Congress of the United States
U.S. House of Representatives
Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515-6315

Memorandum

To:	Members, House Committee on Small Business
From:	Committee staff
Date:	March 19, 2012
Subject:	**Hearing: "A Job Creation Roadmap: How American's Entrepreneurs Can Lead Our Economic Recovery" on March 21, 2012 at 1:00 p.m.**

On March 21, 2012, the House Committee on Small Business will meet at 1:00 p.m. in Room 2360 of the Rayburn Building for the purpose of receiving testimony on encouraging entrepreneurship. Witnesses will include Andrew Razeghi, Adjunct Assistant Professor, Kellogg School of Management, Northwestern University, Evanston, IL; Seth Goldman, Co-founder, Honest Tea, Bethesda, MD, testifying on behalf of the American Beverage Association; Heath Hall, President, Pork Barrel BBQ, Washington, DC; and Clinton Tymes, State Director, Delaware Small Business Technology Development Center, Newark, DE, testifying on behalf of the Association of Small Business Development Centers.

I. Introduction

According to U.S. Census data, there are about 26.9 million businesses in the United States, composed of 21.1 million non-employer firms and 5.8 million firms with employees.[1] Of the employer firms, 89.7% have fewer than 20 employees.[2] A 2010 study for the U.S. Small Business Administration found that over the past 15 years, small businesses have accounted for about 65% of private sector net job creation.[3] And small firms provide the greater share of net new jobs.

The statistics on entrepreneurship in the United States are revealing. According to the Kauffman Foundation, entrepreneurship is changing, in large part due to the economy. But the size of startups is also changing.[4] And these new business patterns are likely to have an impact on our economy and the numbers and types of jobs that are created or lost.

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[1] U.S. BUREAU OF THE CENSUS, STATISTICS OF U.S. BUSINESSES, *available at* http://www.census.gov/econ/susb/.
[2] *Id.*
[3] BRIAN HEADD, U.S. SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, AN ANALYSIS OF SMALL BUSINESSES AND JOBS (March 2010), *available at* http://archive.sba.gov/advo/research/rs359tot.pdf.
[4] Id. at 16.

II. Who are Today's Entrepreneurs?

Trends in Entrepreneurship

A 2010 Kauffman Foundation report[5] found that the average number of existing self-employed persons in 2010 was 11.9 million, comprising 6.5% of the adult population. The overall rate of entrepreneurship remained consistent with 2009, but the rate is higher than before the recession began.[6]

From 1993 to 2009, the mean size of both establishments and startups declined, with more startups having no employees at all.[7] This could have important ramifications for the labor market, such as small businesses creating fewer net new jobs.[8] In recent years, much of the research on small business job creation has centered on the so-called gazelles or high impact companies, younger firms that experience high growth and/or high sales over a short period of time. These companies demonstrate significant contributions to job creation.[9]

The trends today indicate slight shifts. Among demographic groups, the number of people starting businesses who are ages 55 to 64 is rising,[10] and generally, their education level is below average.[11] Many of these adults were probably displaced from jobs by the recession, and they are starting businesses as alternative careers.[12]

The number of new firms started by immigrants remains strong, with Latinos demonstrating the highest entrepreneurial activity.[13] In 2010, immigrants were more than twice as likely to start

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[5] ROBERT FAIRLIE, KAUFFMAN FOUNDATION, KAUFFMAN INDEX OF ENTREPRENEURIAL ACTIVITY 1996-2010 (March 2010), *available at* http://www.kauffman.org/uploadedFiles/KIEA_2011_report.pdf.
[6] *Id.* at 4.
[7] *Id.* at 16.
[8] *Id.*
[9] *See* ZOLTAN ACS, WILLIAM PARSONS AND SPENCER TRACY, HIGH-IMPACT FIRMS: GAZELLES REVISITED, OFFICE OF ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION (June 2008), *available at* http://archive.sba.gov/advo/research/rs328tot.pdf, DANE STANGLER, HIGH GROWTH FIRMS AND THE FUTURE OF THE AMERICAN ECONOMY, KAUFFMAN FOUNDATION (March 2010) (finding that the top performing 1% of firms create 40% of new jobs, and "gazelle" firms (ages three to five) comprise less than 1 percent of all companies, yet generate roughly 10 percent of new jobs in any given year), *available at* http://www.kauffman.org/uploadedfiles/high-growth-firms-study.pdf, and SPENCER L. TRACY, JR., ACCELERATING JOB CREATION IN AMERICA: THE PROMISE OF HIGH-IMPACT COMPANIES, OFFICE OF ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION (July 2011), available at http://www.sba.gov/sites/default/files/rs381tot.pdf (finding that, on average, high-impact companies grow in size between 115 and 400 percent and generate all net jobs in the economy).
[10] *Id.* at 10.
[11] *Id.* at 11.
[12] W. Robert Fairlie, Kauffman Index of Entrepreneurial Activity 1996-2010, *supra* note 5 at 6.
[13] *Id.* at 7.

a business than non-immigrants.[14] Some have speculated that immigrants, because they have taken the risk of immigrating, have a proclivity toward risk taking, so starting a business does not seem overly risky to them.

From 1996-2010, entrepreneurship was least likely among those from ages 20-34.[15] Student entrepreneurship, however, is now on the rise, at least partly due to the lagging economy and fewer job prospects. Enterprising students are starting businesses so they will have work when they finish school, but they also see opportunities to fill niches in the economy.

Teaching Entrepreneurship

Some young people are starting businesses because their universities are teaching entrepreneurship. Schools such as Harvard and the University of Virginia have formal entrepreneurship programs, and enrollment and interest in them has been overwhelming.[16] The number of programs is multiplying, and according to the Kauffman Foundation, there are more than 250 at U.S. colleges.[17] Over 2,000 schools now offer entrepreneurship courses.[18]

Many universities sponsor business plan competitions or even "pitch" sessions, where students present their ideas to instructors with entrepreneurship experience and other student entrepreneurs or compete for seed funding. Foundations are even providing grants to colleges and universities to encourage a university-wide entrepreneurship approach, rather than secluding the program in the business school.[19] In this way, students in all fields of study have access to entrepreneurship education and training. Increasingly, students view having their own small business as a way to control their destiny and follow a passion, effect change or promote social responsibility.[20]

III. Financing Obstacles Entrepreneurs Face

Starting a business can present challenges for all entrepreneurs, and many cite funding as the primary obstacle they face.[21] Although some surveys have found that traditional small business

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[14] *Id.* at 9.
[15] *Id.* at 12.
[16] Amy Reinink, *Student Entrepreneurship in College is on the Rise in Poor Economy*, WASHINGTON POST, November 3, 2011, *available at* http://www.washingtonpost.com/lifestyle/magazine/student-entrepreneurship-in-college-is-on-the-rise-in-poor-economy/2011/10/17/gIQAxEMuiM_story.html (hereinafter "Student Entrepreneurship").
[17] JUDITH CONE, TEACHING ENTREPRENEURSHIP IN COLLEGES AND UNIVERSITIES: HOW (AND WHY) A NEW ACADEMIC FIELD IS BEING BUILT, KAUFFMAN FOUNDATION, *available at* http://www.kauffman.org/entrepreneurship/teaching-entrepreneurship-in-colleges.aspx.
[18] *Id.*
[19] *Id.*
[20] Student Entrepreneurship, *supra* note 16.
[21] KAUFFMAN FOUNDATION REPORT, HIGH GROWTH ENTREPRENEURS PLAN TO CONTINUE GROWING, September 11, 2011, *available at* http://www.kauffman.org/newsroom/high-growth-entrepreneurs-plan-to-continue-growing.aspx.

lending from financial institutions has increased,[22] a lack of funding can be one of the reasons that some startups fail.

Small business lending has declined markedly since the recession began.[23] That reduction in lending has been attributed to changes in the supply of credit and the tightening of credit standards by banks.[24] According to research by the Kauffman Foundation, approximately fifty percent of new firms do not survive past five years.[25] Given the volatility in the survival rate of new firms and their lack of collateral, most banks are unwilling to lend to a startup business.[26]

For entrepreneurs unable to secure a loan from a bank, there are other financing alternatives available to access capital. Many entrepreneurs borrow money from friends and family,[27] or use equity in their homes[28] or their personal credit cards to finance the early stage of their business.[29] Other alternatives range from the business owner seeking an equity investment from a venture capitalist or an angel investor, or seek out newer, more creative methods such as "pitch" sessions and crowdfunding.[30]

Unlike a bank loan that requires the business to make a monthly payment which can restrict cash flow at a time when the business might be struggling to turn a profit, an equity investment typically does not require a fixed monthly payment.[31] Rather, the business owner receives a lump sum of cash in exchange for an ownership stake in the company. This ownership stake guarantees the investor a percentage of future earnings. While there is the potential to profit from the growth of a firm, if the endeavor fails, the investor does not see a return on its investment. Besides receiving an injection of capital, another advantage of an equity investment is that the investor has a stake in the success of the company. So, investors are usually willing to offer strategic advice and management assistance to the entrepreneur, as well as introduce the entrepreneur to the investor's network of business contacts.

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[22] Andrew Chow, *Lending to Small Business Up 18% in 2011*, Thomson Reuters/PayNet Small Business Lending Index, *available at* http://www.reuters.com/article/2012/01/12/tagblogsfindlawcom2012-freeenterprise-idUS144193860120120112.

[23] BURCU DUYGAN-BUMP, ALEXEY LEVCOV AND JUDIT MONTORIAL-GARRIGA, FINANCING CONSTRAINTS AND UNEMPLOYMENT: EVIDENCE FROM THE GREAT RECESSION 1 (DECEMBER 14, 2011), QUANTITATIVE ANALYSIS UNIT, FEDERAL RESERVE BANK OF BOSTON, *available at* http://www.bos.frb.org/bankinfo/qau/wp/2010/qau1006.pdf (hereinafter "Financing Constraints").

[24] Financing Constraints, *supra* note 22 at 1.

[25] DANE STANGLER AND PAUL KEDROSKY, NEUTRALISM AND ENTREPRENEURSHIP: THE STRUCTURAL DYNAMICS OF STARTUPS, YOUNG FIRMS AND JOB CREATION KAUFFMAN FOUNDATION, available at http://www.kauffman.org/uploadedfiles/firm-formation-neutralism.pdf.

[26] ROBERT D. HISRICH, MICHAEL P. PETERS & DEAN A. SHEPHERD, ENTREPRENEURSHIP, 347 (7th ED. 2008).

[27] One startup in Ohio, SoMoLend, has pioneered these loans with software that uses the web and interactive mobile devices to pair borrowers with lenders. Revenue comes from fees paid on the transactions through electronic payment systems. One of the first lenders of its kind, it was started by a young entrepreneur who won a university entrepreneurship competition.

[28] Robbie Whelan, *When the Home Bank Closes*, WALL STREET JOURNAL, February 1, 2012, *available at* http://online.wsj.com/article/SB10001424052970203686204577112761171475078.html.

[29] *Id.* at 348.

[30] FINANCING HIGH-GROWTH FIRMS: THE ROLE OF ANGEL INVESTORS, OECD PUBLISHING 21 (2011), available at http://dx.doi.org/10.1787/9789264118782-en.

[31] R. HISRICH, M. PETERS & D. SHEPHERD, ENTREPRENEURSHIP, at 346.

The main drawback to this kind of investment is that the entrepreneur must give up a share of their business to an investor who may not share the same vision on how the company should be managed. There are several kinds of equity investments which differ based on their organizational structure and the growth stage in which they invest. The two most common forms of equity investment in small firms come from venture capital funds and angel investors.

Venture Capital

Venture capital firms are professionally managed funds raised from institutional investors such as pension funds, hedge funds and mutual funds. The venture capital firm uses these funds to invest in small companies in exchange for an ownership stake in the company.[32] Venture capital companies exercise control over the management of the business by taking seats on the company's board of directors so they can actively participate in management decisions.[33] The goal of most venture capitalists is to grow the company to the point where it can either be acquired, or the company can be taken public where the venture capital company can use their profits to return money to the venture capital firm's investors.

When choosing a company to invest in, venture capital firms look for companies with rapid growth potential so their money is not tied up for an extended period of time and there is potential for greater profit. Because of this investment criteria, venture capital companies typically only invest in certain high growth industries and in companies where the venture capital firm has a core competency of expertise. Since venture capital companies play an active role in the management of a company, they want to invest in industries where they understand the business and how to grow a company. This experience helps the venture capital company raise funds from institutional investors who believe that the venture capital company has ability to grow the companies and provide a return on their investment. The most common industries for venture investment are healthcare, biotech and technology. According to a 2011 Global Insight Study, venture-backed companies accounted for nearly 12 million jobs and $3.1 trillion in revenue in the United States in 2010.[34]

Angel Investors

Another common type of equity investment comes from high net worth individuals know as angel investors. Angel investors are typically successful entrepreneurs who reinvest the gains they received from starting their own company. Along with seeking a return on their investment, angel investors also want to share their expertise and experience with a new crop of entrepreneurs.[35] Angel investments share many of the same attributes as venture capitalists in terms of the stage at which they invest and the strategic advice and access to business networks they can provide an entrepreneur, but there are some distinct differences.[36]

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[32] R. HISRICH, M. PETERS & D. SHEPHERD, ENTREPRENEURSHIP, at 377.
[33] FINANCING HIGH-GROWTH FIRMS: THE ROLE OF ANGEL INVESTORS, OECD PUBLISHING 23 (2011), available at http://dx.doi.org/10.1787/9789264118782-en.
[34] National Venture Capital Association Home Page, *available at* http://www.nvca.org/index.php?option=com_content&view=article&id=339&Itemid=653.
[35] FINANCING HIGH-GROWTH FIRMS: THE ROLE OF ANGEL INVESTORS, OECD PUBLISHING 72 (2011), *available at* http://dx.doi.org/10.1787/9789264118782-en.
[36] *Id.* at 31.

Because the investment comes from an individual, the dollar amount is usually smaller than an investment from a venture capital firm.[37] Additional differences can include a more hands-on approach with the management of a company and a willingness to accept a smaller return or greater risk.[38] Since angel investors do not raise funds from institutional investors, they can also invest in smaller companies which have a greater risk of loss. The most important difference is that angel investors do not have to answer to investors or their own board of directors, so they have more flexibility in the length and the structure of their investment.[39] Angel investors might also choose to invest in a specific cause or interest, such as companies that are organized for a social or environmental purpose.[40] These companies usually have a dual mission of both creating a profit and advancing their particular mission. Most angel investors are accredited as *sophisticated investors* under securities laws.[41] In the 1930s, federal securities laws[42] regulating the sale of company stock were enacted to protect investors[43] from fraudulent practices, such as unsophisticated investors being lured into illegal investments. There has been an effort in Congress to update the securities laws and make it easier for small firms to raise money while still protecting investors.

"Pitching" for Funding

Whether seeking a bank loan or an equity investment, entrepreneurs must be able to present (or "pitch") their business concept to investors. While applying for a bank loan typically involves a one-on-one meeting with a loan officer, pitching to equity investors can consist of presenting a business concept to a large audience of investors. These sessions are usually convened by investor groups, non-profits or universities.[44] Some organizations and universities even invite entrepreneurs to practice their pitch and receive coaching and feedback from academics and fellow entrepreneurs. Because capital is scarce and entrepreneurs may receive only one brief opportunity to present their pitch, rewriting and refining their message can be critical steps in honing their skills. Some startups have formed precisely to assist other entrepreneurs with funding pitches.[45] Recently, legislative proposals have been introduced to allow entrepreneurs to pitch to investors directly through the Internet. Soliciting funds from a large group of potential investors is known as crowdfunding.

Crowdfunding

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[37] FINANCING HIGH-GROWTH FIRMS: THE ROLE OF ANGEL INVESTORS, OECD PUBLISHING 34 (2011), *available at* http://dx.doi.org/10.1787/9789264118782-en.
[38] *Id.*
[39] *Id.* at 31.
[40] *Id.* at 179.
[41] *Id.* at 29.
[42] *See* The Securities Exchange Act of 1934, 15 U.S.C. § 78a (2010), *available at* http://www.sec.gov/about/laws/sea34.pdf.
[43] R. HISRICH, M. PETERS & D. SHEPHERD, ENTREPRENEURSHIP, at 359.
[44] The University of Maryland's R.H. Smith School of Business holds regularly scheduled "pitch" sessions that provide entrepreneurs with feedback or allow competition for funding. *See* http://www.rhsmith.umd.edu/dingman/students/pitch/docs/AboutPitchDingman.pdf.
[45] *See* Investor Pitch Clinic, *available at* http://investorpitchclinic.com/.

Crowdfunding is a fundraising platform, where a large number of private investors donate funding for a startup or ongoing small business. Because of current securities laws, the investors cannot receive an equity stake in a company. Rather, the investor donates money to a company in exchange for a product or service available only to investors.[46] One of these platforms is kickstarter.com.[47] On kickstarter.com, entrepreneurs must apply to have their project accepted, and the funding is collected by Amazon Payments, a third party payment processor. There are estimates that over 250 similar sites are now actively seeking investors.[48]

In the United States, current law allows only "accredited investors" to invest using crowdfunding.[49] On November 1, 2011, the House passed H.R. 2930, the Entrepreneur Access to Capital Act, which would allow ordinary investors to invest up to $10,000 in small businesses that are not registered with the Securities and Exchange Commission.[50] Similar bills have been introduced in the Senate, but no action has been taken. Concerns have been raised about the legislation limiting investor protections and providing fewer opportunities for due diligence.[51] Supporters of crowdfunding cite the required disclosure and communication as adequate investor protections.[52]

IV. Where Can Entrepreneurs Get Advice?

The Small Business Administration (SBA), through its website, district offices and entrepreneurial outreach partners, provides training opportunities and counseling services to help business owners become educated about how to run a business or grow an existing business. SBA-supported education programs leverage state government and private resources to provide a wide array of services to both prospective and established business owners at no cost to the business owner. For example, courses are offered on how to start a business, obtain capital and contract with the federal government.[53] These courses are offered though SBA's Small Business Development Centers (SBDCs) and the Service Corps Of Retired Executives (SCORE).

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[46] David Pogue, *Embracing the Mothers of Invention*, N.Y. TIMES, Jan.25, 2012, *available at* http://www.nytimes.com/2012/01/26/technology/personaltech/financing-the-stuff-of-dreams-through-kickstarter-state-of-the-art.html?_r=1&ref=venturecapital.
[47] http://www.kickstarter.com/.
[48] Editorial, Crowdfunding: *Many Scrappy Returns*, THE ECONOMIST, Nov. 21, 2011, *available at* http://www.economist.com/node/21538770 (hereinafter "Crowdfunding editorial").
[49] The term "accredited investor" is defined in Regulation D of Rule 501(a). In December 2011, the Securities and Exchange Commission adopted a final rule which amends, the definition of "accredited investor." The revised definition was required by the Dodd-Frank Act. Under the revised definition, an accredited investor is one with a net worth of $1 million excluding the value of one's primary residence. Net Worth Standards for Accredited Investors, Final Rule, 17 C.F.R. pts. 230, 239, 270 and 275 (December 2011), *available at* http://www.sec.gov/rules/final/33-8518.pdf.
[50] Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. § 3, *available at* http://lis.gov/cgi-lis/query/D?c112:3:./temp/~c112OijouL.
[51] See Crowdfunding editorial, *supra* note 41. *See also* Editorial, *Making It Legal: Crowdfunding Bills Navigate Critics*, Crowdfunding.com website, *available at* http://www.crowdsourcing.org/editorial/making-it-legal-crowdfunding-bills-navigate-critics/10077.
[52] Kevin Lawton, *Crowdfunding 101: What You Need to Know To Make an Informed Decision*, Startup Exemption, *available at* http://www.startupexemption.com/archives/category/kevin-lawton#axzz1jNE5fAG1.
[53] http://www.sba.gov/content/online-courses-starting-your-business.

SBDCs are public-private partnerships supported by SBA to educate entrepreneurs on small business finance, marketing, production, organization and engineering. Additional assistance is available to those seeking counseling with international trade issues, procurement assistance, venture capital formation and rural development. The primary SBDC in a state directs a network of smaller centers, making services available to a broad range of small business owners. SBA contributes up to fifty percent of operating funds, with the remaining funds coming from state governments, foundation grants, state and local chambers of commerce, and public and private universities.

A second SBA-supported entrepreneurial education resource partner is SCORE. The SCORE program is composed of a network of working and retired business executives and small business owners. Similar to SBDCs, this organization provides free, expert advice to new and seasoned small business owners. Small business owners receive this assistance through SCORE's website, chapter offices, SBA district offices, and other venues.

Complementing the entrepreneurial development efforts provided through SBA and other federal agencies are efforts that are exclusively funded by the private sector. Many corporations offer education and mentorship programs providing a variety of services. While these efforts vary in both size and scope, these programs can include training, networking opportunities, mentorship and financial assistance.[54] America's vast network of colleges and universities, along with community colleges, also offer courses designed for small business owners. These courses teach important skills for running a business, including leadership training, budgeting and recordkeeping. There are also mentorship and networking opportunities provided through local chambers of commerce and other business organizations.[55]

V. Conclusion

Although the economy shows signs of improvement, it remains weak. Entrepreneurs have cited burdensome and pervasive government regulations, high taxes, and a lack of consumer demand as reasons for slow small business growth and job creation.[56] Small business owners have encouraged Washington decision-makers to enact policies that help small firms, not hinder them.[57]

Small firms create the majority of net new jobs, and our nation's economic recovery depends on these companies expanding and generating the jobs we need. This hearing will provide an opportunity for members to learn about new and creative tools entrepreneurs can use to launch successful startups.

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[54] http://www2.goldmansachs.com/citizenship/10000-small-businesses/index.html.
[55] For example, IKEA of Los Angeles has partnered with SCORE to provide workshops for entrepreneurs on various small business subjects. The workshops take place at IKEA stores throughout the Los Angeles area and feature experts who dispense advice based on their experience running a small business.
[56] NFIB Small Business Optimism Index, January 2012, *available at* http://www.nfib.com/Portals/0/PDF/sbet/sbet201201.pdf.
[57] *Id.*