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Microequity a new model for microfinance in the u.s

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MICROEQUITY: A NEW MODEL FOR MICROFINANCE IN THE U.S.

by

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ABSTRACT

Most of the research on microfinance focuses on the microloan activities of microfinance institutions such as Grameen Bank of Bangladesh and Banco Sol of South America. These institutions make small loans to the poor to help them engage in income generating activities. Many organizations have tried to translate this practice to the United States, but due to fundamental differences between the advanced U.S. business environment and that found in the developing world, such attempts have been met with limited success. There is a substantial amount of research on microfinance institutions and activities in the U.S., however almost all of the activity is focused on making microloans. In this paper, a new method for pursuing microfinance, microequity, is put forward as a potential candidate for successfully and sustainably implementing microfinance in the United States. The preliminary conclusions reached in this paper, based on research into traditional microfinance internationally and in the U.S. as well as research on the pros and cons of traditional equity and debt financing, show that a microequity model for microfinance could offer a solution to the difficulties that have prevented microfinance from being successfully and sustainably implemented in the United States.

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INTRODUCTION

Startups and other small businesses usually require some form of financing to initiate or sustain operations. However, many entrepreneurs are unable to access traditional forms of formal financing for various reasons. Traditionally, in the context of small businesses, formal financing has been defined as commercial banks and similar financial systems, government loans, equity investments, and any other type of financing which relies on the state to enforce contractual legal obligations (Ayyagari, Demirguc-Kunt, & Maksimovic, 2010). Often times the amounts of capital that are required by small or startup businesses are below the threshold of what commercial banks and other similar financial institutions are willing to provide (Pollinger, Outhwaite, & Cordero-Guzmán, 2007). Also, many times would be entrepreneurs may be deemed to not be credit worthy by formal financial institutions.

Microfinance emerged in the recent past as a way to provide small loans to entrepreneurs and circumvent the above difficulties. The microfinance model has been successful in the developing world, but, due to various factors, in the U.S. there have been problems with and questions about its sustainability and effectiveness (Pollinger et al., 2007).

For small businesses, utilizing debt financing is very risky because most small, new businesses are likely to have low expected cash flows. It could be advantageous for these businesses to utilize equity financing rather than debt. First, equity investments provide insurance against becoming insolvent since the equity investor receives no return if the business struggles, as opposed to debt financing where loans have to be repaid regardless. Second, equity

investors such as venture capitalists and angel investors frequently add value to the business they invest in and many times help the business succeed.

In this paper I will seek to answer the question of whether a different model for providing small amounts of capital, microequity, which uses equity rather than debt, may offer a solution to the problems faced in implementing microfinance in the United States.

With the recent passage of the Jumpstart Our Business Startups (JOBS) Act by the U.S. Congress, it seems that a substantial new source of previously untapped equity funding may now be available to small business startups via the Act's crowdfunding provisions. This new Act is certain to have major ramifications on microequity based financing.

Microfinance Overview

For many years, the demand for small loans and credit has been fulfilled by informal financing arrangements, which are defined as “small, unsecured, short-term loans restricted to rural areas, agricultural contracts, households, individuals, or small entrepreneurial ventures” (Ayyagari et al., 2010). Typical examples of these types of arrangements include pawnshops, moneylenders, borrowing from family and friends, and ROSCAs (What is Microcredit?, 2011). ROSCA, which stands for rotating savings and credit association, are community based organizations where the members meet on a regular basis to contribute small sums to a funding pool, which is then given to a different member at each meeting on a rotating basis (Armendariz & Morduch, 2005). These sources of financing have undoubtedly been utilized by entrepreneurs to create income generating activities, however; problems exist with these types of financing. ROSCAs are constrained in two important ways. First, the size of the pool and the regular

payments are inflexible during the life of a given ROSCA. Second, while ROSCAs mobilize locally held funds, they do not provide a way to access funds from outside a given community (Armendariz & Morduch, 2005).

While moneylenders and pawnshops can also be considered as sources of microfinance, credit obtained from these types of sources is often very expensive for the borrower due to the high interest rates charged which are well above those found in the formal financial sector. Another source of microfinance can be family and friends. However, when borrowing from family and friends, interest costs may be low or in fact zero, but social costs and obligations can be considerable. For example, borrowing mom's entire rainy day fund is likely to entail a very hands-on loan monitoring process, and borrowing from a close friend could destroy a cherished relationship in the event of a default.

The formal financial sector faces several obstacles when trying to serve the small credit market. These include asymmetry of information, multiple sources of risk, and the high cost of servicing small loans (Khavul, 2010). Asymmetry of information refers to the fact that in the instant case, a bank or similar financial institution will usually have no information on who is a good risk and who is not, because of the fact that potential small credit customers are likely to have little to no credit history. The multiple sources of risk are the ex-ante moral hazard problem of poor project selection and the ex-post moral hazard of non-repayment. In other words, before the loan is received there will be a tendency for an entrepreneur to choose a project that may be less than optimal, since they are risking the financial institutions capital and not their own. For small loans the problem is magnified because financial institutions cannot charge higher rates to

cover this risk, due to usury law. Then, after the loan is received, there is always the risk that the loan will default for various reasons other than poor project selection. In such cases borrowers may not be as motivated to work through difficulties since they have not invested their own money. Again the financial institutions have trouble pricing in this risk while staying under the usury ceiling. Servicing costs for small loans are high because fixed costs are a significant portion of the loan amount, limiting the economies of scale. Due to these factors, formal financial institutions have generally avoided the small credit market altogether, likely due to the perception that because of the aforementioned reasons there is no money to be made on these types of loans.

The difficulties faced by entrepreneurs in accessing small loans and credit led to the development of the modern microfinance movement, widely accepted to have begun with Grameen Bank in Bangladesh in the late 1970's. Grameen Bank was founded by Dr. Muhammad Yunus in 1976, and was based on a model featuring what is called Grameencredit. The model is distinguished by: a mission to help the poor overcome poverty by creating income generating activities, not being based on any collateral or legal system but based on trust instead, borrowers must join groups in order to obtain loans, and the loans must be paid back in installments (What is Microcredit?, 2011). Since the inception of Grameen Bank, the model has been replicated throughout the developing world, with adaptations, in many instances, but mostly converging to the most salient features of the Grameen model. A typical microfinance institution (MFI) in the global context is a non-profit organization funded by governmental and philanthropic sources. Some are also member owned co-ops. Funding comes from patient and undemanding capital as

opposed to demanding capital which seeks a return. MFIs have evolved from grant-dependent, loan only institutions to include many different forms. Some MFIs offer a variety of financial services such as banking, insurance, loans, etc. and some are profit seeking institutions (Chandra & Arun, 2011).

The microfinance movement in the United States emerged in the mid-1980s. It was influenced by the growth and development of the international microfinance industry, and was a response to the need for better economic options for those entrepreneurs who lack access to formal financing. In particular the movement focused on those classes of people who have been traditionally categorized as disadvantaged: women, racial and ethnic minorities, and public assistance recipients (cited in Servon 2006; Hoy, Romero, & Zeuli, 2012). In the U.S. context there is a further focus on what are known as microenterprises, which are defined as those businesses with five or fewer employees that require \$35,000 or less in start-up capital (Edgcomb & Klein, 2005). According to the U.S. Census (2012), in 2010 there were 4,078,084 businesses with 1 to 4 employees out of a total of 7,396,628 businesses in all, showing that approximately 55% of all businesses could fit into the microenterprise category. Furthermore, these microenterprises had a combined total payroll of over \$290 billion out of a total of \$4.94 trillion for all businesses, giving microenterprises approximately 17% of the entire U.S. payroll. These figures show that microenterprises are a significant part of the U.S. Economy.

Although MFIs in the developing world were originally funded by governments and charitable organizations, an increasing number of these MFIs have made the transition to profit seeking institutions funded by commercial capital (Chandra & Arun, 2011). In contrast, most

MFIs in the U.S. are not self-sufficient and rely on grants, subsidies, and donations to cover their costs (Gollakota & Doshi, 2010). The reasons MFIs in the U.S. have had difficulty making this transition is twofold. First, the regulation of interest rates by the federal and state government(s) presents an obstacle. In order to make a profit, a lender must make a sum of interest on loans which is greater than the sum of the costs of operating, defaults, and inflation. For small loans this is difficult because fixed costs can be a significant portion of the principle amount. An interest rate of 30% has been suggested as sufficient to meet this threshold but this would conflict with usury law (Bell, 2010). According to Flannery & Samolyk (2005), most states have usury laws prohibiting the charging of interest at rates this high, which impairs the ability of MFIs to generate a profit. Some organizations, such as payday lenders, are able to circumvent such statutes, however; the methods they use are probably not available to most MFIs. Payday lenders in many states operate according to enabling statutes which are separate from those governing banks and other mainstream lenders. Absent enabling statutes, payday stores operate as agents for banks located in states with much less restrictive usury limits, such as South Dakota or Delaware which impose no interest rate ceiling at all (Flannery, & Samolyk, 2005). In contrast, most MFIs in the United States are community based organizations and likely lack ties to financial organizations in other states. Also, most MFIs in the U.S. have a mission component and attempt to serve low-income and predominantly ethnic minority communities (Pollinger et al., 2007). In light of this fact, most MFIs are probably unwilling to charge interest rates substantially higher than those found in the formal financial sector even if they were able to do so.

Problem

As can be seen from the preceding discussion, MFIs in the United States have had trouble achieving sustainability and some question whether they are even effective at stimulating economic activity and helping the poor escape poverty. MFIs cannot charge interest rates high enough to cover the costs incurred when making small loans and must depend on subsidies. As stated by Pollinger, Outhwaite, and Cordero-Guzman (2007) “If subsidies are required to serve the market ... it is incumbent on the microfinance industry to demonstrate that theirs is an efficient mechanism for delivering such subsidies” (p. 39). Receiving government or charitable funds is never guaranteed, especially in an environment of economic uncertainty which continues to pervade the U.S. and world economy. These factors clearly make it very difficult to be certain that microfinance is effective in the U.S. context or if it is even sustainable at all.

Research Questions

In this thesis, we attempt to answer the following research questions:

- 1.) Could a microequity financing model offer a solution to the difficulties that have prevented MFIs in the United States from achieving sustainability?
- 2.) How would a microequity financing model work in practice? In particular, would it be possible to create a “micro” version of traditional methods of equity financing, which have a proven track record, such as venture capital and angel investing (“microVCs” or “microangels”)? Do the provisions of the recently passed JOBS act facilitate or inhibit such a model?

These questions will be answered by conducting a focused literature review. First, the literature that highlights the successful practices of international and domestic MFIs will be

reviewed. Next, the relevant literature relating to traditional business financing such as loans, bonds, stocks, venture capital, angel investing, etc. will be analyzed. Some business models that are already in use, which are similar to the microequity concept, will be discussed as well. Finally, the crowdfunding provisions of the JOBS Act will be thoroughly examined as they are of particular importance to the potential implementation of a microequity funding model.

LITERATURE REVIEW

Successes and Best Practices of MFIs

International Perspective

As stated earlier, the international microfinance movement is widely accepted to have begun with Grameen Bank in the late 1970's in Bangladesh. Grameen Bank's founder, Dr. Muhammad Yunus, created a lending model based on the concept of Grameen Credit, which was described earlier. Perhaps the most significant aspect of this model is the group lending feature. Group lending generally refers to individuals who lack collateral joining together to obtain loans. In the classic Grameen model the loans are distributed to individuals, but all in the group face consequences if any one member runs into serious repayment difficulties, this is known as joint liability. (Armendariz & Morduch, 2005). There are also other forms of group lending known as individual liability and village banking. In individual liability, group lending borrowers are not directly responsible for other group members' debt obligations, however; the borrowers come together for regular repayment meetings with the representative of the MFI. The loans are repaid in public and often the meetings do not end until all loan payments are received (Khavul, 2010). In this way the social and moral obligations of group members to repay are retained without actually holding members responsible for the debts of others. Village banking has been described by Khavul (2010) as "...groups of individuals are jointly given a loan amount that they then allocate to their members. Village banks establish leadership roles among members who are responsible for managing and the lending activities. Village banking requires that members cross-guarantee each other's loans" (p. 62).

Originally the motivation for the group lending model was economies of scale, but MFIs soon realized that the model had other important advantages such as reducing the costs of screening and monitoring loans and of enforcing debt repayments. These advantages helped to alleviate the aforementioned problems that financial institutions have traditionally faced when lending to the poor: information asymmetry, multiple sources of risk, and the high proportion of fixed costs on small loans (Khavul, 2010; Armendariz & Morduch, 2005). The way group lending obviates these difficulties is by taking advantage of the strong social networks that exist in low income communities. The borrowers form the groups without input from the MFI, and research has shown that borrowers who are likely to repay will self-select into groups with other “good” borrowers, to the exclusions of borrowers who are unlikely to repay, thereby alleviating some of the problems in multiple risk sources and information asymmetry. Also, the public repayment meetings allow for the fixed costs due to servicing the loans to be spread out amongst many groups (Armendariz & Morduch, 2005).

Because of these advantages, international MFIs have consistently reported very high loan repayment rates, despite the fact that no collateral is used for these loans. However, many have argued that loan repayment rates are an insufficient measure of the success of MFIs and that instead more emphasis should be put on the outcomes for the MFIs’ clients. The question, they argue, is whether or not microfinance is working, in other words, is microfinance helping to alleviate poverty? The answer to this question is still open to debate and is complicated by the fact that it depends on who you ask as there are multiple stakeholders involved in such a complex phenomenon. One thing is certain, MFIs in the developing world have proven to be

sustainable, with organizations such as Grameen Bank and the Association for Social Advancement in Bangladesh having been in existence since the late 1970's (A Short History of Grameen Bank, 2011; About ASA: Origin, 2012), and BancoSol in Bolivia since 1986 (BancoSol: History, 2012).

Microfinance in the US

Microfinance in the US shares the same goals as microfinance in the developing world, helping lower income entrepreneurs to start businesses and escape poverty. However, for a few important reasons, MFIs in the US have had less success than their international counterparts in achieving sustainability. First, financing entities in developing nations are subject to less stringent regulations and are free to charge interest rates sufficient to cover their costs, but in the US this is almost always prohibited by statutes (Bell, 2010; Gollakota & Doshi, 2010). Second, many studies have shown that the social pressure to repay microloans via the group lending practice is ineffective in the US. The reasons for this are: a lower population density compared with places like Bangladesh leading to much greater dispersion in potential customers; a much more transient and mobile low income population; and the fact that most groups that were formed in the US were assigned by the MFIs rather than being formed by the borrowers themselves, which negated the advantages of group lending in information asymmetry problems (Chandra & Arun, 2011; Gollakota & Doshi, 2010). Finally, one crucially important factor in the success of MFIs is that if the businesses started by the loan recipients are successful, then it is clearly much more likely that the loans are going to be repaid. But starting a business in a formal and developed economy like the United States is much more difficult than in the developing

world. For instance, in the US an entrepreneur who is interested in starting a retail store will have to compete with giants like Wal-Mart and Target. Also, there are many regulations at the federal, state, and local level that must be complied with. These obstacles are more or less nonexistent in the developing nations where microfinance has had so much success. Not only does this create additional difficulties for the entrepreneur in creating a successful enterprise in the US, but MFIs in the US realize that they must provide training and technical assistance to their clients if these problems are to be overcome, which adds substantially to the costs of operating for domestic MFIs (Chandra & Arun, 2011; Gollakota & Doshi, 2010).

So, the question is what have MFIs in the US done to cope with the challenges presented by these differences in regulation, culture and the economic environment? First, since US MFIs are unable or unwilling to charge interest rates high enough to cover their costs, many have been very resourceful in finding sources of funding. A major source of funding for MFIs in the US comes from banks who frequently partner with MFIs as part of their compliance with the Community Reinvestment Act (Chandra & Arun, 2011; Gollakota & Doshi, 2010). Many MFIs also receive financial support from the federal government and private philanthropy (Edgcomb & Girardo, 2012). Second, because of the decreased effectiveness of the group lending methodology in the US, MFIs need to come up with another way to ensure repayment. One solution has been to require collateral for providing microloans, although in many cases the full value of the loan is not collateralized and the collateral is mostly symbolic (Gollakota & Doshi, 2010). Another way that MFIs in the US ensure repayment is also the method they use to overcome the more difficult economic environment, and that is by providing business

development services. A survey of microenterprise programs showed that in 2010, 75 percent of programs provided a microfinancing product and 97 percent provided some type of business development services (The Aspen Institute/FIELD 2012). Many times the entrepreneurs who have received microcredit work very closely with the staff of the MFI to receive training, mentoring, coaching, and other business development services.

Since entrepreneurs are somewhat dependent on the MFIs to provide this type of support, they typically have a clear incentive not to fall behind on their payments so that they may continue to benefit from these services. The practice also benefits the MFIs because they stand a much better chance of recovering their investment if they help the microcredit recipient/entrepreneur to start and sustain a successful business (Klein & Gomez, 2010). However, as stated above, providing such services adds to the costs of the MFI. This may necessitate an increased dependence on subsidies, which brings us back to the problem of sustainability for US MFIs.

Traditional Business Financing

Debt Financing

Firms generally prefer using debt rather than equity to finance operations because interest expense is deductible from the firm's taxable income. The firm can take advantage of the fact that a greater dollar amount can be paid out to both equity and debt security holders when the firm uses some percentage of debt in its financing mix, compared to an all-equity capitalization. This concept is known as the tax shield on interest. The tax shield on interest is presumed to have

value in the marketplace and therefore increases the total value of the firm. However, there comes a point where the advantages of the tax shield are offset by the potential costs of firm failure. If a firm cannot meet its debt payment obligations it will be forced in to bankruptcy and will incur associated penalties (Keown, Martin, Petty, & Scott, 2003; Kraus & Litzenger, 2012).

For startups and small firms then, the cost of using debt is much higher. As stated by Klein, O'Brien, & Peters (2002) "Firms with lower expected cash flows find it more costly to incur higher levels of debt (because bankruptcy is more likely) than do firms with higher expected cash flows" (p. 321). It is reasonable to assume that startup and small businesses will have low expected cash flows during the nascent stage of their life. However, these types of firms are forced to rely on bank loans and to operate with higher levels of debt; rather than utilizing more appropriate forms of financing, such as equity, because of flotation costs and problems of access to capital markets (Akyüz, Akyüz, Serin, & Cindik, 2006; Marsh, 1982).

Many small businesses and startups may even have difficulty accessing debt financing because they are not profitable and/or they lack tangible assets (Denis, 2004). One way this problem can be overcome is by having small and startup business owners secure debt financing via personal credit cards and home equity lines of credit, although these sources of financing have been considerably curtailed in the aftermath of the recent financial crisis (Gomez & Edgcomb, 2011). Another solution that is not as personally risky to the owners of the firm is to rely on an alternative source of equity capital, such as venture capital funds or angel investors.

Also worthy of note is an alternative form of debt financing which has emerged in the recent past as a viable option for entrepreneurs, online peer to peer lending platforms. These platforms are somewhat analogous to the crowdfunding intermediaries envisioned in the JOBS Act which will be discussed later in this paper. These lending platforms operate by facilitating loans between borrowers and individual investors. For instance, a borrower may sign up with the lending platform, pass through the screening process, and list their loan request on the platforms website, including details such as the purpose of the loan and the terms they are willing to accept. Then, individual lenders browse the site and can choose to fund loans or portions of loans depending on their desire to diversify risk and their risk/return appetite (FDIC, 2009). Although these platforms are an attractive alternative source of funding, there are still some problems in utilizing these sources of funding for microentrepreneurs. First, the peer to peer lending platforms still have a minimum credit score for borrowers that they will accept (Gomez & Edgcomb, 2011). However, many times potential microentrepreneurs have either poor credit or no credit history at all. Second, these loans are still debt so there is still the difficulty of making regular interest payments which can be especially difficult for startup businesses.

Equity Financing

Equity financing involves a capital investment in a company in return for a percentage of the ownership of the firm. The most notable example of equity financing is the major public stock exchanges and the NASDAQ, where equity securities are sold to the general public. The companies selling shares via these platforms tend to be large established corporations. However, private equity, where the exchange does not take place in the public market, is a substantial

source of equity financing for startups and small businesses. Two sources of private equity financing, venture capital and angel investors, are of potential importance to our discussion.

Venture capital refers to limited partnerships in which the managing partners invest on behalf of the limited partners. The limited partners are typically pension funds, endowments, foundations, and high net worth individuals; the managing partners are often former successful entrepreneurs, businessmen and businesswomen, and other skilled professionals. Together, the partners form a venture fund that will invest in companies developing significant innovations at the early stages of such companies' development, or a more traditional business that has the potential for tremendous growth. These startups are inherently risky and many of them end up failing, but, to offset this possibility, a requirement of the venture capitalist is that the startups have a tremendous potential for growth. In return for the considerable risk of providing the investment the venture capitalists receive an equity stake in the company, from which they hope to earn a substantial profit at an exit event such as an IPO or a sale of the company to a larger corporation (National Venture Capital Association, 2011; Denis, 2004).

A common sense notion is that venture capitalists will receive very high returns on their investment if the companies they invest in succeed, and to that end venture capitalists are frequently very active investors. Research has shown that companies that obtain venture capital are more likely to professionalize along the dimensions of the recruitment process, the overall human resource policies, the hiring of professional sales and marketing staff, and the adoption of stock option plans; more likely to replace the founder with an outside CEO and are faster in effectuating such changes; and in cases where the founder is not replaced with an outside CEO

the venture capitalists focus on fostering professionalization further down in the organization (Hellmann & Puri, 2002). Furthermore, respected venture capitalists can help entrepreneurs to raise additional funds by certifying the quality of a startup. Since these activities are costly to provide, the implication is that venture capitalists add value to the companies they invest in, although there are costs associated with their involvement (Denis, 2004).

Angel investors (angels) on the other hand, are high net-worth individuals who also provide equity capital to startup businesses. Angels are often times former entrepreneurs, industry executives, doctors, lawyers, or other wealthy businessmen. Many times angels will qualify as accredited investors as defined in the Securities Act of 1933, which greatly simplifies the equity transaction since this status allows the transaction to be exempted from the registration requirements of the statute. Although there are some similarities between venture capitalists and angel investors, there are several key differences. One major difference is that angels are investing their own money, as opposed to the managing partners of a venture capital firm who are investing the funds of the limited partners. Also, angels tend to invest in businesses that are too small to attract venture capital funds, frequently businesses that have yet to make any sales. In this way angels are complementary to venture capital investors, as they invest in riskier firms and in firms that venture capitalists are not interested in as they may not be high growth-potential firms, e.g. mainstream businesses such as restaurants, construction companies, daycare centers, etc. While angels may provide assistance to the firms they invest in, many are passive. The likelihood that angels will provide assistance to the businesses they invest in increases with geographic proximity, and many angels only invest in businesses in their local area. Finally,

although typical angel investments are smaller than those made by venture capitalists, by most estimates angels in aggregate fund a substantially higher number of firms and provide a much greater total dollar amount of funding (DeGennaro, 2009; Wong, Bhatia, & Freeman, 2009).

Summary of Financing Options

Although all of these sources of financing are utilized by entrepreneurs, small, startup firms face many obstacles in securing needed funds. As has been discussed earlier, it is often very difficult for these types of firms to secure debt financing, and if debt financing is obtained it can be a considerable burden to the small firm to meet its debt payment obligations. Alleviating this difficulty has been the goal of U.S. MFIs, but MFIs have had problems achieving sustainability. Many small firms do turn to the alternative equity sources of financing such as venture capital and angel investors, but these sources are not perfect either. Venture capitalists focus exclusively on high growth-potential firms, leaving out most mainstream businesses. Angel investors seem to be more willing to finance mainstream projects, but typically do not invest in businesses outside of their local area.

Crowdfunding

One potential solution which has been enabled by the advent of the internet age is the recent innovation of online crowdfunding. Up until the recent passage of the JOBS Act by the U.S. Congress, crowdfunding has been limited to donations or charitable contributions. This is because of the prohibition in the Securities Act of 1933 against the use of any means of communication in interstate commerce to sell securities if a registration statement has not been filed with the Securities and Exchange Commission (SEC) (U.S. Congress, 1933). This has

basically precluded small startups from utilizing crowdfunded equity financing because complying with the registration requirement is a complicated process. Any mistakes in the registration process could subject a small securities issuer to serious criminal liabilities. Therefore, experienced legal counsel has generally been considered the only way to safely comply with the registration requirements, and this is an expense that most small startups simply cannot afford. It appears the U.S. Congress was aware of this difficulty, and the JOBS Act has added an exemption for certain businesses who comply with its provisions.

The JOBS Act

The JOBS Act of 2012 made many major changes to U.S. Securities law. Of particular importance to a microequity model of microfinance is Title III of the act, the portion covering the amendments to the Securities Act of 1933 which legalize online equity crowdfunding. Section 302 of the JOBS Act sets forth many provisions for securities issuers to comply with in order to take advantage of the exemption. In fact, it seems complying with the provisions of the JOBS act will not be a simple process at all, although the intent of Congress was that its provisions are less onerous than the previous requirements that were in place before the Act's passage. Many of the requirements set forth by Congress in the JOBS Act are general in nature and the Act specifically instructs the SEC to promulgate rules stipulating the exact manner in which the Act's provisions are to be complied with. This is clearly a very complex process and Congress had given the SEC 270 days from the enactment of the legislation to draft such rules. The JOBS Act was enacted on April 5th, 2012; therefore the SEC had until December 31st, 2012 to promulgate the final rules and regulations for complying with the provisions of the JOBS Act.

However, this deadline was not met. As of the date of this writing, certain aspects of this law, which will be discussed in this section, are yet to be official.

Although I have made every effort to thoroughly analyze the wording of the actual document produced by the U.S. Government Printing Office, I am limited by the fact that I am not a legal professional and my interpretations of the statute may be different from what the SEC ultimately determines. Nonetheless, I believe that I can make a satisfactory analysis of the Act as it relates to a microequity model for microfinance.

There are actually numerous requirements under Title III of the JOBS Act; to discuss all of them would be impractical. I will discuss the aspects that I believe are most relevant to a microequity financing model. First is the requirement that all transactions are to take place through an intermediary, which may be a broker or an online funding portal (U.S. Congress, 2012). In the case where the intermediary is an online funding portal, such an intermediary may register with the SEC as simply a funding portal which should entail less complexity than registering as broker. However, the funding portal may not handle the funds directly and must hire a bank or a broker to do so, unless the funding portal registers with the SEC as a broker. This requirement could have an impact on a microequity model in that such a funding portal or broker will likely require a percentage of the funds raised as a fee, considering the necessity of hiring a bank or broker or the costs of registering with the SEC as a broker. It will be necessary to ensure that such a fee is not so large that it prevents a useful amount of funds from being delivered to the entrepreneur. Luckily, these transactions will take place in the online forum;

therefore it is likely that there will be many funding portals competing to offer such services.

This competition will most likely keep fees at a reasonable level.

Second, the Act requires that the business issuing securities does not sell more than \$1 million of such securities during a calendar year (U.S. Congress, 2012). This requirement should not be an issue for a microequity model as it is intended to focus on small, startup businesses that should require much less than \$1 million of funding in practice.

Third, it is required that the intermediaries ensure that the offering proceeds are only provided to the issuer if a target offering amount, predetermined by the issuer, is reached by a deadline which is also predetermined by the issuer (U.S. Congress, 2012). This requirement has the potential to create some complications for a microequity model, but as long as the entrepreneur is realistic about their needs and sets a target offering amount that is attainable, then it should be possible to meet the target in many, if not most, instances. Contained in the same subsection as the requirement on target offering amounts is a provision requiring an intermediary to allow all investors to cancel their commitment to invest, apparently while the process of building to the target offering amount is ongoing. This requirement could prove to be a problem for a microequity model or indeed any business attempting to take advantage of the JOBS Act. However, the SEC has yet to determine the exact method of enforcing this provision and it is possible that they will draft the rules in such a way that these cancellations do not count against the target offering amount, or allow the deadline for reaching the target amount to be extended.

Fourth, issuers are required to provide both the SEC and the funding portal or broker with the following information: The name, legal status, address and website of the issuer; the names

of the management and each person holding more than twenty percent of the shares of the issuer; and a description of the business plan of the issuer (U.S. Congress, 2012). The first two of these requirements should not present any problem for a microequity model, however the business plan requirement may prove difficult for a microentrepreneur or other aspiring startup business owner who may lack any formal business training and might have considerable difficulty creating a business plan. This difficulty may be circumvented by reaching out to a local business development service, or perhaps intermediaries may offer assistance to issuers with regards to this requirement.

Fifth, as part of the same subsection requiring a business plan, there is a requirement for financial statements to be provided, with offerings of increasing target offering amounts requiring increasingly complex financial statements (U.S. Congress, 2012). For the purposes of a microequity model I will only consider the requirements for an offering of \$100,000 or less, which include any income tax returns filed by the issuer for the most recently completed year and financial statements of the issuer, which must be certified by the principal executive officer of the issuer. The income tax return requirement should not prove overly difficult to comply with, and the JOBS Act specifically notes that there may be no such income tax return to provide. The financial statement requirement may prove difficult on the other hand, in much the same way as the business plan requirement, due to the fact that a small business owner may be unsure of how to produce financial statements. It seems that technical assistance will be necessary in many cases in order for the issuer to comply with this requirement as well.

Sixth, again part of the same subsection which requires a business plan and financial statements, the issuer is required to provide a description of the ownership and capital structure of the issuer which includes among other things: terms of the securities; each class of securities; method of valuing the securities now and in the future; risks to an investor from minority ownership, corporate actions, sales of the issuer or assets thereof, and transactions with related parties; and finally any other information that the SEC determines appropriate (U.S. Congress, 2012). Again it is clear that this rather complex requirement will be beyond the ability of most small business startups to easily comply with, and will probably present considerable difficulty to the application of a microequity model. Once again, it seems that technical assistance will have to be provided.

Finally, Section 4A(c) provides the right for securities purchasers to sue the issuer for material misstatements or omissions in the offering or sale of the securities (U.S. Congress, 2012). This section clearly has serious ramifications for a microequity model. For one, many of the aforementioned requirements were clearly quite complex. A typical small business owner would probably have considerable difficulty complying with these requirements and could make a material mistake or omission unintentionally and then be subject to severe civil penalties. This might cause potential entrepreneurs to balk at the risk of being sued and facing a judgment that could ruin the finances of their fledgling business.

In sum, the JOBS Act has created a new opportunity for small and startup businesses to raise equity funding via crowdfunding online. However, utilizing the Act's exemptions to the U.S. Securities laws requires strict adherence to numerous complex requirements. The only

reasonable conclusion is that an attorney who specializes in securities law will have to be retained, and it is probable that the assistance of other qualified professionals such as accountants will also be necessary to comply with the Act's provisions. This will add considerable expense that a small business startup may not be able to afford. For a microequity model to utilize the JOBS Act's exemptions, it will be necessary to make sure that the assistance of qualified professionals is available to the entrepreneur at an affordable rate, in order to guide them through the compliance process.

Findings from Literature

MFIs in the U.S. have not fared as well as their international counterparts. Some of the major causes of this discrepancy are the fact that MFIs face much more stringent government regulations in the U.S. as compared to MFIs in the developing world, the lack of a tight-knit social structure among low income entrepreneurs in the U.S., and the difficulties faced by small businesses in the U.S. in competing in a complex market. MFIs in the U.S. have tried to overcome these difficulties by providing business development services and utilizing sources of funding other than interest earned from loans, such as government grants, but the question remains whether or not these practices are sustainable. If not, many would be entrepreneurs will have few options on financing their small business (microenterprise).

Small businesses are virtually shut out of the equity market. Microenterprises typically will not be candidates for venture capital financing as very few of them have the potential for explosive growth that is a prerequisite for these firms to provide an investment. They also in most cases cannot utilize a public equity offering due to the burden of complying with SEC

regulations and would be unlikely to be able to attract a qualified investor in order to make use of a private equity transaction. Angel investing is a possibility, but many small business owners do not know such an individual.

Similarly, microenterprises have difficulty obtaining debt financing. Most lack any collateral with which to secure a loan. Even if there was sufficient collateral on hand, most microenterprises will have periods of very small or even negative cash flows during the early stages of their life, or, in some industries, seasonally. Therefore there is a very high risk of bankruptcy for those that do make use of debt financing.

Microenterprises are clearly starting out with the odds stacked against them. Funding options are limited and they face a highly competitive marketplace. Not only do these businesses need cash, but they also need help and advice in order to succeed. Given the high rate of institutions that offer business development services, MFIs seem to be the best bet for would be microentrepreneurs, yet the U.S. industry has been unable to reach the scale and sustainability of its international counterparts. Debt financing is usually difficult to obtain, and there are no business development services provided by banks and other institutions offering debt financing. Obtaining public equity financing is virtually impossible for microenterprises, and private equity is also hard to obtain unless the microentrepreneur knows an angel investor.

Based on these findings, we have come to the conclusion that there is a real need for a new method of providing small amounts of capital to entrepreneurs, microequity, where investors can work with the entrepreneurs to help build these startups into successful small businesses. We propose models structuring the microequity funding arrangement in a manner

similar to traditional private equity vehicles, venture capital firms and angel investors. The crowdfunding provisions of the recently passed JOBS Act can be utilized in these models to more easily raise funds for these small businesses than previously would have been possible. We will also propose a model using franchising and microequity and/or microloans in order to expand a small business into a larger network of franchises.

Microequity Models

In this section, I propose three models of pursuing a microequity based microfinance arrangement that may provide solutions to the questions of can a microequity financing model offer a solution to the difficulties that have prevented MFIs in the United States from achieving sustainability and how a microequity model would work in practice.

Straight Microequity

In this model, small businesses are funded by investors who take an ownership share in the businesses. The arrangement would work in much the same way as the traditional stock markets, with investors purchasing shares in the microenterprises in return for a certain equity stake. Two possibilities to utilize this model in practice are first; microenterprises could independently offer shares in their businesses for sale via an online funding portal as envisioned in the JOBS Act's crowdfunding provisions; and second, MFI's could structure their microenterprise programs as equity rather than debt. I will discuss each of these possibilities in turn.

If microenterprises offer shares directly to public investors via online funding portals, this will undoubtedly increase the funding options for those entrepreneurs starting small businesses,

however, this arrangement has several potential drawbacks. First, although it is beneficial for the microenterprises to receive the funds from investors, the impersonal and informal nature of the online crowdfunding method means that investors and those small businesses receiving the funds will have little face to face contact. Therefore, the microentrepreneurs will still have to face the considerable challenges of complying with the registration requirements of the JOBS Act on their own. Also, the microentrepreneur who is likely to be an inexperienced business person will have to face the considerable challenges of building, managing, and sustaining a viable and profitable business. It is also questionable whether microentrepreneurs taking this route will actually be able to convince public investors to invest in their businesses and therefore actually be able to raise sufficient funds using this method.

The second possibility of MFIs structuring their programs using equity rather than debt would seem to offer a more promising avenue for implementing a straight microequity arrangement. In this case, a MFI will receive an equity stake in the microenterprise in return for its investment which includes funding as well as business management assistance. In effect the MFI and microentrepreneur will become partners who will share the risks and rewards of the venture. The MFI will have a vested interest in helping the microenterprise succeed and thereby ensuring a reasonable return on their investment. Therefore there will be a strong incentive for the MFI to work closely with the microentrepreneur to provide business development assistance leading to an increased chance of success for the microenterprise. In such an arrangement the equity contract could be structured so that the microentrepreneur pays a specific dividend to the MFI on a regular basis, and then at the end of a specific term, there is an agreement for the

microentrepreneur to buy back the shares from the MFI. In this way the MFI is earning a return via the dividend payments. When the shares are repurchased the MFI is able to reinvest in a new microenterprise and start the process over. This type of arrangement has many advantages over MFI's traditional method of financing microenterprises, microcredit. In microcredit, the microentrepreneur must make regular interest payments, which can present difficulties since it is likely that the fledgling microenterprises will have periods of low or even negative cash flows. In contrast, using microequity dividends are paid only when the microenterprises are profitable. Also, in microcredit, providers cannot share in any potential upside profits, therefore they are only concerned with repayment and will attempt to eliminate any possible loss or risk. This means that venture that may be potentially very profitable yet risky will probably be passed over by microcredit providers.

Micro Venture Capital

This model for microequity would work in a manner that is very similar to traditional venture capital and angel investing. In the case of a micro venture capital (microVC) model, a fund will be created for investment in microenterprises. Sources for the fund will be well to do individuals who are looking for an investment which provides an acceptable financial return as well as providing a social return component. Many investors would like to invest in their local communities and small businesses rather than in the traditional financial markets, and a microVC fund would make this possible. These investors would be fulfilling the role that is played by the limited partners in traditional venture capital investing. In the case microVCs, it is possible that these same investors could be the active managers of the fund, or alternatively, other experienced

business professionals could take the position of the managing partners who will work closely with the microenterprises to provide business support services. In either case, the microenterprises are worked with closely by the managers of the fund to be provided with coaching and business development assistance. The investments can be structured similarly to those described in the straight microequity model above, where there will be regular dividend payments made when the microenterprises are profitable with an arrangement for the microentrepreneur to buy the shares back after a certain term. In this way the fund earns an acceptable return and when these funds are operating in the local community there is the added social benefit for the investors in knowing that they are investing in the success and prosperity of their local community. A microVC fund could also take advantage of the crowdfunding provisions of the JOBS Act. The fund could be created by soliciting fund investors via an online funding portal, although there are some questions as to whether this is compatible with the provisions of the Act, namely the financial statement and business plan requirements. However, as the fund would be structured as a limited partnership and managed by experienced business professionals, these obstacles should be easy to overcome, although this is dependent on the final rules which are as yet to have been promulgated by the SEC.

MicroFranchises

Another option of pursuing a microequity model for microfinance is structuring the investments as microfranchises. To better illustrate how this model would work in practice, it is useful to introduce a small case study of an actual franchisor, Supergalss Windshield Repair. Superglass is an international franchisor. As a former employee of the company, I had many

personal conversations with the company's president, David Casey. Superglass Windshield Repair is a franchisor based in Orlando, FL, with over 300 franchisees operating nationwide, as well as franchises in Canada and South Korea. David A. Casey, president of Superglass, spoke with me on numerous occasions regarding the financing Superglass uses to assist their franchisees in starting their businesses. A Superglass franchise normally costs \$10,000 as a franchise fee, and there is a perpetual royalty arrangement of 3-5%. Many franchisees are not able to pay \$10,000 up front to purchase the business, therefore for a small down payment of typically \$1000-\$2000, Superglass will finance the balance on a credit basis directly to the franchisee. An obvious problem is how to ensure the franchisee will repay the balance of the franchise fee. As Mr. Casey communicated to me, this is not a problem because the business format provided by Superglass includes the right to use Superglass' proprietary windshield repair resin and repair technology. The resin and equipment used by Superglass is superior to what the franchisees would be able to procure elsewhere, therefore the franchisees have a strong incentive to repay, because if they fail to do so they can be cut off from receiving supplies critical to the functioning of their business.

It could be possible to generalize a model for microequity, which utilizes the JOBS Act, based on the practices of Superglass. A "franchisor", in this case actually a type of MFI, would serve as the incorporated business that sells shares via an online funding portal. The MFI is staffed by experienced professionals who are able to ensure compliance with the JOBS Act's provisions. Once a target offering amount is raised, this is distributed in small portions at the discretion of the MFI. The MFI distributes portions of the funds raised to several

microentrepreneurs who are pursuing a small, mainstream business in a few selected industries. The reason for limiting the small businesses to a few industries is so that the MFI in this model can develop business expertise in these fields so that adequate training, coaching, and other business development services can be provided to the microentrepreneurs.

The contract with the microentrepreneurs could utilize a dividend/share buyback arrangement similar to the one discussed in the previous models, thereby ensuring the MFI receives an acceptable return and can then reinvest the funds in new microenterprises.

Alternatively, the MFI could structure the arrangement as a lease to own arrangement, where the MFI retains total ownership of the business and the microentrepreneur makes regular payments towards eventually obtaining outright ownership of the business. The incentive to repay in this arrangement is the eventual ownership of the business by the microentrepreneur. In some cases it is likely that a substantial amount of equipment, i.e. a vehicle, will be part of a package which is provided to the microentrepreneur, this is a further incentive for repayment as this equipment can be repossessed in the event of a default. However, it will be necessary to structure flexibility into the lease to own agreement to assist the microentrepreneur in the likely event of periods of low or even negative cash flows.

CONCLUSION

Based on the models which have been proposed above, this thesis addressed the questions of whether microequity financing models alleviate the limitations of MFIs as well as proposed various micro equity financing models. In regards to the question of whether a microequity model for microfinance can offer a solution to the difficulties faced by MFIs that operate in the U.S., the two main difficulties that are present are the fact that MFIs in the U.S. cannot charge interest rates high enough to cover their costs due to government regulations which put a ceiling on the rates which can be charged, and that due to this factor, MFIs must depend on government and/or charitable funds to cover these costs. However, as mentioned previously, receiving government or charitable funds is never guaranteed, especially in times of economic uncertainty.

A microequity based model of microfinance would alleviate this problem of an inability to cover costs due to interest rate law. The microequity models, which have been proposed, are based on a dividend and share buyback model, thereby circumventing interest rate laws since the financing arrangement is not a loan. The arrangement is also beneficial for the microentrepreneur as there is no pressure to make regular interest payments when the business is not profitable. Also in the microequity arrangement, there should not be a need to depend on government or charitable funds for two reasons. First, MFIs are in a more tightly coupled relationship with the microentrepreneurs and will work much more closely to help the business to be successful as they are investors in the business, therefore there should be a much lower rate of MFI clients'

businesses failing. Secondly, MFIs can share in any potential upside profits from those businesses that turn out to be enormously successful.

Regarding the question of how a microequity model for microfinance would work in practice, various models of microequity finance were presented. Three models of microequity finance were presented: straight microequity, microVCs and microangels, and microfranchises. Each of these models represents a viable microequity option can be put into practice. Obviously, these models would need to be implemented in a real world setting to truly test their viability. As to the question of whether or not the JOBS Act facilitates or inhibits these models, the tentative answer is that the Act does facilitate the implementation of these models. However, as the Securities and Exchange Commission has still as yet to promulgate the final rules and regulations for implementing the Act's provisions, the question is still open as to whether the specifics of these rules will actually be beneficial to such models as have been proposed here.

In summary, microequity shows a great promise for finally enabling a sustainable microfinance arrangement in the U.S. context. Based on the research and models proposed in this paper, notably the recent passage of the JOBS Act and the three models of equity based microfinance proposed here, a sustainable method to assist microentrepreneurs in the U.S. in developing thriving small businesses is on the horizon. Now it will be up to microfinance practitioners and hardworking and resourceful entrepreneurs to make the proposals elucidated in this paper into a reality.

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