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# Angel Investors – Critical Initiators of Startups and Job Creation

SEC Advisory Council on Small and Emerging Companies

September 17, 2013

David Verrill – ACA Chairman and Founder/Managing Director, Hub Angels

Marianne Hudson – ACA Executive Director and Member, Women's Capital Connection and Mid-America Angels

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# Angel Capital Association

- Mission: Fuel the success of angel groups and private investors who actively invest in early-stage companies
- Largest trade group for angels:
- 200+ member angel groups
- 10,000 accredited investors
- Individuals, accredited portals family offices
- 50 states/ 5 Canadian provinces
- Charitable partner:

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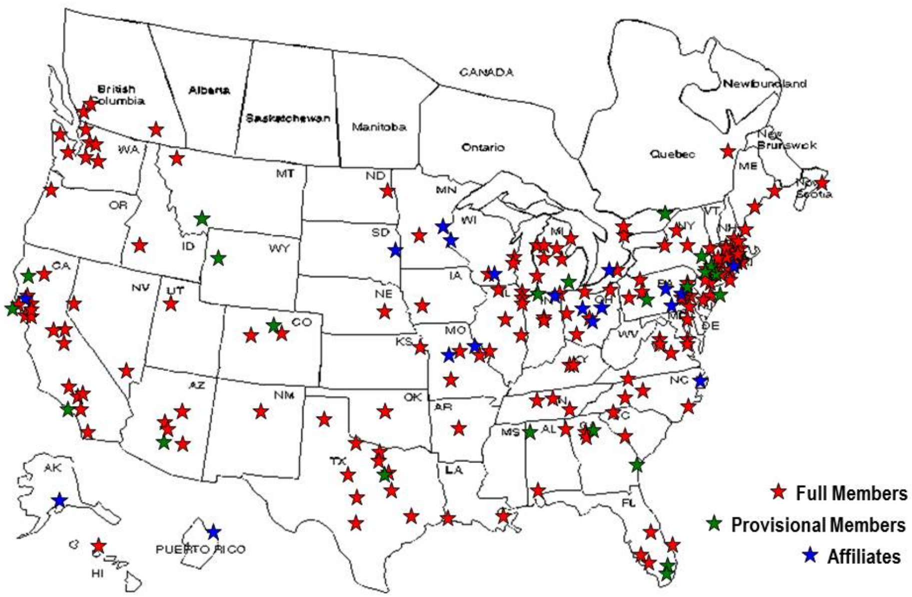
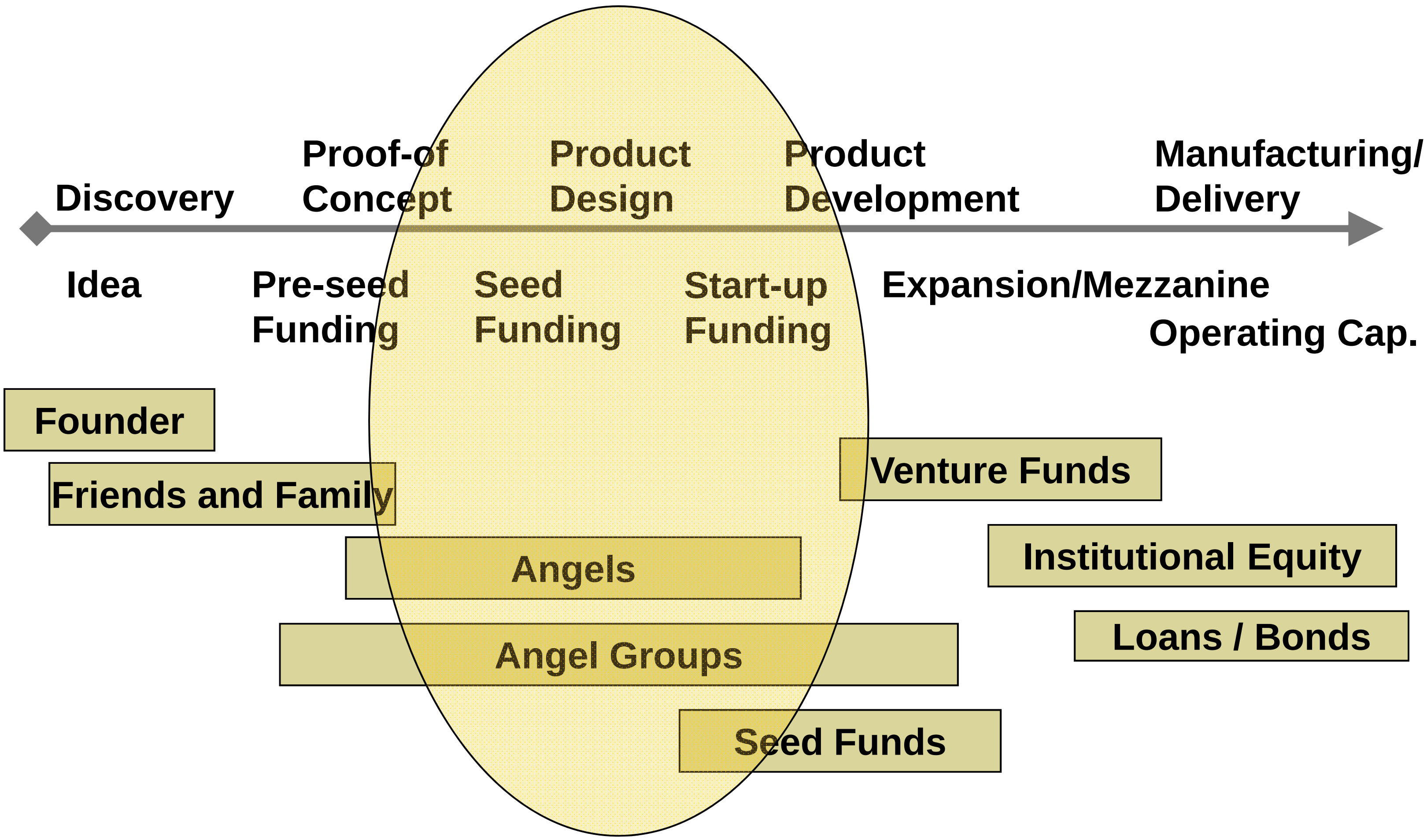


# Financing Life Cycle



# Angels Provide Less Equity by Total Dollars – BUT…

- Angel Investors ($23B)

- Venture Capital ($27B)

- Private Equity ($347B)

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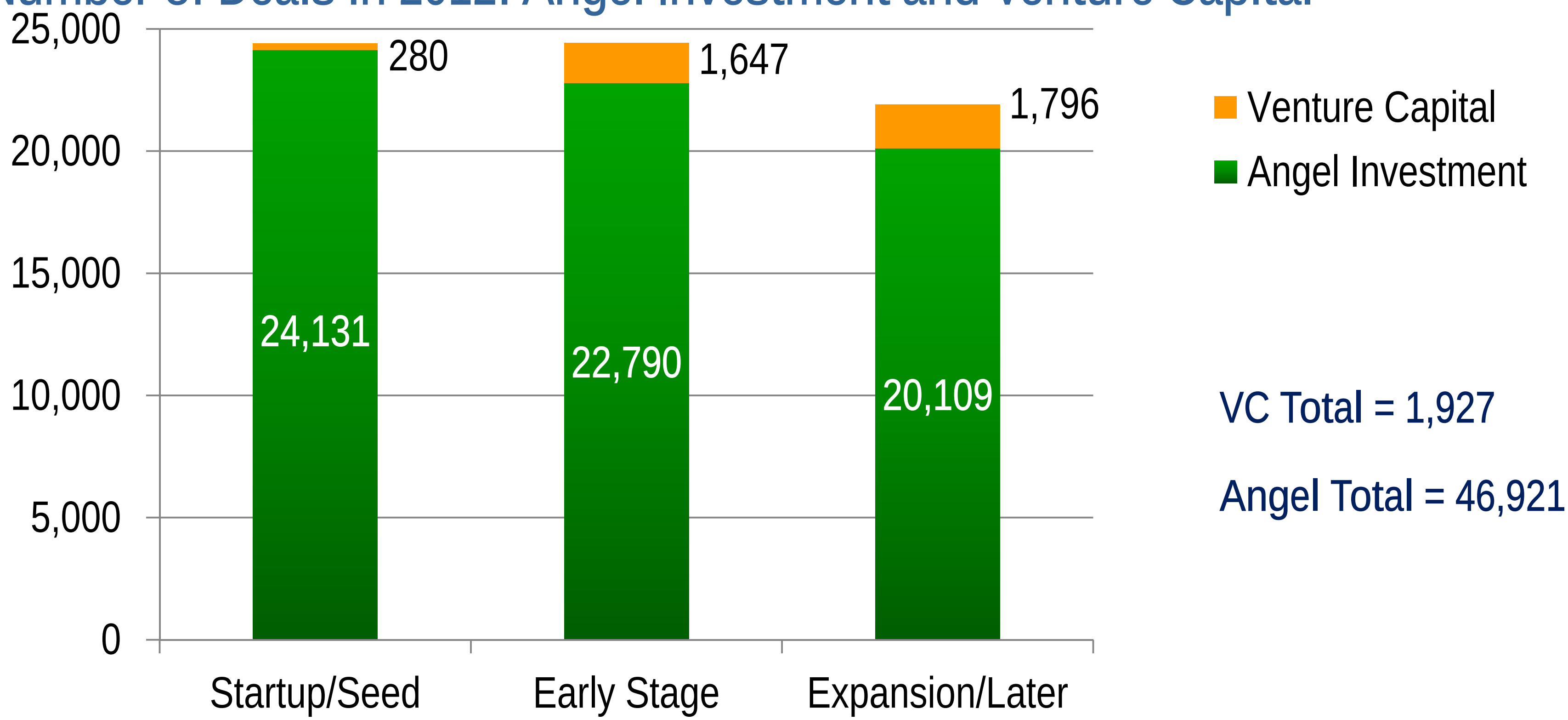
# Angels Fund Nearly All Seed/Early-Stage Deals…

## Number of Deals in 2012: Angel Investment and Venture Capital




Without angels few startups would make it to VC, PE or IPO funding

Source: Jeffrey E. Sohl, Center for Venture Research and 2013 NVCA Yearbook

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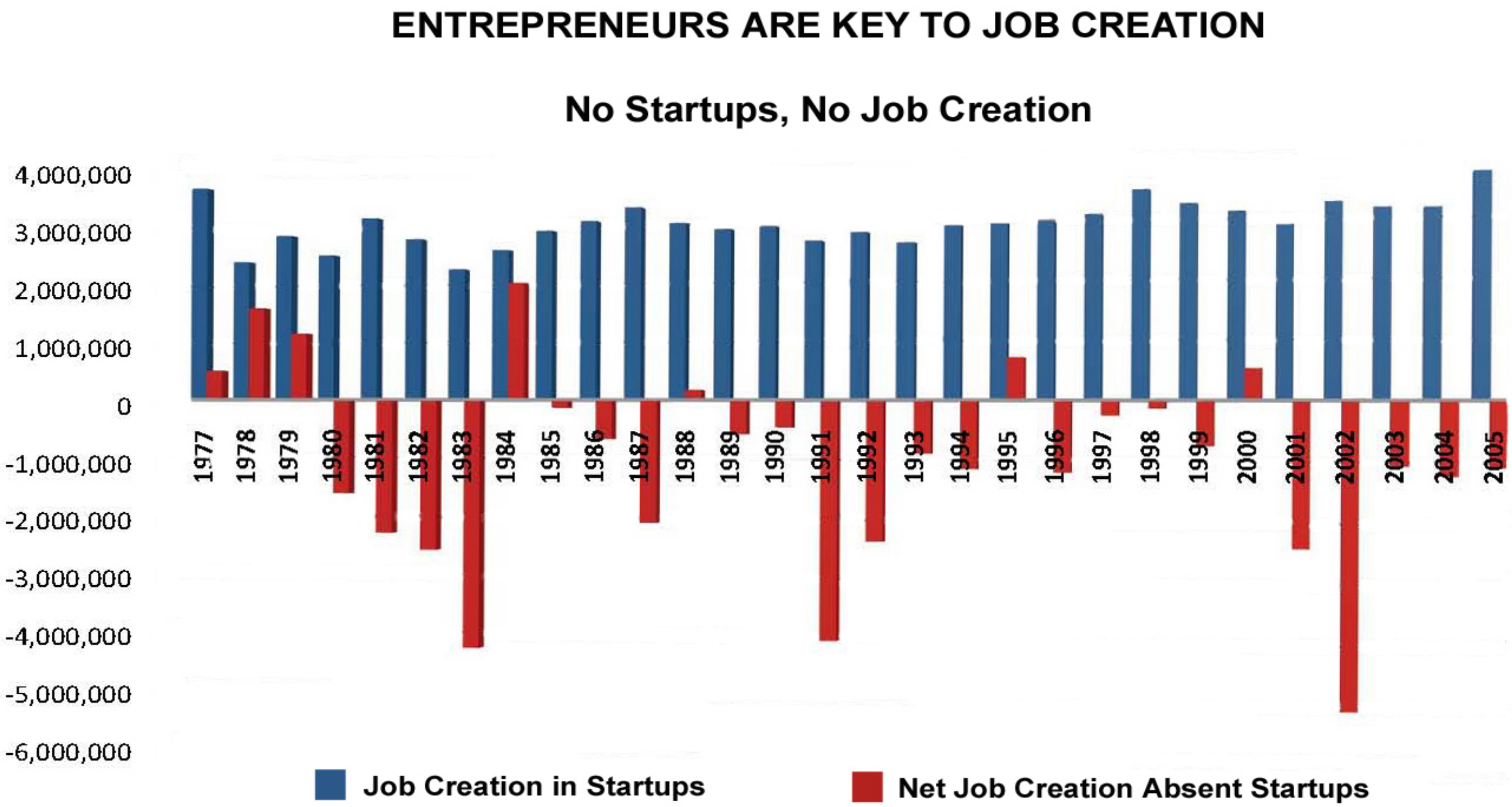
# …And Startups Create the Most Net Jobs




**Source: Business Dynamics Statistics Briefing: Jobs Created from Business Startups in the United States. Kauffman Foundation, January 2009.**

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JOBS ACT
JUMPSTART OUR BUSINESS STARTUPS

# Asked SEC to Develop Rules

- ACA is here to talk about:
  - Angel investment landscape –
    - stats, trends and how sophisticated angels work
    - impact on startups and the health of our economy
  - Final Rule 506(c) – reasonable steps to verify accredited investor status and what that means for startups and angels
  - Proposed Rule on Reg D, Form D and Rule 156 – impacts on the startup community
  - Accredited Investor definition

# Angel Investment Landscape

Stats, Trends and Impact

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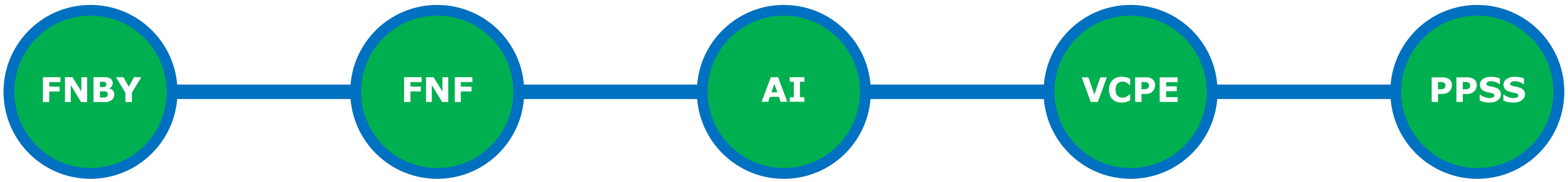
# Five Levels of Equity Capital




- Entrepreneurs (First National Bank of You)
- Friends and Family (*also crowdfunding in future*)
- Angel Investors (Accredited Investors)
- Venture Capital/Private Equity
- Private or Public Stock Offerings

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# Angels Fund Majority of Startups in USA

## Angels Provide ~90% of Outside Equity for Startups

| Angel Investors (2012) | Venture Capital (2012) |
| --- | --- |
| • $22.9 billion | • $26.7 billion |
| • 67,000 deals | • 3,700 deals |
| • 24,000 seed | • 280 seed |
| • 22,800 early stage | • 1,650 early stage |
| • 20,100 expansion | • 1,800 later/expansion |
| • > 268,000 individuals | • 522 active firms |

Sources: Center for Venture Research/ UNH; NVCA 2013 Yearbook; PwC MoneyTree

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# Companies Backed by American Angels

AMBIT® Broadband

THE HOME DEPOT®

YAHOO!®

BEST BUY

amazon.com

bitpipe

facebook

redhat.

COSTCO.COM

ALCOA

CISCO

Google™

green dot

Ask.com™

PayPal®

Regeneration™ TECHNOLOGIES, INC.

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## Who are Angel Investors?

- Often successful entrepreneurs or retired business persons
  - Active investors providing money, expertise, and their network
  - Contribute to their local ecosystem (mentoring, judging, educating)
- Accredited investors – SEC definition (*US & a few others*)
- Invest their own money (not money managers)
- Generally invest in local companies with high-growth potential
- Invest in businesses not run by family

In 2012, 268,000 investors funded ~$22.9B in about 67,000 deals (2/3rds early-stage)

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# What Motivates Angels?

- Help entrepreneurs
- Stay engaged – use skills and experiences to help build a business
- Give back to community or university
- Active form of investing – not just watch markets
- Find their next opportunity
- Network and learn
- Return on Investment is the metric

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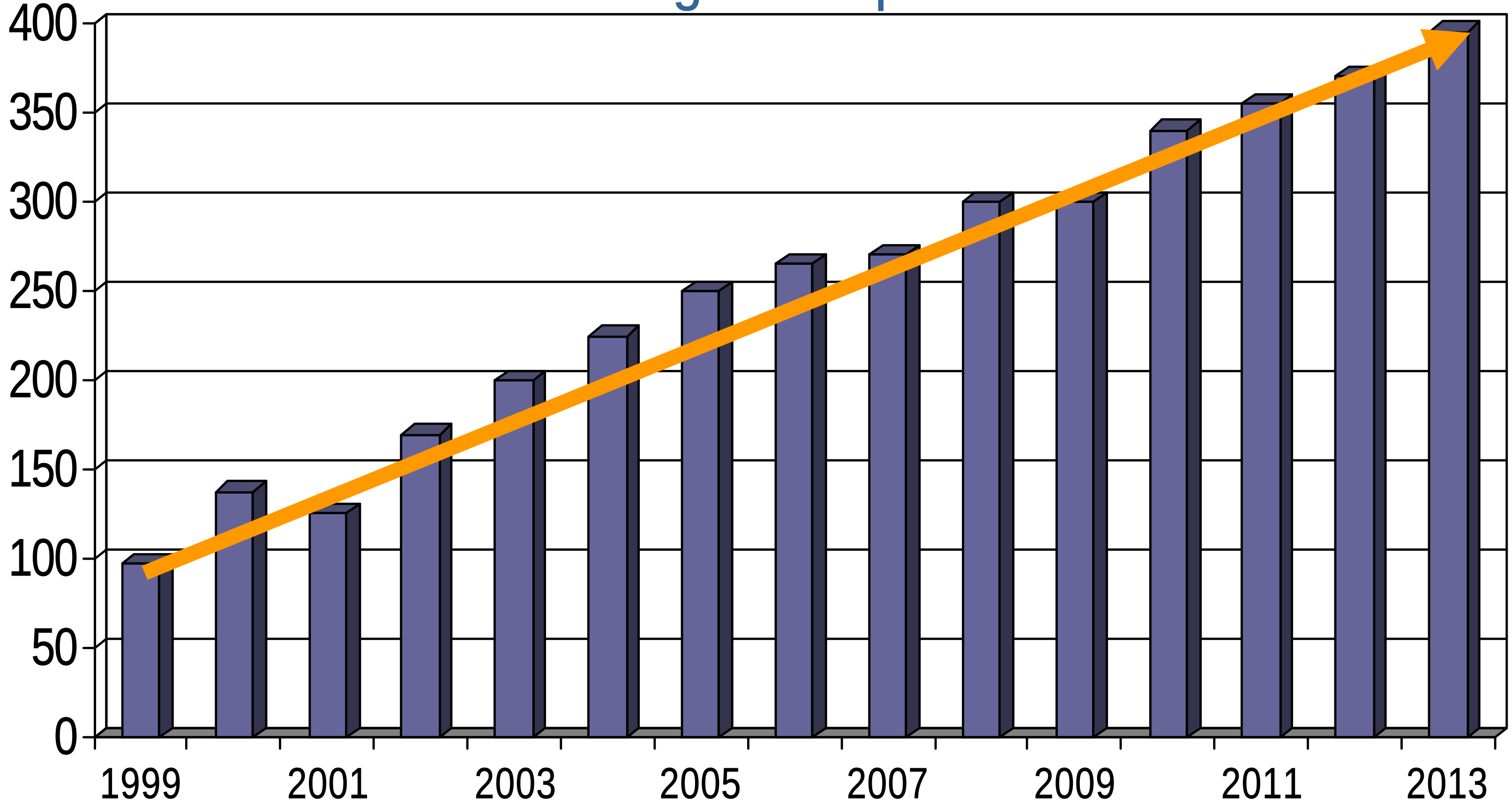
# Angel Groups are Key Trend in Sophisticated Investing

## Growth in Number of American Angel Groups




Sources: Center for Venture Research (pre 03 data) and Kauffman Foundation/ARI (04-13 data)

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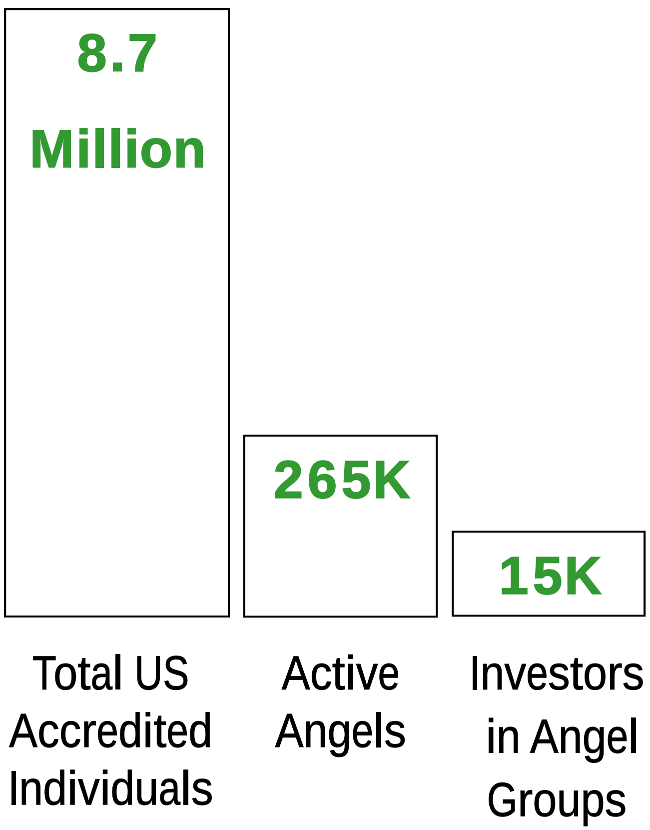
# Angel Groups Take Professional Approach




- Experienced, Accredited Investors
  - Successful Entrepreneurs/Business People
  - Median Years Investing – 9
  - Median Number of Investments – 10
- Invest Where We Live & In What We Know
  - Main Street – Not Wall Street
  - 300+ Groups – In Every State
  - Work as a Team
- Focused on Best Practices
  - Deal Screening
  - Due Diligence
  - Term Sheets
  - Valuation
- Support Companies We Invest In
  - Board Seats and Advisory Boards
  - Contacts, Advice, Recruiting, Strategy
  - Follow-on Funding and Exits

Sources: SEC proposed rule, Center for Venture Research, academic studies, 2012

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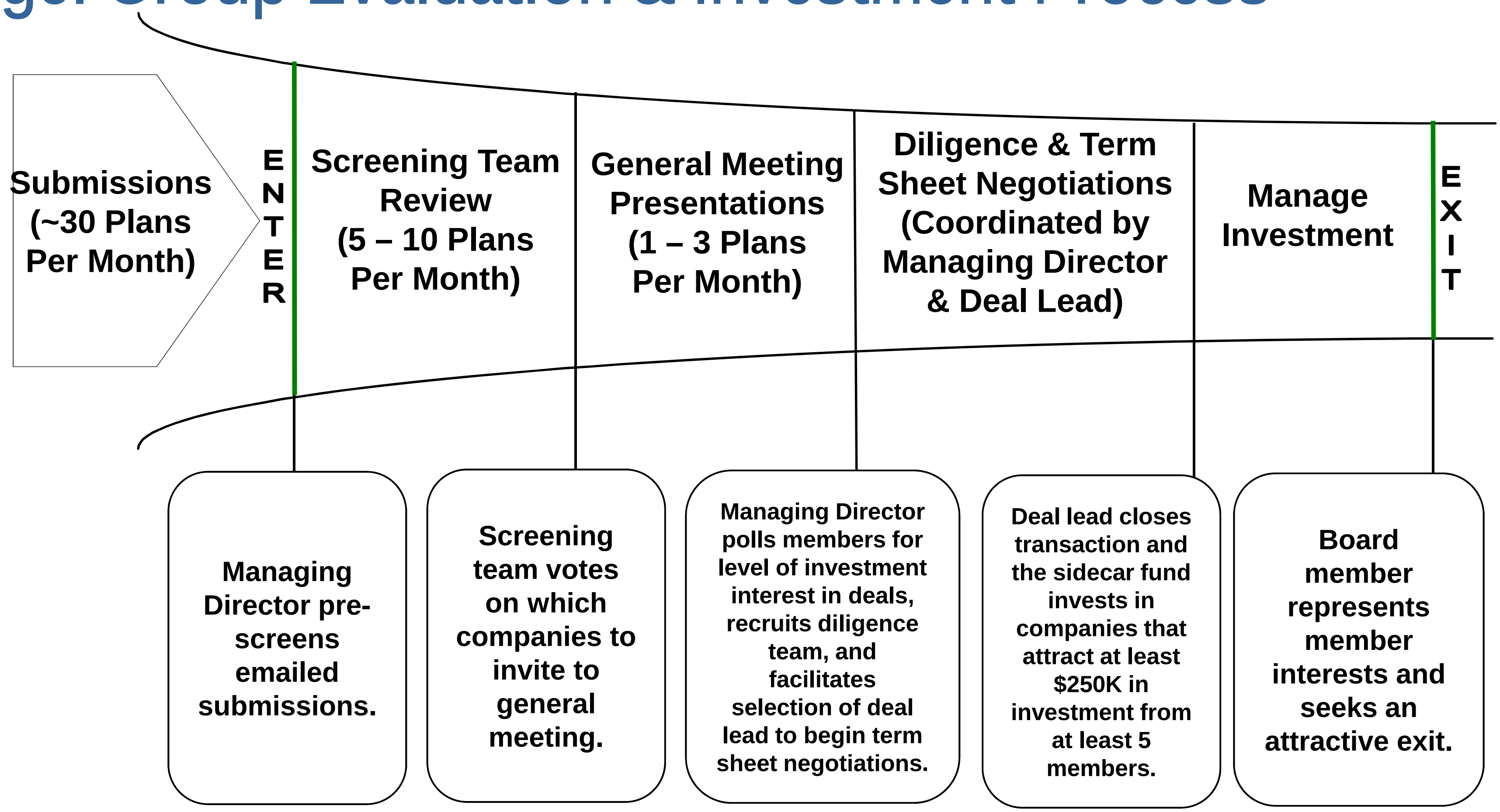
# Angel Group Evaluation & Investment Process




Source: James Geshwiler, CommonAngels, Boston

# The Angel-Entrepreneur Connection

- Many angels provide mentoring before and after investment
- Many serve as board members or observers
- Some join venture as C-level executive for an interim period
- Information rights in term sheet
- Often invest in multiple rounds to ensure entrepreneurs can grow
- Develop relationships with Venture Capital firms for expansion capital
- Help lead M&A process early on
- Angel monitoring/ mentorship improves startup health
  - Harvard/MIT study shows angel support improves startup success rate

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svb Silicon Valley Bank

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Present the

# HALO Report™

## Angel Group Update

## 2012 Year in Review

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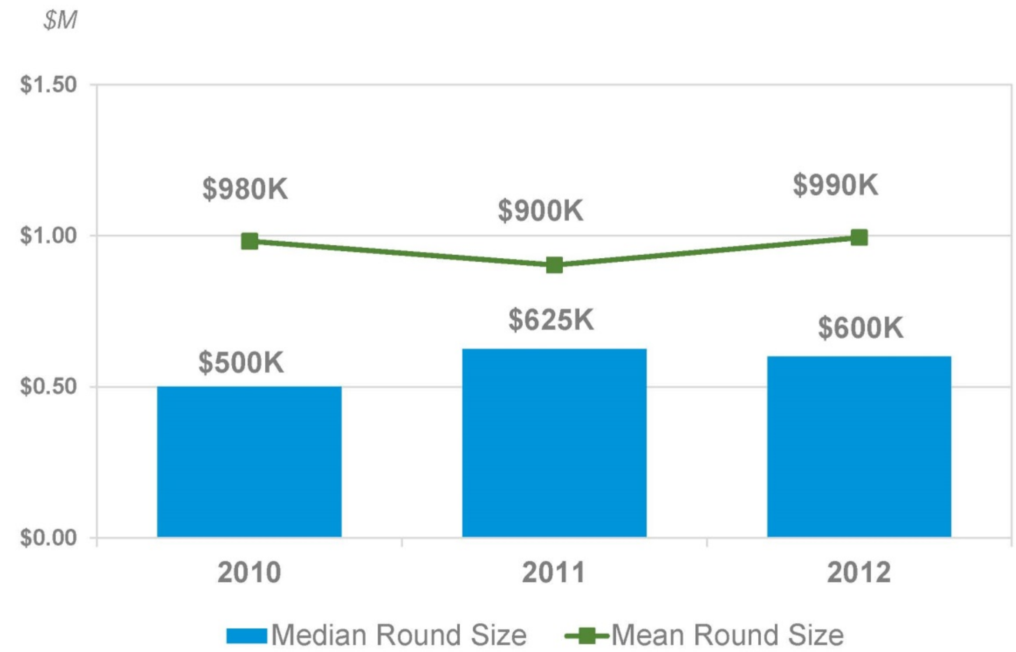
# Median Angel Round Size




*Angel rounds include angels & angel groups only

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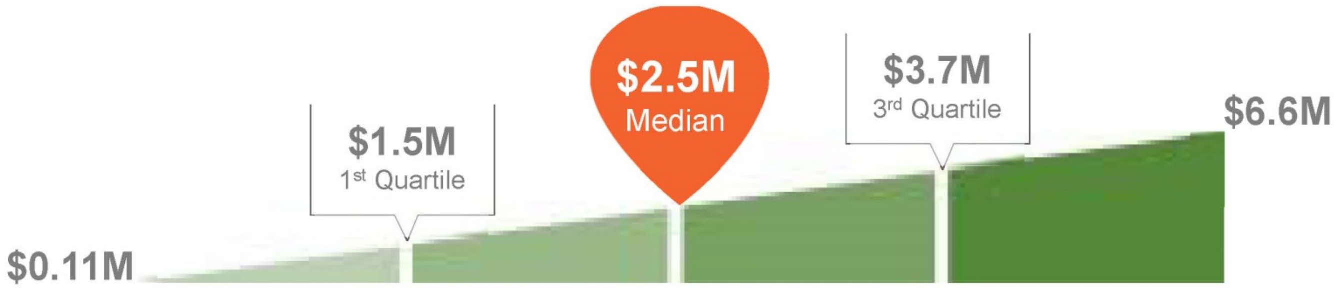
# Median Early Stage Pre-Money Valuation in 2012




*Including all rounds with angel groups before Series A

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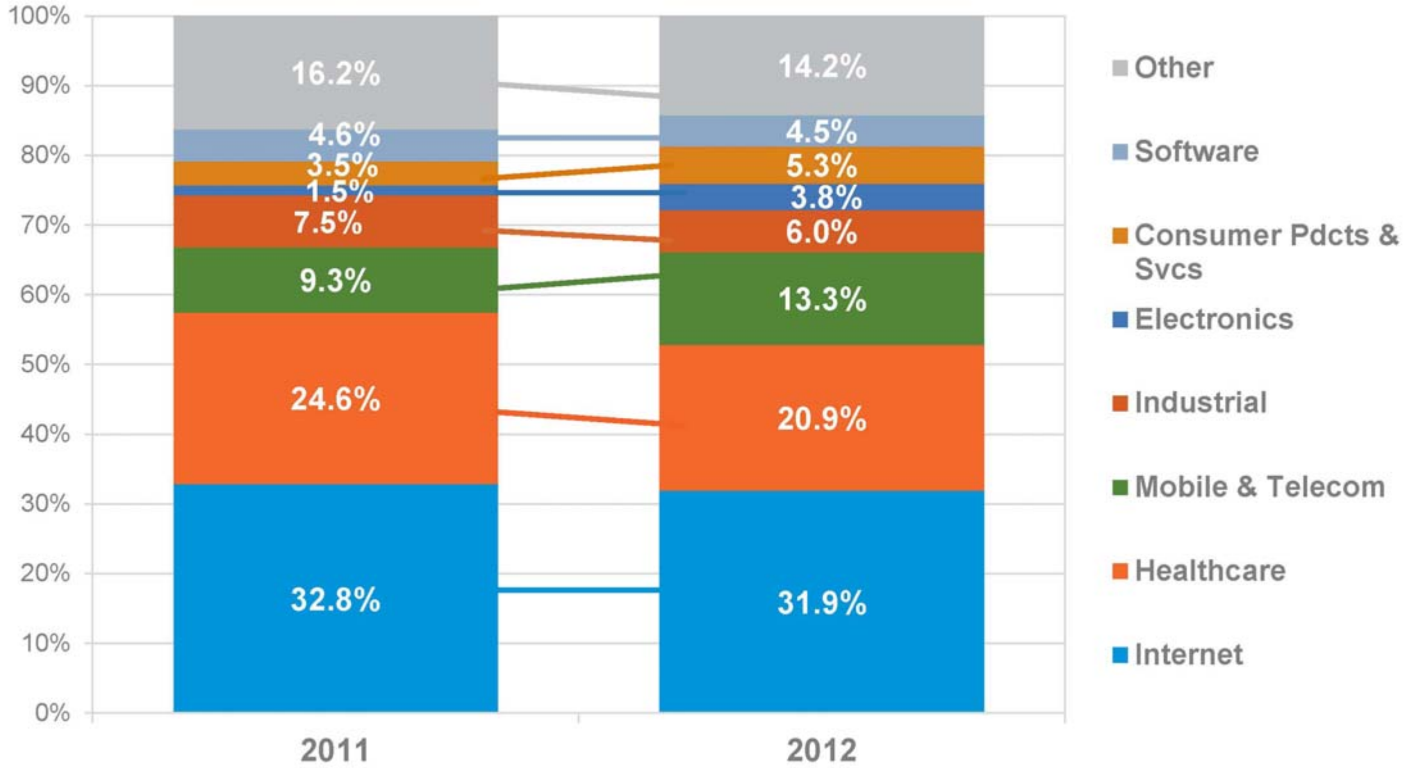
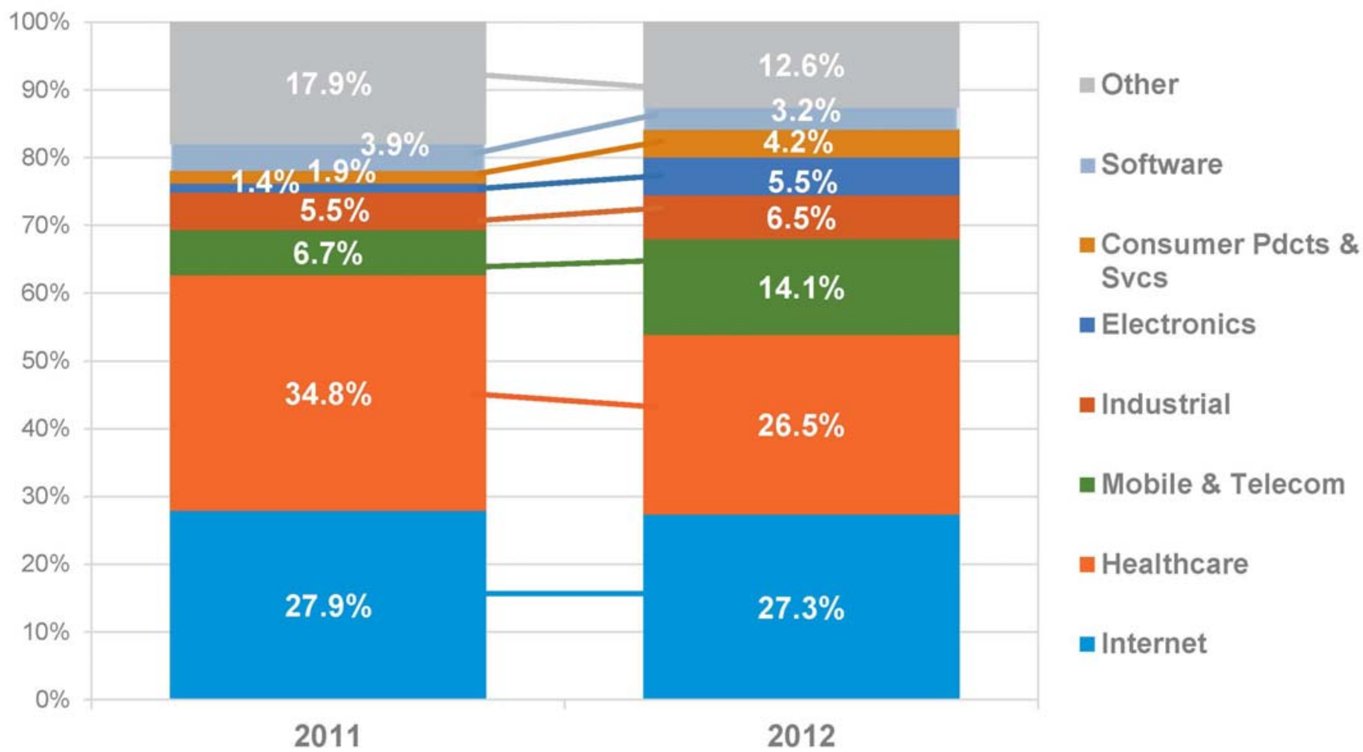
# Angel Group Deals by Sector




Silicon Valley Bank | Angel Resource Institute | Data Powered by CB Insights | HALO Report™

# Angel Group Dollars by Sector



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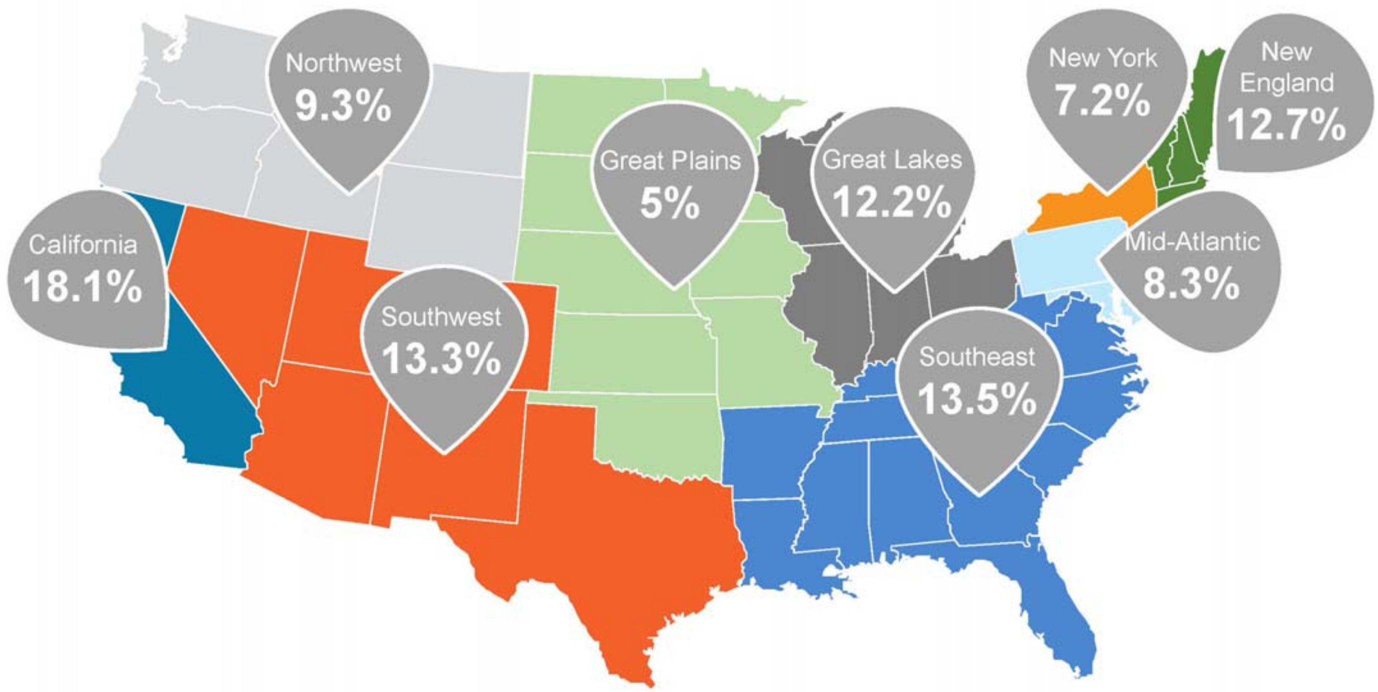
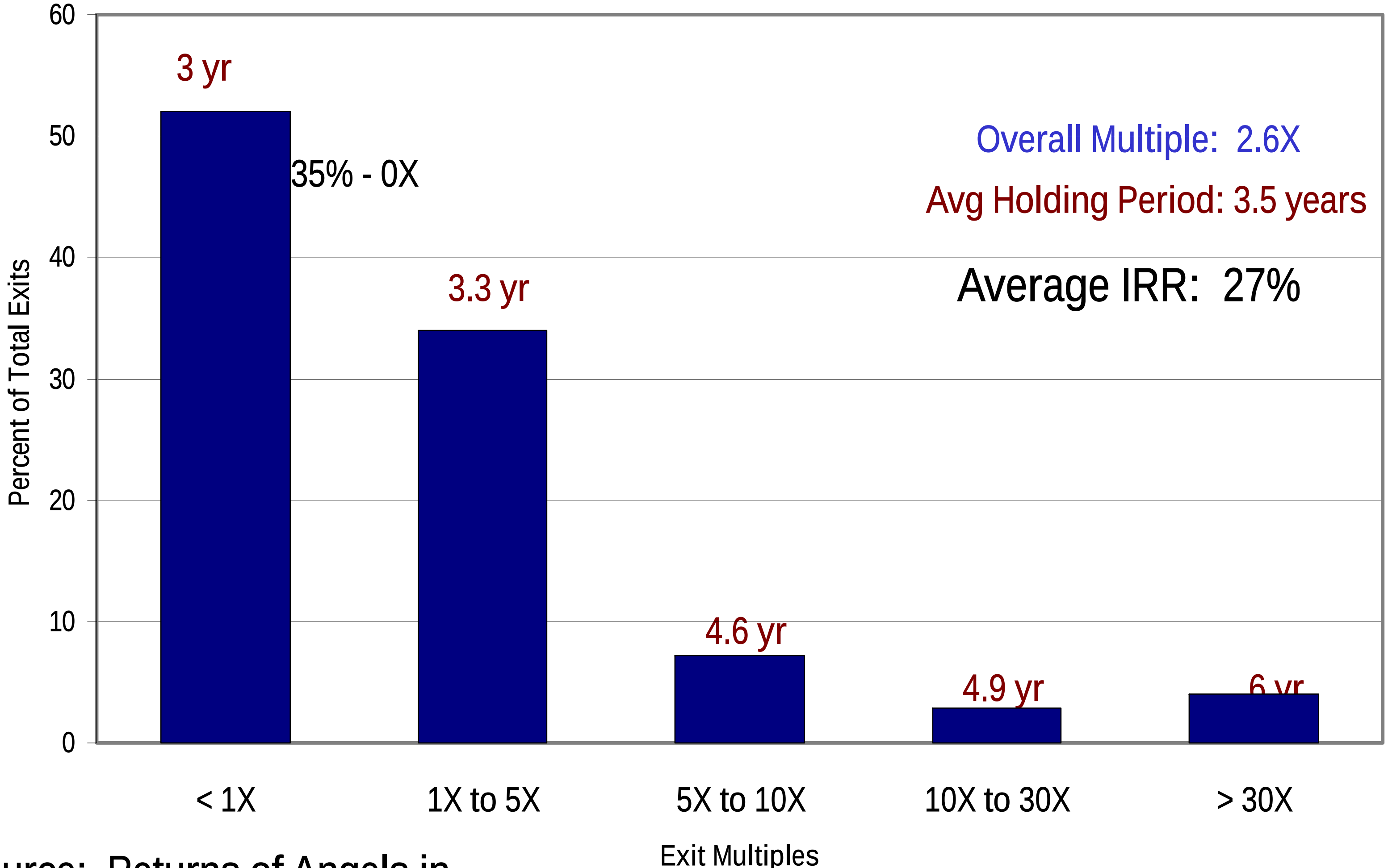
# Angel Investment Deals Distributed Nationally

## Share of Angel Group Deals by Region 2012



# Distribution of Returns by Venture Investment




Source: Returns of Angels in Groups, 2007

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# Final Rule 506(c)

Lifts Ban on General Solicitation

Requires Reasonable Steps to Verify Accredited Investor Status

What This Means for Startups and Angels

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# The Way It Was Pre-General Solicitation: "Quiet Deals"

- No general solicitation allowed
- Self-certification by questionnaire or written representation is allowed
  - No additional verification requirements
  - Issuer must have "reasonable belief" investor is accredited and not otherwise know investor is not accredited

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# The Problem: Many Standard Practices May Be "General Solicitation"

Common Startup Activities Include Pitch or Demo Events Led by:

- Federal government agencies
- State economic development agencies
- Universities
- Local and non-profit entities
- Law firms
- Private sector accelerators

Events are critical source of deal flow for angels and key to economic development efforts

# Generally Solicited Offerings

- All purchasers must be accredited investors
  - Old rule allowing up to 35 non-accredited investors does not apply
  - How do 506(c) offerings handle friends and family investment?
- Issuers must take "reasonable steps to verify" that all purchasers are accredited.
  - "Check the box" self-certification no longer works:
    - SEC: *"We do not believe that an issuer will have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status."*
- Issuers must note on Form D whether they are relying on 506(b) or 506(c)

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# Early Public Attention was on Optional Safe Harbors

| Optional Safe Harbors | Steps Required for Issue to Verify Accredited Investor (Establish a "Reasonable Belief") |
|---|---|
| (A) Income Test | • Review of documents including:<br>o IRS Form W-2, 1099, 1040, Schedule K-1, etc.<br>• Written representation from purchaser that he has a reasonable expectation of reaching the income level necessary to qualify in the current year. |
| (B) Net Worth Test | • Review of one or more documents that is current within prior 3 months, including:<br>o Assets: bank statements, statements of securities holdings, tax assessments, third party appraisals, certificates of deposit, etc.<br>o Liabilities: consumer credit report from national reporting agency<br>• Written representation from purchaser that all liabilities have been disclosed. |
| (C) Third-Party Verification | • Written confirmation from permitted third party that purchaser is an accredited investor<br>• Issuer must take "reasonable steps to verify" that the third party has taken "reasonable steps to verify" the purchaser is accredited.<br>• Permitted 3rd parties: CPA, attorney, registered broker-dealer or investment advisor.<br>• Certification lasts for three months. Any new investments after then need new cert. |
| (D) Previous Purchaser | • Written representation from purchaser that she is an accredited investor at the time of sale. |

These are not appropriate for many angel investors
(but principles-based methodology is appropriate)

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# SEC Developed Principles-Based Verification Method

- Whether the steps taken are "reasonable“ is “an objective determination in the context of the particular facts and circumstances of each transaction,” including:
  - nature of the purchaser and the type of accredited investor the purchaser claims to be;
  - amount and type of information the issuer has about the purchaser; and
  - the nature of the offering
    - manner in which the purchaser was solicited
    - terms, such as minimum investment amount.
- Verification standard requires issuer to establish a “reasonable belief” that purchaser is accredited

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# ACA Guidance & Principles-Based Method

- Principles-based methodology is robust – *don't get stuck in safe harbors*
- Membership in Established Angel Group (EAG) is powerful
  - Accredited investors, many of whom have invested in 506 deals before
  - Membership by invitation or referral from current member with pre-existing relationship (familiar with professional/financial status)
  - New members complete applications with self-certification and details on professional background
  - Strong investment practices, members make own investment choices, no transaction-based compensation
- Issuers must check with legal counsel
- Principles-based methodology may be appropriate for other active angels
  - Active individual angels, accredited crowdfunding platforms, family offices

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# Clarifications Needed from SEC

- Affirm that ACA's guidance on EAG is a reasonable principles-based method so market can develop practices and help capital formation
- Common request from full ecosystem: what does "general solicitation" mean?
  - Could some demo day events be outside of advertising?
  - Particularly important for issuers in proposed rule
- How do 506(c) investments work if previous round had (unaccredited) friends and family investments?

# Proposed Rule on Reg D, Form D and Rule 156

Impacts on the Startup Community

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# Proposed Rules Are Problematic for Startups

- Highly complex and difficult for startups – probably unworkable
- If startup relies on 506(c)
  - Must file Advance Form D 15 days prior to the event
  - File materials by day of use and include legends on materials
  - If company fails to file, it is out of compliance
  - Many will not realize they are out of compliance
- Can only cure once, and must occur with 30 days
- If not cured, company may not again use Rule 506 for one year

<u>Proposed rules would put many startups out of business</u>

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# Startup Profile – Before Raising Angel Money

Startups do not have resources of larger companies:

- No revenues or low revenues – not profitable
- Few employees (2 to 5 common)
- Often can't afford experienced lawyers
- Many are first-time CEOs & raising capital for the first time
- Funded through friends, family, credit cards & bootstrapping

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# How Startups Raise Equity Capital (Now)

- Submit executive summaries & business plans to investors
- Rarely use PPM, broker or other intermediary
- Investment terms often negotiated with lead investor
  - Extensive due diligence required by lead investor
- Identify potential investors from existing relationships, referrals, events, Web, email, LinkedIn, etc.
- Business model and plan change radically and often
- Answer many inquiries for evaluation to due diligence
- Terms of investment, amounts raise often not publicly revealed

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# Key Concerns

- Significant burden and disproportionate impact on startups/ small biz
- Pitch events are long-standing practice - many in ecosystem will not realize these may be general solicitation
- Many startups will not be aware of rules & accidentally break them
- If filings inadvertently missed, issuer cannot raise 506 offering for year – with no cash, startups go out of business
- May have to file multiple Form Ds as business models change
- Disclosures/legends take away advertising ops and increase costs
- All ad materials must be provided on first day of use
  - Rules don't include constraints for SEC use of materials
  - Is material collection even possible from a technology standpoint?
- Potential of issuer mistakes adds to risks – many investors will not invest

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# ACA's Recommends:

- Withdraw rules as currently proposed

- If re-develop proposal:
  - Remove harsh penalties for non-compliance
  - No advance Form D
  - Allow parts of Form D to be confidential (e.g. financing amount)
  - Require legends/disclosures only when terms are communicated
  - Form working groups from advisory bodies to monitor and report, rather than requiring all advertising materials

# Accredited Investor Definition

The current definition works great

for the economy and investor protection

# Current Definition for Natural Person

- A natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person
- A natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year

# ACA Recommendations on Definition

- Make no change to income or wealth thresholds
- Add questions for proof of “sophistication” to questionnaire
  - Membership in an angel group, professional organization or angel platform
  - Work experience (e.g. private or public company director)
  - Investor experience (grandfather all who have made Rule 506 investments)

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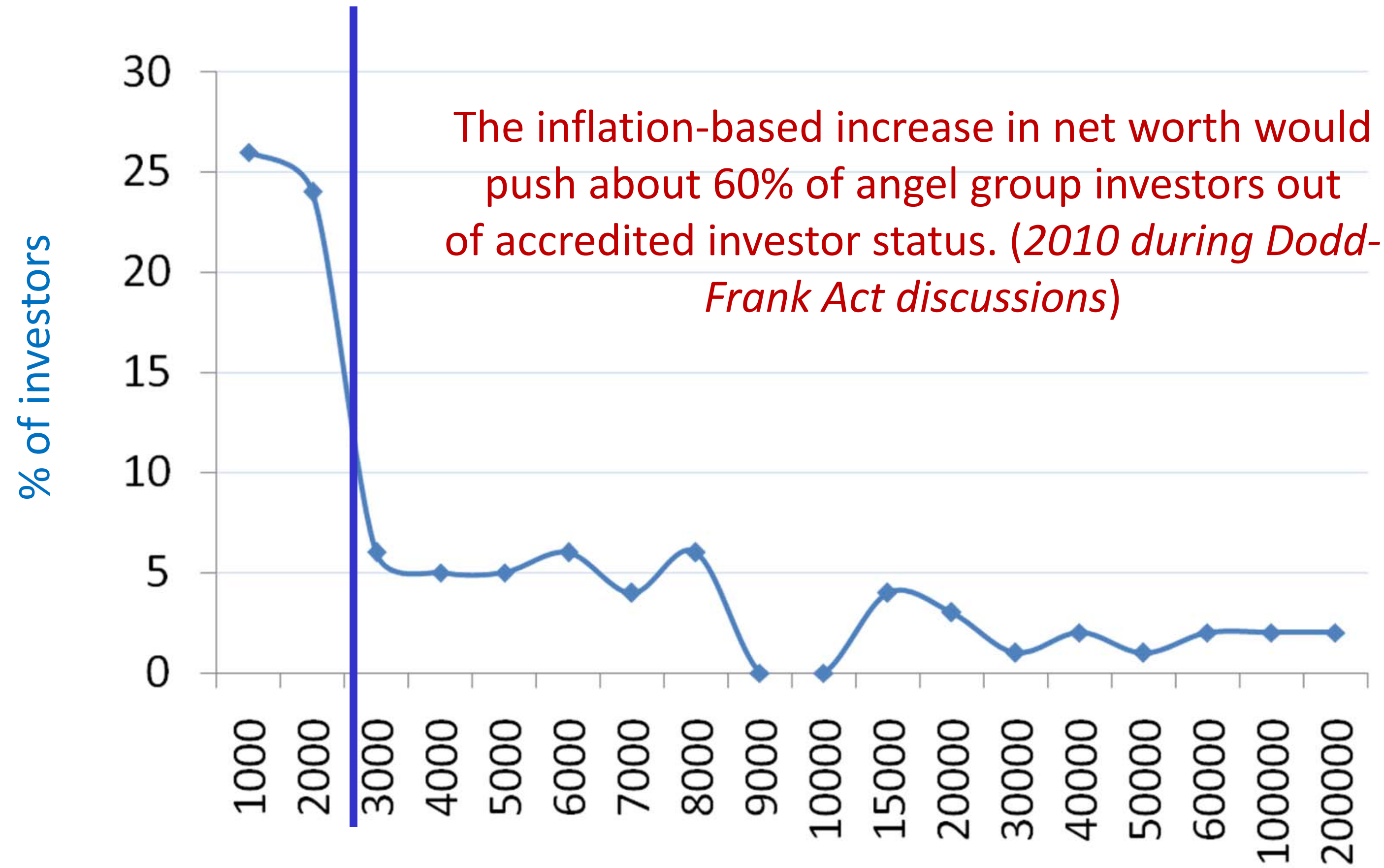
Fewer angels, less capital for entrepreneurs

# Impact of Accredited Investor Increases




Net Worth of Group Angel Investors (000's)

Wiltbank & Boeker, AIPP Data

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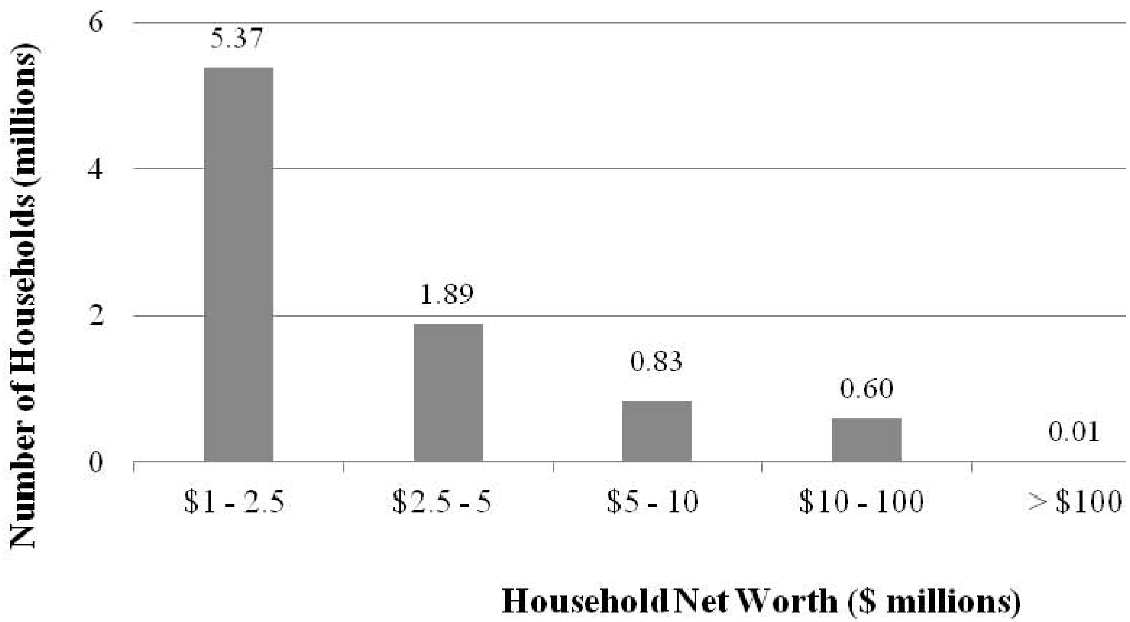
# SEC Proposed Rule Included Similar Data

**Figure 6: Number of U.S. Households that Qualify as Accredited Investors Based on 2010 Net Worth**




GAO report to SEC, July 2013: <u>adjusting net worth thresholds from $1M to $2.3M would decrease qualifying households from 8.5 to 3.7 million</u>

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# Observations of 2010 Dodd-Frank Act on Accredited Investor Standards

- Removal of primary residence value from net worth was a significant change
- SEC Report (*Ivanov-Bauguess*): Median Reg D investment had zero unaccredited investors
- Act says future reviews of definition should incorporate "protection of investors, in the public interest, and in light of the economy"

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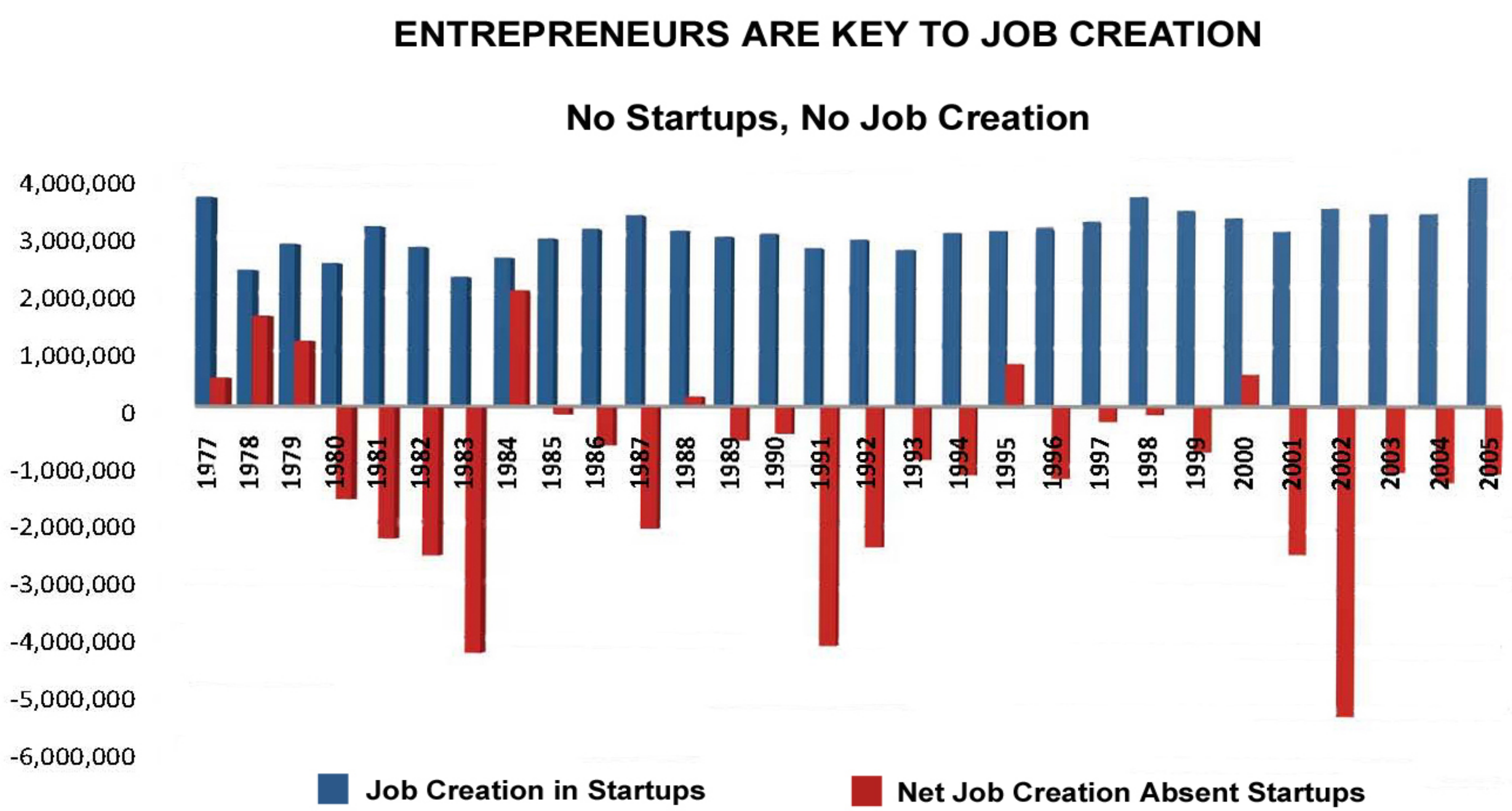
# Startups Create the Most Net Jobs




**Source: Business Dynamics Statistics Briefing: Jobs Created from Business Startups in the United States. Kauffman Foundation, January 2009.**

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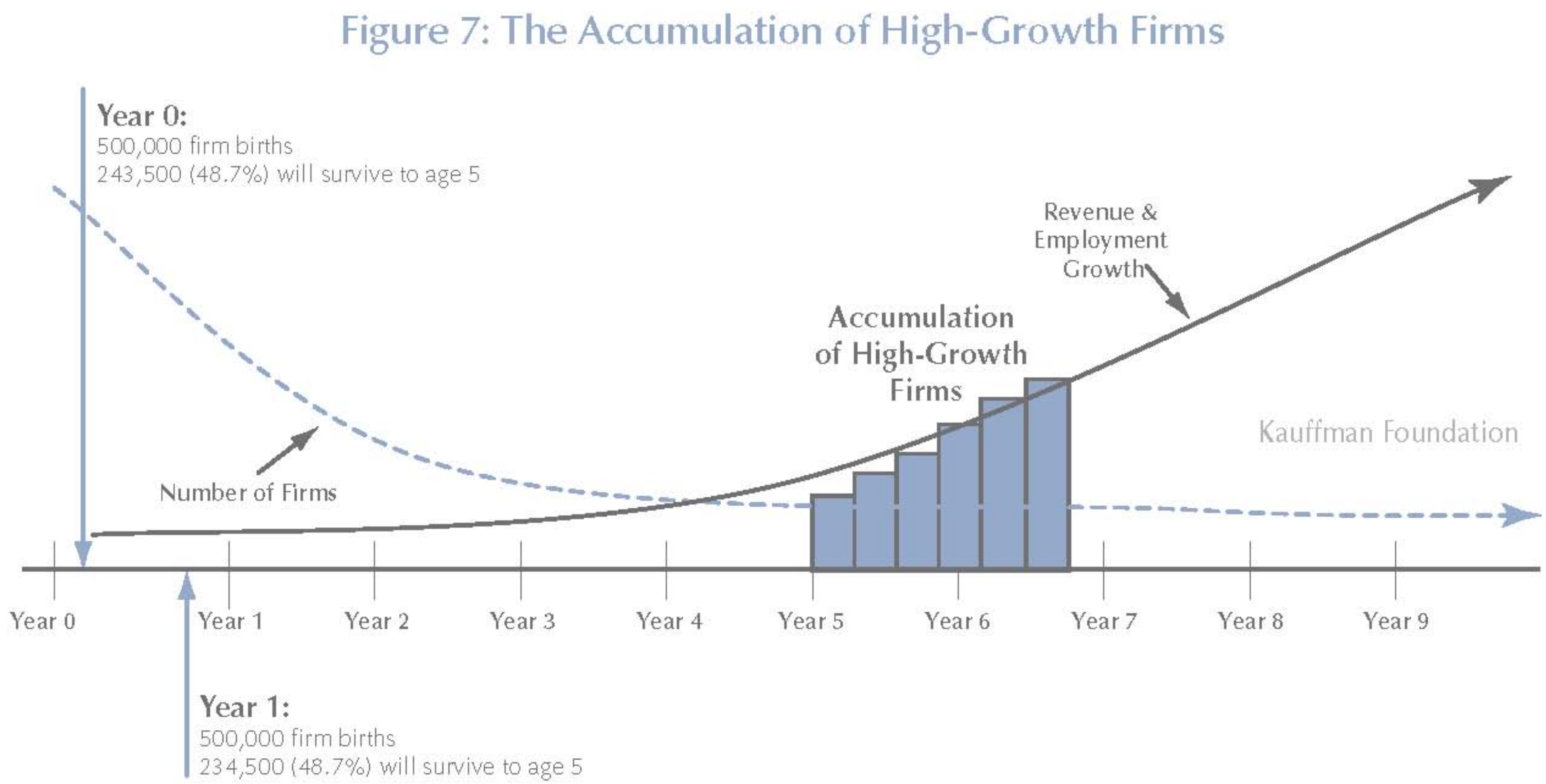
# Most Jobs Come from High-Growth Firms




Source: High Growth Firms and the Future of the American Economy, Kauffman Foundation, 2010

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# More Information


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