.\(^{123}\)

See also: Small Business Capital Formation Advisory Committee Recommendation.\(^{124}\)

Investor Participation in Private Offerings

Background

Much attention has been paid recently to investors’ access to opportunities in the private markets, where much of today’s companies’ “J-curve” growth is occurring prior to their IPOs, which are increasingly used as a liquidity rather than capital raising event. Many of the offering exemptions used in the private markets, whether under Rules 506(b) or 506(c) of Regulation D or under Regulation A, limit participation to accredited investors or contain restrictions on participation by non-accredited investors, including complete participation restrictions or investment limitations. The definition of “accredited investor” is “intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act’s registration process unnecessary.”\(^{125}\) The Senate Committee on Banking, Housing, and Urban Affairs noted that the addition of the accredited investor definition in the Small Business Investment Incentive Act of 1980\(^{126}\) was intended to “give small businesses greater access to ... sophisticated investors without the costs associated with the registration requirements.”\(^{127}\)
The SEC’s current rules define a natural person as an accredited investor if that investor either:

- earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year; or
- has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person’s primary residence).

The definition also qualifies many types of entities as accredited investors if they have assets exceeding $5 million. However, the definition’s enumerated list omits certain types of entities, such as American Indian tribal corporations, which has the practical effect of excluding otherwise sophisticated investors from participating in investment opportunities.

For retail investors (i.e., individuals buying securities for their own account), there are few opportunities to participate in the growth of the private markets via diversified portfolio holdings, whether through pooled investment vehicles (i.e., mutual funds or exchange-traded funds) or otherwise. Private funds, such as venture capital funds and private equity funds, generally operate under exemptions from registration, which limit their accessibility to most retail investors. Current liquidity and valuation requirements on open-end funds, the most popular fund type for retail investors, present challenges to significant holdings in private companies. Closed-end funds, such as interval funds and tender offer funds, issue shares that are not freely redeemable and thus not subject to the liquidity risk management rules of open-ended funds, making them better suited to hold interests in private companies. However, they often trade at a discount to net asset value, contributing to their relative lack of popularity with investors. Business development companies (BDCs) and small business investment companies (SBICs) are other types of funds that invest in private companies, but they may be more difficult for retail investors to gain exposure to in practice.

Issues Raised
Any changes to the definition of “accredited investor” or to retail access to private markets will have dual impacts on investors’ access to investment opportunities as well as the supply of capital to the exempt markets. Throughout our conversations in FY2019 on raising earlier stage capital from individual investors, whether from angels or friends and family, both businesses and investors have acknowledged the benefit of guardrails for retail investors, while also highlighting the imbalance of a single test based solely on income, net worth, or total assets. Women, minorities, and rural communities have expressed disproportionate challenges with the standard, which often draws a line between the investors’ network and qualification for the most attractive offering exemptions. The current standard arguably prioritizes an investor’s ability to sustain the risk of loss without sufficient consideration of an investor’s financial sophistication. Many have recommended creating avenues for sophisticated investors to participate in exempt offerings by adding alternative criteria for qualification.
In addition, investors—both accredited and non-accredited alike—have criticized their lack of access to high-growth potential companies in the private markets, who often trade on the public markets only after achieving most of their growth potential. Some have expressed frustration with the idea that “you have to be rich to get rich” under the current rules. For some accredited investors, they lack the time and resources to personally source, vet, and invest in a diversified portfolio of private companies that balances return potential with inevitable risk of failure of many early-stage businesses.

Proposed Solution: Accredited Investor Refinement

Adding alternative measures for evaluating investor sophistication would further Congress’s and the Commission’s stated goals of facilitating capital formation while providing appropriate protections for investors. Additional qualifying pathways to individuals being accredited based upon sophistication in making investment decisions could include:

- financial professionals licensed by or registered with the SEC, state securities regulators, or appropriate self-regulatory organizations (e.g., FINRA); and
- attainment of designated financial industry examinations or licenses.

Any additional means of qualifying should provide companies, investors, and their advisors with simplicity and certainty in ascertaining qualification to avoid inadvertent increases in transaction costs and thereby costs of capital. Based upon the differential access to investors, varying costs of living, and corresponding income and net worth levels by geography, we note that increasing the base income and net worth thresholds would have a disproportionate impact in more rural and emerging entrepreneurial ecosystems, as well as on under-represented business owners and investors.

When updating the definition of accredited investor, it would further add simplicity and clarity to eliminate the list of enumerated entities that may qualify if such entity has over $5 million in assets and instead make clear that any entity that has more than the asset threshold would qualify regardless of corporate form.

Proposed Solution: Retail Investor Access to Pooled Vehicles
Current fund rules allow investment companies to deploy limited strategies to invest in less liquid assets, such as private funds, as well as direct holdings in private companies. However, as the above-referenced data indicates, the current tool set is not well-utilized. Attention should be given to whether that underutilization is a byproduct of market preferences or whether the fund rules make those vehicles less attractive for fund formation, management, and investment, with corresponding changes to the rules suggested. While the structure of public funds investing in private funds may be critiqued for a double-layer of management fees, reasonable fees may be justified where they afford investors asset management by professionals with experience in private markets, deal terms on parity with other sophisticated institutional investors, and an otherwise inaccessible diversified portfolio of private market holdings. Efficient fee structures should be prioritized in developing pooled vehicle solutions.

In addition, continued focus on retail investors’ access to smaller funds—including those that invest primarily in smaller cap public companies, those with diversified positions including private holdings, as well as those focused on private market holdings—will further support competition and small business capital formation.

See also: Small Business Capital Formation Advisory Committee Recommendation, Committee on Capital Markets Regulation 2018 Report.

Engaging Investors via Finders

Background
One of the biggest challenges that small businesses face when they seek to raise capital is identifying and connecting with potential investors who are a good fit from market/industry experience, risk tolerance, and investment capability perspectives. Sometimes companies, particularly those raising

The Office collaborates with female business owners on their national advocacy day in Washington, DC, answering questions about their challenges finding investors.
large amounts of capital pre-IPO, engage registered broker-dealers to line up a book of investors in exchange for a success or other fee. However, broker-dealers are increasingly concentrating their activity upstream in the market where they can offer a package of services, leaving companies seeking more routine introductions or relatively smaller amounts of capital (e.g., as one source noted, under $5 million\textsuperscript{147}) without a connection to capital sources. Finders often bridge the gap between entrepreneurs who need funding and potential investors interested in supporting emerging companies by making introductions, often for a fee.\textsuperscript{148} Finders may also provide businesses with support services, such as consulting on market deal terms or commentary on pitch materials, generally engaging in activities short of what many suggest should require registration as a broker-dealer.\textsuperscript{149} Over the course of many decades and through a series of SEC no-action letters and case law, a nebulous distinction between finders and broker-dealers has emerged.\textsuperscript{150} Many proposals have been put forward to provide clarity on where the line should be drawn between exempt finders, on the one hand, and full registration as a broker-dealer, on the other.\textsuperscript{151}

**Issues Raised**

Locating the right investors is challenging no matter where a company is located, but that pain point is felt more acutely for entrepreneurs located far from the “hotspots” of VC and other funding sources where their network may not extend. Some demographic groups—namely women and minority business owners—have expressed that they face higher hurdles to connecting with funders based upon their network of potential investors who may not be accredited, often needing the support of finders to locate investors with the right investment capacity and risk tolerance. In short, the lack of clarity on the role for finders in matchmaking between companies and investors disproportionately impacts smaller companies, companies in geographic areas or segments of the market not served by registered broker-dealers, and companies with under-represented founders.

**Proposed Solution: Clear Finders Framework**

Small businesses and their investors need clarity on what role finders can play in providing services that fall short of requiring registration as a broker-dealer. Over the years, many potential solutions have been offered, from bright line exemptions to carve-outs for de minimus activity to “light” registration requirements.\textsuperscript{152} In implementing a framework for finders to support emerging businesses’ capital needs and provide clarity to investors participating in the market, it is critical that the rules be clear for marketplace participants to reduce confusion, defining in plain English the activities that do not trigger registration and delineating when the scope of activities rises to the level that registration is appropriate. The framework should make clear what offering exemptions are eligible, whether the introduced investors must be accredited, the nature of compensation the finder may receive, the types of other incidental activities that the finder may engage in on behalf of the business, and the respective roles of federal and state regulators. Providing a clear framework should bring welcomed transparency to an otherwise opaque area of the market.\textsuperscript{153}

Crowdfunding

Background
Crowdfunding—or the practice of raising capital in relatively small amounts from a large number of investors, typically over the internet—is one of the newest offering exemptions, with rules finalized by the SEC in 2015 following the Jumpstart Our Business Startups (JOBS) Act of 2012. This mode of capital raising originated overseas in the wake of the 2008 financial crisis because of the difficulty entrepreneurs and small businesses faced in raising funds. In a nutshell: with traditional banks providing fewer loans to earlier stage companies, entrepreneurs began looking elsewhere for capital. While some states had an intrastate crowdfunding framework prior to the JOBS Act, the equity crowdfunding industry did not take off until after the 2012 legislation and SEC rules that followed. Many online portals support companies raising capital through two different regulatory pathways that originated in the JOBS Act: (1) Regulation Crowdfunding under Title III (or Reg CF), which caps the offering at $1.07 million per year and includes other limitations on individual investments, and (2) Rule 506(c) general solicitation offerings to verified accredited investors, sometimes referred to as “accredited investor crowdfunding.” This section focuses on the Reg CF path for crowdfunding.

Further to the origins of the equity crowdfunding funding model, these offerings provide an alternative source of capital where community bank presence has waned. Some studies, as well as anecdotal evidence, have indicated that crowdfunding is boosting success in raising capital for certain demographics of entrepreneurs disproportionately to the rest of the entrepreneurial population, including women-owned, minority-owned, and rural businesses, as well as younger entrepreneurs. These are populations of business owners who are notoriously underserved by traditional capital raising, such as through private placements to accredited investors. In other words, crowdfunding may be bridging the gap between entrepreneurs without broad networks of high wealth investors and interested backers of their companies. Feedback to our Office indicates that the primary beneficiaries of crowdfunding investments are twofold:

1. businesses in communities where smaller or community banks are less accessible; and
2. businesses with meaningful growth potential but who lack “venture returns” of 10x+, such as lifestyle, services, or retail businesses.

For businesses in the first group, they are often raising capital below the current $1.07 million Reg CF offering cap, many times from a loyal customer base. This may be reflected by the $25,000 median target amount sought by companies in Reg CF offerings, where crowdfunding is filling the gap left by banks for small dollar loans. However, for businesses in the second group, the current offering cap has been described as a deterrent or hindrance to utilization of crowdfunding in the first place, with those companies needing significantly more capital than the $1.07 million cap permits.

The SEC published its three-year lookback report in May 2019 examining utilization of the nascent Reg CF exemption, showing modest adoption rates, which may be in part driven by some of the limitations flagged by companies, portals, and investors.
Issues Raised

Users of crowdfunding have flagged various issues with the framework as designed by both statute and regulation. The current constructs may unduly limit investor interest in participation. Company appetite for compliance costs relative to the available proceeds may point them towards offering types with lower compliance costs. Contrasted with their foreign counterparts, companies are raising more capital overseas using crowdfunding in an arguably more efficient manner. Portals, many of which are small businesses themselves that have raised capital to fund initial operations, have flagged the challenges they face with profitability of their business model given the limitations on equity compensation and the high costs of compliance, which may push portals to redirect their focus to other vibrant overseas crowdfunding markets or to other more profitable segments of the domestic market.

Proposed Solutions: Crowdfunding Updates

Changes to the current structure and requirements for Reg CF would enable companies and investors to use equity crowdfunding to its fullest potential. Potential solutions include:

- Increase the total amount that companies can raise in a 12-month period from the current $1.07 million to better align with early-stage companies’ evolving capital needs, as well as international practices. Trends are showing that Series A is “the new” seed funding, as companies seek increased capital to fund early-stage operations (e.g., in 2018 the average seed funding was $5.7 million and average Series A round was $15.7 million, compared with 2010 averages of $1.3 million for seed and $5.1 million for Series A). An increased cap would allow companies to raise meaningful early-stage capital using crowdfunding rather than limiting companies’ options to a narrower set of exemptions.
- Remove the investment cap for accredited investors, which would harmonize the crowdfunding rules with Regulations A and D, neither of which limit investment amounts by accredited investors.
- Reevaluate the thresholds for the various disclosure obligations, such as reviewed and audited financials, to appropriately tier to the capital raised and the costs incurred by companies at investors’ expense. For example, reporting requirements could be simplified for companies raising under $250,000.
- Enable the use of special purpose vehicles (or SPVs), which would have the potential benefits of cleaning up the cap tables for companies, making them more attractive to follow-on investors and mitigating Rule 12(g) threshold concerns, and streamlining management of investor rights, potentially providing a more impactful voice for investors and providing companies with a more engaged investor for strategic support.
- Reevaluate the compliance requirements for portals as well as permissible types of compensation, such as increasing flexibility for equity compensation.


### Scaled Obligations for Smaller, Less Complex Reporting Companies

**Background**

The U.S. securities laws allow companies to access the public markets in exchange for disclosures to investors about relevant financial and operating information. Over the years, the disclosure obligations of public companies have evolved and substantially increased in breadth. In addition to the costs of going public, which cost most companies over $1 million, companies incur significant ongoing compliance costs for being public. In one survey, two-thirds of CFOs estimated spending $1 million to $1.9 million annually for ongoing compliance costs, allocated among auditing fees (32%), financial reporting (18%), legal costs (16%), regulatory compliance (12%), public and investor relations (9%), and various other expenses. These costs are separate from the staffing needs of companies to implement compliance. Put simply, the reporting compliance costs—

The Office engages in a fireside chat discussion about the issues faced by small reporting companies and their investors at the New York Stock Exchange.
in addition to the increased costs of potential shareholder litigation—are costs unique to public companies that are not borne by private companies on a comparable scale.

**Issues Raised**

In discussing the decision to remain private or to embark upon an IPO, many investors and companies—particularly those who are smaller—have pointed towards balancing allocation of resources to compliance obligations versus funding innovation at scale. When weighing the potential costs of public company compliance, the impact of those obligations often has a relatively greater resource-constraining effect on smaller entities, many of whom lack the complexity both organizationally and financially that many of the compliance rules were drafted to address. This debate among marketplace participants on striking the right balance has occurred concurrently with concerns over the waning entrance of smaller public companies in recent years.

**Proposed Solution: Continued Scaling Obligations**

Congress and the Commission have recently taken actions to streamline the pathways for growing companies to access the public markets without unnecessary compliance burdens swaying companies’ and their investors’ decision to remain private. Recently, the SEC has embarked upon a series of rulemakings aimed at improving disclosures for investors while simplifying compliance for companies, with many of the changes aimed at improving the readability of disclosure documents and reducing repetition or disclosure of information that is not material. Many recent amendments to the rules emphasize a principles-based approach, reflecting the evolution of businesses and the philosophy that a one-size-fits-all approach can be both under and over-inclusive. The Office encourages Congress and the Commission to continue to tailor the disclosure and reporting framework to scale the obligations of reporting companies to the complexity and scale of operations in furtherance of capital formation and appropriate investor protection.

Small Business Capital Formation Advisory Committee FY 2019 Summary

The Small Business Advocate Act also established the SEC’s new Small Business Capital Formation Advisory Committee, which replaced the SEC’s former Advisory Committee on Small and Emerging Companies. The new Advisory Committee is designed to provide a formal mechanism for the Commission to receive advice and recommendations on Commission rules, regulations, and policy matters related to emerging, privately held small businesses to publicly traded companies with less than $250 million in public market capitalization; trading in securities of such companies; and public reporting and corporate governance of such companies. The Office provides administrative support for the Advisory Committee, which otherwise functions independently.

In April 2019, the Commission appointed the inaugural members of the Advisory Committee. The membership includes companies and investors from across a diverse set of experiences, industries, geographies, and company life cycle stages.

CARLA GARRETT, Chair
Corporate Partner, Potomac Law Group PLLC
Washington, DC

JEFFREY M. SOLOMON, Vice Chair
Chief Executive Officer, Cowen, Inc.
New York, NY

GREGORY YADLEY, Secretary
Partner, Shumaker, Loop & Kendrick, LLP
Tampa, FL

YOUNGRO LEE, Assistant Secretary
CEO and Co-Founder, NextSeed
Houston, TX

GREG DEAN*
Senior Vice President of the Office of Government Affairs, FINRA
Washington, DC

ROBERT FOX
National Managing Partner, Professional Standards Group, Grant Thornton LLP
Chicago, IL

STEPHEN GRAHAM
Co-Chair, Fenwick & West LLP’s Life Sciences Practice
Seattle, WA

SARA HANKS
CEO and Co-Founder, CrowdCheck, Inc.
Alexandria, VA

BRIAN LEVEY
Chief Business Affairs and Legal Officer, Upwork Inc.
Santa Clara, CA
TERRY MCNEW
President and CEO, MasterCraft Boat Holdings
Vonore, TN

SAPNA MEHTA
General Counsel & Chief Compliance Officer,
Rise of the Rest Seed Fund; Associate General
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Boston, MA

CATHERINE MOTT
Founder and CEO of BlueTree Capital
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Venture Fund
Pittsburgh, PA

POORVI PATODIA
CEO and Founder, Biena Snacks
Allston, MA

MICHAEL S. PIECIAK*
Commissioner of the Vermont Department of
Financial Regulation
Montpelier, VT

JASON SEATS
Chief Investment Officer, Techstars
Austin, TX

MARC OORLOFF SHARMA*
Chief Counsel of the Office of the Investor
Advocate, U.S. Securities & Exchange Commission
Washington, DC

JOSEPH SHEPHERD*
Associate Administrator, U.S. Small Business
Administration
Washington, DC

HANK TORBERT
President, AltaMax, LLC
New Orleans, LA

*Advisory Committee members include the SEC’s Advocate for Small Business Capital Formation and three non-voting members appointed by each of the SEC’s Investor Advocate, the North American Securities Administrators Association (NASAA), and the Small Business Administration, as well as an observer appointed by the Financial Industry Regulatory Authority (FINRA).
RECOMMENDATION RE: COMMISSION’S PROPOSAL TO AMEND FINANCIAL DISCLOSURE REQUIREMENTS RELATING TO ACQUISITIONS AND DISPOSITIONS OF BUSINESSES

August 23, 2019

The Committee supports the Commission’s proposal to amend the financial reporting requirements for the acquisitions and dispositions of businesses including Rules 3-05, 3-14, and Article 11 of Regulation S-X, subject to following recommendations:

- That the Commission continue to look at Regulation A companies and whether they warrant different treatment under these rules; and
- That the Commission further look at the proposed amendments to the pro forma financial information requirements with respect to whether the proposed addition of Management’s Adjustments, which are intended to reflect reasonably estimable synergies and transaction effects, should be optional or not required at all.

Specifically,

- The Committee supports the proposed amendments to the Significance Tests under these rules by:
  — Revising the Income Test to include the addition of a revenue component, such that the registrant must exceed both the revenue and net income components; and
  — Revising the Investment Test to change the denominator of the Investment Test from the registrant’s total assets to the registrant’s fair market value.
- The Committee supports the proposed amendment that would require financial statements of the acquired business to cover up to the two most recent fiscal years rather than up to the three most recent fiscal years.

COMMISSION RESPONSE

As indicated on the Fall 2019 Unified Agenda of Federal Regulatory and Deregulatory Long-term Actions (Fall 2019 Unified Agenda), the Division of Corporation Finance is considering recommending that the Commission adopt amendments to Regulation S-X (Rule 3-05) that affect the disclosure of financial information of acquired businesses. Staff in the Division of Corporation Finance will consider this Advisory Committee recommendation in connection with this initiative.
Members of the SEC’s Small Business Capital Formation Advisory Committee discuss capital formation initiatives at the Committee’s inaugural meeting on May 6, 2019.

Members Catherine Mott and Jason Seats discuss recent Commission rulemakings.

Chair Carla Garrett and Vice-Chair Jeff Solomon lead the Committee in the development of recommendations at the Committee’s meeting.

Members Youngro Lee and Bert Fox engage in discussion with other Committee members.

Member Hank Torbert weighs in on recommendations with experience from his business operations.

Members of the Advisory Committee met at Creighton University in Omaha, NE on August 13, 2019.
RECOMMENDATION RE: COMMISSION’S PROPOSAL TO AMEND THE ACCELERATED AND LARGE ACCELERATED FILER DEFINITIONS

August 23, 2019

The Committee supports the proposal to amend the “accelerated filer” and “large accelerated filer” definitions such that an issuer that is eligible to be a Smaller Reporting Company and has less than $100 million in revenue in the most recent fiscal year shall be a non-accelerated filer.

However, the Committee would welcome the Commission to explore additional further amendments to the definitions of “accelerated filer” and “large accelerated filer” such that more companies could be non-accelerated filers. The Committee’s recommendations include:

- Exploring raising the revenue threshold to be a non-accelerated filer, so that issuers that are eligible to be a Smaller Reporting Company and have more than $100 million in revenues could be a non-accelerated filer.
- Instead of basing revenues for the non-accelerated filer test on the amount of revenues in the most recent fiscal year, base the revenues for the non-accelerated filer test on the three-year rolling average of the amount of the company’s revenues.
- Looking at whether all Smaller Reporting Companies should be non-accelerated filers.

The Commission should also consider input from institutional investors regarding whether or not the auditor attestation of SOX 404(b) is determinative in their investment decision.

COMMISSION RESPONSE

As indicated on the Fall 2019 Unified Agenda,183 the Division of Corporation Finance is considering recommending that the Commission adopt changes to the “accelerated filer” definition in Exchange Act Rule 12b-2 that would have the effect of reducing the number of registrants that are subject to the Sarbanes-Oxley Act Section 404(b) attestation requirement. Staff in the Division of Corporation Finance will consider this Advisory Committee recommendation in connection with this initiative.
END NOTES

1  See, e.g., Last Week Tonight with John Oliver, https://www.youtube.com/watch?v=XkLXMH-YLTAY.


4  The legislation that created the Office also established a Small Business Capital Formation Advisory Committee at the SEC. See 15 U.S.C. §78qq. The Office uses the Committee’s parameters to define the scope of small businesses that it serves.

5  See supra note 3.

6  See id.


10  See supra note 3.

11  See https://www.sec.gov/about/offices/oia/oia_institutes.htm.

12  See http://cle.cobar.org/securities-conference/.

13  See https://www.sec.gov/page/capital-formation-between-coasts.


17  See https://usblackchambers.org/conference/.


19  See https://www.ruralrise.org/; see also https://www.sec.gov/page/small-business-capital-formation-runs-deep-arkansas.


22  See https://www.sec.gov/page/oash-videos.


24  This graphic depicts amounts reported or estimated as raised from July 1, 2018 through June 30, 2019. Data on offerings under Regulations D and Crowdfunding is based on information reported by companies and was collected from filings (new filings and amendments) on EDGAR on Forms D and C, respectively. Data on registered offerings was collected from Thomson Financial’s SDC Platinum database.

25  For offerings under Regulation A, estimates are based on proceeds reported in filings made during the report period. Capital raised is based on information reported by companies in Forms 1-Z, 1-K, 1-SA, 1-U, and offering circular supplements pertaining to completed and ongoing Regulation A offerings and post-qualification amendments, and for companies whose shares have become exchange-listed, information from other public sources. Estimates represent a lower bound on the amounts raised given the time frames for reporting proceeds following completed or terminated offerings and that offerings qualified during the report period may be ongoing. For the offerings that permit pooled investment funds, such as Rule 506(b) and (c) of Regulation D and registered offerings, the data includes offerings conducted by pooled investment funds. We do not yet have data to provide an estimated amount raised under Section 4(a)(2) of the Securities Act or transactions occurring under Rule 144A for the period under consideration.

26  Data for public offerings includes international companies.


17 C.F.R. § 230.506(b); see https://www.sec.gov/smallbusiness/exemptofferings/rule506b.

17 C.F.R. § 230.506(c); see https://www.sec.gov/smallbusiness/exemptofferings/rule506c.


This graphic presents capital raised in registered, Regulation D and Regulation A offerings across the top six industries from July 1, 2018 through June 30, 2019. Offerings by non-pooled investment funds in other industries accounted for approximately $217 billion, $45 billion and $37 million in registered, Regulation D and Regulation A offerings, respectively. Regulation A and registered offerings were classified into industry groups based on the primary SIC code reported by the company. Industry groups were self-reported by companies on Form D. Differences in data sources and definitions may limit the comparability of industry data. Offerings by pooled investment funds, which accounted for approximately $26 billion and $1.38 trillion in registered offerings and Regulation D, respectively, are excluded from this table. See note 24 for a description of how these amounts were reported or estimated.

The maps included in this section depict the amounts reported or estimated as raised by issuers, including pooled investment funds that report a primary location in the U.S., including U.S. territories, from July 1, 2018 through June 30, 2019. See note 24 for a description of how these amounts were reported or estimated.


See 17 U.S.C. § 230.501(a); see also “Investor Participation in Private Offerings” section below.

See Harmonization Concept Release at Table 4.

See Feld and Mendelson, supra note 40, at 265.

See Harmonization Concept Release at note 47. As a comparison point, during the same four-year period, non-accredited investors were reported as participating in over 60% of the Rule 504 offerings. See Harmonization Concept Release at note 264. Rule 504 permits companies to raise up to $5 million in a 12-month period from an unlimited number of investors (without regard to whether or not those investors are accredited).


Feld and Mendelson, supra note 40, at 14.


Pitchbook, supra note 57.


PitchBook-NVCA, supra note 54, at 13 (Q&A with Sulu Mamdani, Managing Partner, SVB Capital).

Id.

Pitchbook, supra note 57.

Id.


Data registered offerings was collected from Thomson Financial’s SDC Platinum database.

Small public companies include public companies with a size less than or equal to $250 million on the date of the offering, calculated by multiplying the price of the company’s stock at the close of the day of the offering by the number of outstanding shares on the day of the offering. Data from the Center for Research in Securities Prices (CRSP) and Dealogic were used to fill in missing information from SDC Platinum. Mutual funds and Closed-end funds are excluded from the statistics. Those companies with missing a stock price on the offering day or number of outstanding shares are not included in the statistics.

“Expanding the On-Ramp,” supra note 71, at 5-6.

Id.


Kauffman Foundation, supra note 56 (citing 2004 figures).

Id.

Sohl, supra note 45.


Sohl, supra note 45.

86 Kaden, supra note 85.


88 Id.

89 Id.

90 Id.


92 Kauffman Foundation, supra note 56.

93 Sohl, supra note 45.

94 Kauffman Foundation, supra note 56.


97 Sohl, supra note 45.

98 Deloitte University Leadership Center for Inclusion, supra note 85.


101 Data from U.S. Census Bureau, American Community Survey (ACS) was used to estimate the population in zip codes affected by the natural disasters as described in infra, note 102. However, certain zip codes were identified as missing population values, so 27% is likely underestimated.

102 Zip codes designated as affected are defined as having one or more residents approved for assistance under FEMA’s IHP program for natural disasters with classifications of Major Disaster Declaration and incident start dates between July 1, 2016 and June 30, 2019. Given the trailing impact caused by natural disasters, each zip code affected in that three year period was included. Classification of disaster areas are based on Disaster Declaration Summaries data at https://www.fema.gov/api/open/v1/DisasterDeclarationsSummaries.csv, and FEMA Housing Assistance Program Data at https://www.fema.gov/media-library/assets/documents/34758. The classification method for disaster areas is based on the methodology in the “2017 Small Business Credit Survey – Report on Disaster-Affected Firms”, Federal Reserve Banks of Dallas, New York, Richmond, and San Francisco at https://www.newyorkfed.org/medialibrary/media/smallbusiness/2017/SBCS-Report-on-Disaster-Affected-Firms.pdf.

103 Evaluated from July 1, 2016 to June 30, 2019 using zip codes affected by natural disasters as described in supra note 102.


105 U.S. Census Bureau, ACS, “Understanding and Using American Community Survey Data: What Users of Data for Rural Areas Need to Know”, Section 1 (July 2019) at https://www.census.gov/content/dam/Census/library/publications/2019/acs/ACS_rural_handbook_2019_ch01.pdf (“Data from the ACS indicate that about 61 million people, or 19 percent of the population, lived in rural areas of the United States in 2016.”).

106 Federal Reserve, supra note 35.

107 Classification of rural areas are based on the list of 2015 Q4 rural area zip codes from the Center for Medicare & Medicaid Services at https://www.cms.gov/Medicare/Medicare-Fee-for-Service-Payment/DMEPOSFeeSched/DMEPOS-Fee-Schedule-Items/DME-Rural-Zip-and-Formats.html?DLPage=1&DLEntries=10&DLSort=2&DLSortDir=descending.


Regulation D, and Regulation Crowdfunding.

See “State of Small Business Capital Formation” section above.

Regulation A, Rules 504, 506(b) and 506(c) of Amendments under each of the exemptions, including limits, when general solicitation may be used, and the particular itemized disclosure requirements under each of the exemptions, including Regulation A, Rules 504, 506(b) and 506(c) of Regulation D, and Regulation Crowdfunding.

See “State of Small Business Capital Formation” section above.

For example, regulatory uncertainty has been cited as a possible explanation for the relatively low levels of utilization of Rule 506(c) offerings using general solicitation. See Harmonization Concept Release at Section II.B.2.f.


See Harmonization Concept Release, which solicits comment on the exempt offering framework generally as well as each of the following topics: accredited investor definition, private placement exemption and Rule 506 of Regulation D, Regulation A, limited offerings under Rule 504 of Regulation D, intrastate offerings, Regulation Crowdfunding, integration, pooled investment funds, and the secondary trading of certain securities.

See “Launch of Video Content” section above.

Currently offering caps exist under Rule 504 under Regulation D ($5 million), Regulation Crowdfunding ($1.07 million), and Regulation A ($20 million for Tier 1 and $50 million for Tier 2). Each cap has been subject to critiques and calls for amendment, and some are subject to periodic review requirements by the Commission.


For further discussion, see Harmonization Concept Release at Section IV.A.2.

129 For further discussion, see Harmonization Concept Release at Section IV.A.2.
131 See, e.g., 17 CFR 270.22e-4 (liquidity risk management programs); see also 15 U.S.C. 80a-2(a)(41) (defining “value”).
132 See Harmonization Concept Release at Section IV.A.
133 For example, as of December 31, 2018, there were only 250 closed-end funds, compared with 17,707 mutual funds and 3,371 ETFs. See Investment Company Institute, supra note 130, at 32.
134 A BDC is a type of closed-end investment company that does not register under the Investment Company Act, but rather elects to be subject to Sections 55-65 of that act. See 15 U.S.C. 80a-2(a)(48).
135 An SBIC is a type of fund registered under the Small Business Investment Act of 1958 or that is approved by the U.S. Small Business Administration. See 17 CFR 230.501(a)(1).
136 See Harmonization Concept Release at Section IV.C.
139 See 17 CFR 230.501(a)(1), (3) and (7).
141 See Advisory Committee on Small and Emerging Companies, Recommendations Regarding the Accredited Investor Definition (Jul. 20, 2016), https://www.sec.gov/info/smallbus/acsec/acsec-recommendations-accredited-investor.pdf.
143 See 2017 Treasury Report at 44 et seq.
146 Committee on Capital Markets Regulation, supra note 62.
147 2017 Treasury Report at 43.
Many portals also facilitate capital formation under Regulation A offerings, sometimes referred to as “mini-IPOs.”


See, e.g., Kaden, supra note 85 (“Last year a mere 12% of venture capital dollars went to companies with a woman on the founding team, a decline from 15% in 2017. The numbers get even worse when you look at female-founded startups that aren’t focused on female customers: They’ve gotten less than 2% of VC investment dollars since 2014.”).

See Mills, supra note 39, at 52 (“Another factor working against small business lending is that the cost of loan underwriting does not scale with the size of the loan. In other words, it costs about as much for a bank to process a $100,000 loan as a $1 million loan. That means that smaller-dollar loans are less profitable for banks. As a result, banks are less likely to lend at lower dollar amounts. One response for a bank is to move away from small business lending and focus on more profitable activities. Some banks have reduced or eliminated loans below a certain threshold, typically $100,000, and some will not lend to small businesses with annual revenues of less than $2 million.”); id at 56 (“Three-quarters of small business loan applications from employer firms were for small-dollar loans—loans under $250,000—and more than half of the loan applications were for amounts under $100,000.”).


174 Id.

175 Pitchbook, supra note 57.

176 See “Small Public Companies” section above.


