UNITED STATES SENATE
COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

HEARING: SEARCHING FOR CAPITAL: HOW VENTURE CAPITALISTS AND ANGEL INVESTORS FUND ENTREPRENEURS AND STARTUP COMPANIES

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Chairman Vitter, Ranking Member Shaheen and members of the committee, thank you for inviting the Angel Capital Association to testify on the important issue of equity funding for startup companies.

My name is Mike Eckert. I am on the Board of Directors of the Angel Capital Association (ACA), the world's largest professional organization of accredited angel investors. ACA has 13,000 member angels, who invest individually or through more than 240 angel groups and online platforms for accredited investors located in every-state in America. I also lead the NO/LA Angel Network in New Orleans, an investor group with 130 members who invest in early stage companies throughout Louisiana. I also am a limited partner in a number of venture capital funds, and was an early stage entrepreneur myself, including being on the startup team and serving as CEO of The Weather Channel. It is my pleasure to discuss with you how angel investors fund and mentor startup companies across the country, and to note some regulatory issues that could reduce angel funding for entrepreneurs.

Angels Fund Majority of Early Stage Companies

According to the Center for Venture Research at the University of New Hampshire, in 2015 angel investors invested $24 billion in an estimated 71,000 early-stage companies, in every state in America. This is capital from private individuals writing personal checks - $24 billion in personal checks to help entrepreneurs start and build their companies. Angel investors are the *only* source of equity capital for most startup companies, and supply as much as 90% of the equity funding these companies raise. These companies are too early and too risky to qualify for bank loans and are too small or too early in life for most venture capital firms. Federal Census data show that high-growth startups create *all* net new jobs in our country. Without angel funding, these businesses would never get off the ground.

The companies which angels support generally need between $50,000 and $2 million, with the median investment size being $850,000. In most cases, multiple individual angel investors are involved in these deals, with each angel investing $10,000 to $50,000 on average per deal.

Angels invest on every Main Street, in every state and in every business sector. We provide not just financial capital, but also "human capital" in terms of time, expertise and mentorship and our rolodexes and contact lists to open doors – often to first-time entrepreneurs who need all of the help they can get. Most often we invest in companies close to where we live so we can support local economic development activities and also to experience the special reward of helping build companies and jobs in our own communities.

Startup companies generally incur three or four layers of early private equity funding. The first layer is called bootstrapping, whereby the entrepreneur puts their own money in his or her company. The second layer is capital from friends and family, should the entrepreneur be blessed with friends and family with wealth—most are not. After friends and families come angel investors and angel groups who very often invest much earlier in a company than do venture capital firms. And following angels come venture capital firms. Businesses that successfully grow after one or more rounds of angel capital may attract venture capital for expansion, and angels build relationships with VCs to help the companies in which they have invested secure this next stage of funding. In states and cities that don't have much venture capital presence, angels and angel groups often co-invest together to provide the capital that startups need to continue expanding

The Companies Angels Support

Every angel investor is unique, but common things they are looking for as they evaluate startups for investment include:

- The entrepreneur and team. Do they have the ability or the potential to create and sell their product or service and to grow the company quickly?
- Does the product or service have a large market? Many angels look for a potential market of at least $500 million?
- Does the product or service have customers or potential customers who validate that the product or service is in development would solve a problem for them?
- Is the company located in the angels' preferred geography and does it have a good chance of remaining there as they grow?
- Is the company in a sector in which the angel or angel group has knowledge and experience, so they understand the company and can help it grow?
- Does the company have a valuation of less than $5 million before the angels invest and is it seeking an amount of equity capital that is typical of angels ($50,000 to $2 million)?
- Is there is a strong plan of exit that could lead to a return of a- significant multiple of the amount of the investment? This is important because more than half of angel investments fail, and angel returns come mostly from companies that provide a 10X return on the investment.

Companies like MobileQubes in New Orleans, a company which makes mobile device battery charging packs, fit these criteria.

Angel investors are also critical parts of startup "ecosystems" in their local states and communities, and often work in conjunction with "enablers" in the local ecosystem – these being business incubators and accelerators, university programs, local business development authorities and other investors - and by participating in formal mentoring programs and as a judges and coaches in local "demo days" and startup pitch competitions.

Key Regulatory Issues for Companies Seeking or Receiving Angel Capital

I understand that this committee has focused on regulatory issues that impact entrepreneurs and want to quickly touch on three issues that have or could impact startups seeking angel funding:

1. ***Definition of Accredited Investor*** – Dodd-Frank requires the Securities & Exchange Commission to study the definition every four years. The SEC has not yet changed the definition, but is considering a variety of suggestions from advocates of both investor protection and capital formation that could do anything from considerably reducing the pool of capital for startups (by

increasing the wealth and income requirements to be an accredited investor) to increasing the angel pool for startups, by providing new avenues for knowledgeable people to qualified as accredited investors. ACA notes that angel investing includes very little fraud for investors, and applauds efforts that continue the current financial thresholds and allow more people with education, certifications and/or experience in business to be accredited investors.

2. ***Demo days and general solicitation*** – One of the components of the JOBS Act allowed entrepreneurs to generally solicit their offerings, providing more avenues to find capital. An unintended consequence, however, is that “demo days” such as long-time local market and statewide venture forums or university business plan competitions are often now considered to be general solicitation, and participating entrepreneurs would need to secure additional verification of accredited investor status when they later obtained investment capital. The problem is that most angel investors will not invest in generally solicited deals, so participating companies would lose their chance for funding. The HALOS Act – passed by the House and with bi-partisan sponsors in the Senate (S. 978) – would exclude demo days from the general solicitation requirements that hold back startups from many angel investors. We encourage this committee to support the HALOS Act.

3. ***Proposed SEC Amendments to Regulation D, Form D, and Rule 156*** – This proposed, but not final, rule could lead to the death of many startups that use general solicitation but fail to adhere to the considerably difficult related filing requirements and as a result. These companies would lose their right to raise equity capital for a year. This 2013 proposal is still of concern, as some advocates, including the SEC Investor Advisory Committee, have recommended it be approved. ACA and many small business organizations would like to ensure these rules are never implemented.

I am pleased to continue to dialogue with this committee to help form additional policies that support small business and to talk more about the angel funding process and the entrepreneurial companies that angels support. Thank you.

SUPPLEMENTAL INFORMATION FROM THE ANGEL CAPITAL ASSOCIATION

National Angel Investing Landscape

Angel investors are high-net-worth individuals as defined by the Securities and Exchange Commission, who provide money for startup firms with growth potential. Many angels started, built and sold their own companies and are now in a position to invest their money and equally important, their time, in new or early stage businesses.

The nation's leading expert on entrepreneurship, the Ewing Marion Kauffman Foundation, estimates that angel investors may be responsible for up to 90% of the outside equity raised by startups after the capital resources of their founders, friends, and family are exhausted. These firms rarely have the collateral to receive bank loans and they are generally too small and too young to receive venture capital.

The University of New Hampshire's Center for Venture Research estimates that angels invested $24.1 billion in about 71,000 companies in 2015. One of the trends in the field over the last decade is the growth of angel groups and online platforms, in which accredited investors join together to invest in and mentor companies, pooling their capital to make larger investments and developing best practices for investing and mentoring. ACA estimates there are more than 450 angel groups, located in every state, more than a three-fold increase from about 100 groups ten years ago.

The HALO Report, the leading assessment of angel investing nationwide, describes the investments angel groups made in 2015:

- Median round size of $850,000
- 70% of investments were in healthcare/life sciences and Internet/IT sectors
- Two-thirds of the investment rounds were syndicated, often with multiple angel groups
- Investments were distributed broadly across the country – two-thirds of the deals were outside of traditional startup equity centers of California, New York, and Boston.

Angel investors are proud to be an important resource for the startup companies that have created the large majority of net new jobs in the United States over a 25 year period. Angel-backed companies have been some of the most prolific job creators and innovators in recent times: Google, Facebook, and Starbucks are just a few examples.

Thousands more companies supported by angel groups and individual angels are less known, but significant in the innovative products and jobs they have created.

For example, the NO/LA Angel Network, which has130 members from throughout Louisiana, has invested in technology, life sciences, and other sectors in companies including:

- MobileQubes, a New Orleans company created to solve the problem of on-the-go charging for smartphone users all over the world. MobileQubes' self-service, fully automated kiosks give smartphone users power where they need it—on-the-go and in their hands.

- Cyber Reef Solutions, a Shreveport, Louisiana-based company that provides leading-edge Virtual Private Network capabilities that will benefit and further drive the “Internet of Things.”
- Servato, a New Orleans based company that provides hardware and software solutions that extend the life of critical back-up batteries at cell-phone towers and data centers.

There are also great stories of companies that raise angel and venture capital for large expansion. Cradlepoint, a mobile wireless-router maker and networking company in Boise, Idaho, started with funding from local angels and has since attracted more than $48 million from VCs and private equity companies. The company is adding hundreds of employees each year.

Angel investors provide seed-stage equity at a rate that is 20 times the number of companies financed by venture capital. In 2015, angels invested $24 billion dollars in 71,000 startup and early-stage companies, while the venture capital industry in total put two percent of the $60 billion in seed-stage companies. According to Census Bureau Business Dynamics’ data, startups comprise less than one percent of all companies, but generate 10% of all new jobs in any given year. Without angel funding, these fledgling businesses would simply never get off the ground**.**

Risk and Angel Investment

Returns to Angel Investors in Groups, the first ever dataset and analysis of angel group returns, confirmed what many investors thought about their success:

- 52% of all exit returns less than the capital the angel had invested in the venture (with 35% of all exits losing all of the money invested)
- 7% of the exits achieved returns of more than ten times the money invested, accounting for 75% of the total investment dollar returns
- 31% of the exits returned the investment between 1 and 5 times the investment.

The study, which looked at 1,137 exits from angel investors connected to angel groups in many areas of the United States, also provided data to support that best practices in angel investment lead to better results for investors and the entrepreneurs they invest in. This includes matching investor expertise with the company, conducting a good level of mentoring and monitoring of company progress, and conducting due diligence in reviewing investment opportunities.

It is conventional wisdom that small business is responsible for the majority of net new job creation in the country in any given year. A growing body of focused research, using the Census Bureau’s *Business Dynamics Statistics* database, dramatically illustrates that it is a smaller subset of dynamic, high-growth startups that make up the vast majority of that job growth

- According to a Kauffman study, these so-called “gazelle” firms (ages three to five years) comprise less than 1% of all companies, yet generate 10% of all new jobs in any given year.
- A similar study from the National Bureau of Economic Research using the same database, found that, after controlling for age of a small business, startups account for almost 20% of gross job creation in any given year.

These are exactly the businesses that angel investors – and mostly only angel investors -- invest in.

The true shift in job creation has moved away from publicly-traded companies to the realm of startups that are funded almost entirely by private capital.

Sources

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