IMPLEMENTING A DIRECT PUBLIC OFFERING (DPO); PRESENTING THE CAPITAL 101 ON-LINE COURSE PLATFORM FOR CLASSROOM USE

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Academic Abstract

The Capital 101 on-line course is an academic exercise. It gives students an opportunity to gain a better understanding of the capital formation process on the equity side of the balance sheet. A Direct Public Offering (DPO) is a unique funding vehicle for small businesses. The course/exercise is a self–paced distance learning activity which can be accessed online. It gives students the opportunity to discover and implement a mock "public venture capital formation event" from within any academic environment. The presenters will outline the specific skills necessary in private equity investing and will offer some suggestions for curriculum development.

Executive Summary

Small business corporate finance is in the middle of an evolution. Due to the Internet, traditional Investment Banking practices have become more commoditized. In 2004' Google implemented a "direct public offering" or DPO by marketing its stock offering directly to the public without the help of an Investment banker. How might Google's effort have set the trend for small business corporate finance in the future? What implications might this have in developing an entrepreneurial stock aftermarket for small companies? In any case, preparing and certifying a corporate entity for a private offering or DPO can pose a real challenge and require special skill-sets in entrepreneurial finance. At the same, time a mock capital formation event (such as DPO or private equity offering) can be a rich learning opportunity in the classroom.

Presenters will demonstrate the Capital 101 course learning platform. Presenters will point out the various pedagogical features of the Capital 101 on-line course and discover some implications for curriculum development.

So What?

Conventional wisdom among entrepreneurs has always relied upon the Investment Banking community, Venture Capitalists, or high net worth investors in order to fund new enterprises. These avenues are no longer as feasible as they once were, just ask any entrepreneur seeking capital today. Going public in the US via an Initial Public Offering (IPO), it will cost, out of pocket, between $1,500,000 and $2,225,000. It takes an average of 18 months to get an "Effective Letter" in order for a company to begin trading. The days of an American private company going public as a traditional "IPO" as a status symbol are over with. If a company wants to list on Nasdaq, the cost would be an additional $500,000.

Combining the Internet with existing securities regulation can help mainstream a new method of corporate finance for SMEs. This workshop will include the notion of "affinity group financing" by utilizing DPOs for small companies seeking "public venture capital." DPOs are proven financing vehicles, thousands of companies have used them in the past. The course contains proven strategies and tactics used by literally thousands of successful entrepreneurs who raised tens of millions of dollars (companies large and small). Companies such as Costco, Google, Ben and Jerry's Ice Cream, Annie's Home Grown, and the Red Rose Collection (only to name a few). These companies used DPOs in order to expand, finance, and retain control of their companies.

Note, time will not allow to go into any specific case studies. DPOs can open the door for the funding of all sorts of sustainable energy, "green projects," including special social entrepreneurship initiatives. This is of particular interest among investors and entrepreneurs who share these concerns and are interested in social entrepreneurship.

The first step toward broader acceptance and utilization of DPOs is shedding the mystery around this little known government-sponsored program. A better public policy making climate surrounding DPOs is needed. This is something which our non-profit organization is pursuing. We need your help by participating in this course. This can make the future for DPOs even brighter. Perhaps a public market for private shareholders (or an entrepreneurial exchange) will be developed for directly issued securities in small companies. Exploding the myths around DPOs will mainstream DPOs for the social good. This will apply particularly to "socially minded" entrepreneurs seeking to work in conjunction with economic development entities.

General Overview

State securities administrators in most states have adopted a standardized securities disclosure form referred to as a U-7 for use in DPOs. The U-7 was developed after the Small Business Investment Incentive Act of 1980 (now contained in section 19 of the Securities Act of 1933). The U-7 is a waiver for small companies to sell stock to the general public without the high costs and complexities of a traditional Wall Street or underwritten offering by utilizing an investment banker. This securities offering registration method also makes coming into the market for "public venture capital" less costly for most entrepreneurs. It reduces information asymmetries between issuers of those securities (the entrepreneurs) and the investors by reducing the possibly of a law suit from a disgruntled investor due to insufficient disclosure. Because U-7 filings eliminate much of the need for specialized legal and accounting aid, its filing expenses average less than one-tenth of the traditional costs of a public offering.

The use of the U-7 is available to a small company wanting to raise less than one million dollars within a twelve month period of time. The Capital 101 on-line course is available to any academic community, Small Business Institute (SBI) or entrepreneurship center around the U.S. and the world. It is primarily a non-profit initiative, which is designed to shed the mystery of the U-7 form and expands on the little-known government program around it.

Raising capital through a direct public offering (debt or equity) is a great way for a small company to finance the launch of a new business or product line or take the company "public." It can provide a mechanism for a company to raise equity (or debt) capital by publicly selling its shares. The benefit of this type of public offering is that it allows your company to approach prospective investors (including customers) through cold calling, newspaper advertisement, direct mail, radio, or seminars.

The Small Corporate Offering Registration (SCOR)
(The Specific Legal Vehicle for DPOs)

The Small Corporate Offering Registration (SCOR) was designed with the small business securities issuer in mind. It allows small companies to raise equity (or debt) capital publicly without having to register with the Federal Securities and Exchange Commission. It is designed to streamline the state public securities review process by using standardized forms and review. Audited financial statements are many times required. Each state separately reviews the company's filings and issues a permit allowing general solicitation to the public in that state. Permits are usually issued within 30 days (in the case of Nevada) or may take up to 6 months (in the case of California), depending on each state's regulatory standards. This form of registration is available to small securities issuers pursuant to Regulation D, Rule 504, of the Securities Act of 1933, as amended, and allows small companies to raise up to one million dollars in an equity offering with certain limitations and guidelines. This program was developed by the North American Securities Administrators Association (NASAA) and was designed to be used in conjunction with each state's registration by qualification statue or "blue sky law." This program has been adopted by almost every state in the United States as well as Canada.

State Registration by Qualification

This method of registration allows companies to raise monies publicly through an equity or debt offering and is usually used in small securities offerings that receive exemptions from federal review. Each state administrator will review the offering based upon the merits of the offering and the guidelines set forth by the Blue Sky law and rules promulgated there under. This method of registration of a security offering allows the maximum freedom to small issuers.

The Process Explained

The end result of a Direct Public Offering process is that a small company and/or its employees will be able to solicit customers and the general public to invest in the securities of the company. In addition, these securities (normally common stock), once purchased, are considered to be "free trading" which allows a small company that has successfully conducted a direct public offering to apply for listing on an Alternate Trading System (ATS) or public securities exchange marketplace such as the Pink Sheets.

Initial Corporate Preparation

The class will form a Company. The Company must develop and maintain an accurate corporate minute book. This is required for the Company to apply for a public offering permit.

Pre-Filing Preparation

During this phase, the class will develop an offering circular, i.e. prospectus (a.k.a. U-7); form U-1 -Uniform Application to Register Securities; Form U-2 - Uniform Consent to Service of Process; and other miscellaneous required documents to publicly register the Company to sell its securities.

Post-Permit Issuance

Students will participate in the development of ancillary marketing materials designed to help the company approach prospective investors. This will include sales approaches, advertising, etc.. Students will also look at eventually providing a mechanism to have the Company listed on an organized exchange (Pink Sheets, OTCBB, or a regulated Alternate Trading System (ATS), which can provide an exit event (liquidity) to its investors.

Suggested Student Activities:

• Form a new Corporation ("Public Corporation" – you should amend the articles of incorporation to accommodate the offering);
• Develop the full Minute Book for a Public Corporation;
• Develop an offering circular on Form-U-7, or other appropriate memorandum, developed pursuant to the Securities Act of 1933;
• Fill out a Uniform Application to Register Securities (Form U-1);

• Fill out a Uniform Consent to Service of Process (Form U-2 and U-2A);
• Prepare and file all the documents required under either Rule 504 of Regulation D or Regulation A of the Securities Act of 1933 (the "Act"), as amended; and other required documents including attorney opinion letters and subscription agreements

What Exempt Offerings Choices Are Available?

Regulation “D” Offerings (Rule 504):

This rule is considered the most relevant solution for a small company that needs to raise up to $1 million but can't afford the time or expense to go through the entire SEC registration process.

Under the Rule 504 exemption, a company can offer up to $1 million of securities in a 12 month period. The most important characteristics are:

• Securities (both debt and equity) can be sold to an unlimited number of persons.
• General solicitation or advertising can be used to market these securities.
• These securities are freely traded and not "restricted." This means investors may sell their securities on the open market without registration or other sales limitations that are on privately-placed securities, because of the free tradability of stock and the fact that the minimum share price can be under $5.
• Audited financials are not required (although some states may require them).

Regulation “A” Offerings

Regulation A is an exempt offering for public securities not exceeding $5 million in any 12 month period. The company must file an offering statement consisting of a notification, offering circular (Prospectus) and various other exhibits with the SEC for review.

These securities can be freely traded in the secondary market. Advantages of a Regulation A offering as opposed to a full registration include:

1 - There are simpler financial statements.
2 - Generally there are no Exchange Act reporting obligations after the offering is made.

What's So Special About Exempt Direct Public Offerings (DPO's) Under Regulation A, and Regulation D Rule 504?

For classroom use and practical economics, it is recommended that wherever appropriate, Regulation “A” and Regulation “D” Rule (504) should be used for DPOs.

Direct Public Offering (DPO) Advantages

1 - By selling stock to your company directly to investors you do not have to pay back the money as is the case in an outright loan. Therefore, you do not have to meet the cash flow burden of principal and interest payments.

2 - A DPO allows you to give up a smaller portion of equity than what is required by venture capitalists or even private placements. A DPO puts you in the driver’s seat when forming capital and structuring the offering to your investors! Remember, in order for it to get a permit to sell the offering must be considered “fair” to the investors.

3 - Implementing a DPO gives you direct contact with potential shareholders/affinity groups long before you conduct an IPO. This takes the guesswork out of the pricing of your securities.

4 - A DPO requires you to implement an extensive publicity campaign and direct marketing activities. Most of this could be done more cost effectively by using the internet as the primary marketing venue. Furthermore, a DPO gives you a great opportunity for your company to get the word out about your company’s product or services at the same time. Your marketing effort will do “double-duty.”

5 - When implementing a Regulation A stock offering you can also “test the waters” by making inquires to potential investors prior to any stock sale. This way you can “test” a marketing effort before implementing a full-blown offering. For cost reasons, it is best to perform this over the internet as well.

6 - A well implemented DPO involves employees, suppliers, distributors, and customers. Getting these people involved and “invested” means that <u>they</u> are economically motivated to see you succeed as well.

Direct Public Offering (DPO) Disadvantages

1 - There are also disadvantages. DPOs are hard work because you need to get a document through the state security regulators or in the case of Regulation A, the SEC. In the past, many DPOs were not successful because the entrepreneurs presumed a successful sale of their stock. A successful sale of stock can never be presumed. Marketing your DPO requires a good understanding of direct marketing principles and a good strategy to monetize your product or service. Furthermore, A DPO might be just one of a variety of methods you choose to finance your company.

2 - You can implement a DPO by spending hundreds of thousands of dollars on expert help or just a few thousand dollars. It’s up to you. If you do the proper front end marketing research necessary, it doesn’t have to be such a gamble of your hard earned dollars and your time.

3 - What is the risk verses reward tradeoff? Is your proposal something that you could in good conscious offer to investors? Does it pass the mother test? Would you sell it to your mother, aunts, and uncles? Are you just passing unnecessary product development risks to the investors?

4 - Are you ready to commit the extensive time and effort to a relatively involved process? A DPO requires good business planning skills, legal, accounting, and a concerted direct marketing effort.

Summary

Can you understand your business easily enough to identify and develop affinity group of potential investors? Can you deliver the right sales message-to-market match? If you haven't figured out these things you probably won't get your offering completed or sold. It is imperative that you use internet-based keyword research tools to help you identify your markets and do the appropriate front-end homework.

To date thousands of companies (large and small) have successfully raised money using DPOs (from the local bed and breakfast to Google). The Capital 101 course explodes the myth that it is only the Investment Banking community or Venture Capital community who represent the single source or gateway to the capital formation process. This can be valuable information for Entrepreneurs, Social Entrepreneurs, and economic development entities.

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