A Financing Overview

This Financing Overview is provided as an informational overview to entrepreneurial financing. You will find sections addressing the following topics:

Entrepreneurs are back again
The ingredients you need to be a successful entrepreneur
The hurdles you face in entrepreneurship
Entrepreneurial Goals – why and how to set them
Decisions and the entrepreneur
Business planning
Financing – debt and equity
Regulation D Explained

Bonus Attachment - Outline for a Business Plan

Entrepreneurs are back -- Small Is Best--Again

For America, small was beautiful well into the twentieth century. We were a country built on individual proprietorships, small shop owners, small family-owned businesses and farms. Then we turned to worship big-big business, big corporations, big farms, and big problems.

Between 1980 and into the present, the Fortune 500 companies shed some 4.5 million jobs. At the same time, our economy created some 28 million jobs. So while big was shedding, small was gaining in a big way. In a closed economy in which smaller companies depend on larger companies as customers, the decline of large businesses could be serious. But America is no longer a closed economy. Small companies are now just as likely to be exporters and more likely to be innovators than large ones.

The last twenty-five years have seen a return to entrepreneurship. There has been a continuing increase of new incorporations. Where many small companies used to be founded because the entrepreneur had a long-term vision of what might be, today a large number of companies are started out of frustration, by people who are frustrated with their current jobs because the big companies are downsizing, restructuring, and putting new initiatives on hold. The Internet has changed the playing field as well as the rules for the game.

This opens up a lot of opportunities. When big companies have trouble fighting foreign competition or keeping pace with rapid product innovation and technology change, their difficulties create a vacuum into which a lot of smaller companies can enter with a rush.

We've come back again to entrepreneurship, to people starring their own businesses. We're more willing to take risks because so many of the big companies are not as stable as was supposed. For large companies, their biggest fixed investment has become people instead of fixed assets. Downsizing was and still is prevalent, and starting a company become a more viable career path.

This trend has opened the door for Entrepreneurs. The big companies have discovered that small companies can adapt to change faster, grab market share faster, create new products and services faster, bring them to market faster, start selling faster, cut fat, trim overhead, go lean and mean with growth-oriented management that is more alert and better equipped to capitalize on opportunities. Small companies thrive best where the rest of the globe hasn't yet dared to venture. Growth companies can plow income back into operations because the larger reward is the ultimate buyout by the biggies.

Two things are happening. The size of economic units that do things is getting smaller, and the number of these units is increasing. It's a fundamental shift in the economic structure which is irreversible for the foreseeable future. Big companies will never look like they did 30 or 40 years ago. Their profitability and market share will come not because of hiring more people but because they use fewer people and use them smarter.

What You Need for Entrepreneurial Start-up

From those who have studied the subject, the general conclusion seems to be that there is no ideal way to find venture opportunities. They seem to pop up in a variety of ways. Most commonly, they are uncovered by recognizing an opportunity as a result of being active in a particular industry.

The Entrepreneur spots a need and determines to start a company to fill it. This may start by moonlighting after hours and on weekends and develop into full-time businesses. The Entrepreneur ofttimes plans a venture during employment in preparation for resignation and start-up thereafter. What points should be considered in this initial planning process?

Acquire These Five Ingredients

Just like setting out to accomplish any task, one should assess what's needed to initiate the project. For the Entrepreneur, there are some basic ingredients.

1. Product or service idea. A thoughtful concept for what the product or service is going to be has to be clearly in place. The company may start with one idea and modify it into something entirely different than what was originally imagined.

2. Technical know-how. Preferably, entrepreneurs should possess the professional skill and knowledge to generate the company's product or service. If you don't have it, you must be able to hire or acquire the knowledge.

3. Personal contacts. Entrepreneurial ventures are not started by persons living in isolation. The entrepreneur and the team must have connections with other people regarding virtually all of the requisites of start-up and company operations. This includes professionals such as attorneys and accountants, but also includes business connections such as people involved in sales or distribution and others involved in production or materials acquisition.

4. Physical resources. Many types of physical resources are needed to start a company. These include capital and assets; some of them may be substantial. Pulling them together is the primary early role of the entrepreneur.

5. Customer orders. Prior to start-up, the entrepreneur must have strong indications for commitments to sales. Without sales or market validation, obviously no venture will succeed.

Even though each of these seems elementary, it often happens that entrepreneurs concentrate on some and ignore others. The results are usually very negative. Entrepreneurs know that the sequence doesn't matter, simply that all the ingredients need to be in place.

Anticipate These Main Hurdles

There are needed ingredients and there are hurdles, three main ones, and the most devastating one might surprise you. One is a failure to obtain operational financing. This probably isn't too surprising. Many entrepreneurs can put the money together to get started, some even to get going on a small scale. It's their personal financing along with some help from close family and friends. But gaining operational financing is another matter. This is the larger amount of money needed to expand production, sales, inventory, and receivables. It has to be anticipated right from the start.

A second hurdle is sales. If the company is not generating revenues, it needs to at least substantiate that sales can be generated. A new product or service idea is not enough. There has to be genuine proof that not only can the product or service be sold, but that there is substantial customer interest, proof solid that customers will order and reorder. That word of mouth says "hey, it works," and then customers will tell others.

But the most important hurdle is to identify a venture with a product or service that has sufficient profit margins. First, there has to be margin to make a profit. Second, there has to be enough margin to provide for the unforeseen, which always arises. And third, there has to be enough margin to cope with competition entering the market, most likely, with lower prices. As an entrepreneur, you don't go into a venture without high profit margins. That's your reason for existing – to make money.

Personal Balanced Goal Setting

For entrepreneurs, the idea of having balanced goals is very difficult to accept. The tendency is to sharply focus on just the business goals and give short shrift to others. This is a mistake, as all people need to have three to five goals in each area of their life. The trick is to realize that it's okay to reprioritize them at different times as these various areas change, but to recognize that, long-term, we need balanced goals. Here are some examples of balanced goal setting:

<u>Family</u> -- Set out both tangible (more frequent contact) and intangible (more loving contact or with deeper emotional feeling).

<u>Business and Career</u> -- In these areas, we need to set both dollar and quality-of-life goals.

<u>Health</u> -- This may be short-term (weight loss, get in shape) or long-term goals (maintain weight, stay in shape).

<u>Social</u> -- Make more friends. Vary between business and social.

<u>Self-improvement</u> -- Read for inspiration, business, or pleasure. Take courses or instructions for the same reasons.

It's well established that there can be all sorts of goal categories, but several very important points need to be made. All goals have to be set in harmony with each other, and you need to be realistic about the amount of time that you set aside for pursuing all the various goals you establish.

The Method to Program Entrepreneurial Goal Achievement

The following steps apply to both business and personal goal achievement. By testing a business opportunity against each of these steps, the entrepreneur can gain a better grasp of the reality of successfully executing an entrepreneurial business opportunity.

Step 1 Desire or needs. Goals should be determined based upon what a company or a person desires or needs.

Step 2 Belief. A person or the top management of a company must believe that they can achieve the goal. This must be based on a realistic assessment, yet the goal must make one stretch.

Step 3 Write it down. Goals must be written and rewritten in as much detail as possible. Writing it down crystallizes it, creates a memory impression, and makes it clear. This helps people commit goals to their subconscious. Writing goals down causes us to think, and the hardest work of all is the art of thinking.

Step 4 How you will benefit. This must be written down for each goal. This includes noting what differences will result from achieving the goal. The more reasons, the better.

Step 5 Analyze the current position. Whether personal or company, current positions must be analyzed in relation to the individual goals. How much money are you making now? Is there room in the market for another similar product?

Step 6 Set deadlines. In setting deadlines, always use the latest outside date. Setting deadlines helps make goal attainment measurable. Deadlines set direction, keep you moving, and help monitor success. Setting goals will give you more time, but no one ever met a demanding goal without devoting time to it.

Step 7 Identify obstacles. It's always very helpful to draw up a list of identifiable obstacles to goal attainment. Large obstacles tend to become smaller when written down. When identifying obstacles, high standards should be set--this increases concentration, and, at a minimum, you'll at least hit an intermediate goal.

Step 8 Identify knowledge. This is especially helpful. It doesn't matter if it's a personal or a company goal, there is always additional knowledge that must be acquired. You will have to learn something or add to the team, someone who has the knowledge.

Step 9 Identify people. For both personal or business, people, groups, and their cooperation are needed to obtain goals. Three laws apply: a. The law of return. Whatever you sow, so shall you reap. You must put in or give before you receive.

b. The law of compensation. Every action has a reaction. Determine what you can put in.

c. The law of service. You can only achieve by serving or filling a need. Today in business it's called customer service. Go the extra mile; do more than you're paid for.

Step 10 Make a plan of the last three steps (7, 8, and 9) and then itemize, prioritize, and list the activities. Review, rewrite, revise; do this as you go along. It's called thinking on paper.

Step 11 Get a clear mental picture. You do this as if your goal is already in existence. By doing this visualization, you can achieve the goal to the degree of seeing the details. Remember, the more you concentrate your gaze on a distant goal, the more apt you are to stumble over something right under your feet. Visualizing in detail helps prevent stumbling.

Step 12 Back up goal setting with determination. With all goals, they must be backed with the determination and resolve to never, never give up. Persistence counts. Realistically, there will be setbacks and failures, but these are signs to alter the goal-achieving strategy. Pick yourself up and go on. Keep on keeping on.

Remember, self-discipline is simply persistence in action and persistence is the measurement of self-belief. In goal attainment, obstacles are what you see when you take your mind off the goal.

What Goals Look Like

A goal is long-range. Objectives are the intermediate targets with shorter timeframes. Both have a predetermined end result. The attributes of effective goals are:

Must be demanding
Must be achievable
Should be specific and measurable
Must have a deadline
Should be agreed to by those who must achieve it
Should be written down
Should be flexible

The goal-setting sequence starts with a long-range goal, a specific target. Then work carefully down to today with successively shorter-range targets, called objectives. This makes breaking long-range goals into smaller, more do-able, and mentally achievable pieces. The business goal test is yet another tool in Entrepreneurial opportunity testing.

Goal Setting

For entrepreneurs, goal setting is an obsession. Their goals are their dreams--dreams with a deadline, dreams being acted on. They realize that goals assist them in controlling their lives. They know that their goals have to be positive, have to be definite, have to be emotionally stimulating--something that turns them on, gets them excited, something that they really want to work for.

To them, goal setting is simply the long-term version of keeping track of time. Entrepreneurs divide their goals into a lot of different areas, compartmentalize them into both small and large objectives. The goals are long-range, while the objectives are intermediate targets with shorter timeframes.

Entrepreneurs have a keen awareness that goal setting must be in place throughout their company. They know that realistic goals must be established by unified decisions. They have a gut feel for bringing the goal achievers into the process of identifying the goals to begin with. They recognize that building support for defining priorities and establishing measurement standards makes the process of obtaining goals much easier and palatable.

Finally, they have a deep and firm recognition that goals are attained by action.

The Entrepreneurial Action Decision Sequence

Entrepreneurs understand the need to take action, and they develop the confidence to take action because they have also developed an action-decision making sequence process that supports their confidence. This process is as follows:

Is Action Needed or Not?

The first question is: "Does the situation really call out for attention or a need for action?" But if we say that entrepreneurs take action, how can the first point be taking no action? Perhaps it's a situation that should be addressed with "stay cool." No real need to get excited, just "lay back and trust me on this one." Maturity and lots of past experience can be very beneficial in this case. Many decisions stop right here. No action is needed.

Is There a Choice of Actions to Be Taken?

Here the entrepreneur works on the importance of selected values or evaluating options as they conclude there is no choice but to take a specific action or not to take it. They ask themselves and others, "Is there only one action or do we have others to consider?" In other words, is it an offer that can't be refused? Maybe we're better off seeking and considering alternatives. Usually, comparisons result in all alternatives being easily rejected. The offer suits the situation and they decide that they have no other choice; however, they recognize they can easily adjust to the action.

Will a Habitual Course of Action Suffice?

Habits make our life more simple, a lot easier, and a lot more comfortable. This also applies to the action-decision process. Habits enable us to make fewer decisions. The entrepreneur asks, "Is what I usually do (by habit) the best now, or am I better off doing something else?" They question if they can rely on the past, or is this a case where they should get out of the rut, engage in the fact that variety is the spice of life, and do something different? The choice is between habit or a new alternative.

Reduction of Alternatives

This is used when there are a lot of complicated facts or unfamiliar situations---too many things to choose from. Here the entrepreneur doesn't let the alternatives be eliminated or eliminate those not immediately favorable to them. In each case, they specifically question if they should consider the choice or not This way they can narrow the choices down to a few serious objective contenders.

Choice of Preferred Course of Action

With the alternatives narrowed down to a limited number, each is approached on the basis of: Is this what I ought to do or not? This raises the attractiveness of each of the final alternatives.

Decision to Take Action
This is the last step. The entrepreneur asks, "Should I actually do this or not?" The stress is now on the rewards of quick action or the penalties of delay.

If the decision still isn't comfortable, the entrepreneur proceeds back through the steps. Sometimes it helps to question the rewards and penalties of the contemplated action by adding them to the decision making process as follows:

Question reward-What do I have to gain?
Question penalty-What do I have to lose?
Question positive values-What says it's the right thing to do?
Question negative values What says it's the wrong thing to do?

Using a learned action-decision sequence helps improve entrepreneurship. It's another key to understanding what makes a successful. It helps our quest to understand entrepreneurs by studying their basic characteristics. It also helps us understand them by reviewing their positive attitude toward action and to have reviewed their action-decision making sequence. Another key is to examine how they view failures, learn from mistakes, and embrace success.

The Business Plan - Your Primary Business Plan Purposes

There are two primary purposes to a business plan. The first has an outside objective-to obtain funding. There's no business without the bucks. The second serves an inside premise--to provide a plan for early corporate development: to guide an organization toward meeting its objectives, to keep the entrepreneurial business itself and all its decision makers headed in a predetermined direction, to explain in an engaging way with interesting information on how the company will be run for the next three to five years. The entrepreneur must put all the "how's" and "needs" together in one neat package. The human and physical resources must effectively interrelate with the marketing, operational, and financial strategies of the company. Unless an entrepreneur has magical powers of persuasion, this is not the time to try to fake it.

The business plan is considered a vital sales tool for approaching and capturing financial sources, be they investors or lenders. They will want to know that the plan has been carefully thought out by the entrepreneurial team. They want to be convinced that the team has the skills and expertise needed to actively manage the company and that it is prepared to seize opportunities and solve the problems that arise. That's why the business plan must be well prepared, professional in tone, and persuasive in conveying the company's potential.

It cannot be stressed too strongly that a good business plan is the cornerstone of successful financing. If you want investors' money, you've got to give them good reasons to buy in. The business plan is where you lay out the reasons. It doesn't have to be unduly lengthy or complicated, but it must be informative and relevant It needs to maintain logic and order, and show the company as effectively positioned as a good investment.

More important, the business plan should be specifically directed to the funding source and satisfy its particular concerns. For example, you would orient and write the plan differently for presentation to a banker than you would for a venture capitalist, an underwriter, or a private investor. The venture capitalist would want to know what risks are involved, whereas the banker wants more information about how good the security is.

These concerns must be individually addressed. There are no hard and fast rules for preparing a business plan--no established, formal format. The key word is ingenuity. Strive for inventiveness, strive to be interesting and captivating.

(Note : A brief Business Plan Outline is included at the end of this whitepaper.)

Financing - Your Have Two Basic Choices for Financing

For all intents and purposes, the Entrepreneur has two basis choices when considering financing: debt or equity, pledging a part of one's soul or giving away a piece of it. Commonly, one does both.

In simple terms, debt is borrowed money secured in some fashion with some type of asset for collateral. Equity, on the other hand, is contributed capital, usually hard dollars. Debt may be secured by a personal signature only, and equity can also be in the form of a contributed asset. But, most often new businesses require long-term debt or permanent equity capital to support major expansion and anticipated rapid growth. The advantage of borrowing is that it is a relatively simple process to arrange. It does not take a great deal of time and does not dilute equity ownership. The disadvantages are that it is a high-risk strategy as far as company growth is concerned, in that incurring debt subjects the company to a firm obligation, usually including the principals as cosigners. A downturn in business or an increase in interest rates could result in the inability to service debt payments.

Your Two Basic Sources of Financing

Like two choice, there are two basic sources of financing: self-funding and external funding. Self-funding, although the most preferable, is seldom the most practical.

<u>Advantages of Self-Funding</u>

Self-funding involves entrepreneurs investing their personal money. It has the following advantages:

1. Allows the entrepreneurial team to take their time on their business plan and initial product development.
2. Means the only financing source they have to answer to is themselves.
3. Saves them the time otherwise devoted to finding a financial partner(s).
4. Establishes a strong internal discipline regarding the spending of funds.
5. Frequently shortens the time needed to get the product or service to development stage.
6. Usually lessens overhead costs.

The biggest point in favor of self-funding is the fact that this is the best way to build additional value, and hence equity, into the company. A company with a prototype product or service that has been self-financed, is worth much more than several individuals with just an idea.

External Funding Is More Complicated
External funding, while not as preferable in concept or seed stage, comes from a lot of different sources of both debt and equity. They can be divided into two groups: informal and formal investors. The informal are the traditional family and friends. The formal include venture capital firms and the more formal type of investment groups usually brought together in a private placement. With all these possibilities, it makes external funding more complex.

There are pros and cons to all of these areas, debt, equity, self-funding and external funding.

Entrepreneurs Use Combinations
Unlike oil and water, debt, equity, self-funding, and external funding do mix well. In fact, it's an entrepreneurial secret. Growing companies must mix their financing sources and choices.

Which to use, and when, becomes a matter of individual option although there are some pretty well established precedents. Founders' personal investments, including both personal assets and family and friends' equity and loans, are usually what finances concept or seed stage companies.

Development stage companies commonly seek funding from private placements, early-stage venture capital firms, and various grants from both foundations and government sources.

Early-stage production companies may receive financing from bank loans, leasing companies, and research and development partnerships (for incremental product development). Strategic partnerships are often entered into at this stage with potential customers, suppliers, and manufacturers.

Companies at the next stage of ramping up, which is full-scale production and expanded marketing, often receive additional dollar injections. These come from second and larger rounds of traditional venture capital, larger strategic partner companies that are looking for product distribution opportunities, institutional investors, more venture leasing companies (for manufacturing equipment), and additional strategic partners (often seeking secondary manufacturing and distribution rights both domestically and for foreign countries).

After this stage, the entrepreneuring company has some heavy choices to consider. Here is where the harvest point is a natural. They still need more money (what's new), but their choices are a lot broader: more venture capital, bridge or mezzanine financing while going public, being acquired (perhaps by one of the earlier-stage strategic partners), or selling out to a cash-rich company.

So Debt or Equity?
If we're saying that entrepreneurs use combinations, how do we distinguish which and when? The use of debt almost always requires that some equity has come in first. A rough rule of thumb is that a dollar of early stage equity can support a dollar of debt, if there is some additional security to further back the debt. Lenders feel that a start-up has little ability to generate sales or profits. Consequently, the lender wants to have their debt secured, and even then, they feel that the asset value will be decreasing with time and there's always the possibility that management may not be up to the company-building

challenge at hand.

This debt will most likely be short-term debt (one year or less) to be paid back from sales. Short-term debt is traditionally used for working capital and small equipment purchases. Long-term borrowing (one year or maybe up to five) can be used for some working capital needs, but usually is assigned to finance property or equipment that serves as collateral for the debt.

While commercial banks are the most common source of short-term debt, there are more choices for long-term financing. Equipment manufacturers provide some, as does the Small Business Administration (SBA), various state agencies, and leasing companies.

It's true, entrepreneurs can finance start-ups with more debt than equity, but there are some distinct disadvantages. If they negotiate extended credit terms with several suppliers, this restricts their flexibility to negotiate prices. Heavily leveraged (i.e., debt-financed) companies are constantly undercapitalized and will experience continuing cash flow problems as they grow. Paying close attention to strained cash flow requires a lot of management time be diverted from company growth. It also affects the balance sheet, making it difficult to obtain additional equity or debt.

On the other hand, there is one big positive in using debt. Debt doesn't decrease or dilute the entrepreneur's equity position and it provides nice returns on invested capital. However, if credit costs go up, or sales don't meet projections, cash flows really get pinched and bankruptcy can become reality.

Entrepreneurial companies use varying combinations of debt and equity. They determine which is the most advantageous for the particular stage of growth they're financing. Their aim is to create increasingly higher valuations to result in highly profitable harvests.

The Preferred Investment Vehicle – How to get Started

Regardless of the source of your financing--family and friends, angels, or venture capital--you will need some vehicle, forms, or set of papers to make it all nice and legal. On the surface, it would seem that if you're going to sell stock, you could take the investors' check and give them a stock certificate. Or if it was to be a loan, just take the check and sign a note. Unfortunately, it's not quite that simple. And in fact, you don't want it to be.

Today's "sue the buzzards" mentality causes some real problems for entrepreneurs when it comes to raising money. The main problem is the entrepreneurs themselves. Considering their natural propensity and rightful enthusiasm for their project, they tend to oversell. This is okay if everything works out the way it is planned. But we all know that Murphy will enter the program and that not always what is well ends well. In the worst cases, your company may not survive.

The problem then becomes that the friendly original investor is not the least bit happy about the fact that you did not perform up to expectations or lost all their money. Their fee-happy lawyer is more than pleased to take on the case of suing you because you said there wasn't any significant competition, that your engineer was a genius and couldn't miss on inventing the black box, that you had umpteen customers lined up, and the endless list goes on. What it comes down to is your word against theirs, and most likely they have more money (which is why you went to them in the first place) and they can afford the legal upfront fees that will be repaid when they sell your house.

There is a solution to this dilemma, a document that has been blessed by our governmental bodies, that acts like a sort of insurance policy for entrepreneurs to protect them against disgruntled investors, be they friend, family, angel, or venture capitalist. It's called Regulation D and is the subject of the next section.

Regulation D

For some entrepreneurs, the best vehicle to accomplish initial equity financing is through the use of Regulation D, which is a limited offer and sale of their company's stock, or securities, without registration under the Federal Securities Act of 1933.

Simply stated, it's against the law to sell stock unless you are licensed to do so or can qualify for an exemption from the Securities and Exchange Commission (SEC) and the various states securities commissions' rules. The very worst that can happen is that you will have to pay penalties or you can be put in jail. For instance, Section 5 of the 1933 Securities Act ('33 Act) clearly states that "it's unlawful for any person, directly or indirectly to sell a security unless a registration statement has been filed, or to sell or deliver a security after the sale unless a registration statement is in effect (emphasis added)." The '33 Act does, however, contain some exemptions, but they fall short of really helping many small companies.

Reg D Is the Exception

That concern made clear by small business is the sum and substance of Regulation D, commonly referred to as Reg D, which became effective April 15, 1982. It is not just another exemption. It is **THE** exemption for small businesses that want to raise money by selling some of their stock or for incurring some form of debt. It is also a form of taking a company public without the burden and expense of a full registration with the SEC. Reg D should serve as a welcome alternative for many Entrepreneurs.

For many years, and justifiable yet today, the principals of many small U.S. businesses have complained about the expense and trouble of complying with government regulation. It goes back 200 years, to Adam Smith's push for a new era in British economic policy. Smith sought to strip away the shackles of government regulations and constraining ideology, and replace them with the freedom of individual initiative and economic enterprise. Well, some things can't be rushed. The same utterance came from former president Ronald Reagan, when he said in 1978, "For several decades, an ever-larger role of the federal government has sapped the economic vitality of the Nation." The result of this early Reaganomics movement was to remove some of the federal restraints on raising capital. In 1980, Congress enacted the Small Business Investment Incentive Act.

One of the agencies affected by the act was the SEC, which promulgated Reg D. This regulation, along with continuing revisions, broadened the exemptions from SEC's regulations, thereby easing restrictions on equity fundraising.

Reg D established a new set of guidelines that replaced older rules that had been adopted under the '33 Act. Those rules required full disclosure on and registration of securities prior to their being sold to the public. The public in this case is defined as “anyone not directly associated with the issuing company.” It was proposed that the new federal rules be uniformly adopted by all the states, thus following the Reaganomics trend toward deregulation. Reg D returned many responsibilities of government to the states.

States where been slow to adopt Reg D, and some have chosen to design their own version. Consequently, entrepreneurs who are contemplating this type of action had better check their own state's securities regulations before relying completely on Reg D.

The Regulation

Reg D reduces the registration requirements and costs, and has opened the door to substantial exemptions to the '33 Act. The technical provisions, which were always subject to varying interpretations, have also been eased. The process now is simpler, which is relative, and has, in turn, lessened the chance that the offerer (the company) may be subject to recision (giving back monies raised) to the offeree (investor) if a technical provision happens to be mistakenly violated.

Some risks continue under Reg D, but compliance is significantly easier than before Reg D. A major, major point is that by complying with Reg D, it provides the company, its officers, and its directors with an insurance policy of sorts regarding disclosure.

There Are Six Basic Rules

Reg D consists of six basic rules. The first three are concerned with definitions, conditions, and notification. Rule 501 covers the definitions of the various terms used in the rules. Rule 502 sets forth the conditions, limitations, and information requirements for the exemptions in Rules 504, 505, and 506. Rule 503 contains the SEC notification requirements. The last three rules deal with the specifics of raising money under Reg D. Rule 504 generally pertains to securities sales up to $1 million. Rule 505 applies to offerings from $1 million to $5 million. Rule 506 is for securities offerings exceeding $5 million. Here's the details and how they work.

Rule 501

This first rule defines the terms used in the regulations that are applicable to the offering and sales under Reg D. The following are key definitions:

Accredited Investors. The SEC has long had a definition for accredited investors--sophisticated or wealthy enough to be able to assess an offer or stand the risk of the investment without further information about the investment. Prior to Rule 501, it was up to an attorney, accountant, or stockbroker to decide whether a potential investor met the very vague SEC requirements. Now the rule spells it out. Accredited investors include:

- Banks
- Savings and loans
- Credit unions
- Corporations and partnerships with total assets in excess of $5 million
- Brokers/dealers
- Insurance companies
- Registered investment companies
- Nonprofit organizations with over $5 million in assets
- Business Development Companies (as defined under the Investment Companies Act of 1940)
- Small Business Investment Companies (SBICS)

Minority Enterprise Small Business Investment Companies (MESBICS)

And more applicable for most entrepreneurial efforts to raise money privately:
Directors and officers of the company
Individuals whose net worth exceeds $1 million
Individuals whose income exceeds $200,000 annually (during the last 2 years as well as expected in the current year)
Individuals whose joint income with a spouse exceeds $300,000 for 2 years

The term accredited investors surfaces again in Rules 504, 505, and 506. In conjunction with accredited investors, the term reasonably believed is often mentioned. These terms will be used extensively by a company's legal counsel as these persons and the company have a legal obligation to declare (reasonably believe) if an accredited investor meets the requirements of Rule 501. If the company actually believes, and can prove it had reason to believe, it would have no continuing liability as far as accredited investors are concerned. As an extra precaution, however, the company should have the investor attest to the accredited investor facts and qualifications in writing. This accredited investor document should be part of every offering memorandum.

Purchaser Representatives**.** A purchaser representative is a person who is not an affiliate, director, or other employee of the company, or an owner of 10 percent or more of the company, or an owner of any class of the equity securities of the company. Furthermore, such persons should possess sufficient knowledge and experience in financing and business matters to make them capable of evaluating, on their own or together with the purchaser, the merits and the risks of the prospective investment. Additionally, they must acknowledge in writing that they are acting as a purchaser representative, and they must make certain written disclosures as to the identification of the ultimate purchaser. This particularly applies to syndicates, multiple syndicates, and partnership holdings.

Number of Purchasers**.** Rules 505 and 506 limit the number of purchasers, but accredited investors are not included in the total. The rules further state that the company may sell it's securities to an unlimited number of accredited investors in addition to a specified number of other purchasers, such as officers and directors. This also applies to loosely related Parties, which in some cases may be counted as a single purchaser.

Rule 502

This rule establishes the general conditions pertaining to the exemptions. Several areas are notable:

Qualifying for an exemption under Reg D is not dependent on the size of the company.

The exemptions are applicable only to the issuer and not its affiliates, such as subsidiaries, or to others, or for resale of the issuer's securities.

Some offerings of the 'same' securities may be considered as a single offering (that is, integrated) if they are made within six months of the start or termination of the Reg D

offering. This can save legal and registration costs, but there are technicalities involved, so it's best for the entrepreneur to seek knowledgeable legal advice on how best to handle integration.

To further clarify the somewhat confusing interpretation of Reg D. There can be no general solicitation or quasi-public advertising connected with the offering. However, to add to the confusion, Rule 504 explains how this type of situation can be circumvented.

Another general condition is that certain procedures must be followed by the issuer to guarantee that the securities are not being purchased for resale. The issuer must make certain that the purchaser is not an underwriter or an agent for an underwriter. Further, the issuer must provide a written disclosure of this resale limitation. And the actual stock certificate itself must contain a legend specifying the resale restriction. This may seem like a no-win situation, but take heart-Rule 504 contains ways of avoiding this problem also.

Rule 503

This is the rule that sets forth the information that must be filed with the SEC. It also specifies the timing and the type of forms that must be used in the filing.

The company (issuer) must file five copies of the notice of sales of its securities with the SEC on the required Form D, one of which must be hand-signed. This filing must be made within 15 days after the first sale, with a final filing within 30 days of the last sale. Compliance in filing is extremely critical. Should the issuers not comply, they run the risk of the SEC rescinding the entire offering and requiring that all monies received be returned to the stock purchasers if they so desire.

Also, the SEC has the right to request, in writing, that the issuer provide the SEC with copies of all information provided to the purchasers of the securities. This makes the information public record. However, the SEC rarely takes this action. Even so, don't bet on it.

Rule 504

This rule is considered by many as the perfect answer for the company just starting out that needs to raise less than $1 million but can't afford to go through the whole SEC registration process. Until they grow to a point where they can afford it, Rule 504 offers such companies an out:

An exemption to raise up to $1 million
No disclosure criteria
Some general solicitation and resale restrictions
No limit as to the number of investors

Actually, Congress's original intent for Rule 504 was to "set aside a clear and workable exemption for small issuers to be regulated by state blue sky requirements, but by the same token, to be subjected to federal anti-fraud provisions and civil liability provisions." Rule 504 exemption is provided for almost any type of organization,

including corporations, partnerships, trusts, or other entities. However, it is not applicable to companies already reporting to the SEC (subject to the '34 Act) or investment companies.

You Cannot Exceed $1 Million. The total offering amount under Rule 504 can be up to $1 million in a 12-month period, less the aggregate offering of all securities sold within 12 months before the start of a 504 offering. So, if a company has raised $100,000 in preprivate money in the previous 12 months, it can still raise up to $900,000 without being accused of breaking the rules, or integration. Generally speaking, there are no specific disclosure requirements under Rule 504 (disclosing what the company is about, what it intends to do, or who is connected with it). This means that, theoretically, an issuer can have a purchaser sign a subscription agreement and purchase stock without any information about the company being disclosed. However, the rule is dependent on the blue-sky laws of each state in which the securities are offered. This means that if a state's blue-sky rules require disclosure, it must be provided regardless of Rule 504.

Rule 504 also provides that at least $500,000 of securities must be sold pursuant to a registration under a state's securities law. Consequently, an offer must comply with the blue-sky laws of each individual state in which it is offered. In many states, this negates the effective simplicity of Rule 504 and the federal government's intent, because many states' blue-sky laws are more restrictive than Reg D.

A word of caution to the Entrepreneur-regardless of the amount of disclosure the issuer is willing to provide, Rule 504 does not dismiss the issuer from the federal requirements, nor is there an exemption from the fraud provisions, including the areas of material omissions or misstatements. The penalties for noncompliance are severe, including monetary fines and mandatory jail sentences.

Commissionable. One interesting aspect of Rule 504 is the provision for payment of commissions. It was reasoned that if broker/dealers got involved with the selling of 504s, they would provide an extra safeguard for investors. Additionally, it was felt that removing the ban on commissions, which can be as high as the market would bear (generally 15 to 20 percent), would bring the expertise and sales organization of the brokerage firms and investment bankers to the aid of the small business persons. Unfortunately, the measure hasn't had the desired effect, except for a few smaller brokerage firms. It seems the medium-size and large Wall Street firms simply could not justify the expense required to merchandise offerings under $1 million.

The one area in which Rule 504 has helped is in allowing the issuer to generally solicit, or advertise, for subscribers to an offering. Some states have been quite lenient in allowing it. However, in practice, very few issuers have advertised their offerings in newspapers or through other common media as was expected.

Number of Investors. With its limited disclosure requirements, Rule 504 also allows an issuer to sell securities to an unlimited number of investors. Theoretically, a company could raise $1 million by selling its stock at a penny a share to 100 million different investors. Obviously, the economics are not too attractive, but there's no rule that stops an issuer from selling $500 blocks of stock to 2000 investors. Rule 504 is the only rule under Reg D that permits an unlimited number of investors.

A final note on Rule 504 is that the exemption provides for sales of securities of either debt or equity. This opens the door for combinations of both via convertible debentures. By way of explanation, convertible debentures are a debt issue (debenture) that is convertible to a preferred or, most commonly, common stock at some future date, usually at a predetermined price.

Rule 505

Compared to Rule 504, Rule 505 is comparatively hassle-free.

It exempts offers and sales of issuers other than investment companies.

The offering in total cannot exceed $5 million during a 12-month period, less what has been raised by preprivate money, as mentioned in the discussion of Rule 504, plus inclusion of any future offerings contemplated in the 12 months following the last sale under Rule 505.

The sales cannot be made to more than 35 nonaccredited investors and they must be accompanied by the same kind of disclosure information as is required in Part I of the filing for an SB-1 or SB-2 registration, which is the SEC filing document for a company going public.

Sales can be made to an unlimited number of accredited investors.

No general solicitation (advertising) is allowed.

Rule 505 carries the same filing notification requirements as Rule 504.

Rule 505 carries a disqualification from using the exemption if the issuer, defined as just about anybody connected with the company, including officers, directors, principals, or underwriters, are "bad boys," as defined in Rule 252 (c)-(f) of Regulation A. Loosely, a bad boy is a person who has incurred the wrath of the SEC for the potential (without necessarily having been convicted) of having committed a securities violation. However, the SEC can waive the misconduct disqualification. The issuer should seek advice of counsel if anyone connected with the company has had previous problems with the SEC.

The same fraud, misstatement, and material omissions compliance apply as for Rule 504.

Obviously, the largest drawback to selling stock under Rule 505 is the limited number of nonaccredited investors allowed, which naturally means that the average investment per investor has to be considerably more than under Rule 504.

Rule 506
This is the last rule under Regulation D.

It exempts offers and sales of issuers, including sales by investment and reporting companies.
The offering amount must be for offerings over $5 million, with no time restrictions.
Sales cannot be made to more than 35 nonaccredited investors. The nonaccredited investors must be capable of evaluating the merits and risks of the investment, and it is up to the issuer to verify that the investors are knowledgeable enough to make that evaluation.
Sales can be made to an unlimited number of accredited investors.
No general solicitation (advertising) is allowed.
Rule 506 carries the same notification requirements as Rules 504 and 505, with the primary emphasis on filing every six months.
Rule 506 does not contain 'bad boy' disqualifications, but as in all Reg D rules, the SEC's antifraud provisions apply. This leads most issuers to voluntarily make relevant disclosures to safeguard against later charges by disgruntled investors that they were not informed of material facts.

Outline for a Business Plan

Cover Sheet

1. Indicate full formal name of company
   ABC Company/ABC Corporation/ABC Inc. (If you have a logo, use it.)
2. Indicate ownership status
   A sole proprietorship.
   A any state corporation or LLC
3. List full street address
   555 West Fifth, Suite 55, Anytown, State, ZIP USA
4. List mail address if different
   Mail address P.O. Box 55, Anytown, State, ZIP USA
5. List phone, Fax/telecopier, e-mail and web site information
6. List principal contact name and title
   E. E. Entrepreneur,- President
   Home phone number (optional)
7. Date the plan
   Month and year

Table of Contents
Categorize the contents. Use section names and page numbers. You have a choice of only main category headings (History, Management, Product, etc.) or detailed categories (History--date founded, founding members, place founded, etc.). Make a note of any charts, tables, or graphs.

Executive Summary
A very important part, the executive summary briefly sets forth the contents, taking key sentences from each section of the plan to overview the project for the reader. Limit the summary to two or three pages: more is too many. A one-pager is super.
Consider using your mission statement or a brief visionary type of paragraph. Try to do it in one or two sentences, it should be concise and to the point. This section is the first thing that investors read, and they may not read further if you haven't captured their interest.

History
The first several paragraphs should briefly describe the product or service, to whom it is sold, the current status of your industry, and where your new company fits in. This is your <u>second</u> chance to give the reader an overview to establish a basis for detailed understanding.
After this brief introduction, include a description of how, when, and by whom the company was started, its achievements and acceptance setbacks. Then bring these experiences to current-day status.

Product or Service

To succeed as an entrepreneurial company, you must know your product or service; to succeed in obtaining capital, you have to be able to clearly describe your product or service. After giving a simple, straightforward description, outline the need for the product or service in today's marketplace, how it will make a difference, the benefits derived from using it (or what will make the customer buy it), and its advantages. A picture, drawing or diagram is priceless. What unique solution do you bring to what specific major problem?

Explain any special training needed to sell or use it. Include all relevant regulations that may affect its sale or use. Expound on any exclusivity or technological uniqueness. Cite patents, proprietary aspects, trademarks.

Unless your plan is going only to specialists in your industry area, assume you are writing for the layperson. Forget industry jargon and replace it with words that the non-specialist can understand. If you tend to write overly technical descriptions, engage a professional writer.

Market Description and Analysis

This section profiles three key areas: customers, industry, and competition.

Prepare a Customer Profile

Describe what customers form your market, where they can be found, why they purchase your product or service rather than another, and whether it appeals to a single individual or to groups. Document quality, warranty, service, and price significance: pinpoint the buyer and user. Point out political influences, governmental regulations, if any. Describe market coverage, whether local, regional, national, or international.

Prepare an Industry Profile.

Discuss pertinent trends, past, present, and future. Offer available statistical data on sales and units. Use charts, graphs, and tables if they can make the presentation clearer and more impressive. Refer to trade associations if helpful.

Prepare a Competitive Profile.

You do have competition!! A little red wagon competes with an airplane in the transportation industry. Stress advantages of price, quality, warranties, service, and distribution. Include the operational strengths and weaknesses- what do they do well and what don’t they do well. Project potential market share trends in sales and profitability. Comparative feature charts are super.

Don't guess in this section. Check all your facts and note all your sources. You can be sure that these will be checked with a fine-tooth comb during an investor's due diligence process. If you're citing voluminous reports or statistical information, note that you have them available for further review.

Marketing Strategy
This is a critical section that should clearly specify the company's marketing goals, HOW they are to be achieved, and WHO will have the responsibility for achieving them. Qualify all distribution methods (representatives, dealers, and so forth) and describe any planned advertising or public relations activities. Include references to sales aids, foreign licensing, and training plans as appropriate. Simply, detail how you are going to sell the product or service.

Operations Plan
This section is primarily oriented toward facilities, manufacturing capability, and equipment. Disclose all present capabilities as to equipment and facilities, as well as further projections for offices, branches, manufacturing, and distribution.
It often helps if you include current floor plans as well as expected future space plans for production or manufacturing companies. For all fast-growth companies, task/time charts can be especially useful in this section. They help impress on the reader that the Entrepreneur has a real handle on the operational challenge.

Research and Development
The length of this section depends on whether you're a service or product company and--if you're a product company—on how technical your product is. The object is to explain all past research and development efforts and accomplishments as well as future expectations.
Here is your opportunity to justify past time and dollar expenditures. Substantiate the patentability of inventions, proprietary processes, or other advantages that your company will have over the competition and the resultant, anticipated market impact.

Schedule
Describe the timing and sequential steps that will be taken to bring the company up to full speed. Graphs or charts help indicate the timing and interrelationships of the major events in the company.
Take it month by month for the first year. Thereafter, indicate the progress expected quarterly. Areas that may be important include completion of prototypes, starts of beta tests, early significant sales, when key people are to be hired, physical expansions or moves, opening of branches, trade show or convention dates, major equipment purchases, and the like.

Management
In the eyes of the investors, the quality of the management team often determines the potential success of the company. Consequently, this section should cover career highlights, accomplishments, and positions held, with an emphasis on good performance records, for each primary team member.
Describe how the team has worked together in the past. List all directors, consultants, advisers, and other key professionals who will be involved in company operations and point out how they add value. Detailed resumes of key management should be appended with bios of others as appropriate.

Risks and Problems
Risks could be a red flag. There are diverse opinions about the inclusion of this category. Some investors object to the obvious and prefer to discover their own negatives. Others prefer that the company openly acknowledge risks and potential problems. It's a toss-up; however, high profile, success-threatening risks should be brought out.

Use of Proceeds
Judiciously present a timetable indicating how much money will be needed, when it will be needed, and how it will be used. Most companies require multiple stages of financing, including both debt and equity. Show the proposed capital structure, including who is going to own what part or percentage of the company at what stage. Start-up plans need to detail start-up use of proceeds and then generalize on the additional stages.

Finances
Present the company's current equity capital structure as well as future plans. Itemize the equity payments made with dates paid. List all outstanding stock options. Include both historical and current profit and loss statements and balance sheets. Present current and proposed salary structure for those who are already on board and those who will come on board at a later date.
Show projections, including balance sheets, profit and loss statement, and cashflow studies. These should be month-by-month for the first year, quarterly for the second and third years and yearly thereafter. Don't bother with return on investments figures. The investor will do that themselves and your figures will be wrong.
It is mandatory that detailed assumptions accompany all projections. It is also very helpful if the very first part of this section summarizes the details. In fact, in many cases, details can be appended or supplied separately.

Appendix
Include a glossary (if pertinent) and all essential pieces of evidence, such as resumes, product brochures, customer listings, testimonials, and news articles.