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Financing Entrepreneurial Growth

After three decades of relatively steady levels of entrepreneurial activity in the United States, the number of new businesses dropped sharply in 2008 and 2009, and has yet to fully rebound. A close look at available data indicates, however, that the rate of American entrepreneurship began to drop even before the Great Recession. Moreover, the rate of job creation from new businesses also fell significantly during this time.[1] Despite these troubling trends, pockets of intense entrepreneurial activity exist in places such as Silicon Valley, Boston, and New York City. Observers there, in fact, fret instead about a new startup bubble. While trends may diverge based on geography and other factors, there seems to be a national consensus that encouraging entrepreneurship is part of the answer to our sluggish economic recovery. To wit, nearly every area of the country has invested resources in promoting entrepreneurship, introducing scores of new programs aimed at training, or helping entrepreneurs.

Divergent trends also characterize entrepreneurial finance and the extent to which new, young, and growing firms can access the capital they need to start and grow their businesses. Amidst a stumbling macroeconomic environment, the past few years have seen tremendous ferment and innovation in entrepreneurial finance, particularly at the early stage of business creation.[2] This activity potentially will lead to higher levels of entrepreneurship, but it also necessitates a thoughtful regulatory approach. The United States took a significant step toward changing the regulatory environment for entrepreneurial finance in the spring of 2012 with the passage of the Jumpstart Our Businesses (JOBS) Act, which included provisions for equity crowdfunding. The presumed potential of equity crowdfunding for stimulating entrepreneurial growth has led to great public anticipation, which only has been intensified by enthusiasm for the proliferation of "accelerators"—intense programs, similar to boot camps, that typically provide space, networks, mentorship, and other resources in exchange for an equity stake in companies, usually 5 percent to 7 percent.

Despite the promise of such innovation, many new and young companies continue to face significant hurdles as they seek capital. Bank finance has yet to recover from the recession, and there is a great deal of uncertainty over the long-term effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In the public markets, the decade-long drought in initial public offerings (IPOs) has raised concerns that the American system for building innovative and sustainable companies is broken. While the IPO downturn may turn out to be a cyclical phenomenon, it highlights other issues regarding equity finance. Many observers point to erosion in the venture capital (VC) model. The benefits of venture capital for investors are not entirely clear,

1. E.J. Reedy and Robert E. Litan, "Starting Smaller, Staying Smaller: America's Slow Leak in Job Creation," Kauffman Foundation Series on Firm Formation and Economic Growth, July 2011.

2. Pascal-Emmanuel Gobry, "The Way Companies are Getting Financed is Completely Changing," *Business Insider*, November 2, 2011, *at* http://www.businessinsider.com/the-way-companies-are-getting-financed-is-completely-changing-2011-11; Brendan Baker, "The Changing Early Stage Capital Ecosystem: Intermediaries and Network Microdynamics in Startup Funding," Saïd Business School and Oriel College, University of Oxford, December 2010.

and the investment performance of the VC industry has come under increasing criticism in recent years.

It is important to remember that all new businesses do not travel the same financing path. A new company's capital structure will be determined by the type of business, the founders' personal circumstances, and geographic location, as well as other factors. Many new companies, in fact, do not need outside money at all—either the founders or owners contribute sufficient funds, or the companies enjoy enough revenues early on to operate on cash flows. According to the Small Business Administration, the median amount of initial capital used by new employer firms is $50,000.[3]

Personal funds—savings accounts—tend to be the largest source of initial startup funding, while credit cards and bank loans (including credit lines and business credit cards) are also important.[4] From there, the funnel narrows considerably. For the whole universe of companies in the United States—including most small businesses and new firms—these sources, along with working capital, are the biggest sources of financing. For the fast-growing (but mostly small) companies on the 2012 Inc. 500 list, personal savings was the biggest reported source of initial finance, and three-quarters said they funded their growth from cash flow.[5] Four in ten reported no need for outside money, while one-third said access to external capital had been essential to company growth.

The Role of Capital in Jumpstarting America's Entrepreneurial Engine: Policy Recommendations

In July 2012, the Kauffman Foundation convened a meeting of scholars, policymakers, practitioners, and leading thinkers around the topic of finance—specifically, financial issues relevant to the creation and growth of entrepreneurial companies. This report will neither rehash the three days of discussion nor dwell on the details of the financial subjects covered. What follows is a summary of the problems considered by participants and the ideas and recommendations that received broad, but not necessarily unanimous, endorsement by participants.

Some of these ideas are conventional, while others are, for the moment, more "out of the box." As a result, a number of the ideas presented here are admittedly untested, if not also contentious. We advance them in the interest of stimulating healthy public discussion of an important topic: how to improve the financing of new and young companies, which historically have been a vital source of innovation and job creation in the United States.

These policy recommendations are categorized by type of financing:

- Equity (including crowdfunding, angel investors, and venture capital)
- Public Markets
- Debt

3. Small Business Administration, "Frequently Asked Questions about Small Business Finance," Office of Advocacy, September 2011.

4. Alicia M. Robb and David Robinson, "The Capital Structure Decisions of New Firms," Kauffman Foundation, November 2008, *at* http://www.kauffman.org/uploadedfiles/Capital_Structure_Decisions_New_Firms.pdf. For the 4,000 firms in the Kauffman Firm Survey, the capital structure "pecking order" by frequency of use ran: owner equity; owner debt; outsider debt; insider debt; outsider equity. By amount of money raised, the pecking order ran: outsider debt; owner equity; insider debt; outsider equity; owner debt.

5. For Inc. 500 survey results, *see* http://www.inc.com/inc5000/list/2012. In the 1980s and 1990s, personal savings also was reported to be the main source of financing for Inc. companies. Amar V. Bhidé, *The Origin and Evolution of New Businesses* (Oxford, 2000).

Equity Financing

When entrepreneurs need outside money, it falls into two categories: equity and debt. While debt brings repayment obligations, equity means relinquishing ownership stakes in the business. This exchange takes place with different types of investors at varying points along the entrepreneurial path. Crowdfunding, through donations and contributions, has become popular recently, and equity crowdfunding promises to boost early-stage investing. Angel investors often make larger investments at a somewhat later stage (though still early in a new business's development). Venture capital typically steps in as the business is more developed, and initial public offerings allow more mature companies to raise capital by selling shares to the greater public. Even among growth companies, however, many prefer not to take outside equity, and only a minority raises money from angels and venture capitalists. An even smaller share ever goes public. Nonetheless, the availability of equity financing is a key ingredient in the founding and growth of innovative businesses.

Crowdfunding. There are now an estimated 200 crowdfunding sites in the United States, less than half of the global total.[6] Crowdfunding allows individuals and teams to raise money over the Internet from dozens or thousands of sources in small amounts. Globally, crowdfunding platforms raised $1.5 billion in 2011 for one million campaigns, with most of the total raised in North America.[7] Before the JOBS Act passed in spring 2012, crowdfunding platforms in the United States were only allowed to take donations and offer rewards. A contributor to a project through Kickstarter (one of the largest and most renowned crowdfunding sites), for example, would receive a copy of the end product, such as a CD or watch.

crowdfunder.com

Crowdfunder.com officially launched in 2012 as a donations-based fundraiser for businesses. It is an example of a crowdfunding website that plans to offer securities-based crowdfunding when SEC regulations are finalized.[8] While regulations are being developed, it has in the interim been building an ecosystem of startups and investment funds through the investment prize competitions it has offered. For example, the first competition attracted more than 700 companies and 8,000 donators to a $25,000 prize. Crowdfunder.com will leverage this ecosystem to hit the ground running when securities-based crowdfunding is opened up. Crowdfunder.com plans to continue to allow anyone to create a profile on its site, but will vet and only allow a select number of startups to identify investors via its social network and conduct raises on the site. Crowdfunder.com plans to place some emphasis on community-based lending, creating location-based alerts for investors, and building community groups of startups for their investment partners. How crowdfunding platforms ultimately end up offering securities-based crowdfunding will largely depend on how the SEC rules are finalized and how FINRA, the Financial Industry Regulatory Authority, sets additional policies and regulations.

6. *Crowdfunding Industry Report*, April 2012, *at* http://www.crowdsourcing.org/document/crowdfunding-industry-report-abridged-version-market-trends-composition-and-crowdfunding-platforms/14277.

7. *Crowdfunding Industry Report*, April 2012, *at* http://www.crowdsourcing.org/document/crowdfunding-industry-report-abridged-version-market-trends-composition-and-crowdfunding-platforms/14277; Suw Charman-Anderson, "Crowdfunding Raised $1.5 billion in 2011, Set to Double in 2012," Forbes, May 11, 2012, *at* http://www.forbes.com/sites/suwcharmananderson/2012/05/11/crowdfunding-raised-1-5bn-in-2011-set-to-double-in-2012/.

8. As of this writing, rules for accredited investors are anticipated to be finalized around February 2013. Rules for non-accredited investors are anticipated to be finalized by the end of 2013 or the first quarter of 2014.

The JOBS Act opened the door for equity crowdfunding, although the precise contours of how this market can develop will remain unclear until the SEC issues regulations. Under the new legislation, a company can raise up to $1 million per year via equity crowdfunding. Some project that, within a year, the total market for equity crowdfunding could be $4 billion.[9]

Expectations are high for the role of crowdfunding in expanding entrepreneurs' access to financing. For one thing, crowdfunding likely will align with the increasing spread of "user innovators," who account for a substantial portion of innovative new companies.[10] For those companies that would use this new source, equity may be preferable to donations because it could allow them to overcome the cash flow issues that often plague new and young companies.[11] One indication of the potential size and force of equity crowdfunding is a comparison of the amounts pledged through the different crowdfunding models. The Crowdfunding Industry Report found that the average amount given was $3 for rewards, $8 for donations, and $60 for equity or loans.[12] Based on the amounts raised and returned through equity crowdfunding worldwide, the report observes: "Crowdfunding shows to be a viable alternative for raising capital to fund small businesses and startups."[13]

Angel investors. Angels are wealthy individuals, usually former entrepreneurs, who make early-stage investments in young companies and provide varying degrees of advice and help. Angel investors typically precede venture capitalists in terms of company financing, providing amounts ranging from $25,000 to $1 million, and they frequently invest together in angel groups.[14] From 2001 to 2009, the median size for an initial angel round was $450,000, spread over an average of 50,000 deals per year. After dropping in 2010, angel investment rebounded in 2011, when angels invested $22 billion in entrepreneurs. Because their investments are smaller than VCs' are, angel money supported 66,000 companies, compared to the 4,000 deals done by venture capitalists.[15]

AngelList

One especially exciting and disruptive development in the world of angel investing is the rise of AngelList, which is essentially a matching service for entrepreneurs and investors.[16] Traditionally, entrepreneurs found angel investors, and angels found entrepreneurs, through informal networks and conversations. To a large extent, this is still the case. AngelList offers complete data on angels and entrepreneurs in a highly structured format. Data on entrepreneurs include the founders' education and the number of investors in the company; angel data include their investment histories and credentials. This allows for a smoother matching process. Since its founding in 2010, several hundred companies have received funding through AngelList. Entrepreneurs also can access legal documents through the site and, recently, AngelList partnered with the secondary exchange SecondMarket to broaden investor participation in startups. AngelList and other developments are shifting the balance of power between entrepreneurs and investors, particularly in places such as Silicon Valley. (Full disclosure: the Kauffman Foundation is an investor in AngelList.)

9. Tanya Prive, "Inside the JOBS Act: Equity Crowdfunding," Forbes, November 6, 2012 *at* http://www.forbes.com/sites/tanyaprive/2012/11/06/inside-the-jobs-act-equity-crowdfunding-2/.

10. Sonali K. Shah, Sheryl Winston Smith, and E.J. Reedy, "Who are User Entrepreneurs? Findings on Innovation, Founder Characteristics, and Firm Characteristics," Kauffman Firm Survey, Kauffman Foundation, February 2012, *at* http://www.kauffman.org/uploadedFiles/who-are-user-entrepreneurs.pdf.

11. Jason Abbruzzese, "Unexpected Cost of Success," *Financial Times*, November 27, 2012.

12. *Crowdfunding Industry Report*, April 2012, *at* http://www.crowdsourcing.org/document/crowdfunding-industry-report-abridged-version-market-trends-composition-and-crowdfunding-platforms/14277.

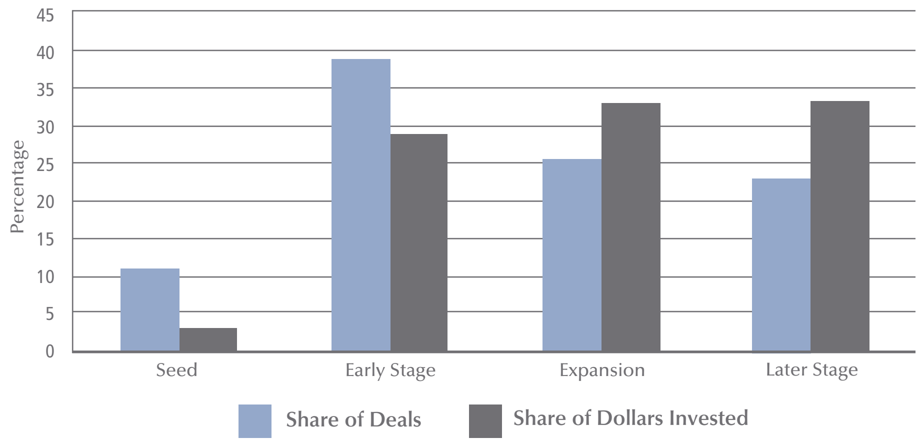
13. *Crowdfunding Industry Report*, April 2012, *at* http://www.crowdsourcing.org/document/crowdfunding-industry-report-abridged-version-market-trends-composition-and-crowdfunding-platforms/14277.

14. Organisation for Economic Cooperation and Development, *Financing High-Growth Firms: The Role of Angel Investors*, December 2011, *at* http://www.oecd.org/sti/financinghigh-growthfirmstheroleofangelinvestors.htm.

15. Jeffrey Sohl, "The Angel Investor Market in 2011: The Recovery Continues," Center for Venture Research, University of New Hampshire, April 2012.

16. *See* https://angel.co/.

Figure 1
Venture Capital by Stage of Financing, 2011



Source: PricewaterhouseCoopers MoneyTree Report.

Even though the angel investor community is far more diverse than that of venture capitalists, angels tend to invest in the same sectors as VCs do and, like VCs, finance innovative companies. A study of initial public offerings from 2001 to 2007 found that two-thirds of the companies had angel investors, and in Noam Wasserman's study of high-tech and life science entrepreneurs, 50 percent of his sample companies had taken angel money as part of a Series A round of financing.[17] Another study of two well-established angel groups found that angel investments had positive effects on the performance of the firms receiving the money.[18]

There has been considerable concern in recent months over a "Series A Crunch," particularly in Silicon Valley among Internet and software companies.[19] This refers to a situation in which an overabundance of seed and angel funding creates a large class of companies seeking venture capital, but with no corresponding increase in the number of Series A deals funding by VCs. Hence, a large proportion of companies that received seed and angel money will become "orphans" and may not survive.[20] This isn't necessarily a bad thing because it demonstrates a higher level of experimentation—in the form of more new companies—and it illustrates the influence of angel funding.

Venture capital. The financial crisis and Great Recession hit the VC industry hard. The volume of funds raised by VCs fell by 25 percent from 2008 to 2009, but rebounded in 2010 and 2011 to more than $32 billion across almost 4,000 deals.[21] The distribution of VC deals and investments can be seen in Figure 1.

There is accumulating evidence that seed-stage deals have risen dramatically over the past year—according to a CB Insights study sample, they have doubled as a share of deals since the third quarter of 2011. In the Internet and Mobile sectors, as well as geographic areas such as New York, seed deals accounted for nearly half of all VC deals toward the end of 2012.[22] Pre-money valuations, after

17. Noam Wasserman, *The Founder's Dilemmas: Anticipating and Avoiding the Pitfalls that Can Sink a Startup* (Princeton, 2012).

18. William R. Kerr, Josh Lerner, and Antoinette Schoar, "The Consequences of Entrepreneurial Finance: Evidence from Angel Financings," Working Paper, June 2011, *at* http://www.mit.edu/~aschoar/KLS-Angels-June2011.pdf.

19. Sarah Lacy, "The Series A Crunch is Hitting Now. Have We Even Noticed?" *Pando Daily*, November 28, 2012.

20. CB Insights, "The Series A Crunch and Startup Orphans," Seed Investing Report, Winter 2012.

21. Ernst & Young, *Globalizing Venture Capital: Global Venture Capital Insights and Trends Report 2011 at* http://www.ey.com/GL/en/Services/Strategic-Growth-Markets/Global-venture-capital-insights-and-trends-report-2011---Global-venture-capital-landscape; PricewaterhouseCoopers, MoneyTree Report, *at* https://www.pwcmoneytree.com/MTPublic/ns/index.jsp; National Venture Capital Association, *2012 Yearbook* (2012).

22. CB Insights, *Venture Capital Activity Report, Q3 2012*, 2012. *See also* Fenwick & West, "2011 Seed Financing Survey," March 2012, *at* http://www.fenwick.com/publications/Pages/Seed-Finance-Survey-2011.aspx.

falling in the United States in 2009 and 2010, rose in 2011 to their highest level over the past decade.[23]

What happens to companies that take venture capital? From 1981 to 2005, only 0.11 percent of new companies received a VC investment, a share that briefly rose to 0.22 percent during the dotcom bubble.[24] Without question, however, venture-backed companies have a disproportionate economic impact. Venture capital is a disproportionate funder of firms that eventually go public, and VC-backed companies today account for between 5 percent and 7 percent of employment in the United States, an increase from 2.7 percent in the early 1980s.[25] A study of 22,000 VC-backed companies from 1987 to 2008 found that:

- 26 percent were acquired;
- 9 percent went public;
- 15 percent were liquidated or went bankrupt;
- 31 percent remained private; and
- 19 percent expected no return to investors.[26]

For entrepreneurs, a venture capital investment brings not just money but also strategic advice, networks, recruiting help, and professionalization. Many studies, moreover, have found a positive effect of venture capital on companies and geographic regions.[27]

Equity Financing Recommendations

A Word on Regulation

The mission of the Securities and Exchange Commission is to protect investors. The National Securities Markets Improvement Act of 1996 introduced an additional mandate to be mindful of the need for capital formation. Facilitating capital formation requires innovations and, accordingly, changes in regulation. While fraud must remain a central concern of the SEC, more consideration should be given to optimal capital formation and innovation, as well. Since the financial crisis in 2007 and 2008, policymakers have increasingly focused on the strengths and weaknesses of the financial system. Accordingly, the SEC has attracted more attention and broader regulatory powers. New and existing regulations must be considered carefully, however—their effect on new business creation will be an important factor in economic growth.

The JOBS Act serves as a prime example of this balance. While passage of the JOBS Act was an achievement, its full implementation requires SEC action and interpretation. It would be a mistake and clearly inconsistent with the legislative intent of the JOBS Act for the SEC to preemptively strangle crowdfunding through onerous regulations. There is already concern that the JOBS Act itself created too many regulations for crowdfunding sites, and SEC interpretation and enforcement could make it worse. Financial innovation has acquired a bad name over the past few years, but the presumption at the SEC should be that any financial innovation carries both risks and rewards and that real-world experimentation is the best way to test a new innovation.[28]

Broadening Investor Participation. Task force recommendations for equity financing, including crowdfunding, angel investors, and venture capital, focused on the need to expand access to private equity markets. For the most part, only accredited investors can participate in the private markets, and these investors are defined by income and wealth thresholds: an individual must have a net worth of at least $1 million and an annual income of more than $200,000 (or $300,000 with a spouse). The Dodd-Frank reforms further tightened eligibility by excluding a person's home from the net worth calculation. These

23. Ernst & Young, *Globalizing Venture Capital: Global Venture Capital Insights and Trends Report 2011 at* http://www.ey.com/GL/en/Services/Strategic-Growth-Markets/Global-venture-capital-insights-and-trends-report-2011---Global-venture-capital-landscape.

24. Marco Da Rin, Thomas F. Hellmann, and Manju Puri, "A Survey of Venture Capital Research," TILEC Discussion Paper, October 2011.

25. Marco Da Rin, Thomas F. Hellmann, and Manju Puri, "A Survey of Venture Capital Research," TILEC Discussion Paper, October 2011.

26. Robert E. Hall and Susan E. Woodward, "The Burden of the Non-diversifiable Rise of Entrepreneurship," *American Economic Review*, June 2010.

27. Marco Da Rin, Thomas F. Hellmann, and Manju Puri, "A Survey of Venture Capital Research," TILEC Discussion Paper, October 2011. There remains a selection question, of course—it's possible that VCs invest in companies that are already more innovative and with greater probability for success.

28. Robert E. Litan, "In Defense of Much, But Not All, Financial Innovation," Brookings Institution, 2009.

narrow rules limit equity investment in private companies to approximately 2 percent of the American population.

Ever since passage of the Securities Act of 1933, private companies have always been able to sell securities without submitting to the full slate of registration requirements for companies going public. Under Regulation D, unregistered securities could be sold mostly to "accredited investors," but under strict constraints as to how those securities could be advertised. The JOBS Act removed the solicitation and advertising limitations on Regulation D offerings.

The crowdfunding provisions of the JOBS Act create an inconsistency in the definition of accredited investors for different types of investing. The provisions governing crowdfunding indicate that investors with a net worth of less than $100,000 can invest the smaller of $2,000 or 5 percent of their net worth. Investors with a net worth of more than $100,000 face an investment limit of 10 percent of their assets. As a result, investors who fail to meet Regulation D accreditation requirements can buy non-public securities through a crowdfunding platform.

- **Extend the requirements for crowdfunding investors to Regulation D accredited investors.** Rather than facing the requirement of having a net worth of at least $1 million and an annual income of more than $200,000 (or $300,000 with a spouse), the new investor participation rules for crowdfunding should be extended to Regulation D offerings.
- **Create non-financial criteria for sophisticated investors with fewer assets.** The current criteria ensure that investors have sufficient wealth to be insulated from losses. And, admittedly, there is greater risk of loss in trading non-public securities than in trading stocks, at least theoretically. Private equity markets are characterized by less information, accountability, and liquidity. Task Force members suggested, however, that private equity markets can be made more inclusive while still protecting naïve investors from these risks. While the current rules only allow for investors who have enough wealth to protect themselves from losses, the definition could be expanded to include those who are sophisticated enough to mitigate some of the risk. A test to certify a certain level of knowledge and understanding (either an existing certification—perhaps an MBA or CFA certification—or a new, much less expensive test to be developed) would allow for knowledgeable investors with fewer assets to participate in private equity markets, without increasing the overall level of risk to investors. Successful completion of the test could be coupled with a limit on the size of the investment, depending on the investor's net worth, as in crowdfunding. And investors with high net worth would continue to be accredited without knowledge certification, as they have adequate wealth to cushion their risk.

Change the Economics of the Venture Capital Industry. Task Force discussions of venture capital suggested that changes in venture capital are not necessarily the purview of public policy, but are best created and implemented by limited partners who invest in VC funds. The Kauffman Foundation's report, "We Have Met the Enemy…and He is Us," provides details about the changes investors in venture capital can make, including the following.[29]

- **Pay for Performance.** Institutions invest in venture capital to generate excess returns above the public market for their portfolios. Yet they don't actually pay VCs to do that. The current market standard of a 2 percent management fee and 20 percent profit-sharing structure ("2 and 20") pays VCs more for raising bigger funds and, in many cases, allows them to lock in high levels of fee-based personal income regardless of fund performance. Compensation structures would thus be negotiated to pay fees based on a firm budget, with profits shared only after investors receive their capital back plus a preferred return.
- **Require VC "skin in the game."** It is currently "market standard" that LPs invest 99 percent of any fund, and the VC general partners make a token 1 percent investment of partner capital to their own

29. Diane Mulcahy, Bill Weeks, and Harold Bradley, "'We Have Met the Enemy … And He is Us': Lessons from Twenty Years of the Kauffman Foundation's Investments in Venture Capital Funds and the Triumph of Hope over Experience," Kauffman Foundation, May 2012.

fund. Higher levels of VC partner investment in their own funds would better align LP and GP interests, and ensure that GPs have a meaningful personal stake in their own investment performance.

- **Consider alternate fund structures.** The current market standard—a ten-year fund with a four- to five-year investment period—creates incentives to quickly invest in and exit companies to realize some returns prior to the next fundraising, which generally starts during year three or four of the prior fund. An alternative to the ten-year fund life is an evergreen structure, where investors invest on a rolling basis over time. Evergreen structures were common when the venture capital industry began. Many of the original VC funds—Venrock, Bessemer, Sutter Hill—were structured as evergreen funds. An evergreen structure is attractive because it reduces the misaligning occurrence of cumulative management fees across several funds and eliminates the time pressure to produce positive short-term returns in time for the next fundraising cycle. An evergreen structure encourages GPs to adopt a longer view on company exits and rewards them for maximizing scale growth opportunities and long-term returns within the portfolio.
- **Improve and standardize VC fund performance measures.** Any VC performance metric should measure whether VCs do what they say they will—generate great returns in excess of the public market. Investors can assess this by measuring VC fund performance using a Public Market Equivalent (PME), an analysis that models a fund's cash flows in comparable indexes of publicly traded common stocks. A PME allows for a clear comparison of performance between public versus private equity performance, as well as across VC funds. Since under the Dodd-Frank Act, the SEC now oversees venture capital, the Task Force discussed the possibility of adopting PME as a consistent standard for VC performance reporting, similar to the Global Investment Performance Standards.
- **Reconsider FAS 157.** The Task Force discussed the effects of accounting rule FAS 157, promulgated by the Financial Accounting Standards Board (FASB). This rule requires VC funds, among others, to establish a consistent "fair market value" for their portfolio companies every year. Traditionally, new valuations were established when new investments were taken in, meaning company valuations were determined by company performance and specific events, such as a round of financing. Task force members expressed concern that FAS 157 forces a mark-to-market valuation that makes valuations more volatile and riskier, and treats private companies as if they were public companies. This increases costs for entrepreneurs and investors, and some members worried that FAS 157 unintentionally encourages fund managers to focus more on short-term than long-term results.

Public Markets

Initial public offerings allow more mature firms to raise capital by selling shares to the general public. The bull market in IPOs through the 1980s and 1990s reached a peak in the late 1990s, and then fell off a cliff. This trend is even more pronounced for small firms.[30] During the 1990s, $50 million IPO transactions accounted for three-quarters of all IPOs. That share plunged in 1998, and has hovered at approximately one-third since 2000. While there is considerable disagreement over the causes of this trend—and whether or not there is a cyclical dimension—many feel that changes are necessary to the current IPO model. One of the most frequently cited culprits of the decline in IPOs is the Sarbanes-Oxley (SOX) law of 2002. While this also is disputed, it is clear that the SOX requirements are more cumbersome for smaller companies than larger ones.

Public Market Recommendations

- **Move to an auction model for IPOs.** Task Force members discussed the attractiveness of an IPO auction model, such as that used by Google for its IPO. Auction-based IPOs differ from traditional IPOs in that auction-based IPOs, specifically Dutch auctions, offer a much larger pool of investors a price to buy shares (through the Internet), and the price is incrementally adjusted to reach a "clearing price" where all shares are sold. Auction-based IPOs allow more investors to participate in the IPO with greater efficiency and transparency around pricing, and they entail much lower underwriter fees.
- **Offer shareholder choice on Sarbanes-Oxley.** The JOBS Act essentially exempted firms with less than $1 billion from the burdensome regulations of SOX. Task Force participants suggested taking this improvement one step further by giving shareholders a choice as to whether their firms must comply with SOX. After all, SOX was enacted to protect shareholders; why shouldn't they have a say in whether their firms must comply with the reforms? Shareholder choice could be extended to public firms of all sizes, encouraging more firms to go public.

30. David Weild and Edward Kim, *Market Structure is Causing the IPO Crisis—and More*, Grant Thornton, Capital Markets Series, June 2010.

Debt Financing

Debt is a far more widely used source of initial funding for new companies than outside equity since the latter is not an available option for the vast majority of new and young companies. Importantly, "debt" can refer to many things. The several thousand businesses in the Kauffman Firm Survey relied heavily on personal loans to the founder, personal credit cards, business bank loans, business credit cards, and lines of credit.[31] Some of these forms of debt, of course, require collateral and, over the last decade in particular, home equity lines of credit (HELOCs) were likely a primary source of initial finance for many entrepreneurs.[32]

Over the past few years, bank lending to small businesses fell substantially, driven both by a contraction in bank lending more generally, as well as reduced demand by businesses for such loans.[33] By 2012, less than one-third of small businesses reported having a business bank loan. It's difficult to know, of course, how the use of bank finance by *new and young firms* has evolved over time and through the recession. Nevertheless, overall small business lending (loans of less than $1 million) fell by $100 billion from 2008 to 2011.[34] Most such loans are so-called "micro-loans" of less than $100,000.[35] Furthermore, the largest banks' role in small business lending has increased during this time. While some expressed concern that such concentration would reduce the availability of capital at the local level, there is mixed evidence on the effect of bank concentration on small business lending.

Another source, albeit small, of loan funds for young and small companies is a loan guarantee from the Small Business Administration (SBA), which administers different types of this program. Its two main lending programs—7(a) and 504 loans—provided $30 billion to 60,000 small businesses in 2011.[36] These do not involve the direct provision of money from the SBA to small businesses, but are partial guarantees for loans made by commercial lenders, and the merits of loan applications are judged by an independent entity.[37] SBA loans play a relatively small role in the overall funding environment: there are well over five million small businesses with employees in the United States and, while not every business seeks capital, even at their pre-recession peak, SBA loans numbered around 100,000. Finally, several new matchmaking models have come online in recent years to better connect companies with lenders of various types.[38]

Debt Financing Recommendations

- **Reduce the regulatory burden on banks.** Small local banks—which remain a critical source of loans for young and small businesses—face substantial costs from bank regulation. Regulators often do not have the same local knowledge as local banks do and cannot discern the same risk characteristics of the loans. The Federal Reserve, Office of the Comptroller of the Currency, and FDIC should issue new guidelines to bank examiners with the goal of providing clarity to reduce banks' regulatory risk-aversion. In effect, bank regulation should be less "one-size-fits-all." Examiners should make greater efforts to customize their examinations to each bank. And examiner teams should feature a mix of junior and senior examiners, with experienced examiners having the discretion to make judgment calls at the local level.[39]

31. Alicia M. Robb and David Robinson, "The Capital Structure Decisions of New Firms," Kauffman Foundation, November 2008, *at* http://www.kauffman.org/uploadedfiles/Capital_Structure_Decisions_New_Firms.pdf.

32. David Robinson, "The Financing Choices of Young Firms," Presentation at Brookings Institution.

33. Data on bank lending are reported only by loan size, not by firm size or firm age. Thus, loan size is here used as a proxy for both small and young firms. While there is considerable overlap between size and age (every young firm starts out small), many small businesses are older firms.

34. Victoria Williams, *Small Business Lending in the United States, 2010–2011*, Office of Advocacy, Small Business Administration (July 2012).

35. At the same time, loans of more than $1 million rose from 2010 to 2011, back to pre-recession levels. Victoria Williams, *Small Business Lending in the United States, 2010–2011*, Office of Advocacy, Small Business Administration (July 2012).

36. J. David Brown and John S. Earle, "Do SBA Loans Create Jobs? Estimates from Universal Panel Data and Longitudinal Matching Methods," September 2012.

37. Office of Advocacy, "Frequently Asked Questions about Small Business Finance," Small Business Administration, September 2011.

38. Nick Leiber, "Matchmaking for Businesses and Banks," *Bloomberg Businessweek*, October 29–November 4, 2012.

39. Robert E. Litan and John D. Hawke, "Value-Added Bank Supervision: A Framework for Safely Fostering Economic Growth," American Banking Association, April 2012, *at* http://www.aba.com/Press/Pages/043012StudyBankExaminationProcess.aspx.

- **Improve collection and analysis of data on small business lending.** Good policy cannot be made on the basis of incomplete information, and public policy actions aimed at addressing difficulties in the small business lending market must be better informed. More data are necessary on small business lending in general. To that end, the Task Force recommends the following:

  1. *The Federal Reserve should reinstate—and ideally annualize—the Survey of Small Business Finances (SSBF), an important data source for firms' demand for lending that was terminated prior to the 2008 financial crisis.*
  2. *The Federal Reserve and the Consumer Financial Protection Bureau must improve data collection, categorizing lending data by firm size and firm age rather than using loan size as a proxy for firm size.*
  3. *The Federal Deposit and Insurance Corporation (FDIC) should require more information on lending activities in its Call Reports, a source of bank lending data that now has limited granularity.* This expansion should include, but is not limited to, information on loan application and denial data, by race, gender, and firm age.

- **Conduct further research.** More research is necessary concerning the effects of banking concentration on the availability of credit for young and small businesses. The availability of better data may spark greater academic interest in the topic, offering policymakers the information they need to make positive changes.

- **Focus SBA programs on research and evaluation.**

  1. *Collect more information and data on SBA-backed loans.* Part of the reason it is so difficult to assess the effectiveness of SBA loan guarantee programs is the general lack of information and transparency regarding them. The Small Business Administration, working with the Federal Reserve and FDIC, should obtain more information on the use of SBA-backed loans and their impact on businesses.
  2. *Conduct program evaluations.* The Small Business Administration should commission extensive research on the effectiveness of not only government lending programs but also other programs aimed at assisting small businesses. In fact, no new public or private programs aimed at helping entrepreneurs should be initiated without a plan from the beginning to track, collect, and evaluate information.[40]

Silicon Valley Bank

Silicon Valley Bank (SVB) is a bank with expertise in a number of industries, and is widely reputed for working with thousands of startups since its founding in 1983. Traditional banks typically do not know what to do with a business that walks in the door with no revenue and no developed product or service. Given the importance of bank financing to startups, a bank that understands startups' assets (typically solely intellectual property or ideas at the early stage), the ebb and flow of startup sales and revenue cycles (particularly during recessions), and has the experience to facilitate connections within a startup's industry is invaluable. SVB provides debt-issuance and operating accounts tailored to startups, and has further expertise in assisting startups backed by venture capitalists. From the perspective of a startup, debt financing typically is less expensive than equity financing over the long haul, but for many high-growth firms, both are needed, for which SVB has played an important role in many startups. More SVBs are not necessarily needed; rather, many banks could learn from SVB about how it is feasible and profitable to work with startups and young firms, even during times of economic crisis.

40. The Small Business Investment Company (SBIC) program, for example, one of the longest-running programs to support entrepreneurship, has never had a full and proper evaluation, despite putative success claimed by many. Josh Lerner, *Boulevard of Broken Dreams: Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed—And What to Do about It* (Princeton, 2009). The SBA does produce a comprehensive report on the SBIC program, which includes a good deal of descriptive information. *See* Small Business Administration, *The Small Business Investment Company (SBIC) Program: Meeting the Capital Needs of American Small Business since 1958*, Annual Report FY 2012, *at* http://www.sba.gov/sites/default/files/files/SBIC%20Program%20FY%202012%20Annual%20Report.pdf.

Financing Entrepreneurial Growth

Recommendations Recap

Equity Financing Recommendations

- Extend the requirements for crowdfunding investors to Regulation D accredited investors
- Create non-financial criteria for sophisticated investors with fewer assets
- Balance the SEC's concern for investor protection with a greater focus on innovation
- In the venture capital industry:
  —Restructure investment models
  —Improve performance measures
  —Standardize data reporting
  —Reconsider FAS 157

Public Market Recommendations

- Move to an auction model for IPOs
- Offer shareholder choice on Sarbanes-Oxley (SOX)

Debt Financing Recommendations

- Reduce the regulatory burden on banks
- Collect better data on small business lending
  1. The Federal Reserve should reinstate—and ideally annualize—the Survey of Small Business Finances
  2. The Federal Reserve and the Consumer Financial Protection Bureau must improve data collection
  3. The Federal Deposit and Insurance Corporation should require more information on lending activities in its Call Reports
- Conduct further research
- Focus SBA programs on research and evaluation
  1. Collect more information and data on SBA-backed loans
  2. Conduct program evaluations

Kauffman Task Force on Entrepreneurial Finance

Tom Alberg

Andrew Bogan

Harold Bradley

Robert Cooter

Oliver Goodenough

Monika Gruter Cheney

William Hambrecht

Frank Hatheway

Thomas Hellmann

Marianne Hudson

Jared Konczal

Josh Lerner

Robert Litan

Diane Mulcahy

Ramana Nanda

Frank Partnoy

Joe Ratterman

Naval Ravikant

Jay Ritter

Alicia Robb

David Robinson

Allison Schrager

Barry Silbert

Erik Sirri

Dane Stangler

Sharon Vosmek

KAUFFMAN
The Foundation of Entrepreneurship

4801 ROCKHILL ROAD
KANSAS CITY, MISSOURI 64110
816-932-1000
www.kauffman.org

0113500JP