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Angel Investors – Critical Initiators of Startups and Job Creation

SEC Forum on Small Business Capital Formation

November 21, 2013

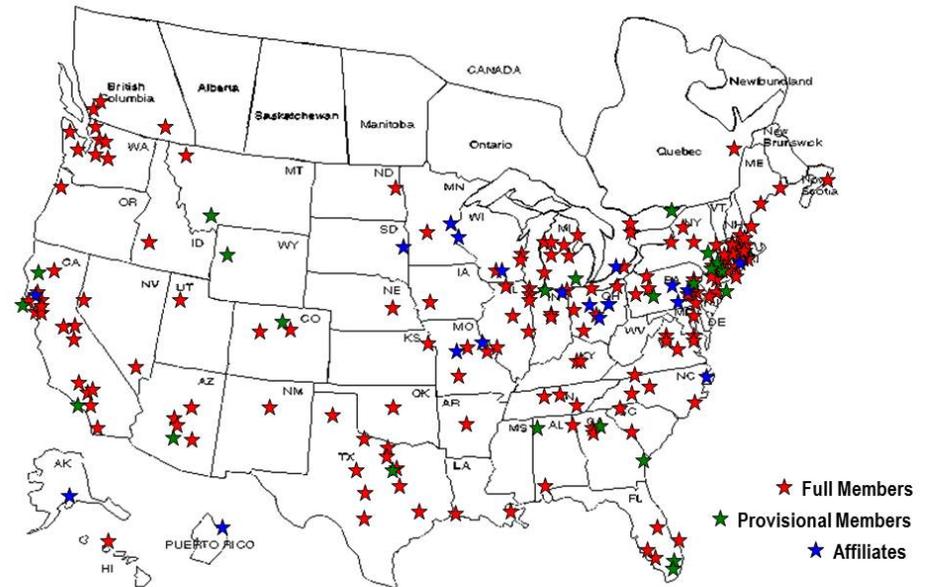
Christopher Mirabile – ACA Board and Managing Director, Launchpad
Venture Group



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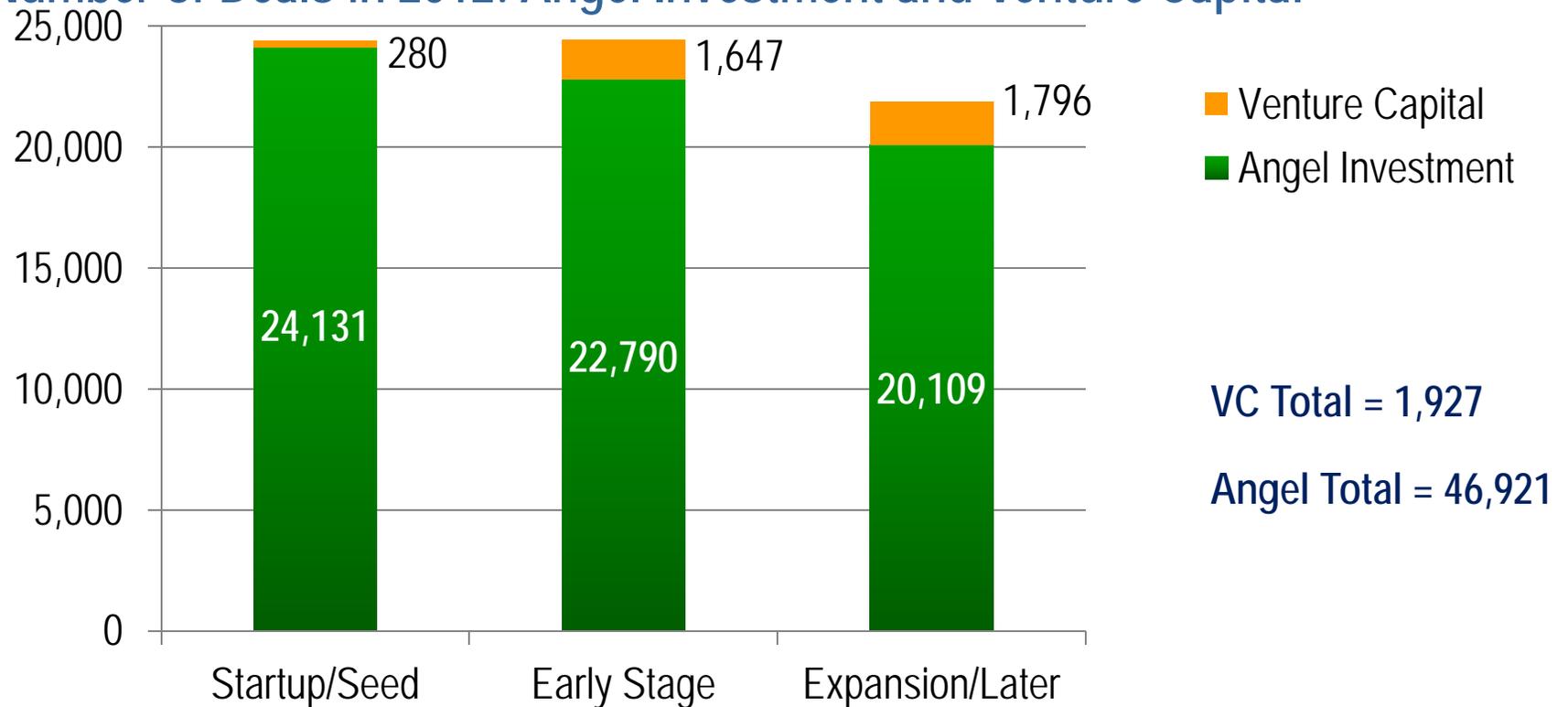
- Mission: Fuel the success of angel groups and private investors who actively invest in early-stage companies
- Largest trade group for angels:
- 200+ member angel groups
- 10,000 accredited investors
- Individuals, accredited portals
family offices
- 50 states/ 5 Canadian provinces
- Charitable partner:





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

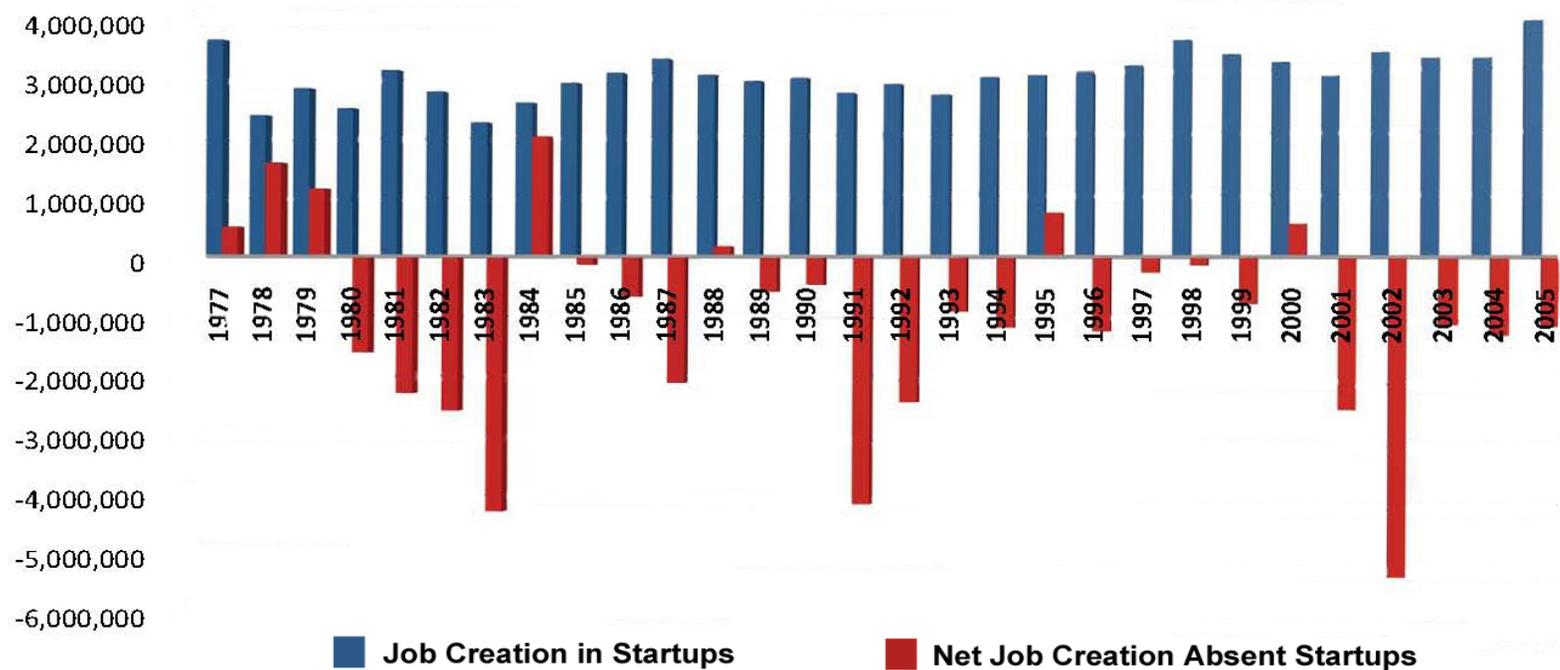
Source: Jeffrey E. Sohl, Center for Venture Research and 2013 NVCA Yearbook



...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.



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

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



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Companies Backed by American Angels





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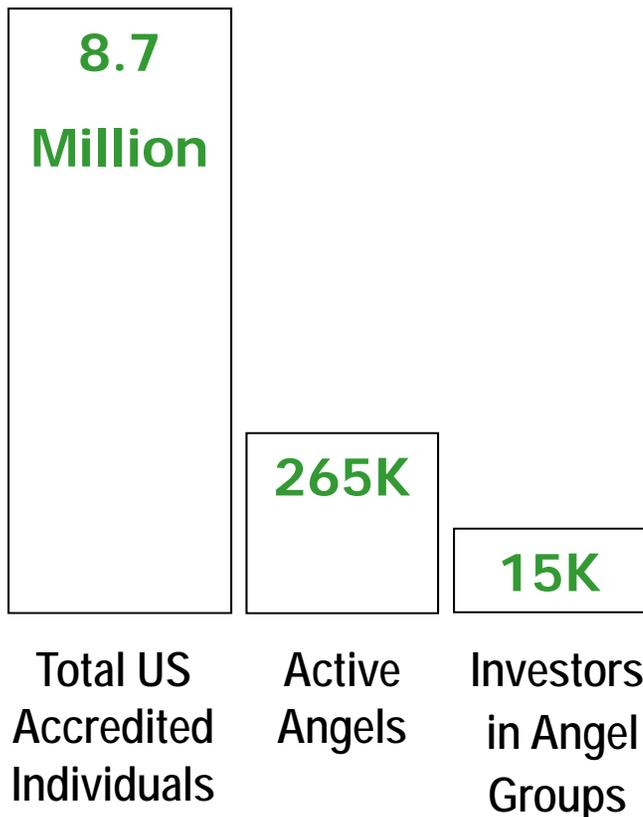
Who are Angel Investors?

- 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)



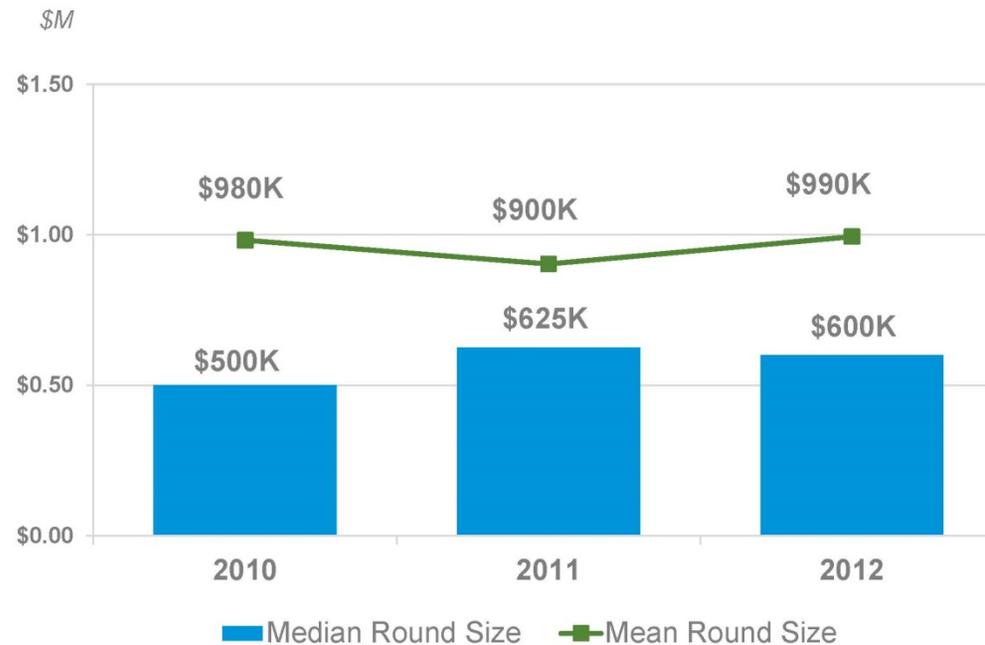
Angel Groups Take Professional Approach



- **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



Median Angel Round Size



*Angel rounds include angels & angel groups only





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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



Three Critical Issues for Angels & Startups:

1. Final Rule 506(c) General Solicitation Deals are almost unavoidable so we need clarification on new Principles-Based Accredited Investor Certification Approach that ACA is recommending
2. Proposed Reg D rules present a significant problem for start-ups and angels
3. Potential changes to Accredited Investor thresholds will have massively detrimental effect on capital formation



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General Solicitation - The Problem: Many Standard Practices May Qualify

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 means of connecting startups with investors
and key to economic development efforts



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Generally Solicited Offerings Are Now Problematic

- 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 Concern Was Around 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 acceptable to most angel investors
(but principles-based approach is)



Principles-Based Verification Method is Workable

- 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 on Principles-Based Method

- Principles-based methodology is robust – *don't get stuck in safe harbors*
- Membership in Established Angel Group (EAG) is very meaningful:
 - 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 New Reg D/Form D & 156 Rules - ACA Recommends:

- **Withdraw rules as currently proposed**
- If SEC re-develops a 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
 - Clarify meaning of General Solicitation and consider carving out long-time economic development events



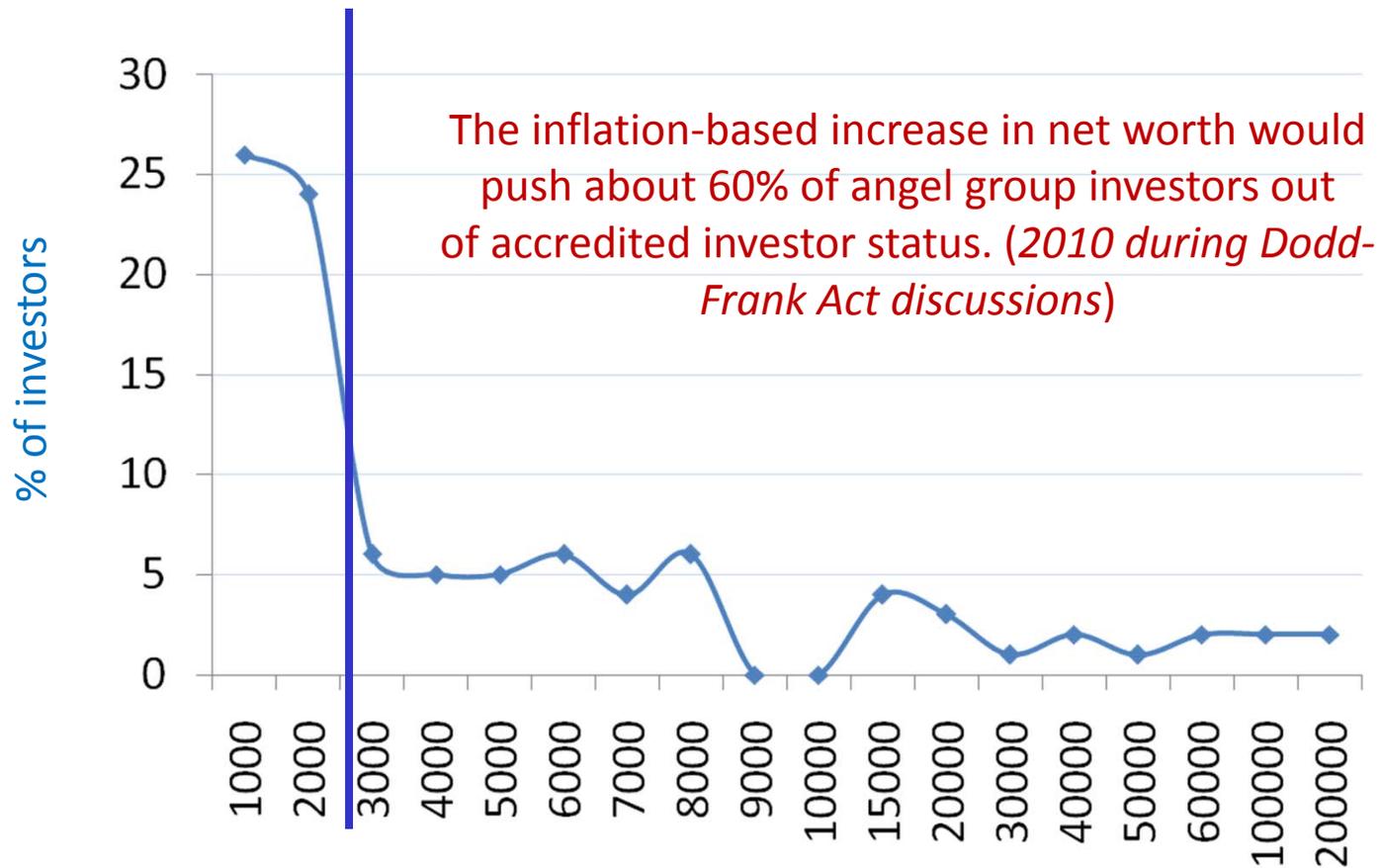
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Accredited Investor Definition - ACA Recommends

- 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)



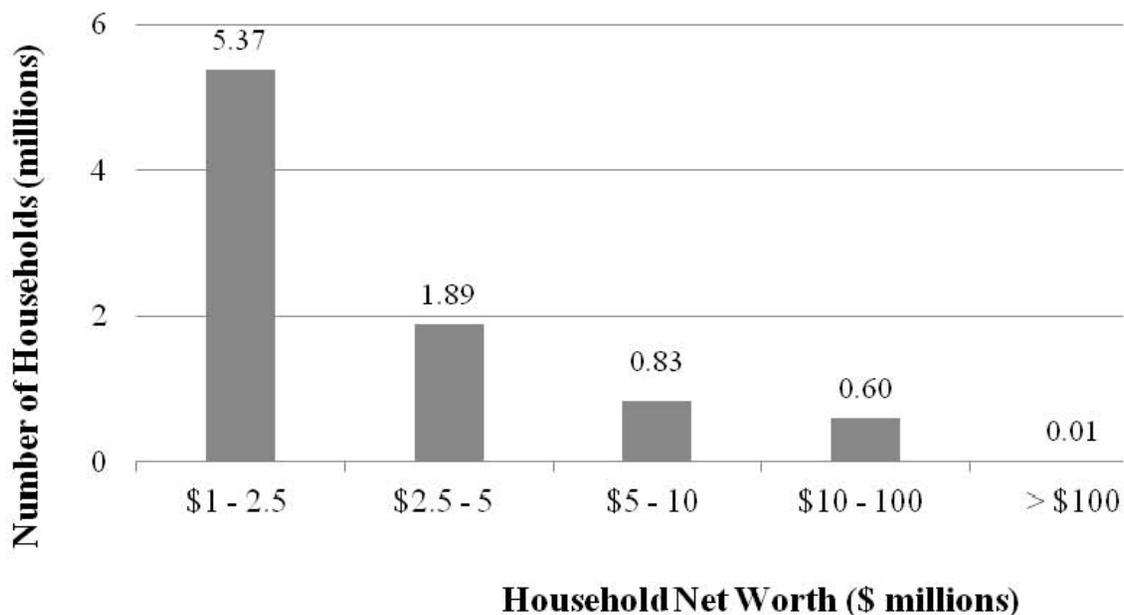
Impact of Accredited Investor Increases





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



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Observations of 2010 Dodd-Frank Act on Accredited Investor Standards

- Removal of primary residence value from net worth was already a very 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**”
- Accredited angels are managing their own money, not acting as brokers
- Distinguish between brokered deals and straight investments



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More Information

Angel Capital Association

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