



ANGEL CAPITAL ASSOCIATION

Angel Investors – Critical Initiators of Startups and Job Creation

SEC Advisory Council on Small and Emerging Companies

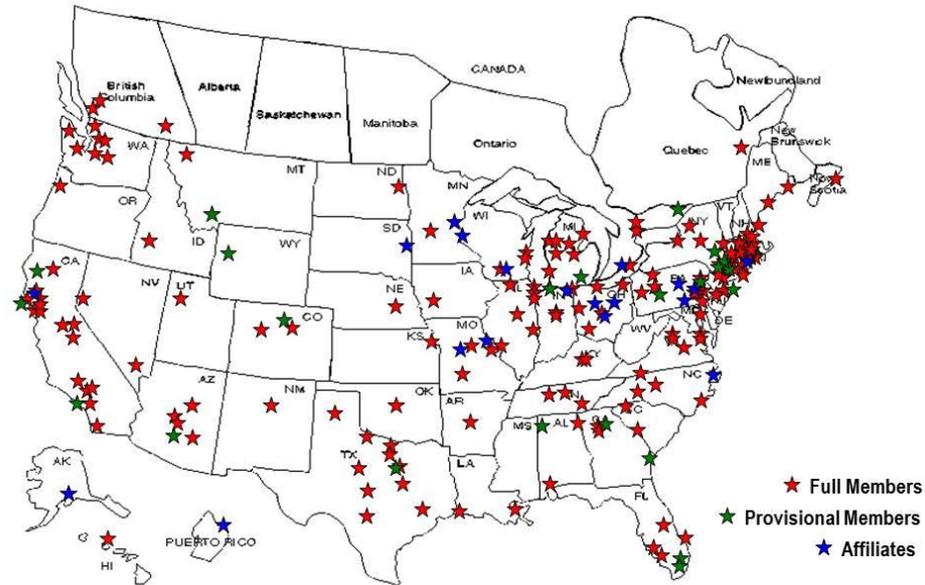
September 17, 2013

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

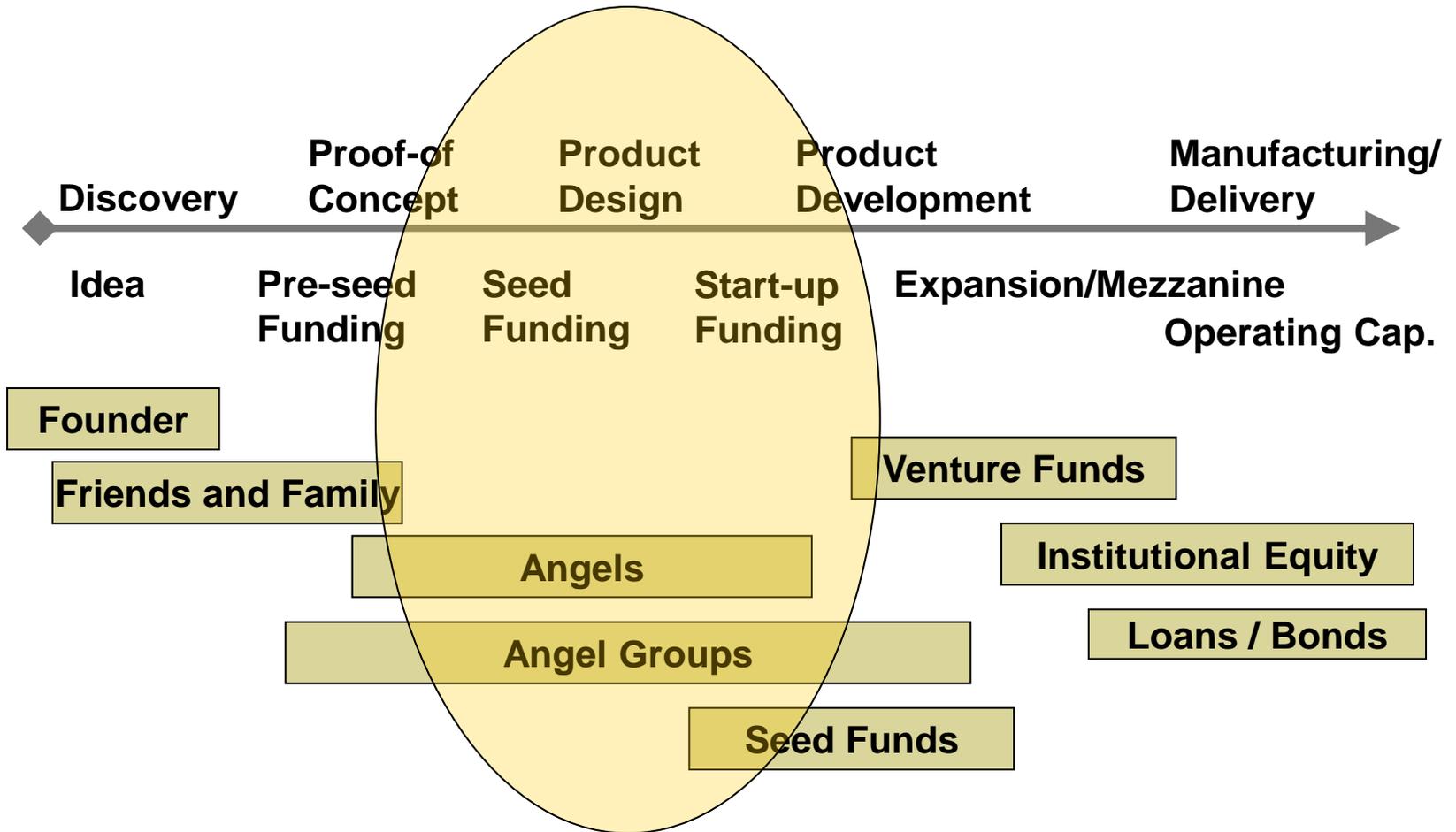
Marianne Hudson – ACA Executive Director and Member, Women’s Capital
Connection and Mid-America Angels

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:



Financing Life Cycle



Angels Provide Less Equity by Total Dollars – BUT...

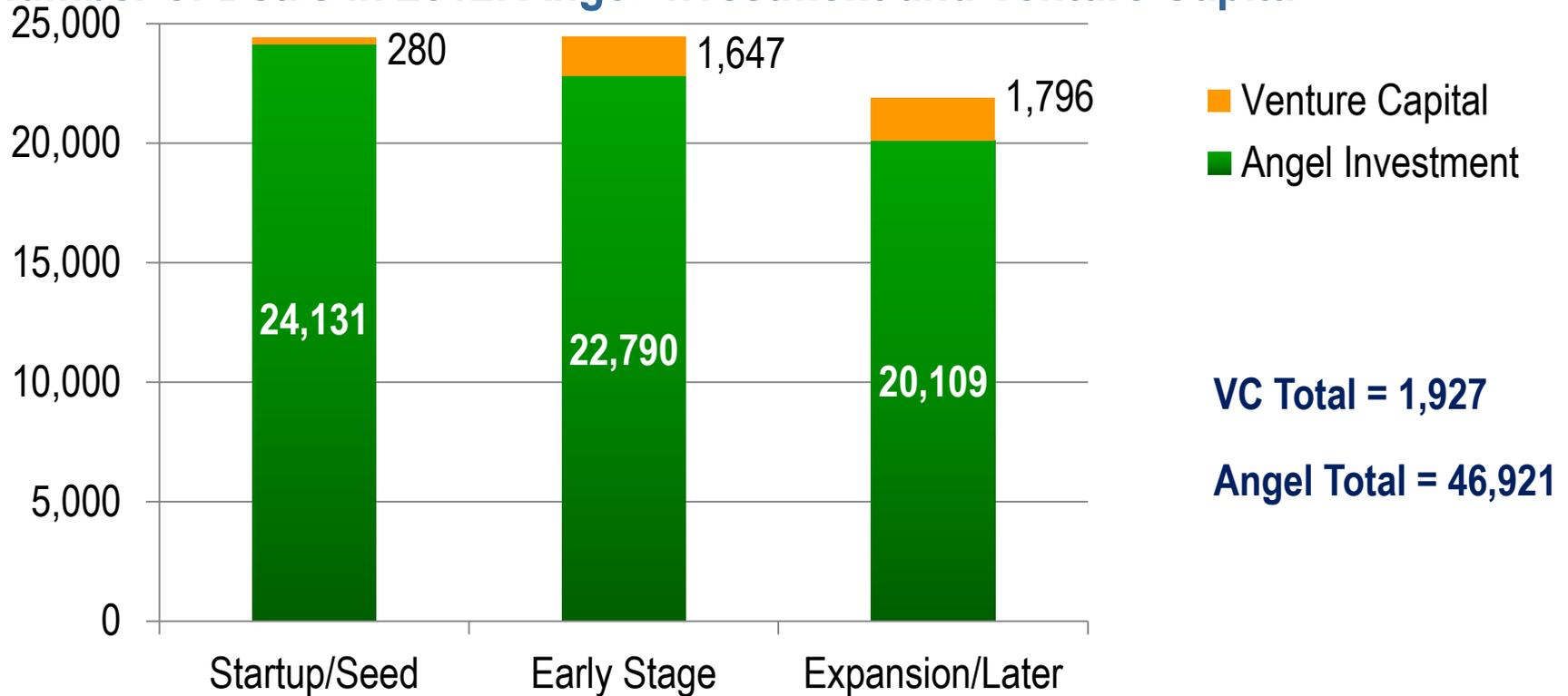
- Angel Investors (\$23B)
- Venture Capital (\$27B)
- Private Equity (\$347B)





Angels Fund Nearly All Seed/Early-Stage Deals...

Number of Deals in 2012: Angel Investment and Venture Capital

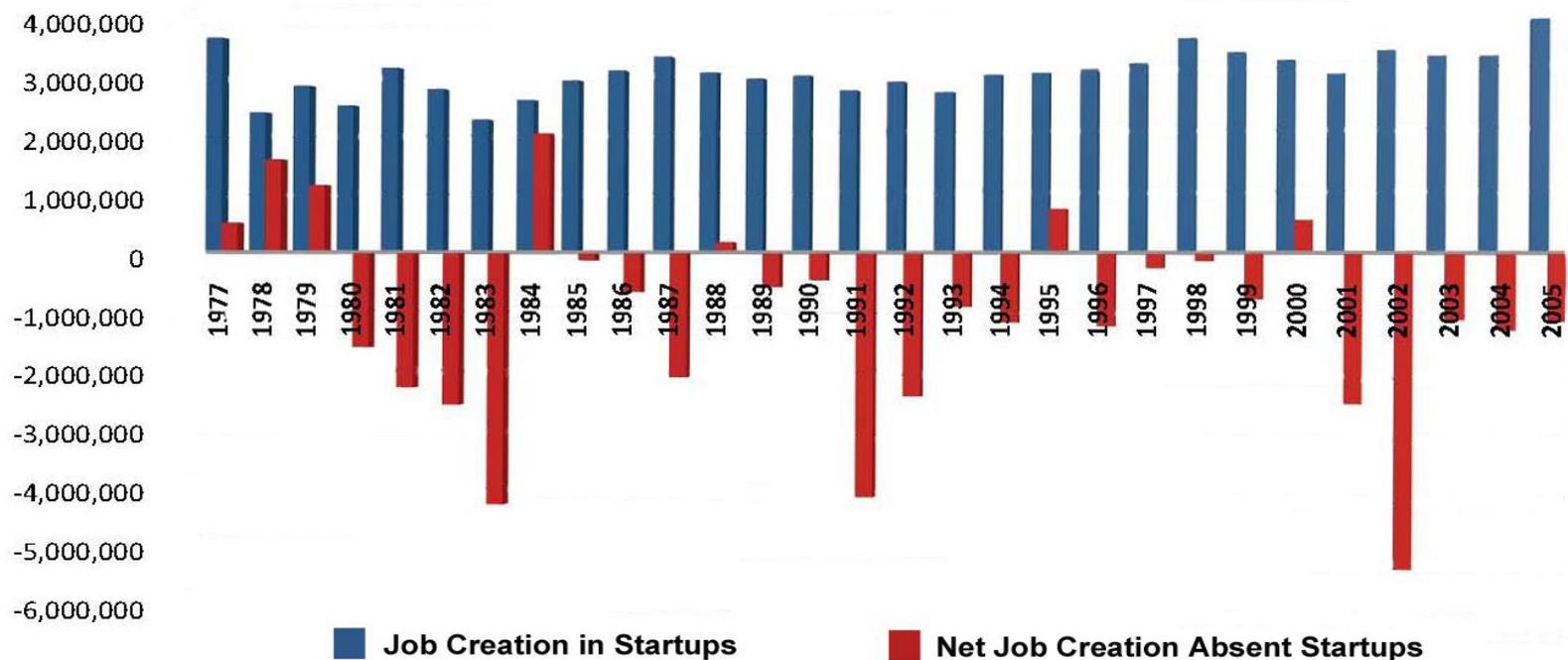


Without angels few startups would make it to VC, PE or IPO funding

...And Startups Create the Most Net Jobs

ENTREPRENEURS ARE KEY TO JOB CREATION

No Startups, No Job Creation



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



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**



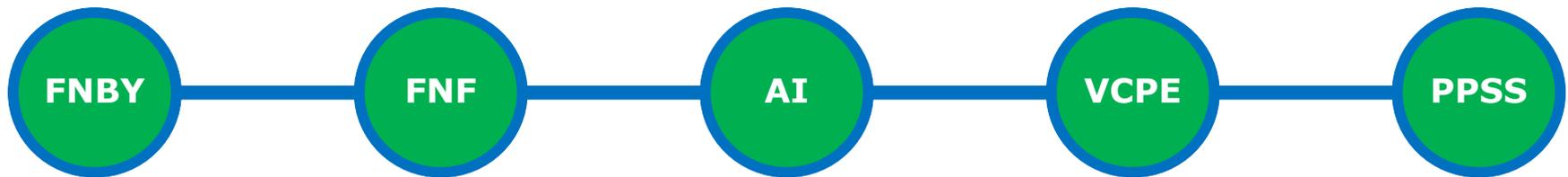
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Angel Investment Landscape

Stats, Trends and Impact



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

Angels Fund Majority of Startups in USA

Angels Provide ~90% of Outside Equity for Startups

Angel Investors (2012)

- \$22.9 billion
- **67,000 deals**
- 24,000 seed
- 22,800 early stage
- 20,100 expansion
- > 268,000 individuals

Venture Capital (2012)

- \$26.7 billion
- **3,700 deals**
- 280 seed
- 1,650 early stage
- 1,800 later/expansion
- 522 active firms

Companies Backed by American Angels





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)**

What Motivates Angels?

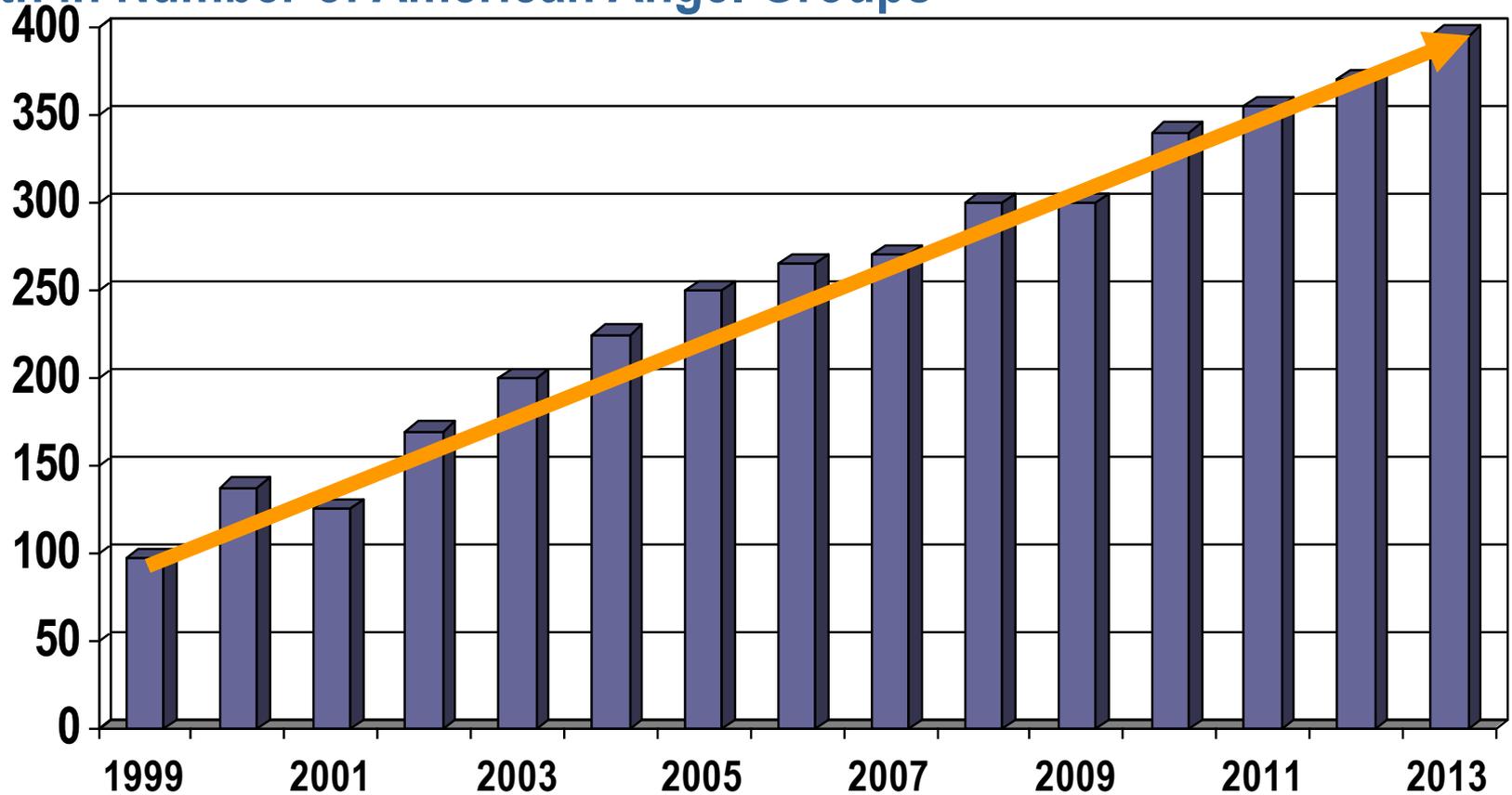
- Help entrepreneurs
- Stay engaged – use skills and experiences to help build a business
- Give back to community or university
- Active form of investing – not just watch markets
- Find their next opportunity
- Network and learn
- Return on Investment is the metric



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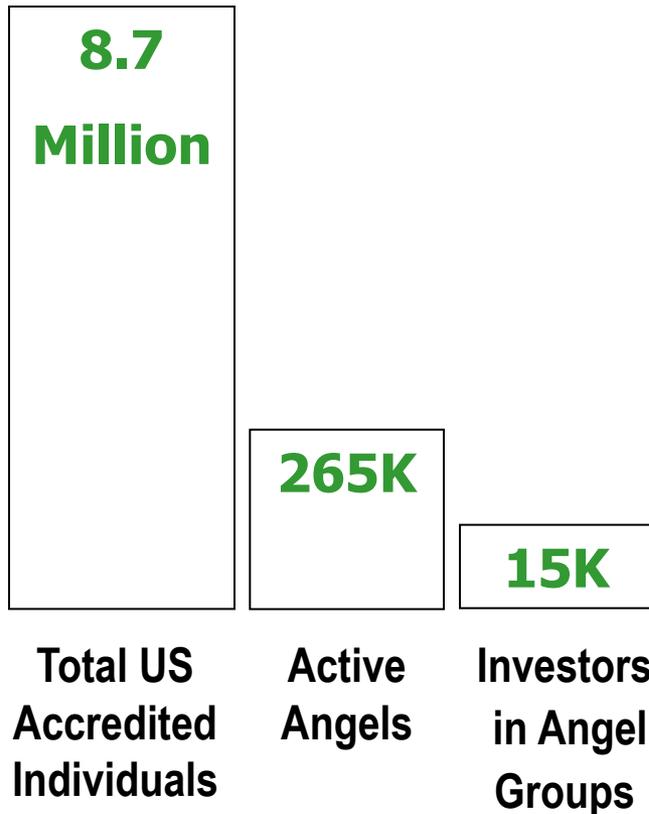
Angel Groups are Key Trend in Sophisticated Investing

Growth in Number of American Angel Groups



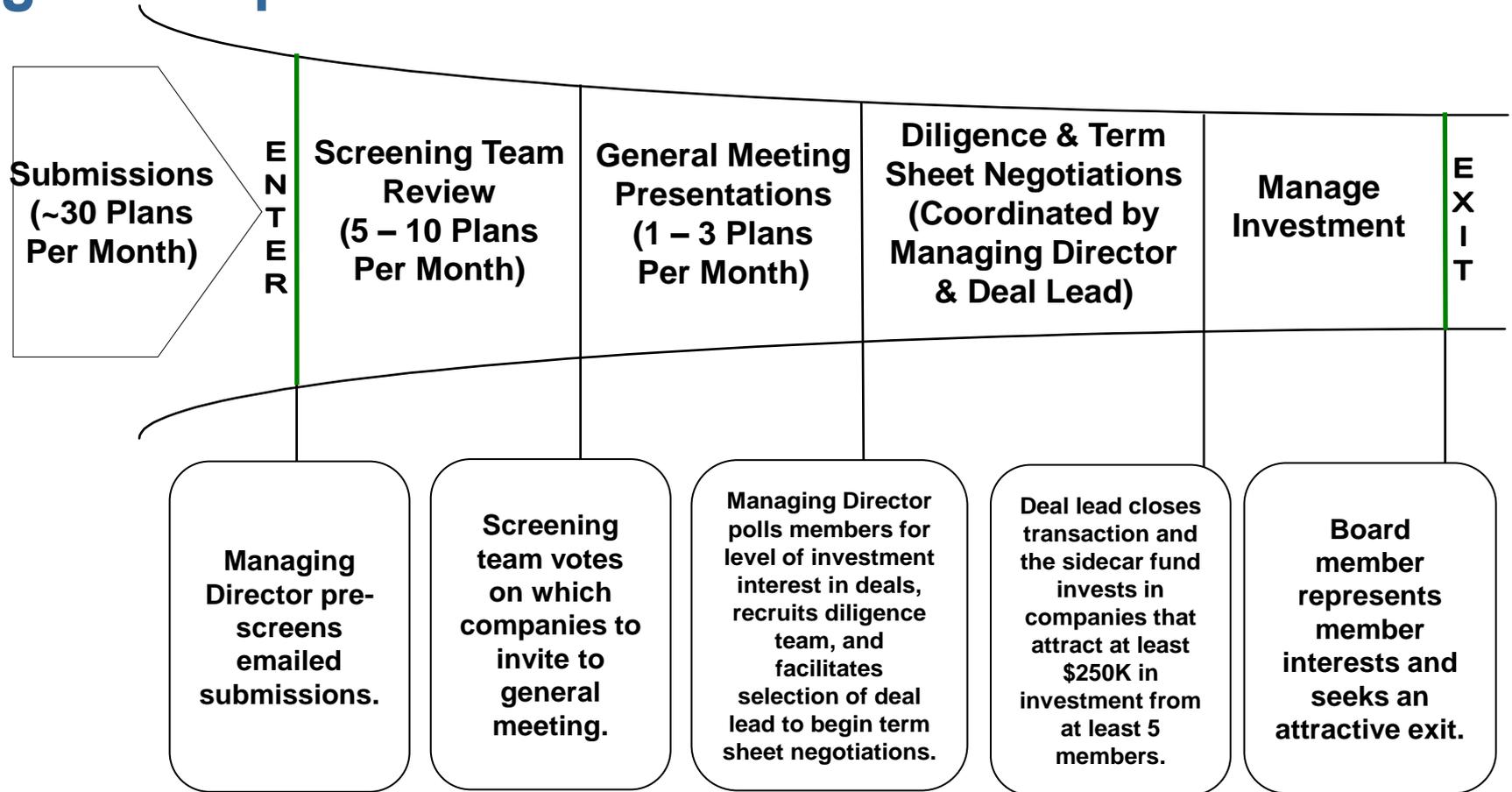
Sources: Center for Venture Research (pre 03 data) and Kauffman Foundation/ARI (04-13 data)

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

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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Silicon Valley Bank



Data Powered by



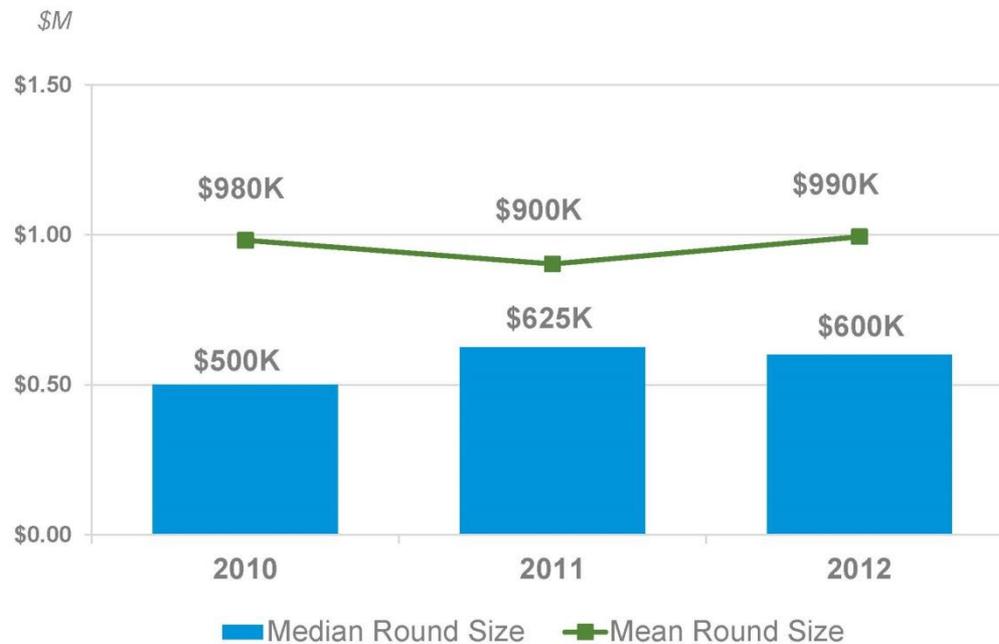
Present the

HWLO Report™

Angel Group Update

2012 Year in Review

Median Angel Round Size



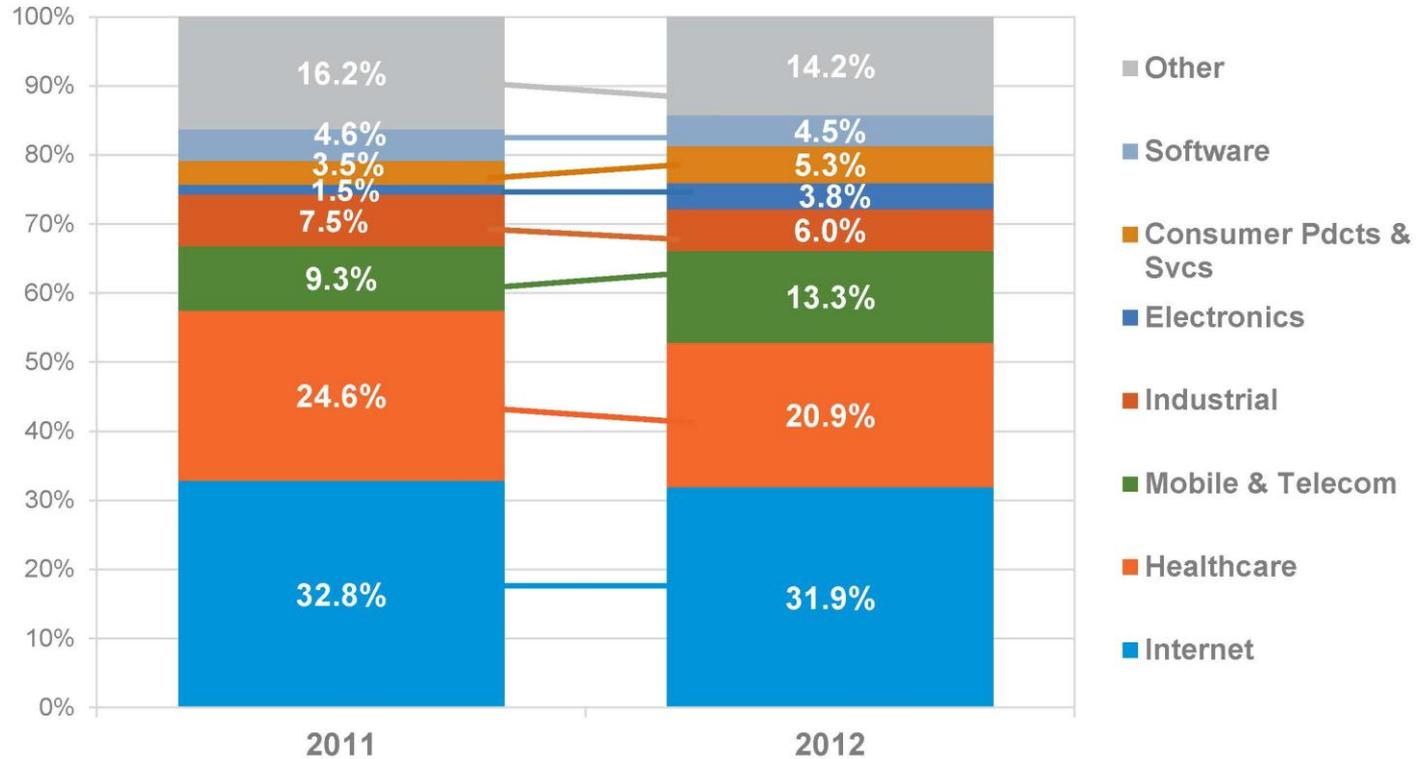
*Angel rounds include angels & angel groups only

Median Early Stage Pre-Money Valuation in 2012

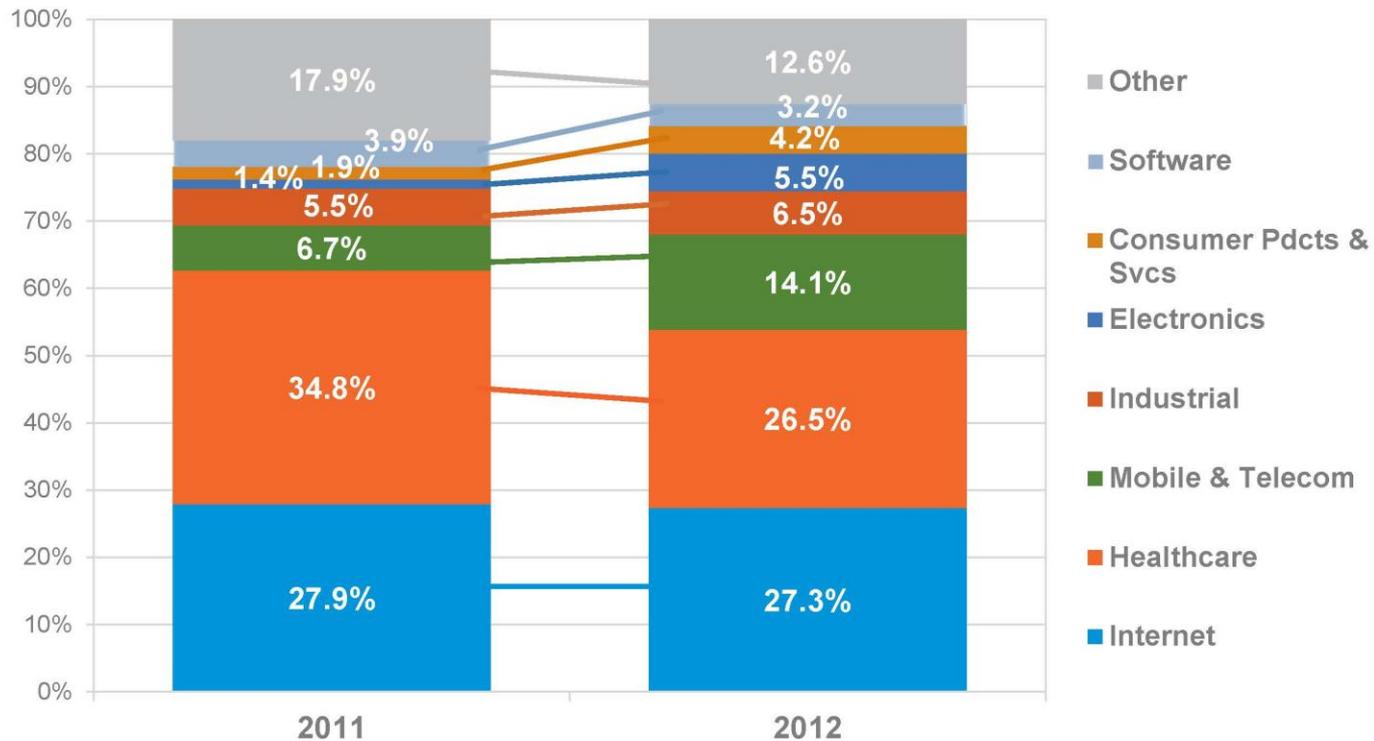


*Including all rounds with angel groups before Series A

Angel Group Deals by Sector

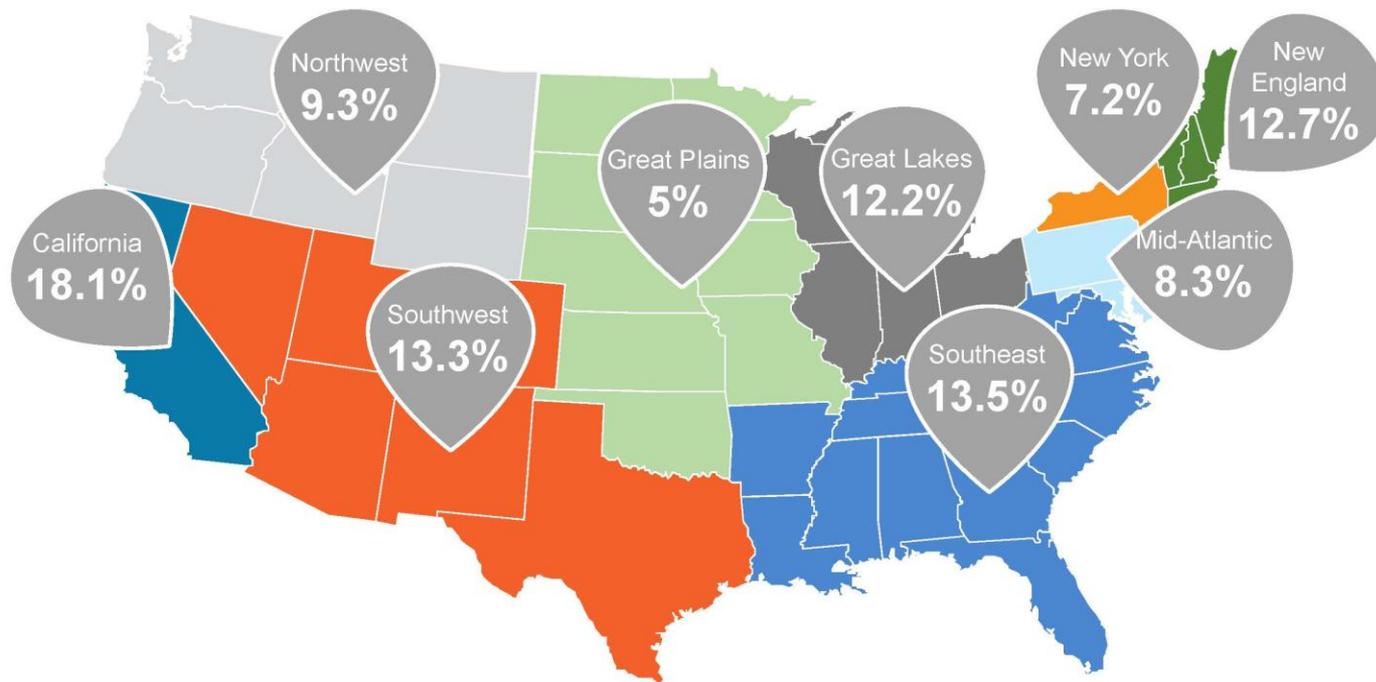


Angel Group Dollars by Sector

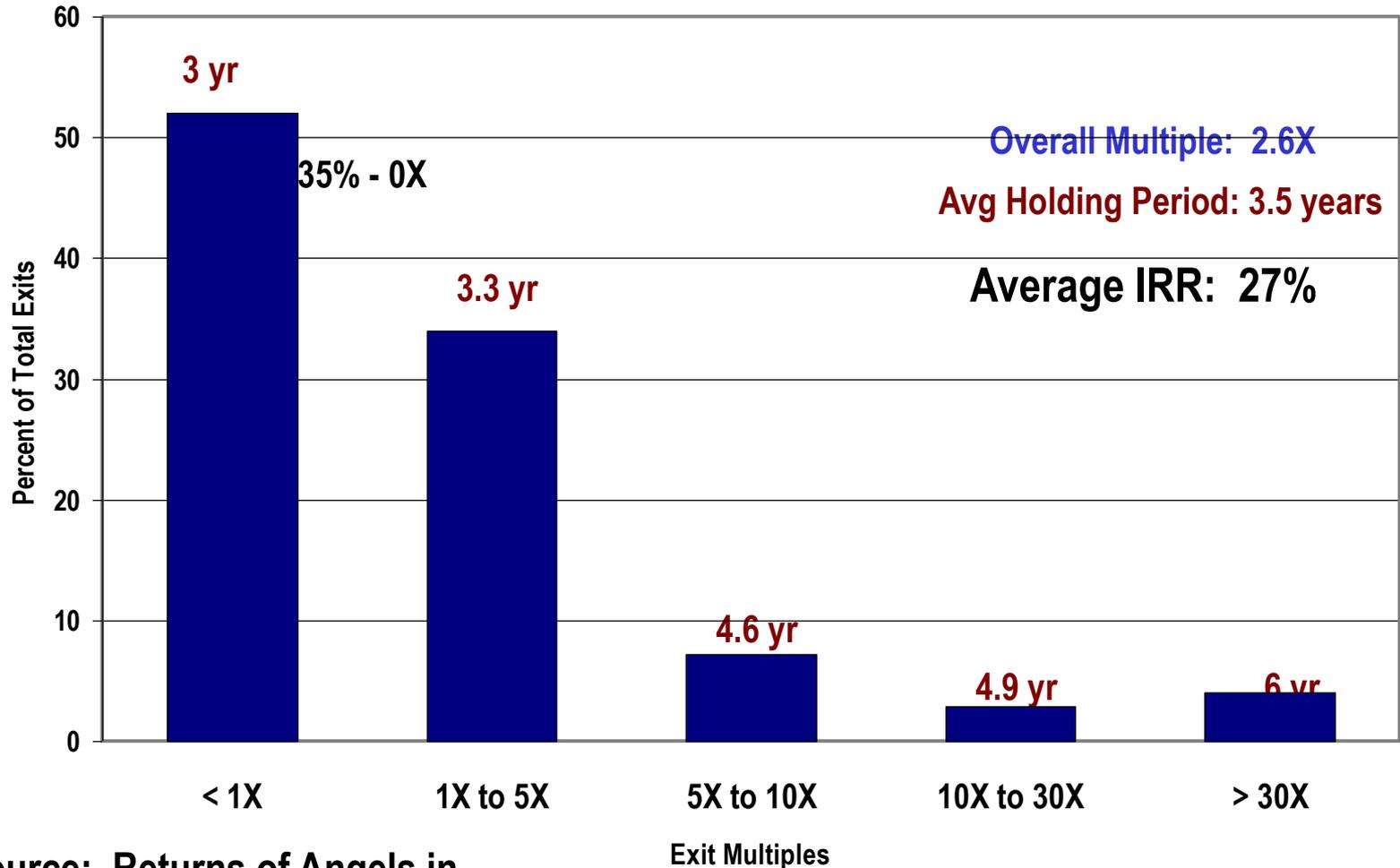


Angel Investment Deals Distributed Nationally

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



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



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)



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	<ul style="list-style-type: none"> • Review of documents including: <ul style="list-style-type: none"> ○ IRS Form W-2, 1099, 1040, Schedule K-1, etc. • 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	<ul style="list-style-type: none"> • Review of one or more documents that is current within prior 3 months, including: <ul style="list-style-type: none"> ○ Assets: bank statements, statements of securities holdings, tax assessments, third party appraisals, certificates of deposit, etc. ○ Liabilities: consumer credit report from national reporting agency • Written representation from purchaser that all liabilities have been disclosed.
(C) Third-Party Verification	<ul style="list-style-type: none"> • Written confirmation from permitted third party that purchaser is an accredited investor • Issuer must take “reasonable steps to verify” that the third party has taken “reasonable steps to verify” the purchaser is accredited. • Permitted 3rd parties: CPA, attorney, registered broker-dealer or investment advisor. • Certification lasts for three months. Any new investments after then need new cert.
(D) Previous Purchaser	<ul style="list-style-type: none"> • 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)**



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



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



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?



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Proposed Rule on Reg D, Form D and Rule 156

Impacts on the Startup Community



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 within 30 days
- If not cured, company may not again use Rule 506 for one year

Proposed rules would put many startups out of business

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

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



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



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



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Accredited Investor Definition

**The current definition works great
for the economy and investor protection**

Current Definition for Natural Person

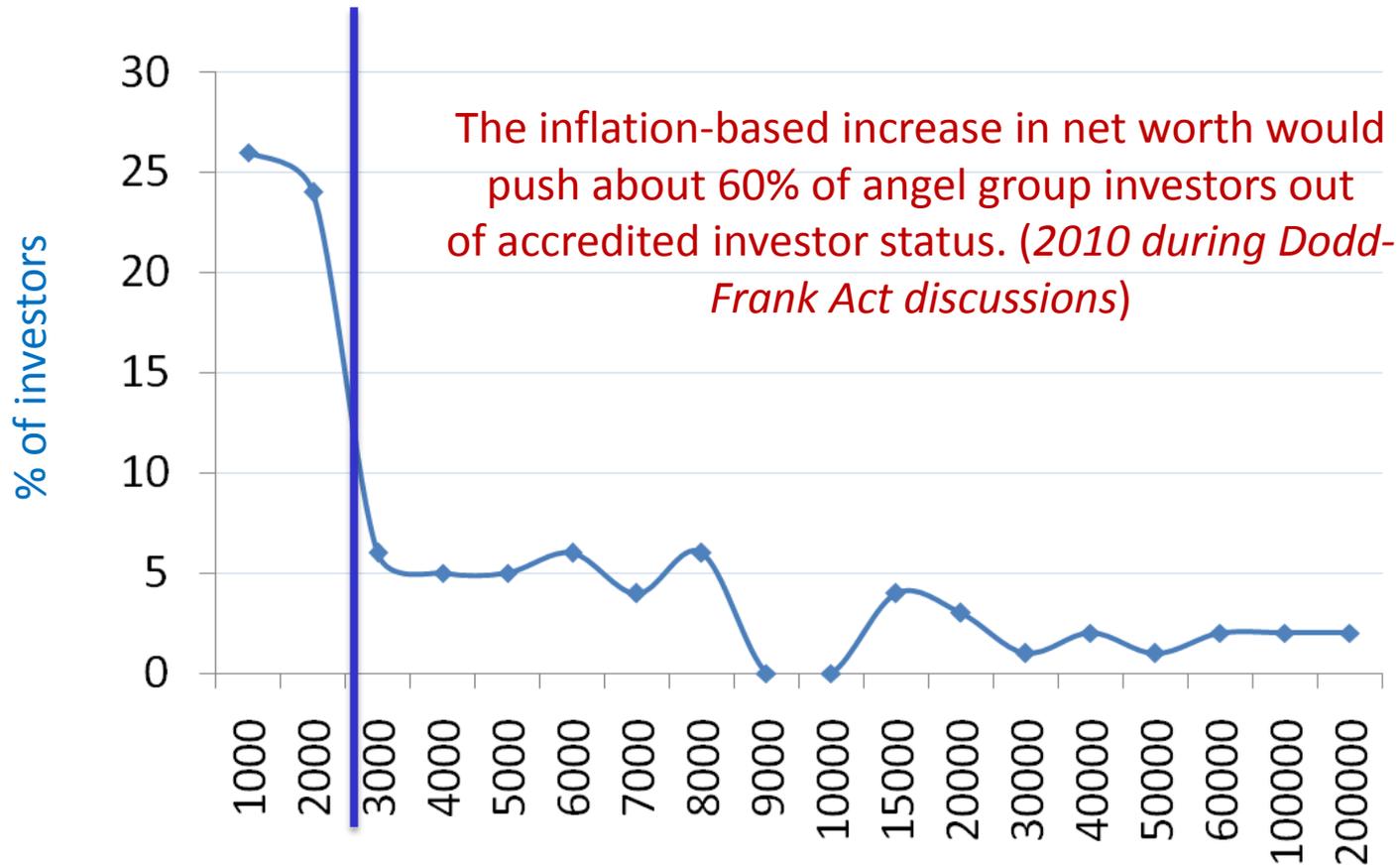
- A natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase, excluding the value of the primary residence of such person
- A natural person with income exceeding \$200,000 in each of the two most recent years or joint 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

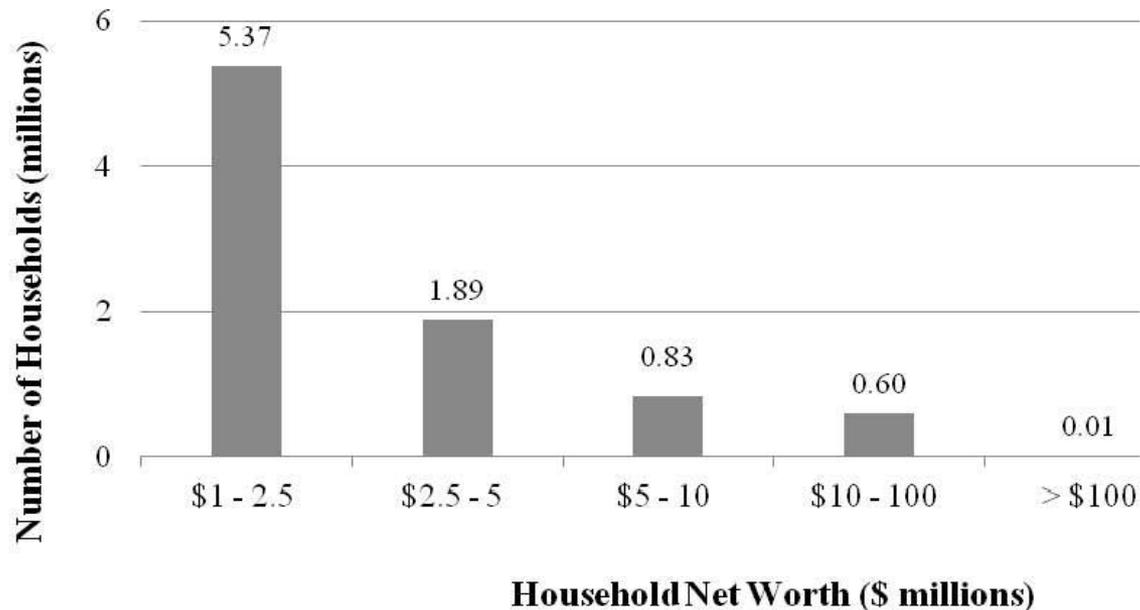
- Make no change to income or wealth thresholds
- Add questions for proof of “sophistication” to questionnaire
 - Membership in an angel group, professional organization or angel platform
 - Work experience (e.g. private or public company director)
 - Investor experience (grandfather all who have made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

Impact of Accredited Investor Increases



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: adjusting net worth thresholds from \$1M to \$2.3M would decrease qualifying households from 8.5 to 3.7 million



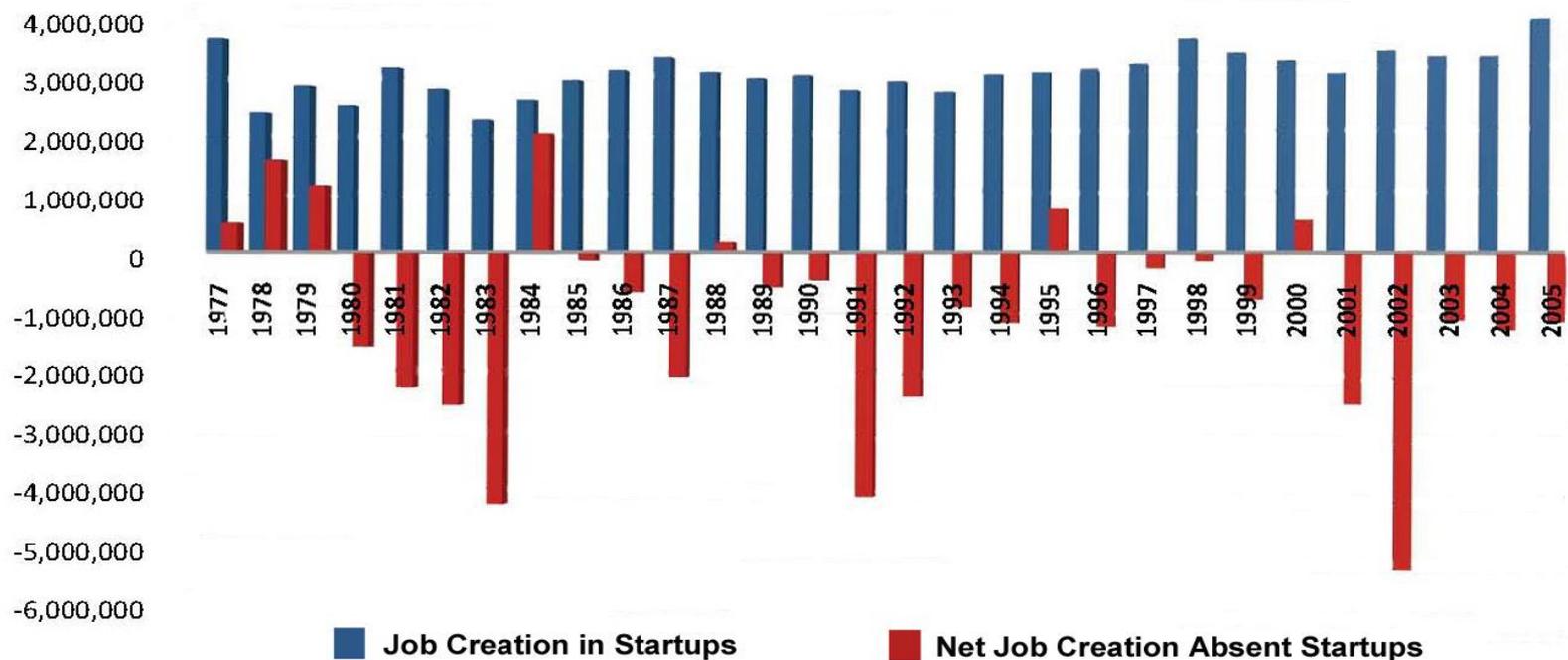
Observations of 2010 Dodd-Frank Act on Accredited Investor Standards

- 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**”

Startups Create the Most Net Jobs

ENTREPRENEURS ARE KEY TO JOB CREATION

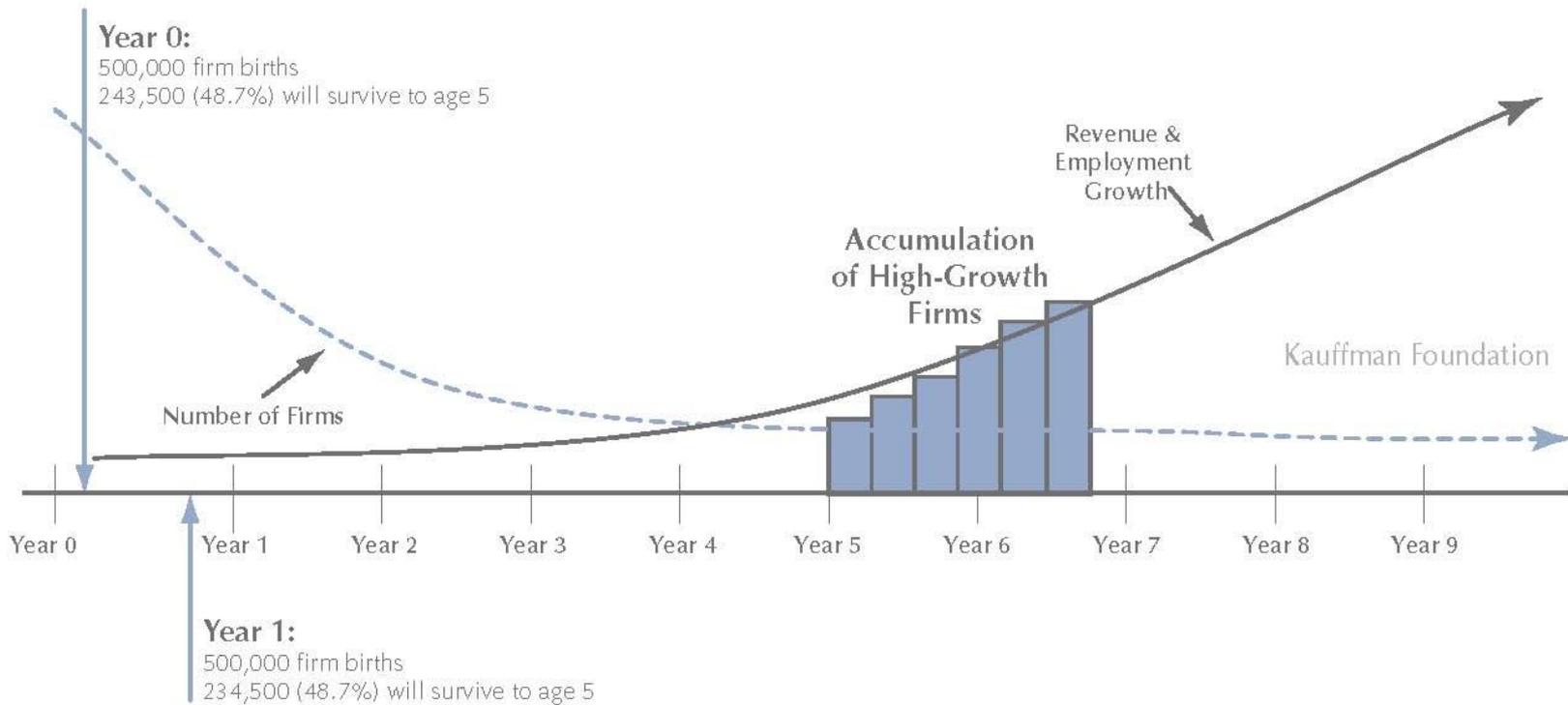
No Startups, No Job Creation



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

Most Jobs Come from High-Growth Firms

Figure 7: The Accumulation of 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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