ANGEL CAPITAL ASSOCIATION

September 23, 2019

The Honorable Jay Clayton
Chairman
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File No. S7-08-19 Concept Release on Harmonization of Securities Offering Exemptions

Dear Chairman Clayton:

Thank you for the opportunity to provide comments to the Commission on its concept release on improving exemptions for private securities offerings. We very much appreciate your leadership in promoting capital formation and expanding investment opportunities while maintaining a good balance with protecting investors. The concept paper includes many interesting ideas and questions that could lead to incredibly important long-term benefits for investors, issuers and the investment ecosystem.

The Angel Capital Association (ACA) is the leading professional and trade association supporting the success of accredited angel investors in high-growth, early-stage ventures. Our 14,000 members are among the angel investors that invest an estimated $25 billion in 70,000[1] early-stage investments every year, with companies located in every state in the country. Our comments today are in support of both angel investors and the nation's startup entrepreneurs, those who create nearly all net new jobs in the country[2] and many of the innovations that improve the quality of life throughout the world. It is vital that promising startups continue to attract angel capital, for their own growth and for the American economy.

Angel investing represents a small portion of capital covered by the regulations the SEC is exploring in the concept paper, but it has a disproportionate impact on the US economy. It is primarily investing directly into new companies responsible for nearly all job growth. It would be a huge mistake to make changes to the rules without considering the additional friction any rule changes could place on issuers, investors and that first capital raised.

This letter addresses some of the key themes ACA sees in sections of the SEC paper, particularly framework, accredited investor definition, Rule 506 of Regulation D and gaps in the current framework. We directly address some of the specific numbered questions but intend for our key theme comments to address multiple questions in the SEC document.

[1] Center for Venture Research, University of New Hampshire, https://paulcollege.unh.edu/center-venture-research/research
[2] John Haltiwanger, Ron Jarmin, and Javier Miranda, Jobs Created from Business Startups in the United States, 2008

Framework

ACA's focus and expertise is entirely on high-growth startups and those who invest in these companies. We believe both issuers and investors are well served by Rule 506 of Regulation D at many points along the growth continuum, so our response will focus only on the one exemption. There are improvements that could be made in investor liquidity (unlocking some capital that could more effectively be invested in additional promising startup companies), the accredited investor definition and Rule 506(c), and our detailed comments on those topics are made later in this letter.

We are also sympathetic to the idea of more people being able to have access to invest in private offerings. Creating new ways for financially sophisticated individuals who do not meet the financial thresholds could significantly grow the percentage of Americans who can invest in Reg D offerings from the current 13 percent, while continuing protections for investors and the exemptions early-stage issuers have relied on for decades. At least in the area of angel investing, however, we do not believe all retail investors who are not financially sophisticated should be able to invest in Reg D offerings because a major influx of unsophisticated capital may provide an incentive for unscrupulous entrepreneurs to create startups of questionable quality simply to access that less sophisticated capital. The result would be an increase in fraud and disappointing returns for those who are the most vulnerable. The concern is exacerbated by the need for investors to develop the diverse portfolios to mitigate the considerable risk of these types of investments. There are also concerns that an increase in fraud could damage the angel "market" for both investors and issuers. Fraud has been almost non-existent in angel investing for many decades.

With the anecdotal experience that there are quality new companies that do not receive investments, we believe it makes sense to grow the number of people who can invest, but in a more cautious way. In addition to expanding the definition of accredited investor to include sophistication as a qualification, other ideas include educating more accredited investors who aren't currently investing in Reg D offerings on how to invest in startups and allowing individuals with experience and past performance requirements, who are not accredited investors, to invest in funds that invest in startup companies.

There are two specific questions within the "framework" section of the concept paper we want to respond to directly:

> ***#11 – Should there be rule changes to broaden the investor pool? Should we allow investors, after receiving disclosures about the risks, to opt into accredited status?***
> In the case of angel deals, it would be helpful for the SEC and regulators to promote data and research on the overall risks and rewards of early-stage investing so new investors are aware that while angel investment returns have historically been positive, investors lose money in the majority of all of these deals due to the concentrated nature of angel investment returns[3]. However, if the question in the concept release means a requirement for providing disclosures on individual opportunities, we believe this suggestion would be counterproductive for both issuers and investors. It would create additional expenses and complications for the issuing entrepreneurial companies thus creating a barrier to entrepreneurial activity and restricting the flow of capital into such projects. Essentially it would create a new category of disclosures, boilerplates and Private Placement Memorandums that many people would need to work on

[3] Robert Wiltbank: Returns of Angels in Groups, 2007, Siding with the Angels, 2009, and Tracking Angel Returns, 2017

producing, but few people would read or truly benefit from in the context of "new idea companies" with no operating history or track record to write disclosure on.

#14 – Should the exemption be conditioned on the involvement of a registered intermediary? For angel opportunities, the answer is an emphatic no. Angels tend to stay away from offerings in which intermediaries are involved. Not only do early-stage investors prefer for all their money to go to the startup company, rather than allotting some of the investment to an intermediary, but the quality of these investment opportunities is broadly perceived to be lower than those that do not use intermediaries. Startup success generally correlates with skills such as inter-personal networking and selling skills. Companies needing to "outsource" the fundraising activity are correctly perceived as having less experience and knowledge about how the startup ecosystem works and representing a lower quality investment opportunity. In addition, requiring an intermediary would reduce or remove the primary driver of startup company success: strong relationships between the company founders and early, lead investors. Forming this relationship is critical to both quality investment decisions and successful company growth after investment as angels are often mentoring the founding team: providing value beyond the money. Intermediaries would actively hinder these important direct relationships.

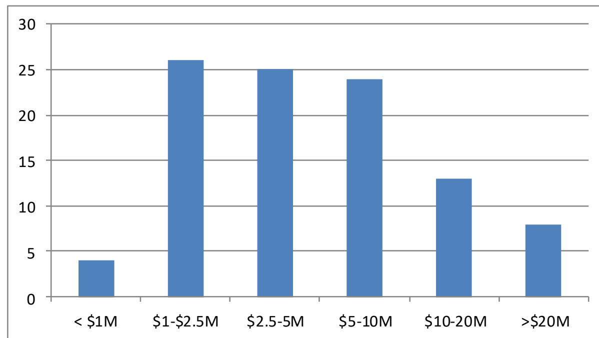
Accredited Investor Definition

The current financial thresholds work well for angel investors and the startup issuers they invest in. Early stage companies – and the accredited angel investors who support them – have relied on the current definition for decades, building a strong capital network that fosters job-creation and innovation nationwide. Accredited angels are the primary source of capital for these innovative companies that account for most of the net new job growth in the United States in the last 25 years.[4] These startups are also a key growth engine for established companies that today increasingly rely on these early-stage enterprises to function as outsourced research and development labs – especially in the life science and technology sectors. ACA strongly recommends continuation of the financial thresholds as they are and urgently cautions the SEC about the negative impacts which would flow from an increase in the thresholds.

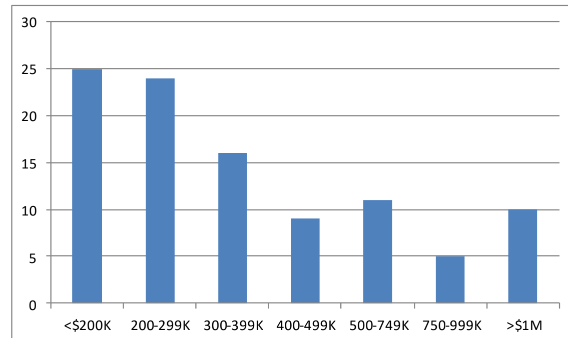
If the thresholds are increased going forward for inflation, there should be ways for investors who no longer meet the thresholds to qualify via their experience and financial sophistication. We suggest this because data we collected from our members in 2013 showed that more of our accredited investors qualified toward the lower end of thresholds for both net worth and income. This is particularly true for investors located outside New York, Boston and California. Increasing the thresholds would disproportionately impact entrepreneurial activity in the parts of our nation which need it the most, such as the Midwest. Additionally, data indicates that more women and minorities are beginning to enter the ranks of accredited investor status. Raising the thresholds may exclude or delay the opportunity for minorities and women to invest in this asset class and would work against the goals of increasing access and diversity in angel investing, which we believe would have a negative impact on issuers from those same demographics groups.

[4] John Haltiwanger, Ron Jarmin, and Javier Miranda, Jobs Created from Business Startups in the United States, 2008

Percent of ACA Members Who Qualify as Accredited Investors Based on 2013 Net Worth



Percent of ACA Members Who Qualify as Accredited Investors Based on 2013 Income



As mentioned earlier, ACA also supports expanding the base of accredited investors by adding a new category of people who qualify by "sophistication" if they don't meet the financial thresholds. These individuals could qualify by education, work experience or professional certification or by taking a test or exam that demonstrates knowledge in a useful, but easy to administer way. We certainly believe those who pass FINRA Series 7 exams should qualify by their certification but the test to qualify as an accredited investor should not be as comprehensive. Otherwise the test would be a barrier to making angel investments thus further restricting the flow of capital. A standard that looks at professional experience, professional qualifications, investing experience, and other *reliable and objective* indicators of financial sophistication would best serve the needs of the market.

In addition to the key points above, ACA also wants to respond directly to a few of the accredited investor questions in the concept paper:

27. Should an individual advised by a financial professional qualify?
No, at least in the case of angel investing, which has different risks and evaluation processes than the larger, public funds or private equity opportunities most financial professionals work in. Such a requirement could also create an industry of people selling "snake oil" to angel investors or "fake angels" who receive fees for acting as advisors.

28. Should investors be subject to limits on the amount they can invest?
No. ACA doesn't believe limits would be effective, including whether to limit investments to a percentage of assets or income. Such concepts are highly problematic – investors would likely have to disclose significant and unacceptable levels of personal information regarding wealth, income, total investments, etc.; and, issuers would be tasked with verifying such data in a secure way that protects privacy and prevents identity theft and associated risks. The complexities and inherent risks of this process would have a chilling effect on capital formation across the private markets. Further, such caps would likely kick in at exactly the wrong time. Angels need to continue to support their companies over time, and often look to increase their investments in companies once it is clear the company is "out of the woods" and likely to be a success. Those later dollars are critical both for company growth and investor returns. If angels are capped, they will need to invest in fewer companies to ensure they have headroom under the limits to support those companies, and that will lead to less capital formation as well as less diversification for angels which correlates with lower returns.

We appreciate the table developed to summarize responses to staff recommendations on the accredited investor definition and provide our thoughts on several of the recommendations below:

- *Keep current thresholds in place, subject to investment limits* – yes to keeping thresholds, no to limits
- *Allow new inflation adjusted thresholds, with no investment limits* – angels can accept inflation adjustments going forward - but only if there are routes to qualify based on sophistication and there are no limits on amounts invested. However, we remain concerned with the disproportionate impact such adjustments would have geographically – particularly outside of the coasts - and on women and minorities.
- *Permit individuals with professional credentials to qualify* – yes
- *Permit individuals with experience to qualify* – yes. This could include individuals with finance degrees, P&L experience, attorneys working on deal docs, former startup CEO, demonstrated competence through examination, etc.)
- *Permit knowledgeable employees in their employers' private funds to qualify* - yes
- *Index all thresholds for inflation on going-forward basis* – Acceptable if there are other ways for formerly qualified investors to meet the definition, as noted above.
- *Grandfather in past investors into offerings of issuers they previously invested in* – yes
- *Individuals who pass an examination should be included* – yes, with a caveat that tests should be reasonable in scope (design and administration) and cost to ensure participation. We strongly suggest that the test be administered within the community – having a test designed and administered by a player from an unrelated part of the industry, such as FINRA, would cause major issues, leading to reduction in capital formation.

Rule 506 of Regulation D

Given the Commission's estimates of the sizes of the investments made through various exemptions – in which Rule 506(b) is responsible for more than half of all unregistered investments - it is clear that Rule 506(b) works well. The experience of ACA member angels is that the exemption continues to work for investors and issuers as the companies move through many phases of growth.

There are aspects of Rule 506 that could be addressed to enhance the flow of capital to startups, while continuing appropriate protections for investors. These include:

- **Investor Liquidity** – It would be helpful for both investors and issuers if there were private secondary markets for stockholders to trade their securities to other accredited investors after a holding period (perhaps one year). This would open up some capital for investors to put into additional promising companies rather than having their funds locked up in slower growing companies. More detailed ideas on this issue are included in the "Gaps" section of this letter.

- **Rule 506(c) Investor Verification (Safe Harbors)** – We believe the exemption for generally solicited offerings has had limited uptake because the rules for reasonable steps for issuers to verify that investors are accredited are difficult and in some cases the rules need more clarification. Investors are often not willing to invest in 506(c) offerings because they don't like the safe harbors for verification. Many angels view getting a three-month certification from a third party as being expensive and time-consuming and a major risk in terms of sensitive personal and financial data. Higher net-worth individuals are especially concerned about the

issue of digital identity theft and this concern has only grown in recent years. Perhaps more investors would be willing to participate if the third party verification was more secure and the time period was longer, say one year – or if the Commission would enable individual investors to certify accredited status using an expanded, detailed, Investor Qualifying Questionnaire (see attached example) that requires substantive qualitative information about the purchaser well beyond a simple “check-the-box” certification. This questionnaire should be *deemed to satisfy the principles-based methodology for an issuer to “take reasonable steps to verify” the accredited status of investors under Rule 506(c*).

- **Rule 506(c) Investor Verification (Principles-Based Methodology)** – ACA believes the market hasn’t yet accepted implementations of the rule’s principles-based methodology for verifying investors are accredited. It appears that the small benefits to be gained from general solicitation are outweighed by the requirements around certification of accreditation and lack of clarity on real examples of verification using the principles-based methodology. Attorneys tend to take the most conservative route in advising their clients, particularly if a verification method could be declared invalid later. It is our understanding that an issuer’s attorney would not accept the evidence of an ACA member investor who was listed on the Forbes 400 wealthiest people. Even after six years after the rule was released, there is no emerging industry standard for principles-based verification. ACA attempted to remedy this for groups of angels working together by creating guidance for membership in “Established Angel Groups” as proof of accredited investor status in 2014 (with positive comments by individuals at the SEC). However, this effort did not tip the balance - fewer than 35 groups applied for the “EAG” certification and ACA received questions from issuers and attorneys. A clearly defined form of self-certification for 506(c) deals might be enough to get generally solicited deals to take off.

- **Clarification of “General Solicitation”** - The current definition of general solicitation is very broad and could essentially include the large majority of angel-like offerings, unfortunately restricting some practices that have been in use for decades without problems or fraud. As new technologies and communications options become available, new entrepreneurs need to have better clarity on when they “trip the trigger” on Rule 506(c), since once that happens they can no longer use the private 506(b) and are less likely to get the funding they need from angel investors who do not want to go through the steps to verify they are accredited investors. Many of the most active angels require, as a condition of investing, a written assurance from founders that they have not generally solicited their deal.

- **Demo Days and General Solicitation** - Of particular concern in the definition of general solicitation is whether or how events such as “demo days”, venture forums, and business plan contests are considered to be part of 506(c). We have seen a wide variety of interpretations in the market about whether these events are general solicitation or not, and the character of many of these events change based on attorneys’ interpretation. We are even aware of one region in which presenting entrepreneurs are advised not to mention their business models, an important component for investors to know about the businesses. ACA notes that many of these events are hosted or sponsored by federal, state, and local government agencies, universities, law firms and non-profits that receive government funding for the purposes of economic development and education. Many of these “demo-day” models have been successfully implemented for many years. These events are important to many sophisticated angel investors, and ACA members have been involved as coaches, mentors, and judges in them.

The companies that participate in the events are the ones angels want to invest in, and these exact activities are great sources of deal flow for angels. As such, demo days should not be considered general solicitation. These are events where investors, service providers, mentors, and other experts who are all knowledgeable about the innovation ecosystem play the critically important role of helping startups find experienced people to help them succeed. The participating investors are not unknowing retirees who are unwittingly being solicited.

In addition to these key improvements to Rule 506, here are some direct responses to numbered questions in the concept release:

34. Should requirements for 506(b) and 506(c) be combined? What aspects should be retained and why?

The two should only be combined if the verification requirements for 506(c) offerings are simplified and financially sophisticated individuals qualify as accredited investors. The attached example qualification questionnaire for self-certification by individual investors could be a start in simplifying the verification process, combined with penalties on the investor for providing false information, including, for example, limits on remedies if they try a legal suit against the issuer. If the requirement for more verification steps for generally solicited deals needs to continue, as proposed in legislation, then the two should not be combined. Adding more verification requirements for 506(b) deals would most likely have the perverse effect of reducing early stage financing activity.

35. Is it important to continue to allow non-accredited investors in 506(b) offerings?

We rarely see unaccredited investors in 506(b) deals. Most investors are concerned about a possible loss of exemption and burdensome disclosure requirements and would either avoid such a deal or insist on having the unaccredited investors redeemed and removed. The statistics in the SEC document make this case. Therefore, it is not important to include non-accredited investors in 506(b) deals

42. Do extra verification requirements for 506(c) impact the willingness of issuers to use the rule?

Yes, verification requirements for 506(c) impacts willingness of issuers to use the rule – but there is more to this story. The real issue is that investors are not willing to invest in 506(c) offerings because of the verification requirements. This keeps capital away from issuers that use the exemption, whether they were aware of most investor preferences. Unfortunately, once an issuer "pulls the trigger" on general solicitation they cannot go back to the private 506(b) world, holding back potential investments in their company. More and more, entrepreneurs use social media and the Internet to contact potential investors they don't know, counter-intuitively reducing their access to capital.

Gaps in Current Framework

One of the biggest issues for angel investors is getting more liquidity in their investment portfolios so that they can recycle those funds into new startups. Not only have some angels estimated that the average positive exit takes 11 years, but 30 plus percent of angel investments are in companies that get stuck in slower growth and more modest profit scenarios than originally projected rather than progressing toward an acquisition or IPO. As a result, angel investments are being locked-up for longer periods than ever. If accredited angel investors had greater ability to trade some of their stock with other accredited investors in a secondary market, the angels would be able to rebalance portfolios and re-invest that capital in additional high growth companies. Unfortunately, complexity and uncertainty under current regulations is slowing the development of secondary markets for angel investors. Liquid secondary markets for angels would both further the investor protection mandate by increasing transparency and help make more capital available for re-cycling outside of tech hubs where it would be most impactful.

ACA member AngelList will include additional details about the angel liquidity policy, but it generally includes:

- Create a definition of a "Qualifying Private Sale" under Section 4(a)(7) that covers secondary sales of minority positions in private and operating companies with limited trading volume in private secondary markets. Buyers would need to be accredited investors.
- Waive the burdensome disclosure requirements under Rule 4(a)(7) for the Qualifying Private Sales, which are unnecessary for investor protection and currently make this rule impractical for angel investors who often do not have access to the information needed to satisfy disclosure obligations.
- Include shares sold in Qualifying Private Sales as covered securities to rely on federal preemption of Blue Sky law so the rules would be the same for sellers across all states.

We appreciate many of the questions in the "Gaps" section of the concept release and address a few of them below:

93. Should we add a micro-offering or micro-loan exemption? If so, what parameters? Would on offering limit of $250K or $500K in a 12-month period be appropriate?
We don't believe that an additional exemption is needed for micro financing because Regulation D already allows for any investment amount. The ACA Angel Funders Report indicates that many investments are smaller than even the $250K mentioned in this question. 21 percent of the investments in the dataset of ACA member angel groups are smaller than $500K.

112. For small issuers, particularly those that seek to raise capital in micro-offerings, to what extent are angel funds an important source of capital?
Angel funds (and networks) are increasingly important for startups to raise the capital they need. Organizations structured as funds comprise approximately one-third of angel groups and online syndicates across the country, up from about one-fifth ten years ago. They provide startup issuers with a structured way to put their investment opportunity in front of multiple investors and get the financing and support they need to start and grow. An emerging trend is the formation of smaller funds of $1M or $2M to make quicker investment decisions and fund companies within 30 days. The angel group can then add on more capital if they like the

opportunity. An example is the Tech Coast Angels – San Diego (see video at http://tcasandiego.com/).

Thank you again for your leadership in promoting American startups, capital formation and job creation. The Commission's focus in the concept release is a testament to the power of harnessing entrepreneurs along with capital markets to leverage economic growth. We would be happy to answer any questions about our feedback on the broad set of questions posed by the Commission.

Regards,

Patrick Gouhin, CEO
Tony Shipley, Chairman
Linda Smith, Chair Emeritus and Public Policy Chair