Sources of Capital

A Guide for Sustainable Entrepreneurs

SUSTAINABLE ENTREPRENEURSHIP PROJECT

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Sources of Capital:
A Guide for Sustainable Entrepreneurs

About the Project

The Sustainable Entrepreneurship Project (www.seproject.org) engages in and promotes research, education and training activities relating to entrepreneurial ventures launched with the aspiration to create sustainable enterprises that achieve significant growth in scale and value creation through the development of innovative products or services which form the basis for a successful international business. In furtherance of its mission the Project is involved in the preparation and distribution of Libraries of Resources for Sustainable Entrepreneurs covering Entrepreneurship, Leadership, Management, Organizational Design, Organizational Culture, Strategic Planning, Governance, Corporate Social Responsibility, Compliance and Risk Management, Finance, Human Resources, Product Development and Commercialization, Technology Management, Globalization, and Managing Growth and Change. Each of the Libraries include various Project publications such as handbooks, guides, briefings, articles, checklists, forms, forms, videos and audio works and other resources; management tools such as checklists and questionnaires, forms and training materials; books; chapters or articles in books; articles in journals, newspapers and magazines; theses and dissertations; papers; government and other public domain publications; online articles and databases; blogs; websites; and webinars and podcasts.

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§1 Introduction

Today even the smallest business can choose from among a wide array of potential sources of capital. In most cases, however, the selection is dictated by the stage of development of the company and the anticipated growth potential of the business in the future. Among the possible sources to consider are the bootstrap financing, government financing programs, commercial banks and finance companies, new business incubators and so-called "venture catalysts", private placement transactions, public offerings and strategic business partners.[1] These traditional sources of funding will usually be supplemented by a number of alternative financing strategies designed to manage the company's capital expenditures and increase the efficiency of its cash flows, including internal financing sources, trade credits, cash management techniques and leasing. In some cases raising capital requires that companies incur certain costs associated with engaging financial intermediaries, such as investment bankers; however, it is now possible to reduce or eliminate these costs by conducting private placements and public offerings over the Internet.

§2 Bootstrap financing

Bootstrap financing is a casual term that includes not only the use of the founders' personal savings and credit sources, but also funding from relatives, friends, and business partners. It is the rare case that substantial amounts of investment capital or bank financing will be irrevocably committed to a new business venture before it is launched. In most cases, the founders will need to expend time and effort to develop the business plan and prototypes of the products and services which the company will be offering. Once that development process has been completed, the concept will be sufficiently mature to take out into the financial community. The development process is certainly not inexpensive. The founders will generally get by with little or no regular salary and it may be necessary to engage the services of outside vendors who will insist on payment before the company is ready to obtain outside financing. In order to survive during this period, the founders will rely on a variety of time-honored "bootstrap financing" techniques that are designed to keep the business together and developing until help can be found from outside investors and commercial lenders. Recently, some companies engaged in technology-related businesses have been able to obtain development-stage financing through new business incubators; however, this type of support is still difficult to obtain and may be limited to businesses involved in certain industries and located in specific areas where incubators have been established. Of course, funds will hopefully be available from operations of the business during this period; however, in many cases, working capital is limited to the founders' personal resources and the trust and patience of their affiliates.

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[1] For further discussion of initial funding sources, see "Entrepreneurship: A Library of Resources for Sustainable Entrepreneurs", prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org). A good summary of various sources of startup funding is provided in P. Graham, How to Fund a Startup (November 2005), http://paulgraham.com/startupfunding.html

§3 --Advantages and disadvantages of bootstrap financing

While running a business on the edge is certainly difficult, there are some short-term advantages to relying on bootstrap financing. First, the founders' will generally be able to avoid significant dilution which might otherwise occur if outside investors are asked to make a commitment at the early stages when the value of the business is low and the risks are high. Second, the paperwork associated with bootstrap financing is minimal and once friends or relatives have been convinced about making the investment, the funds should come in fairly quickly. Finally, the founders will usually be able to maintain control of the business, free from undue influence by investors who are not involved in the day-to-day operation of the business. On the downside, however, bootstrap financing has the obvious disadvantage of straining the founders' personal financial resources and, possibly, their relations with the relatives, friends, and business associates. In addition, the amount of capital collected from bootstrapping usually will not be sufficient to allow the company to grow at the rate necessary for it to meet time-to-market milestones that must be achieved in order for the products and services to meet the objectives set out in the company's long-term business plan. Finally, the founders must not forget that even "friends and family" offerings are subject to federal and state securities laws and there are times when it may be difficult to qualify certain investors.

§4 --Sources of bootstrap financing

One of the most common sources of financing during the start-up stage is the personal funds provided by each of the parties involved in the new venture. Founders may contribute capital from their personal savings, from current earnings received from other employment activities, or from the accrued earnings from prior business ventures. In many cases, the founders will place a significant portion of their personal assets at risk in starting the new venture, leading to high levels of anxiety and stress that extend beyond the substantial uncertainties associated with running the business itself.

While a portion of the capital provided by the founders will typically be in the form of equity (i.e., common stock), it is also common for the founders to extend credit to the company on terms that are no less favorable than those which might otherwise be available from commercial lending sources. Such loans may or may not be secured and often include the option to convert the amount of the loan into equity at some future date. If such loans remain outstanding when the company secures commercial debt financing, it may be necessary for the founders to subordinate their loans to any amounts borrowed from commercial lenders.

In addition to providing their own funds, the founders may be able to obtain financing for the start-up business through loans made by commercial lending sources. Unlike the commercial loans which are available to established and growing businesses, these types of advances, if they are available, will generally be made primarily on the good faith and credit of the founders themselves, rather than the cash flow and projected growth of the business. In almost all cases, the loans will be secured by a lien on the assets of the founders, such as a second mortgage on the residences, or the founders will be required to provide their own guarantees. Financing of this type will generally be short-term, with relatively high interest rates, and places a premium on the company's ability to rapidly begin to generate cash flow to service the debt, or to otherwise develop the business to a point where the short-term debt financing can be replaced by equity or debt financing from outside investors and by more traditional forms of commercial loans from banks and similar sources.

Depending on the type of business, it may be possible to gain access to different types of credit arrangements which are usually available once the company is "up and running." For example, it may be possible to purchase inventory on credit which, hopefully, can be repaid out of fairly rapid sales of the inventory. Also, if the company is able to generate accounts receivable, these may be used as security for additional commercial debt financing. The founders may also tap any personal lines of credit which they might have, such as cash advances from credit cards and the cash surrender value of any life insurance policies which they may have acquired in the past.

Another major source of funding during the start-up phase is financing from various affiliates of the founders, including their friends, relatives and business associates. While the new infusion of funds from these sources is generally welcome, care must be taken to ensure that the exact legal relationship between the company and the investors is well understood. For example, one of more of these “friends and family” may be interested in acquiring some form of ownership interest in the new business, while the founders may not want to part with the right to control the business and enjoy substantially all of the financial benefits of its success. It is important for the parties to agree as to whether the capital contribution is to be considered equity, or is to be a loan which the company is expected to repay at some definite time in the future.

One of the difficulties with start-up financing from affiliates is that it is generally impossible to realistically value the business at that point. As such, the founders may find that they are giving up a substantial portion of the prospective profits of the business. For example, a business associate may be willing to provide the necessary financing in exchange for a 50% "profits interest" in the company. If the company is successful, this profits interest may turn out to be far out of proportion to the actual contribution made to the business. Moreover, the existence of such a large prospective economic interest may make it difficult to land outside financing once the company has begun to grow. As such, the founders should normally insist on some sort of provision which allows the company (or the founders) to reacquire ("call") any interest acquired by outsiders at the earliest stages of the business.

Finally, the company's business partners (e.g., vendors, distributors and customers) may also be willing to consider making an investment in the company. These parties are already familiar with the company at some level and, presumably, may have a keen interest in sharing in any anticipated growth in the future. One problem with investment from business partners is that they may also seek other considerations from the company. For example, a customer investing in the company may request exclusive rights to market the company's products in a specified area. While this type of arrangement may be necessary in the short-term in order to secure needed funding it may significantly impair the long-term strategic alternatives for the company by foreclosing opportunities to shift to other sales and distribution methods in the future.

Bootstrapping

While it is widely believed that startups need outside capital in order to grow and survive, many of the fastest growing new businesses in the country—60% of the companies on the Inc. 500 list in 2015—have been launched using "bootstrapping" techniques with less than $10,000 in capital. In contrast, only 7% of the companies on the Inc. 500 list that year were fueled with funding from venture capitalists. Joel Spolsky, writing in *Inc.* about his own experiences with bootstrapping, said that "our goal has always been to grow slowly, organically, steadily and profitably". This approach contrasts sharply to the "big bang" model that involves rapid growth fueled by significant amounts of capital from outside investors such as venture capitalists.

Spolsky explained that companies that bootstrap correctly move slowly and four important pillars of organic growth—revenue, head count, public relations ("PR") and quality—are always synchronized. In other words, revenue grows only as fast as the company can hire and train skilled employees and awareness of the company's products never gets ahead of the quality of the goods and services that the company is able to provide to customers. When the only capital available comes from actual revenues from sales of products or services, as opposed to outside investors, the company must build its workforce slowly, which means there is more time to train new employees and make sure they understand and embrace the desired culture of the company. Working on a shoestring also means there is no money for big advertising campaigns, which makes the company rely on natural growth of the marketplace and be selective about how it prospects for customers. Product development is more simplistic for bootstrapped companies; however, while initial product offerings are limited in the scope of their features they generally are enough to convince customers that the company is able to offer quality and value.

Several problems can arise when raising large amounts of outside money causes the company to get out of synch with its pillars of organic growth:

- When capital is used for advertising that produces a service in revenues from sales to customers, companies often struggle to keep up because they are unable to hire skilled employees and train them fast enough to keep up with the demands of existing customers and the intense interest of prospective customers. Employees become overworked and demoralized and the failure to keep up with prospects means they lose patience and move on to competitors—generally for good.
- When the company hires employees faster than it can reasonably expect the quality of its product to improve the new employee won't have a chance to learn and absorb the culture of the company because there simply are not enough experienced mentors available to conduct the necessary training. If this continues for too long, the quality of work and service will begin to decline as more and more of the workforce consists of inexperienced employees who haven't had the time to learn about the business and their specific roles.
- When the company uses the money collected from investors to jump start demand through PR campaigns, it often isn't ready for the explosion of interest in the new product or service, which often still lacks all of the features that prospects believe they have been promised in the marketing blitz. The company may find itself handling more customers, but turning them into paying customers is difficult and they may ultimately decide that the product or service is too simple or lacks the necessary quality and never return, even when the company has substantially increased the quality of its offerings. A related risk of misalignment is that the time frame for developing high quality technology-based products is generally quite long, which means that quality has a hard time keeping pace with interest generated from high spending on PR.

Spolsky argued that "raising too much money—whether it is venture capital or private equity or from a strategic investor—is often the key deciding factor in whether a company grows at a natural pace or gets misaligned". His advice was that sometimes it makes sense, however difficult, to say "no" to investors willing to fund a "great leap forward" if the founders know that it will likely become too difficult to manage growth and satisfy customers to the point where they will forge long-term relationships with the company. Having too much money may also lead to waste and a lack of discipline about finding smart solutions to problems in the most efficient manner.

The flip side of the argument is that venture capitalists not only provide money that can be used to accelerate growth, they also provide expertise that can be tapped to improve the business model and connections that are not otherwise available to the founders that can be used to find talent for the business and forge key partnerships. Money from venture capitalists can also be used to make investments ahead of revenues, such as hiring and training employees who are best suited to the particular business and conditioning the market through selective PR campaigns. Venture capital is also seen as a "Good Housekeeping Seal of Approval" for the company, its management team and proposed business model. Finally, founders with money in the bank can spend more time on building their product and business rather than continuously looking for and pitching new investors or assuaging the concerns of employees and/or vendors worried about whether they will be paid. However, venture capitalists are under their own pressures to produce results for their investors and will want to see their invested funds deployed quickly in order to generate value that can be turned into an "exit event" (i.e., a sale of the company or initial public offering) within a relatively short period of time, say five to eight years. Venture capitalists also want to be involved in the steering the business, something that many founders are not totally prepared for. In some cases, investors demand that companies move their offices, install elaborate tracking and reporting processes and adhere to tight milestones to ensure that progress, as defined by the investors, is being made.

In an article in *The Wall Street Journal*, John Roa, the founder and CEO of ÄKTA, observed that bootstrapping wasn't for everyone or every business and that the answers to the following three questions would provide a founder with insight on whether it makes sense for him or her:

- **How well do you know your business and industry?** The founder needs to have a solid understanding of the proposed business and the applicable industry in order to determine the cost structure and price points for the proposed product or service. If launch is not possible without investing in substantial R&D, inventory, etc., the founder may have little choice but to bring in outside investors. If it looks like the business can be launched without such an investment, the founder must nonetheless be prepared to operate "lean" and make sure that the key functions for the business can be operated and talent can be recruited without substantial cash outlays (e.g., by offering equity).
- **What's your comfort level with different kinds of risks?** Bootstrapping is risky business and it is likely that the founder will find himself or herself on the edge of a cliff, with a declining bank balance and no reserves, more than once during the time it takes for the company to gain traction. If the founder is uncomfortable with this, and the accompanying stress, seeking a cushion from outside investors may be the preferred route. Even if the founder is willing to take on such a risk, he or she must have a plan for dealing with unexpected downturns to make sure the business can survive rough patches.
- **Do you want the buck to stop with you?** Founders who want, and enjoy, have full control over the management of the business will be attracted to bootstrapping, since money from outside investors generally comes with demands for sharing in decision making. In many cases, however, founders will benefit from having others who have "skin in the game" and can serve as sounding boards and bring different perspectives and experiences to the table.

Only certain types of companies can realistically look to bootstrapping as a viable strategy: companies that can generate revenue from the very beginning, usually firms that can quickly find a market for their product or service among other businesses. The inherent ability to generate revenues quickly tends to lower the risk for properly-synched bootstrapped companies and the chances of "success" are enhanced by not having to meet the ambitious valuation goals of outside investors and instead concentrate on methodically building a sustainable business with the right amount of growth and marketing to support building a loyal workforce and customer base impressed by the quality and service offered by the company.

The reality is that "bootstrapping" and "big bang" funding are not necessarily incompatible and the ideal may be to use the two strategies sequentially, an approach that is at the heart of the popular "lean startup" methodology. This path begins with self-funding until the point where the business model has been validated and profitability has been achieved. Once that milestone has been reached, outside funding can be used for "company building" and fueling a proven growth model without the founders having to absorb too much dilution to their ownership stake.

Sources: J. Spolsky, "The Four Pillars of Organic Growth: Revenue, head count, PR and quality—if one gets ahead of the others, you're screwed", INC. Magazine (January 2008), 69; C. Said, "Bootstrapped Startups go against the VC trend", San Francisco Chronicle (August 10, 2015), D1; and J. Roa, Weekend Read: Getting Rid of Bootstrapping's Bad Rap (April 3, 2015) http://blogs.wsj.com/accelerators/2015/04/03/weekend-read-getting-rid-of-bootstrappings-bad-rap/

§5 Government financing programs

Most federal, state and local government financing programs provide medium-term loans for business and product development activities. Particular businesses may qualify for long-term loans from the federal Small Business Administration and state and local agencies that are dedicated to providing support for small business activities. The federal government also offers programs through other agencies and departments that provide financing, management and business assistance. These sources include the Export-Import Bank, which provides assistance in financing exports sales of US goods and services by small businesses; and the Farmers Home Administration, part of the Department of Agriculture, which guarantees loans through its Business and Industrial Loan Program for enterprises that will preserve or create employment in rural areas.

The amount of funding will depend upon the size of the business and the amount of financing obtained from other sources, as well as the line of business in which the company is engaged. For example, public financing programs are available from various federal agencies for commercial and industrial projects, agricultural loans, housing and community development loans, and natural resources loans. Also, many states and local communities have developmental corporations organized to finance the establishment of new businesses in either the state or local community. In most cases, the loan terms offered under these government programs are essentially similar to those which might be offered by private commercial lenders; however, a government loan may be available to a firm which might not otherwise qualify for a commercial loan at that particular stage of its development. In addition to loan programs, businesses involved in certain research and development activities may be eligible for various grants and endowments from governmental agencies and non-profit research organizations. For example, for many years, government agencies concerned with health and physical sciences have contracted with private firms to conduct basic research and advanced research on products developed by government scientists.

§6 Commercial debt financing

Commercial loan financing, particularly lending involving banks and similar financial institutions, is invariably one of the important components of any company's capital structure. In many cases, the first funding that the company receives will come from a commercial bank that is induced to provide a loan on the basis of the company's business and financial plans and the financial guarantees of one or more of the founders and/or their associates. As the company grows, its lending relationships will become increasingly important and the business may find itself using a wide range of lending tools on varying terms and with repayment dates which may range from a few months to several years in the future. The managers of the company need to carefully analyze each of the alternatives and take into account the capital requirements of the business and the philosophy of each of the potential lenders. Outside investors and business partners can often provide recommendations to management about an appropriate type of commercial lending relationship.

There are a number of different commercial lenders offering a wide variety of financing arrangements. For example, full-service banks can provide short-term working capital loans, long-term lending, real estate and mortgage lending, inventory and accounts receivable financing, equipment leasing and other specialized forms of debt financing. Banks, finance companies, and thrift institutions can often provide other financing packages, including bankers' acceptance financing, factoring, and leasing. Some lenders can be a valuable source of information regarding financial and credit matters in general and provide companies with advice regarding cash management and establishing internal procedures for handling cash and making short-term investment decisions. Banks and other financial institutions also prepare and disseminate reports on general economic and business conditions.

In most cases, loans from commercial banks will either be payable on demand or will be of short-term duration (i.e., one year or less), although commercial banks also make business loans for longer periods (e.g., eight to ten years). Short-term loans may be renewed; however, in general, commercial banks are unwilling to have short-term loans converted into long-term financing through repeated renewals, and will generally require that borrowers must periodically undergo a complete reevaluation as a condition to any further lending. Demand, or short-term, loans are used by commercial banks to minimize their risks, and also to gain a degree of de facto control over the activities of the borrower. For example, if the bank is displeased with some aspect of the borrower's operations, it can threaten to demand repayment, or refuse to renew a short-term loan, in the event that changes are not made. However, in many cases, the right to force repayment may be of little effect if the parties know that such a demand will bankrupt the company, leaving the lender with only a limited prospect of recovering its investment in the company’s business. As such, it is common to see lenders working with managers of the firm, particularly when the company is in its early stages of development, to formulate a sound business plan. In fact, a number of lenders have sought to develop a "niche" for providing financing to start-up companies in dynamic industries, and may even take an equity position in the borrower.

While some institutional investors may be willing to lend monies on the basis of the security provided by the assets of the borrower, commercial banks, owing to their preference for short-term lending, are most interested in the borrower's capacity to pay interest and repay principal-as evidenced by its cash-flow history. While many bank loans to businesses are secured by property, or guaranteed by third parties, bankers mostly do not like to lend to firms with doubtful capacity to meet their payment obligations in the normal course of business, even if they have good security. If a business is unable to provide evidence of reliable cash flow, it may be forced to look to factors and other commercial financing institutions that are willing to lend, at rates higher than those customary for bank loans, on the security provided by accounts receivable or inventory or other assets.

Commercial debt financing has several key advantages for the borrower. Most importantly, the lender has no direct claim on the future earnings of the company, nor does the infusion of capital dilute the equity interests of the existing shareholders. On the other hand, however, borrowing does create fixed payment obligations that must be satisfied, thereby impacting the company's cash flow planning. Also, the restrictive covenants and security requirements imposed by many lenders can have a significant impact on management discretion regarding operation of the business while the loan is outstanding. In addition, entering into a debt financing arrangement will expose the borrower to a variety of commercial laws relating to the form and content of the terms of the loan and the borrower's promise to repay and the rights of the lender with respect to specified assets of the borrower and, in some cases, its principals in the event that the borrower defaults in its obligations under the loan. Specific areas of law that might come into play include laws governing negotiable instruments, secured transactions, guarantees, and bankruptcies.

While banks frequently provide assistance to new businesses, lending to new emerging companies often creates problems for traditional banking practices. For example, the short-term financing generally offered by banks is not a good fit for companies that are not able to generate cash for repayment until completion of fairly lengthy research and development cycles. Moreover, while some banks have recruited technology managers who specialize in evaluating loan applications from risky, emerging firms, the actual level of training of these managers is minimal. Finally, the key asset of many of these firms, its intellectual property, is intangible and difficult to value and protect, thereby creating problems in crafting collateral arrangements.

§7 --Types of commercial debt financing

Banks typically are able and willing to offer a range of different types of loan. Among the most common arrangements are the following:

- A **term loan** is a loan that is made for a fixed period of time, usually several years and most frequently from five to ten years. It provides for instalment payments of principal on a periodic basis and generally requires interest payments on a monthly basis. A term loan is commonly used for long-term capital needs, such as equipment or fixed asset purchases.

- A **revolving line of credit loan** is like a credit card. The borrower draws upon the available credit as the capital needs of the business dictate; accordingly, the loan balance will continue to fluctuate over the term of the loan. This form of loan should generally only be used to fund short-term working capital, rather than for capital improvements.
- A **revolving credit loan** combines many of the features of revolving lines of credit and term loans. Revolving credit loans begin as a revolving line of credit for a specified period of time, during which interest payments only are required. The terms of the loan specify a termination date, at which time the borrower will be obligated to repay all outstanding principal and interest owing on the promissory note evidencing the loan.
- Most commercial lenders lend money secured by the **receivables** of the borrower. The maximum amount a borrower may have outstanding at any one time is a fixed percentage, which generally ranges from 70% to 90%, of the face amount of the eligible, or acceptable, receivables of the borrower. The actual percentage will depend upon the nature, quality and terms of the pledged receivable. Promissory notes representing advances typically mature on demand or within 90 days. Terms of the credit extension, including the interest rate and the lending base, are typically reviewed annually by the lender in light of the quality of the collateral (i.e. the customer base of the borrower).
- Commercial finance companies will make loans based on the raw material, work-in-process, or finished goods **inventory** of a business. As with accounts receivable financing, the maximum amount a borrower may borrow is fixed as a percentage of the appraised cost or market value of its eligible inventory. However, since inventory is far more difficult to value, and less liquid, than account receivables, the maximum percentage of inventory value a lender is willing to advance is generally much lower than with accounts receivable financing.

§8 --Lender selection factors

While the loan application and processing often seems quite sterile and mechanical, the borrower's relationship with the bank is certainly quite personal. The bank will have access to sensitive information about the borrower's business and will bargain for the leverage to force the borrower to make important decisions regarding the use of funds generated from the business. So, as the lenders evaluate the company, it is important for management to do its own investigation in the following areas:

- Management should carefully examine the overall pattern of decision-making within the bank. For example, if the principal decisions must be made other than at the office where the loan officer is located, the company may be subjected to delays that impair its ability to do business.
- While the loan agreement will be with the bank, the day-to-day relationship will be with the individual loan officer. Accordingly, it is important for the personal chemistry with the loan officer to be right and for the loan officer to have a real

understanding of the company's business model, as well as experience with companies in the same industry.

- It is important to explore the lender's policies in dealing with a borrower that encounters unanticipated financial or operational difficulties during the term of the loan. The company should also seek counsel from other firms that may have some experience with the lender and the loan officer.
- Consideration should be given to the types of information that the lender will request from the company over the term of the loan. The company must be sure that the time and effort associated with preparing the information for the lender will not be excessively burdensome.
- Consideration should be given to the size of the lender. The key is to find a bank that is large enough to absorb the risks associated with borrower's business and still small enough to provide the required personal relationship. Evidence of marketing initiatives to start-up and small, but growing, businesses, can be an important indicator in this area.

§9 --Loan documents and closing procedures

The basic terms and conditions associated with any commercial loan are often summarized in a commitment letter that forms the basis for drafting the definitive loan documents. The commitment letter will identify the amount to be borrowed and type of purpose of the loan. The letter will also describe the interest rate and amortization schedule, collateral and guarantee requirements, and events of default. In many cases, a summary of reporting requirements and principal financial covenants will be included in the commitment letter. Finally, the letter will include a termination date for the bank's commitment and other conditions to the loan (e.g. delivery of legal opinions and no adverse changes in the lender's financial condition).

The central document in any commercial loan transaction is the actual loan or credit agreement that sets forth representations and warranties from the borrower to the lender, certain covenants to be honored by the borrower, and any events of default that may give the lender the right to accelerate payment of the loan. The basic terms of the loan agreement should include a specification of the amount borrowed or, in the case of a revolving line of credit, the maximum amount of the credit line; the payment terms; the term of the loan, including the availability of any renewals; the interest rate to be charged over the term of the loan; the fees and expenses associated with the lender's commitment; the borrower's obligations; the consequences of any prepayment of the outstanding loan amount; the need for a security interest, the terms of the security, and the lender's rights associated with the security interest; subordination agreements; representations and warranties of borrower; the events of default that might permit the lender to accelerate repayment of the loan; and as is common with the case with loans to small businesses, the need for any of the owners to provide personal guarantees.

A number of additional documents may be prepared and delivered in connection with a credit transaction. Obviously, the company will deliver a promissory note that evidences the key economic terms of the loan, although many will simply cross-reference to applicable provisions in the loan or credit agreement. When the loan is secured, the documentation will also include a security or pledge agreement that identifies the specific assets used as collateral and the remedies of the lender as secured party. Also, if the company has other outstanding indebtedness, including debentures, the holders of those obligations may be required to subordinate their rights to those being granted to the new lender. Subordination will be accomplished by a subordination agreement. Guarantees may be required from the founders and other major shareholders. Finally, as with the closing of equity investments, legal opinions and closing certificates must also be prepared and delivered before the loan is funded.

§10 Business incubators and venture catalysts

In addition to financing assistance, many entrepreneurs and companies need assistance with developing their business plan and learning the skills necessary to bring their ideas to fruition. While venture capitalists can, and have, provided this type of support for companies looking for large initial infusions of capital, other companies with more modest requirements (and with significant upside potential) may look to new business incubators and venture catalysts, which provide various types of assistance, including seed capital, with the development of business plans.

§11 --Business incubators

A business incubator is, in effect, a "community" of young firms who brought together under a single roof (or in a common area, such as a "science park") to take advantage of hands-on management assistance, access to financing, and exposure to essential business and technical support services. Entrepreneurial firms also gain access to shared office services, equipment, and flexible leases which allow them to easily expand their space as needs change. In addition, entrepreneurs may participate in education programs, many of which are offered through local universities that support the incubator. Information about business incubators can be obtained through The National Business Incubation Association, which has a Web site that is intended to serve as a clearinghouse of information on the business incubation industry, and from the Center for Technological Innovation and Austin Technology Incubator.

Companies usually remain in the incubation stage for 18-36 months, at which time they should be financially viable and ready to stand on their own with assistance from one of the more traditional sources of funding. Studies have shown that more than four of five recent graduates of an incubation program remain in business. In order to remain in the program, companies must set and achieve clear and concise milestones and adhere to specified policies and procedures. Almost half of the incubators are "mixed use," which means that they provide support to a full range of industries and services. Other incubators will focus on a particular niche, such as technology, manufacturing, services, empowerment, or a specific industry (e.g., biomedical, arts, food production, fashion, etc.). The focus of the incubator usually comes from the interests of the surrounding business community, since community support is a key benefit of incubation and often a source of funding and business alliances.

§12 --Venture catalysts

A "venture catalyst" is a new breed of start-up investor. These organizations, usually quite small and operated by former entrepreneurs who have been through one or more companies on their own, provide both seed capital (usually up to $500,000) and a substantial amount of consulting services to fledgling businesses to prepare them for presentation to venture capitalists. In many cases, venture catalysts will spend one or two days a week with a portfolio company over a six to nine month period assisting the entrepreneurs with refining their business and marketing strategy, attracting board members and senior personnel, and meeting venture capitalists. A well-networked venture catalyst can be the key to getting the company's business plan into the hands of the right investors and, more importantly, getting it read and taken serious. Venture catalysts typically specialize in a particular area, such as software development, consumer retailing, packaged goods, and e-commerce, and will often have informal relationships with one or more venture capital funds. They raise funds from high net-worth individuals and often have anywhere from $10 to $25 million to invest. They generally will take a significant equity position in portfolio companies and charge a monthly retainer.

§13 Private placements

Once the company is established, it generally can look to raise additional capital through private sales of equity and debt securities to various investors, including wealthy individuals and angel investors, venture capitalists and institutional investors (e.g., pension funds, insurance companies, etc.). Private placement transactions for non-public companies generally utilize preferred stock or a debt instrument, generally with the right to convert the preferred stock or debt into common stock (or options or warrants exercisable for common stock). The investors are thus given "downside" protection, in the form of a preference with respect to dividends or liquidation or, in the case of a debt security, a senior position in the event the company's business takes an adverse turn, and the opportunity to participate in the appreciation of the common stock's value should its business prosper. Private investors typically have their own targets for overall return on investment, and will limit their investments to those companies which appear to provide a reasonable opportunity for achieving those objectives within a specified time frame, such as three to five years.

§14 --Definition and regulation of private placements

Private sales of equity or debt securities are generally referred to as "private placements," although distinctions tend to be made between transactions with venture capitalists and sales to institutional investors. Private placements are completed pursuant to an exemption from the registration and qualification requirements of the federal and state securities laws; however, the private placement financing mechanism can be used by public companies and can be used to raise amounts which equal or exceed the size of a registered public offering. While many of the same exemptions from registration apply to the sale of new securities to friends, relatives, and business partners, the term “private placement” is most commonly used to describe the process of obtaining financing from investors who lack a prior personal or professional relationship with the founders. Even though the transaction is “exempt” from registration, issuers must still be cognizant of federal antifraud rules, and the deal may still require registration or qualification under state securities laws.

In most cases, private placements are conducted under the exemption from registration set forth in Section 4(2) of the Securities Act of 1933, as amended (“Securities Act”), known as the "§ 4(2)" exemption, which is available in situations where securities that are offered privately. "Offered privately" within the context of the § 4(2) exemption means that the investors must: (1) have access to the same kind of information which would be included in a registration statement filed with the Securities and Exchange Commission (“SEC”); and (2) possess a level of sophistication necessary to evaluate the investment. The emphasis is on the qualitative rather than the quantitative nature of the investors; if the qualitative measures are not met, an offering made to even one investor will constitute a public offering and will not be exempt under § 4(2).[2]

Because of the highly subjective nature of the case law interpreting § 4(2) of the Securities Act and the consequent inability to predict whether a § 4(2) exemption would be applicable to a particular transaction, it was apparent that the SEC had to adopt a more objective standard for determining when a private offering could be made in reliance on the § 4(2) exemption. Accordingly, the SEC adopted Regulation D (17 C.F.R. §§ 230.501 et seq.) to facilitate capital formation needs of small businesses and to add certainty to the determination of a private offering. Regulation D consists of Rules 501 through 504 (17 C.F.R. §§ 230.501 to 230.504) and Rules 506 (17 C.F.R. § 230.506) through Rule 508 (17 C.F.R. § 230.508), with Rules 501 through 503 setting forth definitions and common elements shared by the various provisions of Regulation D.

Rule 501 sets forth the key definitions applicable to Rule 506 (17 C.F.R. § 230.506), the most important of which is the definition of accredited investor. Accredited investors include certain institutions such as banks, broker-dealers, insurance companies, investment companies, small business investment companies, certain state employee plans with assets in excess of $5 million, and certain employee benefit plans within the meaning of the Employee Retirement Income Security Act of 1974 (29 U.S.C.A. §§ 1001 et seq.). (17 C.F.R. § 230.501) Accredited investors also include any private business development company, certain tax-exempt organizations as described in Internal Revenue Code § 501(c)(3) (26 U.S.C.A. § 501(c)(3)), and any corporation, trust, or partnership not formed for the specific purpose of acquiring the securities offered with total assets in excess of $5 million. (17 C.F.R. § 230.501(a)(2), (3)) Also included within the definition of accredited investor is any director, executive officer, or general partner of the issuer. (17 C.F.R. § 230.501(a)(4))

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[2] See Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119, 73 S. Ct. 981, 97 L. Ed. 1494 (1953).

Rule 506 is often used by growing companies raising large amounts of capital from sophisticated investors, including venture capitalists. Rule 506 may also be used by public companies that are raising funds in a private placement to avoid the expense and delay of registering the securities under the Securities Act. In each case, however, it is important for the issuer to consider that even offerings made solely to a group of accredited investors must nonetheless be accompanied by full, fair and complete disclosure of all “material” facts about the offering and the issuer, its management, business, operations and finances. When non-accredited investors are included in the offering, which is permitted under the conditions laid out in Regulation D, the issuer must provide specific information to all investors as provided in Rule 502 and the informational requirements vary depending on whether the issuer is subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (“Exchange Act”). It should be noted that the requirements for non-reporting issuers (e.g., companies that have not completed their initial public offering) can be quite substantial and burdensome and many such issuers will elect to exclude non-accredited investors from the offering in order to reduce the cost and time associated with compliance with the disclosure requirements.

Issuers interested in taking advantage of Rule 506 should be aware of Rule 506(c), which provides that the prohibition against general solicitation and general advertising contained in Rule 502(c) does not apply to offerings of securities made pursuant to such Rule 506(c) provided that all purchasers of securities sold in any offering thereunder are accredited investors; the issuer meets all terms and conditions of Rule 501 (the definitional part of Regulation D), Rule 502(a) (the Regulation D integration rules), and Rule 502(d) (which provides that securities sold under Regulation D are restricted securities under the Securities Act and thus cannot be resold without registration under the Securities Act or the availability of an exemption from the registration requirements); and the issuer takes reasonable steps to verify that purchasers of securities sold in such offering are indeed accredited investors.[3]

§15 --Advantages of private placements

Private placements can be beneficial to the company in a variety of ways, particularly in comparison to the expense and risks of a public offering. However, one must be careful not to make too much of the dichotomy between public and private offerings. For example, a good number of the advantages typically associated with a private placement are dependent upon a positive relationship between the issuer and the investors, as well as ongoing agreement among the investors as to the performance and financial stability of the issuer. If problems of communication should arise, these advantages quickly disappear. Also, the wave of new financial instruments in recent years is testimony to the growing sophistication of the public markets and the ability of investment bankers and brokers to design and market securities suited to the requirements of the parties in the same manner as privately-placed transactions.

[3] See SEC Release No. 33-9415; No. 34-69959; No. IA-3624; File No. S7-07-12.

A main advantage of a private placement is relative procedural simplicity. Although the disclosure requirements of various federal regulatory rules (e.g., Regulation D) have substantially diminished the facility with which private placements had been accomplished in the past, it is still less complicated and time consuming than the registration process. In addition, as a general rule, private offerings are less expensive than public offerings, since the fees of the investment bankers or finders, if any are used, are less than those charged by underwriters in a public offering, and there are no expenses for preparation of a registration statement, printing and the other costs of a public offering. With a smaller group of potential purchasers, a private placement usually offers greater flexibility in adjusting the terms and conditions of the deal in order to accommodate the objectives of the parties. Consider the situation where investors in the private transaction agree to accept a lower interest rate on the securities in exchange for the issuer's agreement to maintain a relatively strict (i.e., high) ratio of assets to liabilities. The ability to reduce the burden of fixed interest charges may not have been available to the issuer in the public market, since it may have been too difficult to effectively communicate the nature or importance of the asset-to-liability ratio concession to the entire range of potential investors. In turn, the investors may not have been able to gain the greater security afforded by the restrictions on the issuer but for the reasonable expectation of the issuer, created by the private nature of the transaction, that it might be able negotiate alternative relief with the lenders in the event of a subsequent default, particularly since such negotiations may not be feasible or legally permissible if the securities have been publicly issued. Finally, use of a private placement eliminates the need for public disclosure of potentially sensitive information regarding management compensation and other arrangements between insiders and the company.

§16 --Disadvantages of private placements

Private placements do have some disadvantages that may be important in a particular situation. For example, private placements can only be done with strict compliance with the particular exemption from registration that is being relied upon, thereby placing a premium on the use of experienced legal counsel. In addition, the offering price in a private offering is generally less than that which might be attained in the public market, assuming that a public sale could have been made, thereby increasing the level of dilution to existing shareholders. Another to consider is that since private placements necessarily involve sales to a small group of investors, such transactions may lead to a transfer of control to one or two shareholders, whereas as sales in the public market generally are spread among a large group of unrelated investors. Finally, while it is true that a private placement offers greater flexibility in structuring the terms of the investment, the company may be subjected to a wide variety of negative covenants which restricts its ability to make business decisions and take other actions.

§17 --Wealthy individuals and angel investors

Wealthy individuals have always been benefactors of fledgling businesses, particularly when a company is involved in an area in which the individual has substantial prior experience. Recently, however, increasing focus has been placed on so-called "angel" investors, who are high net worth individuals, often businesspeople or professionals with high incomes or individuals from wealthy families who seek high-risk/high-return investment opportunities. The angel investor community has also been buoyed by the entrance of individuals who have previously been involved as founders and/or senior executives of successful businesses and who exited those businesses with significant sums of money from a public offering or acquisition by an outside party. Some of the key characteristics of angel investor preferences and contributions include the following:

- Angel investors are willing to accept more risk and to provide small amounts of money to allow the entrepreneur to develop the company's business plan and complete work on new product prototypes that can be shown to venture capital firms and potential business partners. Venture capitalists generally prefer to make fewer investments and each investment must equal or exceed a certain minimum amount to justify the time and effort that the venture capitalist will spend on the company. In contrast, angel investors (alone or as part of a group of several investors) are often able to provide seed capital in amounts ranging anywhere from a few thousand dollars to several million dollars.
- The due diligence and negotiation process for taking capital from angel investors is generally much shorter and simpler than similar activities with venture capitalists.
- Angel investors are generally more patient than venture capitalists and less likely to require a rapid exit from the investment. Also, the required rate of return for many angel investors is lower than the requirements of venture capitalists, which must satisfy their own investors in order to raise new funds.
- Angel investors tend to place greater emphasis on the attributes of the entrepreneur and personal chemistry, and are more likely to get involved with a company due to interest or experience in a particular industry and their desire to bring their network of contacts to assist the company.
- Angel investors tend to be more proactive than professional investors in providing “hands on” assistance to their portfolio companies, thereby helping to strengthen the skill base of the firm's management team. Studies have shown that primary assistance from angel investors is in the area of general strategic advice and in specialized areas such as marketing, finance and accounting.

However, while angel investors can be an attractive alternative, particularly since closing the deal with an angel is usually quicker and easier than it is with a venture capitalist or institutional investor, an obvious problem is that angel investment alone is generally not sufficient to permit portfolio companies to bring their products to the marketplace. Angel investors are not good sources of capital to build out manufacturing facilities or marketing and distribution channels; these projects are best left to larger investors once the product or service has been polished and verified. In addition, angel investors can be difficult to locate; however, various networks and organizations of angel investors have been formed to ease the process of matching investors with opportunities.[4] At a deal-

[4] For example, Active Capital, formerly known as the Angel Capital Electronic Network (ACE-*Net*), is a nation-wide Internet-based option for matching individuals and institutions that qualify as “accredited investors” under Regulation D promulgated under the federal Securities Act of 1933, as amended, with

specific level, entrepreneurs must also be mindful that angel investors may not be able to provide the extensive network of contacts and resources that venture capital firms make available to companies that join their investment portfolio. Also, while the personal chemistry between the investor and the founders may be good, the actual experiences and specialties of the angel investor, such as marketing, may not be a good fit for the needs of the company, thus reducing the actual "value add" provided by the angel investor. Angel investors also impact the equity positions of the founders and may cause disruptions in management and control of the company. Finally, while angel funding is less formal than a venture capital transaction, the company and its principals must still comply with applicable laws and regulations with respect to disclosures and the manner of offering regardless of the actual size of the investment.

If, after taking all of the factors mentioned above, a decision is made to move forward with an angel financing round, consideration should be given to which of several financing structures might be appropriate for the company and the investor group. Some of the alternatives that might be used include the following[5]:

- Common stock, the same form of equity instrument issued to the founders and set aside for employees, may be sold to the angel investors at an agreed valuation; however, this approach as drawbacks for almost everyone. The investors have none of the protections that will inevitably be given to the next group of outside investors who demand and received preferred stock and the company will have set a valuation for the common stock that undermines its ability to issue stock options with attractive exercise prices to employees, advisors and others needed to assist the company in getting off the ground.
- The most common form of investment instrument for angel investors is probably a convertible note that provides for automatic conversion of the principal and accrued interest into the company's initial preferred stock financing round provided that certain requirements with regard to that financing are satisfied (e.g., size of the round and closing on or before a specified date). In order to reward the angel investors for the risk that they took on to finance the company at an early stage, the conversion rate will reflect an agreed discount from the price paid by the preferred stock investors. They will also gain the benefits of all of the rights given to the preferred investors, including the full liquidation preference even though a discounted price has been paid. Early investors may also receive warrants and other benefits.
- A twist on the traditional convertible note is the so-called "capped" convertible note that provides for conversion into the first round of preferred stock financing at either an agreed discount or at an agreed capped valuation, with the outcome based on what provides the most benefit for the angel investors. Assume, for example, the angel

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companies that have satisfied the requirements for issuing securities imposed under applicable federal and state securities laws.

[5] The following discussion is adapted from a summary presented by R. Karamali, Starting Up the Start-Up: Approaching the Angel Financing Round (Social Media Update, April 6, 2011) http://www.socialmedialawupdate.com/2011/04/articles/startups/starting-up-the-startup-approaching-the-angel-financing-round/ [Accessed May 31, 2011] For further discussion, see the Part on "Seed Capital" in "Finance: A Library of Resources for Sustainable Entrepreneurs", prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

investors have agreed that upon the closing of the preferred financing a 25% discount and $3 million "cap" would apply. If the pre-money valuation at the closing is $2 million, the notes would convert at a per share price determined as if the pre-money valuation was $1.5 million (i.e., the 25% discount would apply). If, however, the pre-money valuation was $5 million, the cap would apply and the conversion would occur at a per share price determined as if the pre-money valuation was $3 million rather than 75% of $5 million (i.e., $3.75 million).

- Some angel investors and law firms have suggested "light" preferred stock as an appropriate way to provide early stage funding instead of convertible notes, arguing that fairly simple terms can be created as an "industry standard" to facilitate efficient preparation of documents without too much expense. Light preferred stock instruments go by a variety of names, including Series AA Equity Financing, Plain Preferred and Series Seed Financing. In reality, however, no standard has emerged from among the various examples that have been proposed and angel investors have also complicated the process by becoming more aggressive about receiving management rights and legal opinions.

§18 --Seed capital funds

As the challenge of closing the initial round of funding from venture capital investors increased the demand from founders for financing at the early development pre-revenue stage led to the emergence of seed capital funds that purport to specialize in seed round financings ranging from $25,000 to $2 million. The size of these seed capital funds varies from $5 to $50 million and while some of them have raised money from the same institutional investors that participate in larger venture capital funds it is more common to see seed funds being support by capital obtained from wealthy individual investors, sometimes referred to as "super-angels" who have made investing in startups their full time passion and are well known in the startup community, and smaller family endowments. The principals of the seed funds typically argue that they will be able to give more attention to smaller companies than the larger venture capital firms and thus be able to guide the founders of those companies through the milestones that needed to achieve in order to secure the interest of venture capitalists and close the elusive Series A round. The reality is that many of the promotors of the seed capital funds lack the experience and external relationships found among larger venture capital firms to provide meaningful assistance to their portfolio companies. In particular, many of the seed capital funds lack the strong relationships with venture capital firms that would be helpful in securing additional financing for their investees. As a result, data shows that companies that obtain seed financing only from seed capital funds have more difficulty in closing a Series A round than those companies that have forged financial and business relationships with larger venture capital firms that also invest a portion of their available capital in seed stage deals.

While founders should exercise care in vetting potential seed capital fund investors, there are several funds who have carved out a strong reputation for their focus on seed-stage companies in specific geographic areas and/or industry sectors and their ability to provide funding, accelerator programs and entrepreneur events.[6] Go observed that while there are now a large number of funds willing to consider investing at the seed stage, not all of them are positioned to "lead" deals.[7] Go suggested that the capacity of a seed fund to act as a lead is constrained by the number of partners and the time and effort required to do spot promising ideas, interview the founders, conduct due diligence and contact the references provided by the founders, draft and issue a term sheet and coordinate finalization of the terms with other investors. According to Go, the best lead investors limit themselves to less than six investments per year per partner and are typically willing and able to get everything done in a few weeks and provide the founders with regular reports on their progress. Go cautioned that if an investor is not willing to commit to an efficient and transparent deal process, or does so and then disappears, it is a sign for the founders to look elsewhere. Go also advised that founders should not waste too much time on convincing investors who are skeptical about the proposed business model and that the fundraising efforts should be focused on identifying the "true believers".[8]

§19 --Venture capitalists

Financing from venture capital companies will be available for companies that are involved in high-growth industries which offer the promise of substantial returns, albeit at loftier levels of business and financial risk. Venture capital is a unique source of funding that covers a broad range of activities, and venture capitalists can be characterized in a number of different ways. Venture capitalists are looking for businesses with strong management teams and an innovative product or service capable of producing extraordinary returns. Venture capitalists realize that such returns may carry substantial risks and are more willing to invest in speculative situations. However, venture capitalists are distinguishable from other sources of investment financing because of their interest in becoming actively involved in the management of the company, generally through participation as members of the company's board of directors, to build the business to the point where the venture capitalists can realize the desired returns on investment through a public offering or the sale of the company to a larger firm. Put another way, venture capitalists provide a commitment beyond mere money to the development of the firm. This type of involvement can be extremely beneficial to companies and the members of their management team but founders and managers need to proceed very carefully before making a final selection of a venture capital investor

[6] For further information see C. Tice, "Money for Startups: Top 10 Seed Funders of 2013", Forbes (January 15, 2014), http://www.forbes.com/sites/caroltice/2014/01/15/money-for-startups-top-10-seed-funders-of-2013/#467e667191f5 and the funds appearing on the slide found at http://www.slideshare.net/schlaf/raising-a-seed-round/27-NOTABLE_SEED_FUNDSRRE_VENTURES_RAISING [both accessed May 31, 2016]

[7] The discussion in this paragraph is adapted from R. Go, "How to Raise Seed Capital: Crucial Steps to Know" (June 20, 2014), http://nextviewventures.com/blog/how-to-raise-seed-capital/ [accessed May 30, 2016].

[8] For detailed discussion of seed capital financing opportunities and instruments, see "Seed Capital" in "Finance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

partner since venture capitalists can be extremely demanding and generally have little patience for poor management practices or failure to meet agreed milestones.[9]

There are actually a number of different types of venture capitalists, including private venture capital funds (i.e. partnerships funded by wealthy individuals, pension funds, etc. and operated by professional general partners); public venture capital funds; corporate investors; funds organized and managed by investment banking firms; small business investment companies; individual investors; and state governments. Venture capitalists generally have distinct preferences as to the types of investment (e.g., the size and stage of financing, industries, and national or regional companies).

A small business which successfully completes a private placement financing with a group of venture capitalists will essentially cease to be a closely held business, even though day-to-day management control will usually remain with one or more of the founders, generally with the assistance of professional managers which may be brought in at the insistence of the investors. The investors may seek the right to elect representatives to the company's board of directors, and will impose various recordkeeping and reporting requirements on the company. Also, since venture capitalists are looking to gain liquidity for the investment within a specified time frame (e.g., two to five years), provisions will be included in the terms of the investment regarding registration of the investors' shares for a public offering and/or sale of the business to a third party. Most venture capital firms employ executives with significant industry experience, or have a network of experienced managers who can be called on to provide assistance to portfolio companies. These industry veterans are often pressed into service as a director of the start-up or emerging company that receives the investment.[10]

§20 ----Investment decision factors

While it is difficult to draw sweeping generalizations regarding the key decision factors that a venture capitalist will consider in deciding whether or not to invest in a particular company, there are clearly some general rules of thumb that founders and managers must bear in mind during the negotiation process. Specifically, venture capitalists carefully review the experience of the members of the management team, both with regard to their general skills in building businesses and in the specific market where the company will be active. The projected return on investment is also very important particularly since

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[9] For discussion of factors that founders and managers should take into account when evaluating prospective venture capital investors, see “Venture Capital” in “Finance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

[10] Information about venture capital firms in the US can be found in the directory published annually by the National Venture Capitalists Association and in "Pratt's Guide to Venture Capital Sources," produced by Venture Economics, Inc. Trade and industry groups can also be used to gather information about venture capitalists that might have an interest in a particular type of business or product. For example, trade groups for entrepreneurs active in the software area will sponsor forums at which venture capitalists will speak on financing and management issues and make themselves available to answer questions regarding business plan development. For further discussion of venture capitalists and the impact they can have on the strategy and management of a new business, see “Entrepreneurship: A Library of Resources for Sustainable Entrepreneurs”, prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

venture capitalists need a few “big winners” to make up for those portfolio companies that fail to execute their business plans in highly risky and uncertain environments. In that regard, competitive and market conditions are obviously another major factor that must be considered. Finally, since venture capitalists do not want to hold their investments indefinitely they will only look at proposals that provide an opportunity for liquidity within three to five years.[11]

§21 ----Terms of investment securities

While, in theory, any type of security may be used in a venture capital financing transaction, the common choice for venture capitalists is convertible preferred shares that allow the holders to participate in any "upside" growth in the company while establishing a preference on liquidation if the venture is not successful. Use of preferred shares also permits creation of special class voting rights for the investors. There are certain instances where venture capitalists will accept other forms of investment instruments. For example, when a company is in financial distress it may issue convertible debt securities to raise short-term cash to fund operations until a larger equity round can be completed. A venture capital firm may also receive warrants and options covering common shares as an inducement to close the transaction.

Assuming the venture capitalists will be receiving preferred shares, it is widely acknowledged that the key terms for negotiation include the following:

- *Dividends and Redemption Requirements:* Preferred shares will be issued with the right to receive periodic dividends and will have a negotiated preference, or priority, over payment of dividends on common shares. Venture capitalists generally do not require mandatory redemption provisions for their convertible preferred shares. However, in a limited number of cases, the company may be given a right to repurchase or redeem the preferred stock at its purchase price plus a redemption premium. In the “real world”, dividends and redemption requirements are generally the least important to most venture capitalists since they are not really interested in a steady dividend stream—they are in it for growth and capital gains—and they usually can get their money out of a deal that has not been as successful as they hoped by forcing a sale of the company.
- *Conversion:* The preferred shares issued to the venture capitalists will be convertible into common shares at the discretion of the holder. In addition, automatic conversion of the preferred shares will usually be required upon the occurrence of certain “exit events,” as defined in the rights and preferences associated with those shares. For example, automatic conversion may be mandated upon completion of an agreement for the sale of the company or the IPO of the company’s common shares. Since conversion eliminates the preferential rights granted to the investors, the documentation is typically rigged so that investors can retain those preferences for as

[11] For a detailed discussion of investment factors and the process used by venture capitalists with respect to valuation and pricing, which obviously impacts their investment decisions, see “Venture Capital” in “Finance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

long as they want subject only to a requirement that conversion must occur if the company progresses to a point where an exit event, such as an IPO at an attractive valuation, is possible.

- *Liquidation:* Holders of preferred shares are generally given a priority claim over the holders of the common shares to receive a fixed amount upon winding up of the company before any distribution is made with respect to the common shares. The preferential amount payable on winding up typically equals the original purchase price of the subject securities plus any and all accrued but unpaid dividends. In many cases, mergers and similar "sale events" will be deemed to be a "liquidation," thereby insuring that the investors will at least have the right to receive the amount of their original investment back upon the occurrence of such a transaction; however, negotiations can get contentious when investors insist on receiving more than their basic liquidation preference upon the occurrence of a sale event.
- *Voting Rights:* Venture capitalists generally seek to exercise significant control over the company through special class voting rights provided to them as the holders of the preferred shares, including the right to vote as a separate class on certain transactions (e.g., the issuance of new senior securities, mergers and acquisitions, a material change to the company's business plan, winding up of the company, and amendments to the company's organizational documents (i.e., articles of incorporation and bylaws)).

§22 ----Company agreements and covenants

Venture capitalists typically require that their portfolio companies enter into a series of agreements and covenants regarding management of the company's affairs. As a general rule, the agreements remain in effect for as long as a specified amount of the securities remain outstanding; however, the covenants, with the exception of requirements for delivery of the financial information, will almost always terminate on the completion of the company's initial public offering.

The covenants in these agreements generally fall into two broad categories: "affirmative" covenants, which impose duties and obligations on the future activities of issuer, and "negative" covenants, which prohibit the issuer from taking certain future actions. For example, one common affirmative covenant is the obligation of the company to provide the investors with certain financial information about the company. Venture capitalists also expect affirmative covenants regarding employee stock ownership and certain steps that will be taken by the company to ensure that the investors have an opportunity to realize a return on their original investment after they have held their shares for a minimum period of time (e.g., registration rights, redemption rights and the right to seek a purchase of all of the outstanding shares of the company by a third party). Standard negative covenants prohibit the company from entering into various specified transactions, such as a merger or an acquisition, or from amending the charter documents, without obtaining the consent of a specified percentage-in-interest of the investors.

Also included under the general category of company agreements and covenants is the need to satisfy the desire of the investors to actively participate in the management of the company through representation on the company's board of directors. The degree of participation will vary depending upon the circumstances. For example, in many cases, the investors are context to elect one member, or a greater number that is still a minority of the members of the board. In other cases, the investors may insist on the right to name a majority of the directors. Another common scheme provides that both the investors and the management team will have equal representation on the board, perhaps with an option to allow the designated directors to elect additional independent board members.

The scope and nature of the required covenants will vary with each investor and the nature of the investment instrument. For example, if the investors will control the company's board of directors following the closing of the transaction, the covenants, if any, will generally not be very burdensome, since the investors will rely on their control of the board to manage the company's continued operations. On the other hand, if the investors will not control the board following closing, and the investment is in the form of an equity investment, the required covenants will necessarily be more extensive. Similarly, if the investment takes the form of a debt instrument, the covenants will usually be more extensive since the holders of debt securities are less likely to participate directly in management of the company. The covenants in favor of the investors may be included in the company’s organizational documents (i.e., articles of incorporation and/or bylaws), in the investment or subscription agreement, or in a separate form of investors’ rights agreement. Founders and other members of the management team will also normally be parties to the covenants and obligations.

§23 ----Management agreements

In addition to voting agreements that establish the procedures for implementing the agreement of the parties with respect to management participation, each founder and senior manager will be required to sign share transfer restriction agreements, including right of first refusal, co-sale and vesting provisions.[12] Also, it is typical for venture capitalists to require formal employment agreements for each executive that sets out the duties and compensation for each person, as well as restrictions on other activities of the executive during and after the term of employment. In addition, each of the key managers and technical employees of the company will be required to execute assignments covering any ownership rights they might have in intellectual property to be used in connection with the company’s business plan.

§24 --Institutional investors

While it is not always true that institutional investors will not be interested in investing in a start-up business, as a general rule institutions are looking to participate in private placements of companies which have reached a level of maturity and which are likely to be considering a public offering in the near future. Institutional investors include pension funds, insurance companies, affiliates of mutual funds and investment banking firms, and

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[12] For a discussion of these and other management and governance agreements, see “Entrepreneurship: A Library of Resources for Sustainable Entrepreneurs”, prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

other similar entities. Institutional investors tend to be more risk-averse than venture capitalists and may sometimes prefer debt securities, perhaps with an accompanying warrant to purchase common shares, to taking an equity position in the company. Institutional investors may be willing to take an equity position in companies with a solid base of operating assets. In addition, if they are willing to purchase common or preferred shares, it is likely that they will insist on extensive operating covenants and mandatory redemption of the shares at a fixed date in the future.

§25 --Finders or placement agents

While the company may approach any and all of these investor groups directly, it is not uncommon to engage a finder or placement agent to assist in locating investors and bringing the financing to a successful conclusion. The placement agent will assist the company in locating potential investors and in attempting to close the financing transaction. For its efforts, the placement agent will generally receive a fee based on a percentage of the funds raised from investors identified by the placement agent and contingent equity compensation in the form of options or warrants. The company may also be required to reimburse the agent for certain expenses incurred by it in contacting prospective investors and preparing the offering materials (i.e., private placement memorandum) based on the company's business plan.

§26 Limited public offerings under Rule 504 of Regulation D

The provisions of Rule 504 (17 C.F.R. § 230.504) of Regulation D, which is described above, are available to any private companies exclusive of investment companies and blind pool companies with no specific plan of business or purpose. The maximum amount that can be raised under Rule 504 is $5 million, less the aggregate offering price for all securities sold within the 12 months before the start of and during the offering of securities under Rule 504, or in reliance on any exemption under § 3(b) of the Securities Act, or in violation of the Securities Act's registration requirements. If a transaction under Rule 504 fails to meet the limitation on the aggregate offering price, it does not affect the availability of this Rule 504 for the other transactions considered in applying such limitation. For example, if an issuer sold $5,000,000 worth of its securities on January 1 under Rule 504 and an additional $500,000 worth on July 1 of the same year, Rule 504 would not be available for the later sale, but would still be applicable to the January 1 sale.

To qualify for the exemption under Rule 504, offers and sales must satisfy the terms and conditions of 17 C.F.R. § 230.501 (definitions) and 17 C.F.R. § 230.502(a) (integration), 17 C.F.R. § 230.502(c) (limitation on manner of offering), and 17 C.F.R. § 230.502(d) (limitations on resale), except that the provisions of § 230.502 (c) and (d) will not apply to offers and sales of securities under Rule 504 that are made: (i) exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions; (ii) in one or more states that have no provision for the registration of the securities or the public filing or delivery of a disclosure document before sale, if the securities have been registered in at least one state that provides for such registration, public filing, and delivery before sale, offers and sales are made in that state in accordance with such provisions, and the disclosure document is delivered before sale to all purchasers (including those in the states that have no such procedure); or (iii) exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to accredited investors.[13]

Thus, if one of these exceptions is satisfied, the offering under Rule 504 need not be limited and may be made to the public at large with general solicitation and general advertising in the media, newspapers, over radio and television, and in seminars and meetings.[14] There would also be no requirement that there be any restrictions placed on the securities as to the resale, which means that the certificates need not bear a legend stating any restriction on resale, no transfer agent instructions must be issued restricting resale of the shares, and that the shares purchased by the investors in the offering may generally be freely resold without registration.[15] In effect, Rule 504 becomes, in these specific circumstances, a limited public offering of securities without the need to incur the expense of a formal registration. Moreover, there is no requirement under Rule 504 that any particular information such as a private placement memorandum be furnished to the investor.

In spite of its apparent flexibility, Rule 504 is rarely relied on as the exemption for a private placement transaction involving venture capitalists and other sophisticated investors. In addition, Rule 504 is only an exemption from federal law and whether such an offering will be lawful depends on the applicable securities laws of the states in which the offering occurs. In that regard, notice should be taken that in approximately 45 states a Rule 504 public offering may be combined with a Small Corporate Offering Registration ("SCOR") procedure, which uses Form U-7, a question and answer disclosure document. Information regarding SCOR requirements, including model documents, can be obtained from the website of the North American Securities Administrators Association.

§27 Crowdfunding

Extensive changes were made in the regulatory framework for financing of emerging growth companies when the President signed the "Jumpstart Our Business Startups Act" ("JOBS Act") into law on April 5, 2012, as Public Law 112-106. One of the most publicized, and controversial, elements of the JOBS Act was the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012", or "CROWDFUND Act", which added a new § 4(a)(6) to the Securities Act (15 U.S.C.A. 77d(a)(6)) that exempts from registration under the Securities Act transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that:

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[13] 17 C.F.R. § 230.504(b)(1).
[14] 17 C.F.R. § 230.504(b).
[15] 17 C.F.R. § 230.504(b).

- The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the § 4(a)(6) exemption during the 12-month period preceding the date of such transaction, is not more than $1million;
- The aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the § 4(a)(6) exemption during the 12-month period preceding the date of such transaction, does not exceed: (i) the greater of $2,000 or 5% of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and (ii) 10% of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000;
- The transaction is conducted through a broker or "funding portal" that complies with the requirements on intermediaries set forth in § 4A of the Securities Act[16]; and
- The issuer complies with the requirements imposed on issuers under § 4A(b) of the Securities Act, which are described below.

The requirements on issuers referred to above are set forth in § 4A(b) of the Securities Act, which provides that for purposes of § 4(a)(6) of the Securities Act, an issuer who offers or sells securities shall:

(1) File with the SEC and provide to investors and the relevant broker or funding portal, and make available to potential investors:

- The name, legal status, physical address, and website address of the issuer;
- The names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20% of the shares of the issuer;
- A description of the business of the issuer and the anticipated business plan of the issuer;
- A description of the financial condition of the issuer, including, for offerings that, together with all other offerings of the issuer under § 4(6) within the preceding 12-

[16] In general, § 4A(a) of the Securities Act provides that a person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others pursuant to § 4(a)(6) of the Securities Act shall, among other things, register with the SEC as a broker or a funding portal (as defined in Exchange Act § 3(a)(80); register with any applicable self-regulatory organization (as defined in Exchange Act § 3(a)(26)) (i.e., FINRA); provide such disclosures, including disclosures related to risks and other investor education materials, as the SEC shall, by rule, determine appropriate; ensure that each investor: (A) reviews investor-education information, in accordance with standards established by the SEC; (B) positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and (C) answers questions demonstrating an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers; an understanding of the risk of illiquidity; and an understanding of such other matters as the SEC determines appropriate, by rule; and take such measures to reduce the risk of fraud with respect to such transactions, including obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20% of the outstanding equity of every issuer whose securities are offered by such person. Additional requirements are also applicable including requirements set forth in any rules prescribed by the SEC.

month period, have, in the aggregate, target offering amounts of: (i) $100,000 or less: (I) the income tax returns filed by the issuer for the most recently completed year (if any); and (II) financial statements of the issuer, which shall be certified by the principal executive officer of the issuer to be true and complete in all material respects; (ii) more than $100,000, but not more than $500,000, financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures for such review or standards and procedures established by the SEC, by rule, for such purpose; and (iii) more than $500,000 (or such other amount as the SEC may establish, by rule), audited financial statements;

- A description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount;
- The target offering amount, the deadline to reach the target offering amount, and regular updates regarding the progress of the issuer in meeting the target offering amount;
- The price to the public of the securities or the method for determining the price, provided that, prior to sale, each investor shall be provided in writing the final price and all required disclosures, with a reasonable opportunity to rescind the commitment to purchase the securities;
- A description of the ownership and capital structure of the issuer, including: (i) terms of the securities of the issuer being offered and each other class of security of the issuer, including how such terms may be modified, and a summary of the differences between such securities, including how the rights of the securities being offered may be materially limited, diluted, or qualified by the rights of any other class of security of the issuer; (ii) a description of how the exercise of the rights held by the principal shareholders of the issuer could negatively impact the purchasers of the securities being offered; (iii) the name and ownership level of each existing shareholder who owns more than 20% of any class of the securities of the issuer; (iv) how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions; and (v) the risks to purchasers of the securities relating to minority ownership in the issuer, the risks associated with corporate actions, including additional issuances of shares, a sale of the issuer or of assets of the issuer, or transactions with related parties; and
- Such other information as the SEC may, by rule, prescribe, for the protection of investors and in the public interest;

(2) Not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker;
(3) Not compensate or commit to compensate, directly or indirectly, any person to promote its offerings through communication channels provided by a broker or funding portal, without taking such steps as the SEC shall, by rule, require to ensure that such person clearly discloses the receipt, past or prospective, of such compensation, upon each instance of such promotional communication;
(4) Not less than annually, file with the SEC and provide to investors reports of the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate, subject to such exceptions and termination dates as the

Commission may establish, by rule; and
(5) Comply with such other requirements as the SEC may, by rule, prescribe, for the protection of investors and in the public interest.

Section 4A(c) of the Securities Act provides for liability for material misstatements and omissions made during the course of an offering under § 4(a)(6). Section 4A(e) provides that securities issued pursuant to § 4(a)(6) will be "restricted securities" and thus may not be transferred by the purchaser of such securities during the one-year period beginning on the date of purchase, unless such securities are transferred to the issuer of the securities; to an accredited investor; as part of an offering registered with the SEC; or to a member of the family of the purchaser or the equivalent, or in connection with the death or divorce of the purchaser or other similar circumstance, in the discretion of the SEC. According to § 4A(f) of the Securities Act, § 4(a)(6) shall not apply to transactions involving the offer or sale of securities by certain types of issuers including issuers that are subject to the reporting requirements of the Exchange Act.

The SEC rules for the "crowdfunding" initiative are set out in 17 C.F.R. Part 227, titled "Regulation Crowdfunding, General Rules and Regulations" and include the crowdfunding exemption and requirements (17 C.F.R. 227.100), requirements for issuers (17 C.F.R. 227.201 et seq.), requirements for intermediaries (17 C.F.R. 227.300 et seq.), funding portal regulations (17 C.F.R. 227.400 et seq.) and miscellaneous provisions relating to topics such as restrictions on resales and disqualification provisions (17 C.F.R. 227.501 et seq.). With respect to the requirements for issuers, 17 C.F.R. 227.201 et seq. addresses disclosure requirements, ongoing reporting requirements, filing requirements and form, advertising and promoter compensation. The rules:

- Permit a company to raise a maximum aggregate amount of $1 million through crowdfunding offerings in a 12-month period;
- Permit individual investors, over a 12-month period, to invest in the aggregate across all crowdfunding offerings up to: if either their annual income or net worth is less than $100,000, than the greater of $2,000 or 5 percent of the lesser of their annual income or net worth, or if both their annual income and net worth are equal to or more than $100,000, 10 percent of the lesser of their annual income or net worth; and
- During the 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings may not exceed $100,000.

All transactions relying on the rules must take place through an SEC-registered intermediary, either a broker-dealer or a funding portal. The rules include detailed requirements for funding portals, which must be prepared to register with the SEC on "Form Funding Portal" and become a member of a national securities association (i.e., FINRA).

Companies relying on the rules are required to conduct their offerings exclusively through one intermediary platform at a time and must be "eligible" to use the exemption. Under the rules, ineligible companies include non-U.S. companies, Exchange Act reporting companies, certain investment companies, companies that are subject to disqualification under Regulation Crowdfunding, companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding during the two years immediately preceding the filing of the offering statement, and companies that have no specific business plan or have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies.

Importantly for companies eligible to seek crowdfunding under the exemption, they must be prepared to file certain information with the SEC on Form C and provide this information to investors and the intermediary facilitating the offering, including among other things, information that discloses:

- The price to the public of the securities or the method for determining the price, the target offering amount, the deadline to reach the target offering amount, and whether the company will accept investments in excess of the target offering amount;
- A discussion of the company's financial condition;
- Financial statements of the company that, depending on the amount offered and sold during a 12-month period, are accompanied by information from the company's tax returns, reviewed by an independent public accountant, or audited by an independent auditor. A company offering more than $500,000 but not more than $1 million of securities relying on these rules for the first time would be permitted to provide reviewed rather than audited financial statements, unless financial statements of the company are available that have been audited by an independent auditor;
- A description of the business and the use of proceeds from the offering;
- Information about officers and directors as well as owners of 20 percent or more of the company; and
- Certain related-party transactions.

In addition, companies relying on the crowdfunding exemption would be required to file an annual report with the SEC and provide it to investors.

Securities purchased in a crowdfunding transaction generally cannot be resold for one year. Holders of these securities would not count toward the threshold that requires a company to register its securities under Exchange Act Section 12(g) Act (§ 151:37) if the company is current in its annual reporting obligations, retains the services of a registered transfer agent and has less than $25 million in total assets as of the end of its most recently completed fiscal year. In addition, securities issued under § 4(a)(6) will be considered to be "covered securities" for purposes of the National Securities Markets Improvements Act thus exempting such securities from state securities law registration requirements.

While "crowdfunding" has received a large amount of media attention, it remains to be seen whether or not it becomes a practical alternative for issuers given that they are limited to $1 million in 12 months; investors are limited to small amounts; transactions must be conducted through a regulated intermediary—either a registered broker or a registered funding portal; and they are subject to significant disclosure, financial information and reporting requirements and restrictions on outside advertising. Rule 504, which is discussed above, already allows issuers to raise up to $5 million from an unlimited number of investors; however, it is rarely used because Rule 504 offerings are still subject to regulation under state securities laws. Information regarding Regulation Crowdfunding, including the new forms, is available on the SEC website.

§28 Research and development financing

Another special form of financing focuses on research and development ("R&D") activities of the business and provides investors with certain tax benefits as well an opportunity to share in the profits from successful development efforts. Over the years, companies and their financial advisors have devised a number of creative strategies for raising capital for R&D activities. For example, at one time it was common for investors to participate in research and development limited partnerships, so-called "R&D partnerships," formed to finance the research activities. The limited partnership form is used to take advantages of the income tax deductions relating to research work. The company performing the R&D, referred to as the "sponsor," would contribute the base technology to the limited partnership, and the investors would contribute the capital to fund the R&D on the basis of the sponsor's previous success in developing the base technology. The sponsor then performed the R&D for a fee that approximated the amount contributed by the limited partners. The limited partners received a return on their investment in the form of royalties based on the sale of products using the technology developed by the sponsor during the research program. If the sponsor believed that revenues from the products will be substantial, it could "cap" the investors' return by exercising a right to "buy-out" the interests of the limited partners at a formula price (which can often by paid in stock of the sponsor). Originally, R&D partnerships were extremely popular because they allowed sponsors to finance the development work without using their own funds. In effect, the financing risks of these risky projects could be shifted to the investors and the investors were willing to take on these risks because they could obtain tax benefits from deducting the expense of the research work against ordinary income from other sources. However, with the adoption of the "passive income" restrictions on the deductibility of business expenses, many of the tax advantages of the R&D partnership were reduced, if not eliminated,

Some companies have formed a new subsidiary to raise funds for a particular research project. The parent corporation (the "sponsor" in this structure) grants an exclusive license to the new subsidiary to use the base technology for R&D activities, and the sponsor contracts with the new subsidiary to perform the R&D. The research funding is obtained through an offering of units consisting of both a share of stock in the new subsidiary and a warrant to purchase shares of stock in the sponsor. The sponsor would have the option to "call" or repurchase the shares of stock in the new subsidiary at a specified premium over the original offering price; however, the investors may still continue to participate in the success of the research work by exercising the warrants.

Other R&D arrangements involve two companies. In these arrangements, one company might perform the R&D under a research contract with the other company, or the parties might form a joint venture for the R&D and, perhaps, any subsequent manufacturing and marketing of the resultant products. One of the goals of this type of arrangement is to induce an outside party to provide capital for specified R&D projects and perhaps develop a long-term strategic relationship party that extends into other areas of the product development and commercialization process. Unlike funding from other types of investors, however, strategic partnering involves difficult decisions about how much control should be surrendered with respect to ownership and usage of technology and intellectual property rights that might be created during the R&D project.[17]

§29 Registered public offerings

While it is possible to make what is, in effect, a public offering of securities without completing the formal registration process through the use of one of the "simplified" public offering mechanisms now recognized under federal and state securities laws (e.g., Rule 504 of Regulation D, which is described above, and Regulation A[18]), the term is generally associated with the preparation and filing of a registration statement covering the broad distribution of securities into the public capital markets which is accomplished with the assistance of a group of investment bankers who manage the distribution and act as "underwriters" with respect to the ultimate sale of the securities.

For companies that have not raised money in a registered offering in the past, the decision to "go public" is often extremely difficult and requires careful consideration of a number of countervailing advantages and disadvantages. On the positive side, an "initial public offering," or "IPO," may be attractive for the following reasons—it allows existing shareholders to gain liquidity for their investment in the company; a public trading market provides a basis for further appreciation of the interests of the founders and other existing shareholders; the price level for securities which are sold in a public offering is generally higher than that which could be attained in a private placement; a marketable security can be used as the basis for expanding the company through acquisitions; and a public trading market for the securities can be useful in attracting new executive and scientific talent. For seasoned companies, the attractiveness of a registered primary

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[17] For further discussion of research and development projects with strategic partners, see “Technology Management: A Library of Resources for Sustainable Entrepreneurs”, prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

[18] Regulation A is an exemption from registration for public offerings, although offerings made pursuant to this exemption share many characteristics with registered offerings. In March 2015, in order to implement Section 401 of the JOBS Act described above, the SEC amended Regulation A by creating two offering tiers: Tier 1, for offerings of up to $20 million in a 12-month period; and Tier 2, for offerings of up to $50 million in a 12-month period. For offerings of up to $20 million, companies can elect to proceed under the requirements for either Tier 1 or Tier 2. There are certain basic requirements applicable to both Tier 1 and Tier 2 offerings, including company eligibility requirements, bad actor disqualification provisions, disclosure, and other matters. Additional requirements apply to Tier 2 offerings, including limitations on the amount of money a non-accredited investor may invest in a Tier 2 offering, requirements for audited financial statements and the filing of ongoing reports. Securities in a Regulation A offering can be offered publicly, using general solicitation and advertising, and sold to purchasers irrespective of their status as accredited investors. Securities sold in a Regulation A offering are not considered “restricted securities” for purposes of aftermarket resales. To sell securities pursuant to Regulation A, the SEC must first issue a “notice of qualification,” after staff review of the company’s offering materials filed in accordance with the requirements of Form 1-A promulgated by the SEC, which requirements are extensive and akin to those applicable to a registered public offering.

offering of securities depends largely upon an assessment of the relative cost of capital, particularly if such companies have the option of commercial loan financing or other alternatives which do not immediately dilute the financial interests of the existing shareholders.

On the other hand, there are various disadvantages to the company and its managers in raising funds in the public market—the registration process can be expensive and extremely time consuming, particularly in the case of the company's first public offering; a company making a public offering will probably be subject to greater public disclosure of its affairs than would be the case in a private placement, including disclosure of management compensation and transactions between the company and its insiders; once the company has gone public, it will be subject to the detailed reporting requirements included as part of the federal securities laws, as well as similar requirements imposed by the exchanges on which the securities are traded; and public companies and their significant shareholders must comply with various rules relating to the solicitation of proxies and the reporting of certain transactions in the company's securities by insiders.

§30 --Regulatory framework

Capital raising through a public offering of securities is strictly regulated by the provisions of the federal Securities Act of 1933 ("Securities Act") and the Exchange Act of 1934 ("Exchange Act").19 The focus of the Securities Act is the disclosures and liabilities involved in the offer and sale of securities to the investment community, in both private and public offerings. Under Section 5 of the Securities Act, offers and sales of securities must be registered with the federal Securities and Exchange Commission ("SEC") unless one of the exemptions from registration included in Sections 3 and 4 of the Securities Act is available. Disclosures in the registration statement are intended to include all of the material information regarding the issuer and the terms of the offering and the Securities Act contains provisions designed to insure that the information is disseminated to the investment community before the offering is completed.

The basic purposes of the Exchange Act are to regulate securities exchanges and the securities market; to make available to persons who buy and sell securities information relating to the issuers of such securities; to prevent fraud in securities trading and manipulation of markets; and to control the amount of credit which may be used in the securities market. The provisions of the Exchange Act relate primarily to the activities of issuers and their affiliates after their securities have been distributed into the public market. The Exchange Act requires the registration of each class of an issuer's publicly traded securities with the SEC, as well as the filing of periodic and other reports with the SEC and securities exchanges by those issuers and its officers, directors and controlling shareholders. The Exchange Act also regulates the solicitation of proxies with respect to registered issuers, as well as tender offers and other specified transactions. Finally, the

[19] For full discussion of raising capital through a registered offering, particularly initial public offerings, and the consequences of becoming a public company, see "Managing Growth and Change: A Library of Resources for Sustainable Entrepreneurs", prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

Exchange Act establishes a number of rules relating to the creation and operation of the securities markets, including requirements applicable to broker-dealers, stock exchanges, clearing agencies and transfer agents.

The question of whether a registered public offering of its securities is an appropriate financing transaction depends upon the goals and objectives of the company and its owners and managers. In most cases, attracting additional capital for the business is a primary objective, thereby requiring consideration of one or more economic factors—the amount of funds required and the expected use of proceeds; potential capital providers (i.e., banks, individuals, institutions, the public); the "price" of the offering and the relationship thereof to such tangible measures as book or market value; the timing of the offering; the manner of offering and use of an investment banking intermediary; and the risks involved with successfully completing the offering. In addition, the various advantages and disadvantages of public company status should be analyzed.[20]

§31 --Disclosure requirements

The specific disclosure requirements of Section 5 of the Securities Act are implemented by the provisions of the integrated disclosure system, particularly Regulation S-K[21]; Regulation C, which sets forth the various procedural guidelines relating to the preparation of Securities Act registration statements; and the applicable registration form. Moreover, consideration must be paid to the broad requirements set forth in Sections 11, 12 and 17 under the Securities Act, and Rule 10b-5 promulgated under the Exchange Act, which collectively require that all material information be included in the prospectus, whether or not specifically prescribed by the registration form.

§32 --Underwriting and distribution arrangements

The actual offer and sale of the securities to interested investors is handled through a group of investment bankers—a syndicate—that acts as underwriters in connection with the financing transaction. One or more of the underwriters act as managers of the syndication group—the so-called managing underwriter(s)—and act as the primary contact with the company regarding the terms of the offering and the conduct of the offering process. The formal agreement regarding the terms of the offering is set out in an underwriting agreement, which is essentially a stock purchase agreement that sets forth the basic relationship among the company, any selling shareholders and the syndicate group. The content of the underwriting group is generally fairly "standard," including the terms and conditions of sale, representations and warranties, closing conditions, indemnification provisions and provisions with respect to termination of the agreement prior to closing. In some cases, the language in the agreement will vary depending upon the style and "custom"

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[20] For full discussion of advantages and disadvantages of public company status, , see “Managing Growth and Change: A Library of Resources for Sustainable Entrepreneurs”, prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

[21] For further discussion of the information requirements included in Regulation S-K, see “Managing Growth and Change: A Library of Resources for Sustainable Entrepreneurs”, prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

of the particular managing underwriter. The underwriting agreement will address the basic financial terms of the offering include the type of securities offered (e.g., common stock, debt securities or some combination of equity securities and warrants); the size and price of the offering; the type of underwriters' engagement (e.g., firm commitment or "best efforts"); the amount of the underwriters' commission; and the overall expenses associated with the offering, excluding underwriters' compensation.[22]

§33 --Exchange listings

Both the company and the managing underwriter will be anxious to insure that the company's securities will be listed for trading on an appropriate exchange or listing system immediately following the commencement of the IPO. Application must be made to the exchange or trading system contemporaneously with the filing of the registration statement. In each case, care must be taken to insure that the requirements for such listing will be satisfied by the time that trading is scheduled to begin. The listing standards and requirements of the major national securities exchanges—the New York Stock Exchange ("NYSE") and The Nasdaq Stock Market ("Nasdaq")—have become quite demanding in response to regulatory mandates such as the Sarbanes-Oxley Act of 2002 and companies should expect to take a number of actions such as strengthening the composition and role of the audit committee and preparing to comply with the various certification requirements that will be triggered by approval of the listing application.[23]

§34 --Secondary trading and public company status

Once securities have been sold by the company, regulatory attention turns to the resale of the securities to investors who were not involved in the original distribution. As a general rule, resale transactions, referred to as "secondary trading," can be accomplished without the formality of registration. However, there are certain situations where secondary trading can only occur if the securities are included on a registration statement or sold in strict compliance with regulations designed to insure that the seller is not an "underwriter" with respect to the securities.

If the company has completed a registered primary offering of its securities, or has otherwise become subject to the reporting provisions of the Exchange Act, secondary transactions will take place in the context of the integrated disclosure system's formal requirements of annual and periodic reporting.[24] Proxy statements must be filed with the SEC and delivered to shareholders by companies with a class of equity securities registered under the Exchange Act in connection with the solicitation of proxies. The content of the

[22] For further discussion of underwriting and distribution arrangements, see "Managing Growth and Change: A Library of Resources for Sustainable Entrepreneurs", prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
[23] For further discussion of listing standards and requirements, see "Governance: A Library of Resources for Sustainable Entrepreneurs", prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
[24] For further discussion of the formal requirements of annual and periodic reporting, see "Managing Growth and Change: A Library of Resources for Sustainable Entrepreneurs", prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

proxy statement is prescribed by Schedule 14A adopted by the SEC pursuant to Section 14(a) of the Exchange Act. Public company status can become quite burdensome to the company; however, the ability to access the public capital markets carries with it the responsibility to adhere to the guidelines of the SEC and the various securities exchanges with respect to disclosure and protection of shareholder rights.[25]

§35 Strategic business partners

As the company grows and develops, it will enter into a variety of business relationships with third parties with regard to research and development, product manufacturing, the supply of raw materials and semi-finished goods, distribution and service. Each of these "strategic partnerships" is of extreme importance to the company and serves to build a sense of shared commitment and reliance between the parties. In some cases, the functional arrangement, such as a licensing or distribution agreement, will also provide a foundation for a financial investment beyond the obligations that might be contained in the basic agreement. For example, a large company with an established line of products and a strong distribution network may contract with a smaller company to purchase and resell certain goods manufactured by the smaller company. In order to gain greater access to the smaller company's technology and provide additional capital that the smaller company can use to accelerate its own development efforts, the larger company might make an equity investment in the smaller company, on terms which tend to be similar to those which are used in venture capital investment transactions. In some cases, the larger company will actually receive an option to acquire the smaller company at a later date.

Investment transactions, often referred to as "corporate partnering," have become quite popular and many large corporate investors have developed a good deal of experience in analyzing and valuing the infant technologies of the smaller firms which form the talent pool for an investment transaction. For smaller companies, investment transactions provide access to the capital required to complete the development of the new technologies, as well as a partner which understands how the technology works and the difficulties in bringing the products to market. For the investor, an investment transaction allows it to exercise greater management control over the development project and to share in overall success of the smaller company.[26]

§36 Internal financing sources

While business financing usually concerns itself with raising capital from investors, lenders and other outside sources, the needs of the business must be determined by reference to the amount of funds that can be generated internally. Obviously, one

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[25] For further discussion of the duties and obligations of public companies with respect to corporate governance, see “Governance: A Library of Resources for Sustainable Entrepreneurs”, prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

[26] For further discussion of corporate partnering and a comparison of this type of financing source to venture capitalist, see “Entrepreneurship: A Library of Resources for Sustainable Entrepreneurs”, prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

important source of capital is after-tax earnings from prior operations that are retained in the business, rather than distributed to shareholders in the form of dividends. The board of directors generally has the discretion to determine the amount of dividends that can be paid, subject to the terms of any agreements with corporate shareholders and the limitations set out in the applicable corporation law statutes. The power to declare dividends also may be subject to restrictions imposed by commercial lenders. As a general rule, dividend policy must be determined in light of management's goals and objectives for future expansion. Other internal sources of funds include cash that is available for use pending payment of future obligations that are accrued on the company's books and records. For example, federal and state income taxes with respect to income generated by the company are not payable until after the income has been received. Such amounts, while accrued as a future liability on the company's financial statements, can be used until the payments become due. Available cash flow can be increased by accelerating depreciation on equipment, since this is a noncash expense which reduces the company's tax liability.

§37 Trade credits

When a company purchases goods and services from other firms, it will generally be allowed some period of time, albeit short, in which to pay for such goods and services. In cases where there is a continuing relationship between a firm and its suppliers, some amount will always be owed by the firm to its suppliers on such "open account" credit. These suppliers are referred to as trade creditors, and trade credit in some businesses may be a significant part of the firm's source of funds. Trade creditors receive a return on their "investment," through a portion of the profits that are earned from doing business with the company. Trade credit is, by its very nature, of limited duration, and generally does not involve any elaborate agreements or protective devices, as might be found in other forms of debt financing. Trade creditors do have some ability to exercise control over the purchaser by threatening to suspend further sales until all amounts owed have been paid, but this generally occurs only when there appears to be a significant risk of insolvency. Of course, rather than lengthening the period before payments are made to trade creditors, companies may elect to take advantage of discounts which might be offered in the event that outstanding invoices are promptly paid. The decision regarding the use of discounts obviously depends on the size of the discount, the company’s other short-term cash requirements, and the possibility that the company will need to return a portion of the goods covered by the invoice.

§38 Cash management techniques

Creative cash management, including the use of basic tax strategies, can also help companies increase their working capital. For example, companies can use interest-bearing checking accounts to increase their returns from temporarily idle funds, and can also use accounts which automatically consolidate balances from within the same bank and from different institutions. The company can maximize the "float time" on the funds used to pay its bills by using a bank account located out of state. It is also possible for the company to increase the investment return on its working capital through information systems now offered by banks which provide companies with up-to-date status reports on collections and disbursement of funds. Finally, systems can be established which automatically advance daily cash needs into a master account from a line of credit and move excess funds overnight from that account back into short-term investment accounts.

Effective use of expense deductions and credits for tax purposes can also increase a firm's working capital. For example, the company may choose to expense the entire amount of the purchase price for certain property in the year in which such property was acquired, rather than depreciating the cost of the property over its useful life. In addition, companies can directly reduce the amount of their tax liability by taking advantage of tax credit equal to all, or a certain percentage, of the company's investment in certain activities. In the past, credits have been available for incurring expenses in renovating existing properties, research and development expenses, and for wages paid to members of certain economically disadvantaged groups.

§39 Leasing

Leasing is another method which can be used by companies to enhance cash flow. The most popular lease transactions include a long-term lease of an asset or facility; a long-term lease with an option to purchase the asset or facility at the end of the lease term; and the sale of the asset or facility to a third party coupled with an agreement by the purchase to lease the asset or facility back to the seller under a long-term lease arrangement. Railroads have been involved in the leasing of lines and cars for some period of time; however, in recent years, leases of industrial equipment, machinery and motor vehicles has also become popular. Leasing is a convenient method for acquiring the use of an asset without committing substantial capital or incurring the costs associated with the issuance of new securities. Moreover, the terms of the leases can often be structured in a manner that allows the lessee more flexibility than might be the case had there been a need to issue securities to finance a purchase. For example, the rental charges may vary over the term of the lease and/or might be subject to adjustment for various reasons.

§40 Sustainable finance

Sustainable finance has been described as the interrelationships that exist between environmental, social and governance ("ESG") issues on the one hand, and financing, lending and investment decisions, on the other.[27] Sustainable finance has also been explained to be a long-term approach to finance and investing, emphasizing long-term thinking, long-term decision-making and long-term value creation.[28] Companies now operate in an environment in which more and more capital providers are taking sustainability issues into consideration when deciding whether to fund a particular company or project and this means that companies need to understand how their ESG-

[27] For detailed discussion of sustainable finance, see "Sustainable Finance" in "Finance: A Library of Resources for Sustainable Entrepreneurs" prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

[28] A. Krauss, P. Kruger and J. Meyer, Sustainable Finance in Switzerland: Where Do We Stand? (Zurich: Sustainable Finance Institute, September 2016), 15.

related strategies, principles and practices can impact its access to capital and the stability of its relationship with investors and bankers. An additional consideration is measurement and reporting of ESG-related performance. Measurement and reporting techniques are evolving and differ across jurisdictions; however, there are emerging standards that need to be understood as more investors and lenders rely on sustainability reporting for collecting information necessary for them to make decisions about allocating their capital.

Various factors that motivate investors and decision makers to incorporate sustainability aspects into their investment and lending decisions[29]:

- Many investors and lenders take sustainability issues into consideration in order to make better risk management decisions, avoid future financial issues and make better long-term investment and lending decisions. Investors and lenders are increasingly skittish about funding companies and projects that carry high legal and reputational risks due to concerns about compliance with applicable laws and regulations and ESG norms and standards.
- A growing number of investors and lenders are focusing on sustainability as a means for uncovering promising new business opportunities and undervalued assets. Companies that can offer investors and lenders a path to participate in financing innovative solutions to environmental and/or social problems can tap into new pools of capital.
- Investor are taking a more values-driven approach to funding decisions and avoiding investment in companies or projects considered to be "unethical" and/or which are likely to cause environmental or social harm. At that same time, these investors are proactively seeking out projects that have a demonstrable positive environmental or social impact.
- Certain investors, as well as shareholder activists, are interested in applying pressure on companies to change their behavior with respect to operational activities that have adverse environmental and social impacts (e.g., threatening to withhold or withdraw capital unless companies cease to engage in activities considered to be unsustainable).
- Some investors, like consumers, enjoy being associated with "good causes" and are therefore driven to invest in companies that have a good reputation with respect to ESG matters as a means for embellishing their own social identity.

Sustainable investment can be broken down into several categories, information that is helpful to companies when they attempt to identify the types of sustainable investors that might be interested in providing capital for their operations and new projects[30]:

- Negative/exclusionary screening: Negative or exclusionary screening consists of avoiding specific assets due to considerations of moral values (e.g., tobacco or gambling), standards and norms (e.g., human rights), ethical convictions (e.g., animal testing), or legal requirements (e.g., controversial armaments such as cluster bombs or

[29] Id. at 16.
[30] Id. at 18-19.

land mines, excluded in order to comply with international conventions). Companies engaged in "negative" activities must be prepared to make significant modifications to their business models in order access capital from investors and lenders applying these types of screens.

- Best-in-class/positive screening: "Best-in-class" (positive) screening contrasts significantly with negative screening and calls for investment and lending decisions to be made based on a company's demonstrated high ESG performance. Investors can rely on a growing number of reference indexes to select projects that can improve both the risk and return aspects of their portfolio and companies need to be mindful of the criteria applied by the reference indexes and track their performance, although it should be understood that such indexes are not infallible and that it remains difficult to reliably measure ESG performance..
- ESG integration: ESG integration involves new and emerging methodologies intended to systematically and explicitly include ESG risks and opportunities into traditional financial-based investment analysis. ESG integration differs from ESG indexing in that it does not rely on benchmarking ESG performance vis-à-vis peers. As with ESG indexing, companies need to understand the how investment analysis taking ESG risks and opportunities into consideration is conducted, not only to gain a better understanding of the expectations of investors but also to potentially improve their own risk-adjusted rate of return on assets and mitigate sustainability-related risks.[31]
- Impact investing: Impact investing has been described as "investments made in companies, organizations, and funds with the intention of generating social and environmental impact (pursuit of positive externalities) alongside a financial return". So far, impacting investing, which has often focused on microfinance and development investing, has been available mostly through private markets from funds managed by specialized asset managers. Access to capital from impact investors may be limited for companies that lack scalable high-quality investment projects.
- Thematic investments: Thematic investments include investment activities focused on specific high profile sustainability themes such as cleantech, infrastructure, energy-efficient real estate or sustainable forestry and thematic investments are projected to become increasing important for certain long-term oriented investors such as pension funds, insurance companies and sovereign wealth funds.
- Active ownership: Active ownership takes a different approach to sustainable finance by focusing on engagement and dialogue with portfolio companies after an initial investment is made in order to influence ESG strategies and actions through exercise of ownership rights and being a visible activist for change. The growing role of

[31] An interesting example of ESG integration is provided by Just Capital (www.justcapital.com), which has developed its U.S. Large Cap Diversified Index based on Just Capital's analysis and rankings of the largest US companies based on issues that matter most to the American public based on surveys conducted by Just Capital. The Index includes the top 50% of Russell 1000 companies ranked by JUST Capital by industry and is constructed to match its industry weights. Companies are ranked based on their performance vis-à-vis pressing social issues including worker pay and wellbeing, customer treatment and privacy, beneficial products, the environment, job creation and strong communities. The JUST U.S. Large Cap Equity ETF, which was launched by Goldman Sachs Asset Management in June 2018, seeks to track the Index in order to provide investors with an opportunity to align their investments with the public's priorities with respect to just and responsible and corporate behavior.

activism can be seen by charting the increasing numbers of proxy votes relating to ESG issues, a trend that has materially impacted how boards and senior executives manage investor relations.

For lenders, as opposed to investors seeking attractive risk-adjusted returns in addition to recovery of their original capital, ESG issues appear in their reluctance to enter into loan transactions that might ultimately involve them in financing controversial activities and/or projects that are overexposed to identifiable environmental or social risks and potential liabilities. Lenders are not only concerns about the possibility that ESG issues for the parties to whom they lend may impact their ability to repay but also fear reputational damage from being associated with such borrowers and their environmentally harmful and/or unethical practices. Many lenders follow an approach similar to the negative/exclusionary screening described above.[32] At the same time, however, lenders are themselves interested in enhancing their sustainability reputations and are adopting various types of positive screening and ESG integration methodologies into their loan analysis and proactively seeking qualified borrowers in the areas of interest to thematic sustainability investors.

Investment Criteria of Sustainable Investors

Sustainable investors are concerned not only with what companies are striving to accomplish, but also with the way in which those companies intend to operate and the values and methods that will be used by the principals of the companies. Specifically, sustainable investors look for individuals and companies that value and exhibit transparency and honesty and candor in communications among stakeholders; define economic success by social and ecological impact, not just financial results; have an entrepreneurial spirit and culture that encourages and fosters innovation and continuous improvement; and which are truly pioneers in their areas interested in building the fields in which they operate through collaboration and "open sourcing" of methods and ideas. Sustainable investors also tend to be particularly interested in developing and maintaining close, long-term relationships with their investees and providing them with appropriate support and resources throughout the investment period. One way this is accomplished is by matching entrepreneurs with local investors from the same community to develop a sense of shared responsibility and facilitate face-to-face interaction.

Enterprises seeking financing from social venture capital funds and other sustainable investors need to understand the criteria that these types of investors use when evaluating potential portfolio companies. A modest survey of the published investment criteria of various investors indicates that are looking for companies that:

- Have a primary, clear objective to achieve significant social change and a business model in which generating social impact is an essential and necessary part.
- Provide goods and services that meet human needs and have significant social impact (e.g., food, medicine, clothing, housing, heat and light, transportation, communication, recreation, renewable energy, and "green" products and services). These goods or services must be based on core technology that is economically better or create greater social impact than what is available currently through the market, aid, or charitable distribution. Sustainable investors prefer and expect evidence of customer feedback on the utility of the proposed goods or services.
- Have a clear business plan and model that demonstrates the potential for financial viability and sustainability within a five to seven year period, including the ability to cover operating expenses with

[32] A. Krauss, P. Kruger and J. Meyer, Sustainable Finance in Switzerland: Where Do We Stand? (Zurich: Sustainable Finance Institute, September 2016), 15, 20.

operating revenues and generate a fair return for investors.

- Have a strong and experienced management team with the skills, will, and vision to execute the business plan, an unwavering commitment to achieving the desired social impact in an ethical manner.
- Demonstrate a clear path to scale for the number of end users over the anticipated investment period, and be positioned as one of the leaders in the market.
- Provide positive leadership in the areas of business operations and overall activities that are material to improving societal outcomes, including those that will affect future generations.
- Balance the needs of financial and nonfinancial stakeholders and demonstrate a commitment to the global commons as well as to the rights of individuals and communities.
- Advance environmental sustainability and resource efficiency by reducing the negative impact of business operations on the environment, managing water scarcity and ensuring efficient and equitable access to clean sources, mitigating impact on all types of natural capital, diminishing climate-related risks and reducing carbon emissions, and driving sustainability innovation and resource efficiency through business operations and products and services. Red flags for sustainable investors would include a record of poor environmental performance and failure to comply with applicable laws and regulations, activities that contribute significantly to local or global environmental problems, and/or risks related to the operation of nuclear power facilities.
- Establish an environmental management system with objectives and procedures for evaluating progress, minimizing negative impacts, training personnel and transferring best practices to customers, suppliers and other participants in the marketplace through trade associations and other collaborations.
- Contribute to the quality of human and animal life. Sustainable investors will not invest in companies that abuse animals, cause unnecessary suffering and death of animals, or whose operations involve the exploitation or mistreatment of animals.
- Contribute to the community through charitable giving, encouraging employee volunteering in the community, making products and services available free or at cost to community groups and supporting local suppliers and striving to hire locally.
- Respect consumers by marketing products and services in a fair and ethical manner, maintaining integrity in customer relations and ensuring the security of sensitive consumer data.
- Respect human rights, respect culture and tradition in local communities and economies and respect Indigenous Peoples' Rights. Sustainable investors will not invest in companies that have exhibited a pattern and practice of human rights violations or have been directly complicit in human rights violations committed by governments or security forces.
- Promote diversity and gender equity across workplaces, marketplaces and communities. Sustainable investors look for diversity throughout the organization, beginning with the board and senior management team, and will not invest in companies that discriminate on the basis of race, age, ethnicity, religion, gender, sexual orientation or perceived disability or support the discriminatory activities of others in their workplaces, marketplaces or communities. Red flags include a record of consistent violations of workplace-related laws and regulations and failure to adopt and enforce explicit policies against discrimination in hiring, salary, promotion, training or termination of employment.
- Demonstrate a commitment to employees by ensuring development, communication, appropriate economic opportunity and decent workplace standards. Sustainable investors will not invest in companies that have been singled out for serious labor-related actions or penalties by regulatory agencies or that have demonstrated a pattern of employing forced, compulsory or child labor. Sustainable investors seek confirmation that companies have implemented and follow personnel policies that promote the welfare of their employees, adhere to internationally recognized labor standards, value employee welfare and safety, pay a living wage to its employees and maintain a reasonable ratio of CEO earnings to average employee earnings, maintain cordial and professional relations with labor unions and bargain fairly with their employees, and follow sustainable employment practices.
- Save lives by guaranteeing product safety while promoting public health. Concerns for safety and public health caused sustainable investors to reject proposals from companies engaged in certain "prohibited business activities" such as the manufacture and/or sale of tobacco products; the manufacture of alcoholic beverages or gambling operations; the manufacture and/or sale firearms and/or ammunition; or he manufacture, design or sale of weapons or the critical components of

weapons that violate international humanitarian law.
- Provide responsible stewardship of capital in shareholders' best interests.
- Exhibit accountable governance and develop effective boards that reflect expertise and diversity of perspective and provide oversight of sustainability risk and opportunity. Sustainable investors will shun companies that have demonstrated poor governance, including failure to practice transparency in disclosures to shareholders or respond to shareholder communications or proposals, or engaged in harmful or unethical business practices.
- Commit to an external code or standard or a set of business principles that provides a framework to measure the company's progress on environmental and social issues.
- Integrate environmental and social risks, impacts and performance in their material financial disclosures in order to inform shareholders, benefit stakeholders and seek their ideas and views and contribute to company strategy.
- Lift ethical standards in all operations, including in dealings with customers, regulators and business partners. Sustainable investors require that the companies in which they invest adopt and rigorously follow codes of conduct that are based on recognized global best practices to guide their policies, programs and operations.
- Demonstrate transparency and accountability in addressing adverse events and controversies while minimizing risks and building trust.

Sustainable investors often focus their activities on companies engaged in addressing needs, problems and challenges in a specific societal domain and/or geographic area. Popular target societal domains include agriculture, education, safety, demography, community, poverty, environment, health and well-being, housing, and ethical goods and services. Geographic areas that have attracted substantial interest from sustainable investors include East Africa, West Africa, India, Pakistan and Latin America.

Given the nature of some of the requirements described above, it is not surprising that many sustainable investors are not interested in pure "startups" and are looking for companies that have advanced to the "early stage" of development and have identified a stable business model that has already achieved some minimum level of revenues.

Many sustainable investors have developed "exclusionary criteria" that list activities and other characteristics that will disqualify companies from investment consideration. For example, a sustainable investor is quite likely to rule out funding companies that:

- Are involved in the extraction of carbon based resources, such as coal, petroleum, and natural gas, for the production of fossil fuels;
- Are primarily involved in producing or distributing alcohol or tobacco products;
- Develop, manufacture or profit from weapons, including conventional, chemical, biological, and nuclear weapons;
- Generate nuclear power;
- Genetically modify seeds or living organisms (although such activities may be allowed with a showing of countervailing social benefits such as demonstrating leadership in promoting safety, protection of Indigenous Peoples' Rights, the interests of organic farmers and the interests of developing countries generally);
- Are involved in the gambling, gaming or adult entertainment industries;
- Have primary business practices that involve the inhumane treatment of animals; or
- Have profited from conspicuous consumption, land speculation, predatory financial practices, or privatized detention facilities.

Source: The criteria identified and discussed in the text draws upon a review of published criteria of various social venture firms and investors including Calvert Group, Acumen Fund, City Light Capital and Root Capital. Each investor has its own specific set of requirements based on its goals and objectives. For links to information on other social venture capital firms, see Cause Capitalism "15 Social Venture Capital Funds That You Should Know About", http://causecapitalism.com/15-social-venture-capital-firms-that-you-should-know-about/#sthash.A7KQmImG.dpuf [accessed June 1, 2016].