FINANCIAL

IMPATIENTLY WAITING FOR PATIENT CAPITAL

by MARILYN D. LANDIS
President/CEO and Founder of Basic Business Concepts, Inc.

An existing company can promise to repay a bank loan — first payment in 30 days — based on existing cash flow and an experienced calculation predicting when and how much the return will be on their expansion investment. An innovative upstart cannot. In fact, most innovators wait months — years if FDA approval is required — to source intellectual property protection and regulatory approval before they can take their products to market. Then, they operate at a loss for additional months or years until sales exceed expenses and their cash flow turns positive. Only patient capital will wait this long to see a return.

Who are these patient capital providers? They are friends, family, angels, venture capitalists and equity funds – in that order of patience. Friends and family are the first in and provide critical early, early stage funding. But what if your friends and family aren't wealthy? Social media has redefined "friends and family." We now share personal details via Facebook and Instagram. We collaborate with colleagues via LinkedIn, chat rooms and group discussions. In fact, social media dramatically broadens our friends and family circle of like-minded individuals. So what if your "friends" — the ones that are geographically close enough to meet with and pitch your innovative.idea to — don't have money to invest? Why not post your investment opportunity online to your broader group of like-minded contacts and solicit their funds? Because legally you can't.

Using the internet to reach out and find funding is generically referred to as crowd funding. Kickstarter and other successful crowd funding sites can only offer gifts (dinner with the founder, or one of the first runs of the product) which works well if you have an innovative retail product. But truly patient investors want a piece of your company if they are to wait, and wait, for their return on investment.

As other forms of crowdfunding emerge, equity-based crowdfunding remains untapped. It was established under Title III of the Jumpstart Our Business Startups (JOBS) Act (2012). The law required the U.S. Securities and Exchange Commission (SEC) to write the rules for expanding the ability for entrepreneurs to sell equity to prospective investors online. Until the SEC issues the final rule, equity-based crowdfunding for the vast majority of Americans remains off-limits for capital raises up to $1 million. Why hasn't the SEC issued these rules? I have gained some insights by testifying on SEC issues before the National Regulatory Fair Board in June 2014, joining in small capitalization discussion groups at the Heritage Foundation, participating in the SEC's public comment forum in November of 2014, and directly from my clients who seek equity investors.

The need to expand options for patient investors is well documented. By looking at these current examples, the report concludes that equity-based crowdfunding could create an efficient alternative funding source for small businesses and microbusinesses which are unable to attain their desired level of credit in an environment where the amount of small business loans being made available is shrinking. Further, census data clearly show pockets of wealth are not evenly distributed – thus some geographic areas are investor deserts.

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Figure 1. Credit Application Outcomes

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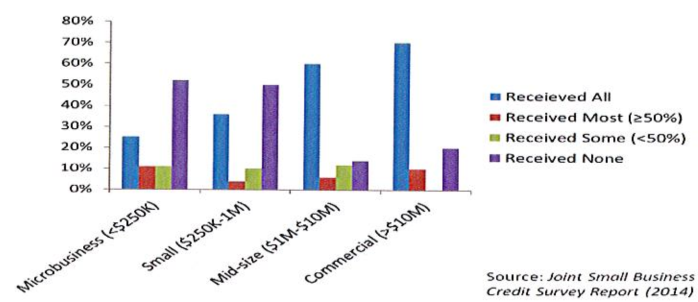
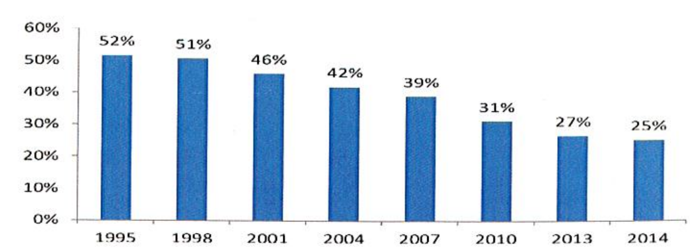


Source: *Joint Small Business Credit Survey Report (2014)*

Figure 2. Small Loan Share of Nonfarm, Nonresidential Commercial Loans by Loan Balances ($ Millions)



Source: *FDIC Call Report Data as of March 2015*

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The opposite force is the SEC's founding mission in 1933 — protect the investor. The November discussion at the SEC made it clear the commissioners feel the threat of fraudulent offers and potential loss is greater when solicitation is made via the internet instead of in person. The rules the SEC has proposed for equity crowdfunding have been vigorously opposed by the innovafion community and their advocates because they a place higher level of scrutiny on equity crowdfunding. For example, non-internet friends and family can self-certify that they meet the SEC requirements for a "certified investor," but online investors must have a third party (CPA or equivalent) verify their status. A non-online capital raiser can provide potential investors with internally prepared financial statements – online pitches must use audited statements. A non-internet company investment does not have to publish a list of its investors, but an online capital raise must list all investors by name on its website. Even the amount an individual can invest online is limited by a formula based on frequency of investment and investors' income. Whereas, absent equity crowdfunding, investors are free to determine their own maximum investment.

The Innovation Process

Unfortunately, in their zeal to protect investors from themselves, the SEC has shielded small innovators from an alternative method of raising small amounts of capital. If the current SEC proposed rules are promulgated, they will add cost and a heavy regulatory burden to what had been hailed in 2012 as a capital access solution. Currently, innovators use SEC Regulation D to raise private capital rather than go public. Meeting all the legal and regulatory requirements for Reg D can cost a small company $20,000 or more. Reg A — another part of the SEC code available for small, private capital raise — requires filing not only with the SEC but with every state's securities regulator where an investor resides.

Until, and unless, the SEC writes regulations implementing Title III of the JOBS Act that balance the need to protect investors with the need for innovators to raise capital, Title III will remain an unfulfilled promise. This is why innovative entrepreneurs are impatiently waiting for better access to patient capital. WP

ABOUT THE AUTHOR

Marilyn D. Landis is the President & CEO of Basic Business Concepts, Inc., a multifaceted service firm providing the support to keep businesses financially balanced, on-track and growing.