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White Paper

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Small Is Beautiful

Previously published by The National Interest

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SMALL-TO-MEDIUM enterprises (SMEs) around the world face a common problem: obtaining a "sliver of equity" to enable them to achieve growth and positive cash flow. While this might not be an imminent problem akin to international terrorism or to nuclear proliferation, the results could be as catastrophic for America's financial interests as the failure to predict the danger posed by Al-Qaeda prior to 9/11 was to our security interests.

Without economic growth, states are unable to cope with a myriad of challenges, from providing employment to funding social services. In the Summer 2004 issue of The National Interest, Adrian Karatnycky highlighted the threat posed by poor economic performance to democratic polities by noting:

> "*Of the world's 88 free and liberal democracies, 38 have a per capita gross national income of $3,500 or less, and 18 have a per capita gross national income of less than $1,500. Evidence suggests that disillusionment with liberal institutions can set in if poor democracies are mired in economic stagnation.*"

Transitioning economies have to produce at a growth rate of 10-25 times that of the United States, which starts with a per capita gross national income of $37,800.

The importance of SMEs and the micro-cap market lies in their potential for job creation, innovation and commercial aggregation facilitating the integration of global markets. (1) The Small Business Administration (SBA) reported that small firms create more than half of the new jobs in the U.S. economy. A companion 2003 SBA study also found that SMEs were a major source of technological innovation. SMEs accelerate the generation, dissemination and application of innovative ideas. In modern global markets it is not so much financial capacity but creative capability that is the key to success.

AMERICA has the only micro-cap market that is able to fund SMEs to any degree of scale. But while the last bull market saw both the transformation of the U.S. capital market from a niche to a mass one and the formation of more than 150 capital markets worldwide, the wealth it created was primarily confined to the top-tier U.S. markets such as the NYSE and NASDAQ. Ownership of financial assets rose from approximately 18 percent to 74 percent of the American population and NYSE capitalization rose from $511 billion to $12 trillion during this period. But although SMEs drove innovation and job growth, most of the capital generated went to large firms. Analysts actually withdrew their coverage from smaller companies in droves. According to data released by Reuters Research, 53 percent of 2,400 small-cap and mid-cap publicly listed U.S. companies in the firm's database lost coverage during 2002-03.

Why? SMEs face a core difficulty in their pursuit of equity financing. That is not investor indisposition to SMEs, however, but regulation--in particular, a fundamental failure of the one-size-fits-all approach to regulating equity securities. Put simply, the current system works well for the firms that are tracked by the Wilshire 3000--an index of publicly traded U.S. equity securities--but it is inefficient and may be ineffective for the remainder of the 12,000 publicly traded U.S. companies and the majority of global SMEs. In other words, the regulatory system imposes costs that are high relative to the likely economic gains sought by the firms. And the firms may therefore not comply with an ill-devised regulatory system.

Regulatory proposals designed for top-tier market, risk-management regimes are disproportionate when applied to the micro-cap market. This top-tier perspective was recently illustrated by Paul Volcker and Arthur Levitt, who defended the added cost imposed by the Sarbanes-Oxley legislation by stating,

> "*$5 million down and $1.5 million a year is not too much to pay for a multibillion-dollar international company compared to how much investors have lost.*[2]"

But what about the SMEs that cannot afford such added costs? Do we continue to treat SMEs as if they were large corporations? This is very much a case of mixing apples and oranges. (3)

After all, responsible investors allocate funds among different investment categories and hold different types of securities for various economic reasons. Generally, government securities--low risk but low yield--are purchased for savings accounts. Top-tier issues (stocks and bonds) are usually bought for investment portfolios. Micro-cap stocks, however, are usually sold to venture investors who are willing to accept a higher level of uncertainty. A defining trait of sophisticated venture investors is that they would rather incur investment errors of commission than SEC-constrained errors of omission.

In a related issue involving a hedge fund proposal, two SEC commissioners, dissenting from the majority decision, used logic consistent with an SME exchange:

> "*[R]egulatory action aimed at eliminating every vestige of fraud in a given market would place such a heavy and costly burden of compliance upon issuers that investors would be safe but unable to achieve any meaningful return on their investments. The regulatory agency would also incur a high cost of enforcement. Carried to its logical end, investor protection as a sole reason for regulation, without also granting markets the freedom to reward those who take risk, ironically keeps investors safe and yet fails to fully protect the investors' sole interest in investing in the first instance: to achieve the highest return commensurate with their individual tolerance for risk.*[4]"

Similarly, the current micro-cap market regulatory regime tries to make investing in SMEs as "predictable" as investing in top-tier NYSE issues. Equating GE with a small electronics firm (in the absence of exemptive relief for liability) would mean that the costs of compliance and administration would often be greater than the "sliver of equity" that micro-cap issuers seek. This discourages SMEs from raising equity capital. Yet the cost and time required to obtain a "safe harbor" exemption from SEC registration requirements are well beyond the means of many SME issuers. (5) This frustrates economic development and limits investment opportunities, as there are insufficient incentives for SME capital formation.

Systemic change is necessary for the micro-cap market to price SME equities efficiently. To improve the existing capital market platform, we propose the formation of a micro-cap market, which we call the Entrepreneurial Exchange (EntEx). It is a regulatory regime specifically tailored for domestic SMEs, and it could eventually be expanded to international firms for whom the existing U.S. regulatory system may present integration difficulties. EntEx's regulatory regime would recognize the difference between event-driven stocks that are "sold" in the micro-cap market and earnings-driven stocks that are "bought" in the top-tier market. (6) It would provide proportionate regulation that is compatible and appropriate for a registry of sophisticated micro-cap investors--and once again, we stress that these investors understand the tradeoffs associated with the uncertainty inherent in micro-cap markets.

Effective Regulation of Securities

The International Organization of Securities Commissions sets forth three principles for issuers of securities: There should be full, timely and accurate disclosure of financial results and other information material to investors; holders of securities in a company should be treated in a fair and equitable manner; and accounting and auditing standards should be of a high and internationally acceptable quality. But the devil is in the administrative details as they relate to the initial condition. Strategic transparency decisions in financial markets are determined to a large extent by the dominant investor. In general, bank-controlled,

debt-driven firms prefer less information attendant to stock market trading. Conversely, equity shareholders prefer more disclosure to promote the strategic advantage of firms in a strong competitive position. America is predisposed to investment banking and equity-driven markets, whereas Europe is predisposed to commercial banking and debt-driven markets. The differences between these regimes can best be illustrated by the $1 billion revision to earnings that Mercedes Benz experienced when it applied for listing on the NYSE.

Regulators set policy through choosing commands (the package of standards and rules) appropriate for the available incentives (the possible net benefits derived from compliance). In the context of prospective issuers, standards represent "compliance hurdles" that issuers must overcome to participate in the market. Rules are the retrospective codification of best-practice procedures that should, in theory, optimize market efficiency. Once these are specified, firms face the imbedded cost of abiding by the rules in order to continue to participate in public markets.

A September 2002 paper by Wharton School Professors Brian J. Bushee and Christian Leuz examined the economic consequences of SEC disclosure requirements using a recent regulatory change on the OTC Bulletin Board. This requirement substantially increased mandatory disclosures for firms that previously did not file with the SEC. They documented that SEC disclosure requirements imposed significant costs on smaller firms that forced many SMEs from the OTC Bulletin Board. (7) De-listings can actually lead to decreased transparency for shareholders of such companies--the reverse of what the legislation was meant to accomplish.

The low-cost alternative for SMEs can be found in the gray market located underground and offshore. Issuers choose underground markets when rules are burdensome or too costly relative to the costs associated with underground markets, such as the cost of private protection and the potential for government penalty. Issuers choose offshore markets when they are unable to meet standards. Offshore markets can be costly as well, in terms of the inefficiencies that occur when issuers adjust their behavior to suit investors in the offshore market. For regulators, offshore and underground markets represent "errors of omission" as opportunities migrate to these markets to satisfy unmet demands. So the key challenge faced by policymakers is identifying the appropriate levels of standards and rules relative to incentives.

Raising Capital: The EntEx Model

ECONOMISTS believe that for every seller there is a buyer, and vice versa. What is germane from a financial market perspective is whether the seller or the buyer initiates the transaction to gain a "first-move" advantage. We argue that the economic atom needs to be split between top-tier "bought" and micro-cap "sold" metrics for effective and efficient capital formation.

Revenue-driven firms whose securities are "bought" are broadly characterized by an established history of positive cash flow. This history permits a predictable valuation as a multiple of cash flow, earnings, dividend and other measures dependent on accounting-based analysis. Thus, the risk associated with revenue-driven firms is measurable. Conversely, SMEs are event-driven issues that tend to be "sold" in a transaction where the seller makes the first move. The seller compensates for the SME's lack of positive cash flow history by identifying benchmarks that lead to the occurrence of the critical event. Uncertain stocks that are "sold" are valued primarily as a function of their corporate mission, percentage of market share or price-to-sales ratio. For example, a firm's performance may primarily depend on successfully negotiating a single contract to provide services to the federal government. If the contract is negotiated successfully, the firm will thrive; otherwise, the firm may fail. Further, the lack of earnings history means that investors face uncertainty, which is distinct from risk insofar as it cannot be measured and is therefore difficult to manage. Until an SME realizes the critical corporate event that enables it to generate positive cash flow, then reduction of uncertainty is the best that investment research can provide.

Consequently, standards and rules that apply to revenue-driven enterprises tend to be disproportionate for event-driven SMEs from both the investor (supply) and firm (demand) perspectives. Yet the standards and rules associated with conventional regulatory models rely heavily on measures of financial performance. While such measures are useful for public companies in developed capital markets, they are less appropriate for most SMEs, which make up a large portion of U.S. micro-cap enterprises as well as global enterprises in transition economies.

Using the same regulatory regime for both "sold" stocks that are uncertain and "bought" stocks that are predictable from a risk management standpoint is inefficient (negative cost/benefit) and may be ineffective (non-compliance). The standards and rules that provide investor protection for revenue-driven firms are not necessarily relevant to the investment-making decision process for venture investors. They produce added costs with little or no benefit.

Presently, the SEC accomplishes its regulatory objectives through overseeing and regulating securities issuers, intermediaries, and self-regulatory organizations such as stock markets. As compliance costs associated with being a public company rise, the burdens of such costs are borne disproportionately by micro-cap participants. While large public companies in the top-tier NYSE and NASDAQ markets are able to digest these additional costs, micro-cap public companies lack the overhead capacity.

The SEC argues that it provides for proportionate regulation for both investor protection and robust capital formation for micro-cap issuers. (8) Yet when exceptions to the rule become the rule, the system itself needs to be changed. Does the goal of protecting unsophisticated investors impose commercial censorship on sophisticated micro-cap investors? In an attempt to ensure the standard of "fairness" for novice investors, has regulation "dumbed-down" the consumer base at the expense of market efficiency? Given different pricing and practice metrics for "sold" and "bought" stocks, the SEC can no longer govern fairly, transparently and efficiently with one-size-fits-all regulation.

The SEC must evolve its regulatory scope beyond "risk" issues (that is, probabilistic top-tier NASDAQ and NYSE securities) to address "uncertain" issues that are indeterminate (unseasoned enterprises or projects with negative cash flow and their attendant derivative products). The dictionary defines "risk" as the chance of loss. Risk is probabilistic and thus presents foreseeable consequences, whereas "uncertainty" is indeterminate and characterized by unforeseeable consequences. These terms should be carefully defined to better coordinate regulatory procedures with an understanding of business drivers.

Reality ***is*** contextual. Market governance should be proportionate to the level of commercial activity and the stage of economic development to promote practitioner buy-in. Innovation and adaptability in an uncertain environment are the very hallmarks of a free market. Current financial products that are structured in a complex way evolved from earlier, simpler versions that required adaptive mutations to address uncertain and unforeseeable circumstances. (9) For markets to be robust and innovative, the investment environment must provide opportunities that arise from "uncertainty." Imposing commands to attain predictive capability on capital markets characterized by "uncertainty" undermines market resiliency and increases the probability of systemic failure.

EntEx, in contrast, creates a proportionate regulatory regime of commands and incentives that are specifically tailored for the micro-cap market. It does so in a revolutionary way. It shifts the regulatory emphasis from the investment to the investor and from investor financial capacity (net worth and income) to investor financial capability (investor sophistication and specific micro-cap knowledge).

This concept runs counter to prevailing regulatory trends. But a securities regime that emphasizes regulating investors would represent a market-driven approach towards governance. (10) For investors with superior understanding of issuers, no mandatory regulation is necessary other than anti-fraud provisions. A core principle of the Entrepreneurial Exchange's transactional process is that investors should be financially sophisticated and therefore not in need of regulatory protection when they are offered or sold securities of micro-cap issuers. To this purpose, a third party, self-regulatory organization or a distance-learning provider could develop an education program with an eye to creating a registry of

micro-cap investors. (11) EntEx creates a "preferred shoppers" network for participants in the micro-cap market through consumer education and market infrastructure enhancements.

Having reduced liability considerations and the costs of disproportionate regulation by emphasizing investor capabilities, EntEx increases the incentives to direct capital to SMEs across the globe. SMEs themselves recognize the desirability of connecting to a global network capable of providing capital for growth and expansion. The current dilemma that SMEs face is whether to join forces with a large international concern and risk of being acquired, or to ally with a foreign emerging-growth company and face the risks that such an alliance entails.

EntEx's premise is that companies of a similar size, corporate culture and product development are the preferred choice to become strategic partners. Examples include many software companies that face similar challenges in terms of software development and marketing risks, or companies that provide consulting services that face similar challenges. What SMEs have lacked to date is a suitable forum in which to operate. EntEx is that forum. EntEx would provide scalable sponsorship to enable foreign emerging and U.S. micro-cap markets to become a global integrated network that generates an exponential wealth effect. This, in turn, would provide the "golden river" necessary to sustain economic growth--and, looking farther afield, effective nation-building.

The increasing globalization of economic activity, driven by advances in technology and telecommunications, means that a growing number of companies wish to raise capital in more than one country. Sophisticated investors, issuers and market intermediaries are looking for global market solutions. As markets become more robust, however, consumers seek financial instruments tailored with increasing precision to their needs. When the demand for housing increased in the latter half of the 20th century, the thirty-year, fixed-rate mortgage was tailored to accommodate different maturities, variable interest rates, negative amortization and balloon payments. As standardized mortgage niches attained critical mass, they were securitized to mobilize capital efficiently and drive down the cost of capital. In exactly the same way, the proposed Entrepreneurial Exchange provides optimal governance and wealth creation for the micro-cap market.

The Securities Exchange Commission should provide for a proportionate regulatory regime that is tailored to the specific requirements of SMEs and global micro-cap markets. Consumer choices rather than top-tier SEC commands should determine the degree of global micro-cap commerce.

Notes:

(1) SMEs are defined as firms with less than $250 million in capitalization, and micro-cap markets are markets that trade such firms. We are focused on firms on the lower end of that capitalization spectrum.

(2) Wall Street Journal, June 14, 2002.

(3) The fate of the Ziegler Companies, Inc., a one-hundred-year-old company that became one of the highest profile casualties of Sarbanes-Oxley, is sobering. This firm, which in 2003 reported third-quarter revenues of $19.9 million (compared to $17.3 million in 2002), had to de-list itself from the American Stock Exchange. This did not go unnoticed at the 2003 U.S. Securities and Exchange Commission Small Business Forum. The final report did address the heavy economic burden imposed by Sarbanes-Oxley, and many SME executives called for the "one size fits all" aspects of Sarbanes-Oxley to be reviewed.

(4) S7-30-04, "Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins", www.sec.gov/rules/proposed/ia-2266.htm#dissent.

(5) The term "safe harbor" generally refers to the protection against liability a company will have if it follows certain procedures or makes certain statements.

(6) EntEx's regulatory concepts were introduced at the July 2004 North American Securities Administrators Association Conference.

(7) "Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board", September 2002.

(8) The SEC's considerable regulatory experience leads it to believe that the term "accredited investor" strikes the appropriate balance between the necessity for investor protection and meaningful relief for small business offerings. Yet the "accredited investor" test is primarily a measure of self-insurance that neither addresses an investor's financial sophistication nor differentiates financial knowledge relative to securities that are "sold" from securities that are "bought."

(9) Edgar Peters, Complexity, Risk, and Financial Markets (New York: Wiley, 1999) p. 19.

(10) But these ideas have found a more receptive audience in academic circles. See S. J. Choi, "Regulating Investors Not Issuers: A Market-Based Proposal", California Law Review, 88 (2000).

(11) A registry of micro-cap investors who satisfactorily completed their coursework and/or who are "grandfathered" pursuant to demonstrated prior expertise would serve, absent fraud, as a safe harbor to the provisions of the 1933 Securities Act and 1934 Securities Exchange Act. Investors who do not meet the criteria above or who are subject to a statutory bar could still transact micro-cap issues subject to either an exemptive waiver or the current regulatory regime. One-time waivers could be granted to non-investors contingent upon their knowledge of a particular company's CEO, of the specific industry, of the innovation being provided by the firm, etc. After receiving a specified number of waivers, an investor would be grandfathered as a certified investor.

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