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SMALL BUSINESS CAPITAL ALLOCATION

By Raymond Wang

INTRODUCTION

The American Dream has served as a national expectation within the United States since its founding, pushing for the ideal of a level playing field where everyone is given equal opportunity to achieve prosperity and success. Small businesses sit as the enabler at the heart of this belief, allowing anyone with the right idea, determination, and work ethic to bring prosperity upon themselves and society.

Technology startups are a type of small business typically requiring capital infusions to scale
Wikipedia

Policymakers face challenging decisions in their regulation of avenues through which small businesses can raise **capital**. These include questions surrounding the use of new ways, such as crowdsourced funding, to raise money for a business. Should businesses be allowed to raise money from anyone? Or, should the ability to invest be limited to accredited investors only, given the risky nature of early ventures? Even then, how should accredited investors be defined — does the current application of a financial *assets* test make sense, or should accreditation be based on an assessment of financial *knowledge* instead?

Furthermore, how much should the government be involved in promoting access to capital amongst historically disadvantaged groups and geographical areas? If so, how do we balance the use of government grants, loans, tax breaks, and other incentives, to help small businesses while leaving room for other important items on the Congressional budget? Indeed, adequately addressing these challenges will require a careful balancing of interests from all socioeconomic groups across America.

Capital *– Financial assets in the form of money, equipment, and facilities used to generate wealth through investment*

EXPLANATION OF THE ISSUE

Historical Development

The United States Senate Committee on Small Business and Entrepreneurship is a standing committee with jurisdiction over the Small Business Administration and a mandate to research problems facing entrepreneurs and small businesses throughout the country.

Tracing its roots to 1950, it was created as the Select Committee on Small Business before gaining standing committee status in 1981. Attesting to the widespread and ongoing challenges that small enterprise face, the body is the oldest Senate Select committee still in operation today, owing its most recent name change to John Kerry, who sought to call particular attention to the challenges of **entrepreneurship**.

Entrepreneurship *– The journey of launching and running a new business, which typically starts out as a small business*

Small Business Administration (SBA)

The United States Small Business Administration was established in 1953 under the Small Business Act with a mission to oversee capital, contracts, and counseling of Small Businesses. With conceptual origins tracing to the 1930s Reconstruction Finance Corporation, which helped businesses reemerge from the Great Depression, its official job is "to maintain and strengthen the nation's economy by enabling the establishment and viability of small businesses."

The SBA helps Small Businesses fund, plan, and grow their businesses

Fortune

During the 96th congress, the Senate Committee has expanded the SBA, including loan programs for increased operator ownership, Small Business Development Centers (SBDC), and export development assistance amongst its programs. To date, it has provided incentives that increase the accessibility of capital for small businesses, programs to enhance the competitiveness of businesses across all groups and neighborhoods, and measures to encourage the participation of small businesses in government purchase contracts.

Scope of the Problem

We begin our exploration of the problem by exploring the precise definition of a small business. Officially, the Small Business Act defines sector-specific standards that determine the small business status of an enterprise across a range of industries. These can include anything from mom-and-pop stores and neighborhood restaurants, to budding tech companies and independent artists.

Net Worth *— The value of all assets owned by an individual or entity, subtracted by liabilities owed*

Typically, maximum tangible **net worth** and average income is used to determine small business status. This definition is used for purposes that include providing Section 7(a) loans and Title V Small Business Investment Act (SBIA) development loans (15 U.S.C. 695),

***Securities** — A negotiable financial instrument that holds some monetary value, such as a stock that represents equity ownership in a public or private company*

The SEC is responsible for Regulation D, governing private placement exemptions

Fortune

***Accredited Investor** — Individuals must have commanded $200K+ in income for the past two years to qualify; an entity can qualify for such status if it holds assets over $5 million or acts as a registered broker or investment advisor*

***Securities and Exchange Commission (SEC)** – The SEC is an independent federal agency that maintains order in securities markets to investigate and limit fraudulent and manipulative practices committed against investors*

discussed later in this briefing. Specifically, an entity can qualify as a "small business" if it has a maximum tangible net worth of less than $15M, and an average net income after taxes of less than $5M for 2 full fiscal years before the date of the application.

Private Investment in Small Business

The need to balance investor exposure to risk sits at the heart of most small business issues. By the nature of their size, small businesses and early ventures are often exposed to significant business uncertainty. For example, it can be difficult to know from the get-go whether a newly established restaurant would succeed, or whether a software startup will find the right product-market fit. Small businesses are also typically more susceptible to market fluctuations than large enterprises, which may limit their ability to weather downturns in the business cycle. While investors can stand to benefit greatly from the growth of successful early ventures, in certain cases of business failure, investors may lose their entire investment. Thus, these investments can often be risky.

These challenges often make it difficult for even the most well-seasoned of professional investors to judge the potential for success of small businesses and early ventures. Therefore, the ability to invest in equity stakes for these early businesses, which may offer these through **securities** that are not yet registered with financial authorities, have been historically limited to **accredited investors**.

In the United States, the protection of investors falls under the purview of the **Securities and Exchange Commission (SEC)**, an independent federal government agency created by Congress in 1934 to maintains the orderly functioning of securities markets and capital formation. Importantly, its goal is to investigate, and limit fraudulent and manipulative practices committed against investors, advocating for fair play in both the public and private markets.

Of interest to the discussion of this committee is SEC Regulation D ("Reg D"), a rule that governs **private placement** exemptions. Oftentimes, small businesses, which are typically private companies, can leverage private avenues to fundraise for their businesses in a less costly and quicker manner than through a public offering. Reg D allows these businesses to fundraise through the sale of debt or equity securities to accredited investors without requiring prior securities registration with the SEC. In other words, it means small businesses don't have to jump through the same hoops that large corporations do in order to secure funding – a critical advantage given small businesses don't have the experience, time, or infrastructure to comply with those regulations.

Currently, a financial assets test is used to determine whether someone can be an accredited investor. In particular, individual accredited investors must have commanded $200,000 in income for the past two years, with expectations of earning the same or higher income in the current year. Alternatively, individuals may become accredited investors through holding a net worth in excess of $1 Million. Since the Dodd-Frank Act of 2010, which produced large-scale financial regulation reforms as a response to the 2008 financial crisis, a person's primary residence is excluded from the calculation of the net worth figure.

An entity can qualify for accredited investor status if it holds assets over $5 Million, or, since a 2016 act of Congress, acts as a registered broker or investment advisor. Fundamentally, investor accreditation has conventionally been designed to ensure that investors in small businesses and early ventures are savvy enough to understand the risks that they are exposing themselves to.

For this reason, the CROWDFUND Act, a component of the 2012 JOBS Act, has created some controversy. Its enactment has opened the door for early ventures to raise money through crowdfunding, from large numbers of non-accredited investors in small chunks of offerings. This means that all members of the general public can now take part in select private offerings made through crowdfunding, as long as these investments are made through funding portals registered with the government. In order to fundraise through this method, small businesses must provide (at a minimum) an income tax return for the most recent year, with companies seeking more than $500K required to provide audited financial statements.

As Congress continues to work out how to best walk the line between protecting investors from risk and allowing broad access to capital for emerging businesses, the investor accreditation process is almost certain to be a key issue of debate.

Qualified Small Business Stock & Emerging Growth Companies

To provide incentives for investment in small businesses, Congress, the **Internal Revenue Service (IRS)** offers special treatment to **Qualified Small Business Stock (QSBS).** This is a concept created by Congress in 1993 to encourage long-term investment in budding Qualified Small Businesses (QSB), typically those registered as a domestic **C-Corporation** in select industries with less than $50 Million in gross assets.

A QSBS investment, also termed a Section 1202 investment, named after the relevant IRS code, allows non-corporation investors who acquired and held original stock in a **QSB** to obtain a 50% exclusion of **capital gains tax**, a tax assessed on profits from the sale of assets. Section 1202 provisions were made permanent by the Protecting Americans from Tax Hikes Act (PATH) in 2015, which additionally provides for a 100% capital gains exclusion on QSBS acquired after September 2010.

While these tax incentives certainly benefit investors who back QSB companies, open questions remain on the impact of such policies on wealth distribution as a whole.

Private Placement *— A sale of stocks, bonds, or securities directly to a number of select individuals, rather than publicly on the open market*

IRS *— The Internal Revenue Service is responsible for administering and enforcing US Federal Tax Laws*

Qualified Small Business Stock (QSBS) *— Stock ownership in a QSB, typically those registered as a domestic C-Corporation in select industries with less than $50 Million in gross* ***assets***

The IRS is responsible for QSBS treatment of QSB investments

IRS

C-Corporation *– An incorporated business that is taxed separately from its owners, as distinguished from other corporate structures without this property, such as the S-Corp*

Emerging Growth Companies (EGCs) are companies under the JOBS Act that have newly scaled, with total annual gross revenues less than $1.07B and have not yet sold registered common equities. They are subject to less extensive narrative disclosures that typical publicly reporting companies and are able to leverage **test-the-waters communications** with institutional accredited investors in gauging interest for an **Initial Public Offering** (**IPO**).

QSB *– A Qualified Small Business includes domestic C-Corporations in select industries with less than $50 Million in gross assets*

Economic Incentives for Small Businesses

In many ways, small businesses are uniquely vulnerable: their limited holding of capital and often high-growth needs often render starting and successfully scaling a business a rather challenging task. For this reason, the government has historically enacted several incentives to support the growth of small businesses, including the SBA Loan Guarantee Program and SBA Microloan program for nonprofit intermediary lenders.

Capital Gains Tax *– A tax assessed on profits from the sale of assets, rendered on the gain between the sale price and the original purchase price*

The SBA provides these loans through partner banks and credit unions, backed by a partial government guarantee. Such guarantees serve a crucial purpose to, in effect, underwrite the loan, allowing lenders to make such loans with lower interest rates and more flexible terms than otherwise offered. To illustrate, in 2008, as part of the Recovery Act and the Small Business Jobs act, the SBA offered small businesses loan packages backed by a 90% guarantee to counter the credit freeze of the Financial Crisis.

A QSBS Investment allows non-corporation investors in a Qualified Small Business to obtain a 50% exclusion of capital gains tax

Programs and Assistance for Underserved Groups

Another important issue concerning small businesses relates to the broadening of access to resources for historically economically disadvantaged or otherwise underserved groups, such as low-income areas or specific minorities.

According to a 2018 SBA report, there are 8 Million minority-owned businesses in the US, including by women, ethnic minorities, and other disadvantaged groups. Together these small businesses employ over 47% of all employees in the United States. Thus, a priority of the SBA has been to ensure that minority-owned businesses can compete on equal footing in the American economy.

Test-The-Waters Communications *— Refers to oral and written communications by a business to prospective institutional buyers to judge interest in a registered offering, such as an IPO*

In carrying out its mandate, the SBA has placed a special focus on broadening small business ownership amongst groups that previously owned or operated little productive capital, with particular attention to low-income geographies.

The SBA also looks after the Small Business Ownership Development Program, which provides financial, management, and technical assistance to groups with limited productive capital. In order to identify underserved areas, the SBA defines Historically Underutilized Businesses Zones (HUBZones), which are "located within 1 or more qualified census tracts, qualified nonmetropolitan counties, Indian reservations, or other designated areas".

IPO *— An Initial Public Offering is the process of offering shares of a previously private company to the public through the issuance of stocks*

Through SBA Section 8(a), eligible businesses, owned by minorities, are allocated at least 5% of all federal contracting dollars

The SBA has setup Small Business Development Centers (SBDC) across the country with the goal of spurring entrepreneurs. It has over 900 sites located at hubs like community colleges and state universities. In addition, the SBA has helped to create SCORE, a nationwide mentorship network of experienced businesspeople, founded in 1964 as a resource partner of the agency.

Government procurement has also focused on equal opportunity development, with the SBA administering the Section 8(a) Development Program to help level the playing field. Section 8(a) eligible businesses, defined as those who have existed for at least two years that are majority owned by socially and economically disadvantaged people including women, minorities, veterans, and people with disabilities, are allocated at least 5% of all federal contracting dollars, receiving up to $4M for goods and services and $6.5M for manufacturing.

HUBZone Historically Underutilized Business Zone

HUBZone logo
Georgia Tech Procurement Assistance Center

Congressional Action

Over the years, the Senate Committee has been actively involved in capital formation, and tax and securities law reforms. Currently in the 116th Congress, Sen. Marco Rubio (R-FL) serves as Chairman with Sen. Ben Cardin (D-MD) as Ranking Member.

Amongst the significant recent legislation to note include the Small Business Jobs Act of 2010, which authorizes the creation of a Small Business Lending Fund overseen by the Treasury Department to increase credit availability for small businesses, and the Jumpstart Our Business Startups (JOBS) Act of 2012.

President Obama Signs the JOBS Act of 2012 into Law
TIME.com

The JOBS Act in particular is a landmark bipartisan bill that contains several important sections impacting the availability of capital to small businesses. In particular, Title I on Emerging Growth Companies, Title III on Crowdfunding, and Title IV on Regulation A+ have expanded entrepreneurial access to capital, allowing for easier fundraising from the General Public.

Other Policy Action

Simultaneous to the enactment of substantial Federal activity in the space of expanding small business access to capital, states themselves have reacted accordingly to provide more favorable environments for small businesses as the backbone of every regional economy. In particular, Illinois, New York, Texas, Florida, and California have all enacted notable recent legislation to encourage small business growth.

IDEOLOGICAL VIEWPOINTS

Conservative View

The JOBS Act is designed to increase the accessibility of capital for small businesses through selective easing of securities regulations

Conservatives have historically been cautious with their support of the SBA and its programs. While they generally to believe in the importance of small business in America, Conservatives tend to focus on the potential opportunity costs of small business incentives, loans, and tax breaks on other parts of the Congressional budget, including possible decreases to Federal government revenue that result. Historically, in 1996, a Republican-controlled chamber attempted, but failed, to eliminate the SBA in the House of Representatives. In more recent years however, bills in support of the SBA's expansion, such as the JOBS Act, have successfully gone on to receive bipartisan support, highlighting a common belief, to a degree, in the importance of supporting small businesses using the SBA.

Liberal View

Liberals believe that small businesses should be given as much opportunity as possible to raise money for growth. They advocate for expansions of new ways to raise money beyond family, friends, and traditional accredited investors, including through crowdfunding, made possible more than ever by the technology of online marketplaces.

Furthermore, Liberals advocate for government programs to equalize the playing field, such as through providing support to disadvantaged regions and groups of people, whether in the form of grants, tax credits, or other financial incentives. Illustratively, in 2000, Liberals vehemently defended the SBA, providing it with a record high budget. However, like Conservatives, Liberals recognize that regulating the playing field for emerging businesses with access to capital is a fine balancing act, requiring careful consideration to protect those who invest while minimizing unneeded red tape for small businesses to acquire capital.

Presidential View

Presidential support for Small Business programs and the SBA has shifted over recent years. While the Bush Administration repeatedly sought to cut the SBA's budget, to the extent of freezing certain expenditures in 2004, the Obama administration significantly expanded its programs, including supplemental appropriations enabled by the American Recovery and Reinvestment Act of 2009, the Small Business Jobs Act of 2010, and the landmark JOBS Act of 2012. Currently, the Trump Administration has remained generally supportive of the SBA budget.

AREAS OF DEBATE

Regulating the playing field for emerging businesses requires balancing investor protection with small business capital accessibility

Several pieces of legislation have impacted the ability of small businesses to raise capital. These, along with their pros and cons from a policy perspective, are highlighted below.

Building Upon the Jumpstart Our Business Startups (JOBS) Act

Enacted in 2012, The Jumpstart Our Business Startups (JOBS) Act is designed to increase the accessibility of capital for small businesses through selectively easing securities regulations. The massive bill emerged as a way to help revitalize small business growth in the economic aftermath of 2008, combining the contents of several bills, including H.R. 3606, H.R. 1070, H.R.2930, H.R. 2940, H.R. 2167, and H.R. 4088.

There are several key impacts of the JOBS Act. Title I has enabled Emerging Growth Companies (EGCs) with less than $1 Billion in annual revenue to go public via an IPO with relaxed reporting requirements. While this lowers the costs of going public for emerging businesses, relaxed reporting requirements could provide increased opportunity for companies to selectively occlude unfavorable financial information from investors.

Small Businesses employ over 47% of all employees in the USA

Fortune

The JOBS Act has also increased the number of shareholders a company can have before needing to register its common shares with the SEC, raising the threshold from 100 to 500 unaccredited shareholders with company assets at $10M. This, together with **crowdfunded equities** trading provisions made possible by Title III, now exempts certain types of small offerings from registration with the SEC, such as those made through government-registered "funding portals."

Crowdfunded Equities *– This occurs when broad groups of investors fund small businesses, in return receiving small pieces of share in the business*

While such provisions have increased the channels through which small businesses can fundraise, they also expose members of the general public to higher amounts of risk by providing the possibility for any person to invest in early-stage businesses. While the JOBS Act as a whole passed with bipartisan support, the novelty of Title III has drawn much public debate, given that it now permits the offering of securities through crowdfunding, a previously prohibited activity.

In an effort to protect members of the general public who elect to invest this way, the JOBS act provides for a yearly aggregate limit in the amount of capital that individuals can invest through crowdfunded equities, being the greater of $2,000 or 5% of earnings for those with yearly earnings up to $100K, and being the lesser of $10,000 or 10% for those earning $100K or more.

Implications of crowdfunded equities and the risks they can pose to the general public are still not fully known, and whether JOBS Act provisions are sufficiently satisfactory for their purpose of protecting investors that are members the general public protection remains a contentious question. Therefore, modifications to the scope of the JOBS act and its protections remain open possibilities for debate.

Knowledge-Based Investor Accreditation

The current finance-based accreditation test can be controversial in that it uses a financial metric to exclude certain members of the public from the ability make certain investments in small businesses, such as through conventional private placements.

Some proposals recently arisen have advocated for alternate ways to assess investor accreditation, arguing that investing experience does not necessarily correlate with net worth, but rather correlates better with study of the financial industry in general. Thus, these proponents argue that a knowledge-based accreditation standard be applied instead, such as via obtaining certain financial certifications or passing a relevant set of written tests.

Expanding Alternatives to IPOs

NASDAQ is an example of a market where successful small businesses may one day list to offer equities to the public

NASDAQ

The entry into force of Title IV of the JOBS Act, known as Regulation A+, expands upon Regulation A to allow both accredited and non-accredited investors to participate in what are functionally "mini-IPO's." These alternatives to a traditional IPO enable smaller, early stage companies to leverage a 12-month period of "public solicitation" to raise up to a $50M equity round with shares exempt from SEC registration. Regulation A+ provisions furthermore permit public funding, raised through such means, to be combined with private funds from traditional sources, like venture capital firms, to enable larger fundraising rounds than previously possible. Again, the point here is that such deregulation must simultaneously be accountable for any consequences for investor protection that may arise. In any case, the rise of even newer forms of fundraising, such as through Initial Coin Offerings (ICOs) in the cryptocurrency space, demand that new questions for the effective regulation of IPO alternatives be carefully considered.

Expanding Assistance Programs

The continued support of programs targeted towards leveling the playing field for small businesses is one that raises the classic debate of government involvement. While liberals tend to support programs targeted towards small businesses in historically disadvantaged areas, such programs do not operate without cost, both in terms of explicit costs of operation and opportunity costs imposed on other parts of the congressional budget. The development of a plan to evaluate the efficacy and plan for the future of such assistance programs will almost certainly be a principal issue in the debate to most optimally support equitable small business growth.

BUDGETARY CONSIDERATIONS

Given the ubiquity and importance of Small Businesses across the United States, funding and budgetary impacts should be carefully considered in determining whether solutions presented would be acceptable to government, industry associations, and individual small business stakeholders. For example, in pushing for tax breaks for small businesses, consider the impact that this may have on federal government revenue as a whole, and how that may affect other line items on the Congressional budget. In thinking about how funds will be directed, consider the effectiveness of your plans — for example, how would you balance incentive structures for investors with those of small business owners? Should we place more of an emphasis on providing investors with tax breaks for supporting small businesses, or should we provide financial incentives and programs that specifically target entrepreneurs and small business owners instead? How should we draw the line between accredited investors and members of the general public, and how will this impact the robustness of financial systems overall? All these are important factors to consider in the development of an effective and economically sound approach to small business capital allocation for all stakeholders involved.

How would you balance incentive structures for investors with those of small business owners?

CONCLUSION

The balance between investor protection and business owner capital accessibility has always been a difficult one, making Small Business Capital Allocation a particularly challenging issue to tackle. In considering the issue of regulation, it is helpful to keep in mind that existing rules were typically written for a reason, in order to carefully consider the multiple facets of impact that reforms in this space may produce. The outstanding questions in this area have challenged regulators for decades, and new innovations in the way that small businesses fundraise and make their business activities known to the public markets demand similar creativity in the approach to regulation.

How should we draw the line between accredited investors and members of the general public?

Given the highly financial nature of capital allocation, should tests of a person's financial assets be a necessary component of measuring an individual's readiness for and understanding of the risks of small business investing, or should a more academic, knowledge-based approach be used for investor accreditation? How much should the government be involved in balancing access to capital for historically disadvantaged groups? Thinking about these questions, and the resulting incentive structures created by your solutions, will help the committee identify the best combination of tools, from grants and loans to tax breaks and non-financial incentives, that should be applied to address the wide-ranging challenge of Small Business Capital Allocation.

GUIDE TO FURTHER RESEARCH

Small business capital allocation is a complex topic that can often be filled with technical details, and financial industry jargon in particular. While some texts may be intimidating, it is not necessary (nor possible, even for industry lawyers and policymakers) to understand every technicality of financial operations to develop a sound solution. One way to approach research in this area is to read summary briefs developed by news outlets and industry websites, making sure that you take away a high-level understanding of the arguments presented. To diversify your sources, reading about public opinion surveys from the various localities, states, and relevant interest groups in small business from a variety of industries can be especially helpful, particularly with developing a nuanced view on the issue, tailored to the region of your constituents.

In this process, keep in mind that these topics are frequently subject to debate and may be highly contentious. Ensure that your sources are reliable and backed by evidence — government agency data, economics research reports, industry whitepapers, etc. are all useful places to look. A list of sources used in the writing of this briefing is also included below to assist with your research.

GLOSSARY

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