

Raising Capital for Small Companies Using SCOR and the Internet

By, Karl Reed Guest, Attorney

Background

Every business at one or more times during its existence needs to raise capital. It may be at the start up phase to first get the business off the ground. It may be after the business has been operating successfully for several years and needs additional capital to expand and fund its growth. It is a commonly known fact that many businesses fail for lack of adequate capital. Yet in the past, the vast number of businesses have not had access to the capital they need to grow and succeed.

Businesses needing to raise capital can generally be divided into three segments, based mostly on the amount of capital required, and two of which have distinct sources of capital. The first group is usually in the early start up stages and requires some \$250,000 or less. The traditional sources of this capital are family, friends, second and third mortgages on homes, raiding retirement plans and pensions, banks, and Small Business Administration loans. So, there are a good number of sources for businesses in this segment.

The third segment of these businesses is those seeking over \$5,000,000 in capital. These businesses are generally those with a successful track record and sufficient sales to attract, in order, venture capital firms, initial public offerings in the traditional sense, and the major stock exchanges. These firms attract great attention and support from members of the financial community, in large part because of the large fees and profits to be made from providing financial services to these firms.

But what happens to those companies caught between \$250,000 and \$5,000,000 capital needs? They have fallen into a funding "no man's land". Friends, family, banks, and home loans generally cannot provide a million dollars in funding for a growing business. Traditional venture capital firms, underwriters and brokerage houses are not interested in these businesses because the fees generated are not thought to be sufficient for the work and risk involved.

Finally, over the past 8 to 10 years, this lack of access to capital for these businesses has started to change. Great results have yet to be seen, but for those with the properly situated business, creativity, and foresight, a quiet revolution in fund raising has begun. The greatest trigger to this revolution is the emergence of the Internet as a means of disseminating information. With changes, of course, come fears, risks, and, most notably for those willing to properly utilize the changes and innovations, opportunity.

The basis of this change is the Small Corporate Offering Registration, or SCOR, offering and Regulation A, or Reg A, offering. A SCOR offering allows a company to raise up to \$1,000,000 in a 12-month period, while a Reg A offering allows \$5,000,000 to be raised.

What's Different?

So what's different? Companies have always been able to raise these amounts of money through private placements and such offerings. The key is the manner in which the securities can be offered and the people eligible to buy them.

Private placements and exempt registrations severely restrict the market place for a company's securities. For an entire offering, generally all but 35 investors must be "qualified" or "accredited" investors - those with high net worths and/or income. Thus, the good customers who buy your product and eagerly support your business may not be allowed to help its expansion and participate in its growth because of these restrictions.

All states have methods for qualifying securities for sale to the general public. It involves preparation of a prospectus, or offering memorandum, which must be approved by the state regulatory authorities. They may place some restrictions on the qualifications of buyers, but they are not anything like those of the exempt offerings.

If a company wants to sell securities to buyers in more than one state, they have to register, or qualify, them in each state. Once the company involves more than one state, federal securities regulators become involved since the intrastate federal exemption is no longer available.

SCOR is really nothing more than a uniform format for the offering memorandum used to qualify securities on a state level which has been recognized as exempt on the federal level. Though qualification in each state in which the securities are to be offered is still required, the work involved has been greatly reduced by the use of a common format –Form U-7. First adopted by the state of Washington in 1988, Form U-7 has now been adopted for use in some 39 states. Reg A offerings can also use Form U-7 as their registration format, but they must file with the federal authorities as well as the individual states, and must file additional documents as well.

So now we have a relatively new means of registering or qualifying securities for sale. What difference does that make? They still must be sold. SCOR and Reg A offerings in and of themselves definitely constitute an innovation in fund raising, but alone they do not make a revolution or even really provide the ground work for one. When combined with the Internet and its possibilities for information dissemination and the support such innovations have received from not only the entrepreneurial world, but also from the regulators, the ground work for a true advance in fund raising for these middle segment of businesses is laid.

SCOR and the Internet

Enterprising individuals began using the Internet for posting of SCOR offerings several years ago. In May of 1996, the Securities and Exchange Commission, the federal regulatory authority over securities offerings, issued a release regarding the use of electronic media for purposes of delivering required financial disclosures in securities offerings. In essence, the SEC approved of such information delivery as long as specific conditions set forth in that release were met.

In November 1996, the California Commissioner of Corporations, the California regulatory authority over securities, issued a release regarding Internet offerings exempting such offerings so long as no offers to sell were made in California unless the securities offered in California were exempt or were properly qualified. Most other states have followed suit.

From a regulatory standpoint what these changes mean is that registration is simpler and less expensive, the market place for securities is much greater because of the reduced restrictions on purchasers, i.e., it is a lot easier to find someone willing and able to spend \$2,500 on a company's stock rather than \$25,000, and the restrictions on marketing methods are greatly relaxed.

These offerings are often referred to as "direct public offerings" (DPO), rather than the traditional initial public offerings (IPO), primarily because they are usually offered directly to the purchaser rather than through brokers or underwriters, although those channels can be used if interest can be generated in them.

Now that regulatory approval has generally been given to these types of offerings and their dissemination via the Internet, what really provides the excitement is the rapid growth of interest in them. Recently, several Internet sites have been developed for the exclusive purpose of posting such offerings and facilitating their sale. Realizing a lack of liquidity in these securities, limited approval has been given to several bulletin board type trading sites for individual companies stock. The Pacific Stock Exchange has developed a program for registering and trading these offerings after they meet certain conditions. Programs are being put on across the country promoting these methods and the support services that are developing.

While one of the first seminars on the subject featured panelists from traditional underwriters and investment banking firms expressing great skepticism about these offerings, these entities are now active participants in the more recent seminars. This only seems logical, as one could only be surprised and not understand or believe at that early seminar why the larger and more traditional investment bankers would not encourage entrepreneurs to utilize these tools in order to grow and become proper targets for their more expensive services in a true IPO. These smaller direct offerings would seem to be a great "farm team" system to provide larger venture capital and eventual IPO candidates. At any rate, the traditional service providers seem to now be taking a more active role.

Logical Candidates

What company is a good candidate for these offerings? Enough SCOR and direct public offerings have been done to develop a profile of a good candidate company. The characteristics are generally not that different from those for any fundraising effort and are as follows:

1. A successful track record for at least some time.
2. Being in a growth industry and achieving rapid growth.
3. A need for capital.
4. A qualified management team.
5. And most importantly, based on the success or failure of other efforts to date, having an affinity group to sell for the stock sale.

What Works

Stories of many different types of businesses surface in discussions about these new offerings. Many types can be found on the various Internet locations dedicated to listing them. Businesses in all stages from start-ups through established and rapidly growing companies are found. One of the industries, or sub-industries, often mentioned are micro-breweries. Tales are told of coupons being placed in six packs of beer encouraging customers who like the beer to request an offering memorandum for the company's stock.

The basic requirements for any successful offering, items 1-4 above, are a given. The importance of that fifth requirement of an affinity group to whom the stock can be marketed, however, cannot be overstated. In all of the literature and seminars on this subject, the same example of a tremendous success is always given - that of Real Goods Trading Corporation. Real Goods Trading Corporation is a mail order company in Northern California selling "green", or environmentally sound products, all over the country. When its expansion created a need for additional capital, Real Goods sold stock through a SCOR offering. Their target? Their existing customers. Information regarding the offering was included with orders and other correspondence with existing customers. They were so successful, that the offering was oversubscribed by some forty-percent -i.e., money had to be returned to investors because they had raised too much.

What characteristic did this target market have? They were all satisfied customers of the offering company. There is an old adage in marketing that eighty-percent of new business comes from existing customers or clientele. It appears that in these stock offerings the same basic premise holds true. And it only makes common sense. Existing customers are already sold on a company and its products or services, or they would not continue to be customers. By offering them an opportunity to purchase stock in a company, a company is offering them a chance to participate in the success they have helped to create. A simple premise, but a very powerful one as well.

Consultants May Make a Difference

Electronic offerings appear to be an opportunity for companies to leverage their electronic marketing skill for capital funds raising. However, the opportunity may be nullified if the company is only beginning to understand the possibilities of "electronic" marketing itself. There is a unique combination of the marketing and finance functions that must come about to improve chances for a successful offering. Neither traditional financial services people nor even computer consultants typically offer the opportunity to learn and apply electronic marketing techniques. There is an emerging need for specialized consulting groups offering just that opportunity - that unique combination combining corporate development and management experience with legal, financial and electronic marketing skills. CBC Communications Corp., a San Francisco Bay Area firm, reports itself as one such group.

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