Committee on Small Business
Subcommittee on Oversight, Investigations, and Regulations
Hearing on "Navigating Regulations: Alternative Pathways to Investing in Small Businesses"

Testimony of Parag Shah
Founder, Vēmos
March 12, 2024

Chairwoman Van Duyne, Ranking Member Mfume, and members of the Subcommittee, thank you for inviting me to testify today regarding my experience with alternative financing for small businesses. My name is Parag Shah, and I am the founder of Vēmos, a Minnesota-based company that creates personalized experiences between consumers and hospitality businesses such as restaurants and bars.

Using our app, consumers can view a personalized menu tailored to their allergies and dietary needs, quickly view and pay their bill, while saving their favorite menu items at their favorite spots. Our app helps restaurants better understand their customers and provide a more personalized experience so they can grow their business. Prior to Vēmos, I have started a handful of other technology companies, many of which have failed but a couple of which have succeeded. I am also a proud member of ACT | The App Association, a trade group representing small tech companies like mine.

Based on my experience, there are three concepts I want to highlight for the Subcommittee and other small business owners who may have an interest in these issues:

1. **Alternative financing options** have improved over the past 15 years or so and become better distributed throughout the country;
2. When looking for investors, entrepreneurs should **take time to compare their options;** and
3. **Overregulation and government intervention** threaten our progress on alternative financing in several ways.

Alternative Financing options: an overview

There are several "early-stage" options for securing capital. One route involves private equity, and I know other witnesses at this hearing can cover these scenarios more authoritatively. I have more experience with options like friends and family investment, angel investment, and so-called "seed rounds" of fundraising before a venture-backed Series A or B fundraising round. Although I have never pursued crowdfunding, I can speak to its pros and cons, having seen friends and colleagues make use of it. With each of my companies, I have looked at the needs of my particular business, our strengths, and what we might be able to offer an investor, as well as the economic conditions at the time.

Starting a tech company often involves lower overhead costs than starting a brick-and-mortar retail store or restaurant. For us, the biggest asset has always been our human capital. You can have an idea, find a few cofounders, and get to work on your code without a lot of initial startup costs. The bumps in the road for these small tech companies start when they try to grow that business without money. If they don't have an immediately viable and available client base, they need some kind of investment. This is why alternative financing options are often relatively more attractive for software companies than for other kinds of startups. On the one hand, it usually takes less overhead to start a company, because you don't have to invest in physical inventory or infrastructure. On the other hand, traditional loans usually require physical assets as collateral, and it can be more difficult to create a viable client base with software, although the app stores have helped fast-track the process of acquiring customers.

Back in 2007, I was ready to start my first company. Founders didn't have as many resources then as there are now, so I didn't understand the process as well. Plus, being in Minnesota meant that it was more difficult to find capital since much of it was concentrated on the coasts. After struggling to raise sufficient funds through a seed round—which generally means raising between $1 million and $8 or $9 million, depending on the market—we ended up getting angel investment.

We had trouble finding local Minnesota investors who were willing and able to write checks large enough to make a dent in our seed round. We also made the choice to only work with accredited investors, which means that they have a certain annual income and ability to invest. Eventually, my cofounders and I exited that company through licensing our technology.

Crowdfunding

My current company received venture funding in the form of a seed round. Vēmos is fortunate to be a portfolio company of Revolution's Rise of the Rest, a seed funding effort focused on companies across the country that are not necessarily based in investment centers like Silicon Valley or New York City. Before settling on this deal, we considered other financing options. One option for some businesses is crowdfunding. In my opinion, this type of financing works better for small, physical businesses than it does for tech companies. With crowdfunding that involves an exchange of equity for cash, each investing entity is afforded the same rights as a shareholder, whether they invested $1 or $1 million. Even though federal law does not require these securities to be registered if they're less than $5 million in aggregate, it's really hard to effectively run a company like ours if you have such a large capitalization table (a spreadsheet showing the equity stake each investor owns). Since every name on a capitalization table represents an investor with an equity stake, I am accountable in specific ways to each of them. Having 100 bosses is difficult enough, and even more complicated if some of them have only invested small amounts while others have invested heavily. For their part, higher-level investors are also sometimes wary of those small-dollar funders having equal access and rights to those who have contributed much more.

The other category of crowdfunding is a “donation based” model, which might work better for a business like a coffee shop, or some other service-based business that could offer a non-monetary good or service in return for “donations” received via crowdfunding. You can offer incentives like free coffee for a year for a certain investment, something that’s not as easy to do with different types of technology. This would be considered a “donation based” campaign rather than a “securities based" campaign because there is no expectation of profits from a common enterprise and there is an element of consumption. Courts have consistently held that crowdfunding-style capital campaigns are not securities based if there is a consumptive element to the contract, such as in my coffee shop example, or in the example of one lawsuit where people purchased stock in a housing co-op in order to rent apartments. Kickstarter is another good example of a platform that facilitates a donation-based model. Individuals can contribute money toward a board game or piece of technology, with the expectation that they will receive a piece of the thing they invested in. They would not receive shares in the company making the game or the technology. For companies that are looking to increase profit through growth, the donation based model would not apply—investors would be looking for some return rather than effectively donating to a venture.

Regulatory impacts

While some regulation is important to make sure that investors are not being swindled out of money and entrepreneurs can count on their funders to follow through, overregulation leads to stagnation, decreases in new company formation, and limits in deployment of new capital. We have seen this dynamic play out over the past year: less capital was deployed last year than any recent year. Regulations have made it harder for business owners to exit the market, which for someone like me is a key way to build capital in my next company—but for others is their retirement plan.

The Hart-Scott-Rodino Act and related Federal Trade Commission (FTC) actions

One of the most significant proposed rules that I see threatening businesses now is the potential update to the process of filing a premerger notice under the Hart-Scott-Rodino Act (HSR). HSR review requires entities about to enter into a transaction that is over a certain size (currently $119 million) to file a premerger notification with the Department of Justice (DOJ) and Federal Trade Commission (FTC). These agencies work to clear the merger or to determine whether more information is necessary. Most mergers do not require additional information and are allowed to go on as planned, while some that the agencies believe are likely to cause antitrust harm are subject to this additional review. That review requires significant new document production and lawyer hours to answer adequately. And as I’m sure you’re all aware, lawyer hours are very expensive, especially for a specialty lawyer like one with extensive merger experience.

There is a change under consideration to require every proposed merger subject to HSR rules to provide the information found in the additional review up-front, even if they would have been

cleared through the initial document production. As a reference, under current rules the vast majority of mergers—about 98 percent—are able to be cleared using just the documentation from the first stage, while the remaining 2 percent that are judged higher risk must produce additional documents. Forcing all prospective mergers to conform to this much higher standard would, frankly, be a waste of time for all parties involved. For small companies, who would have to spend many more hours and much more money on this unnecessary documentation, this change would also affect their ability to be acquired by making it much less attractive for larger companies to consider an acquisition.

The HSR proposal is just the latest in a series of actions at the FTC that are making it harder to be acquired. Beginning three years ago, the FTC already decided to stop issuing letters letting merging parties know their review is over (and therefore that it's safe to merge unchallenged); began sending "warning letters" saying investigation is ongoing even after expiration of the review period; and issued merger guidelines declaring a wide range of mergers to be presumptively illegal. Taken together, all of these updates send strong signals to potential acquirers not to bother with it.

Even for companies that do not have a valuation of higher than $119 million (the current HSR threshold), their value decreases as well, as the market generally for acquisitions slows down under the weight of the additional red tape and uncertainty placed on the larger acquisitions. Entrepreneurs like me use acquisitions and other types of exits to fund new companies, and some business owners use acquisition as a retirement plan. But the resulting depression in value of companies like mine also means that my other options are less attractive; if my company is less valuable, investors are going to give me worse terms in any financing vehicle under consideration. Whether or not it's too uncertain or expensive to acquire my company has an impact on that valuation and on my bargaining position. In turn, this has a reverberating effect on my ability to find viable alternative financing.

I do not worry much about the failure of my company due to strong competition or tough market conditions. I've started up successful companies, and I can do it again. I do, however, worry about regulatory interventions like this that can short-circuit the cycle of creation that I thrive on.

Regulation D

The Securities and Exchange Commission's (SEC's) Regulation D is a rule that governs the private placement of stock. Private placement is an alternative to an initial public offering (IPO)—something that is out of reach for many small businesses—that allows companies to pre-select investors and offer equity to raise capital. There are fewer regulatory requirements on private placement than on an IPO, which makes them easier for small companies to do while still leaving open the door to an IPO at a later date. Through Regulation D, buyers are still allowed the same legal protections as other investors while companies can have more flexibility in raising funds.

One of the largest limitations on Regulation D investment is the requirement that most investors be "accredited investors." This means that issuing companies have to do some due diligence to discover whether their investors are accredited or not. Companies may sell securities to up to 35 non-accredited investors, but those investors must be considered "sophisticated," meaning they must be able to evaluate the risks and rewards before investing. Again, this requires some due diligence and being able to show that you looked into whether the investor is sophisticated. Additionally, the threshold for accredited investor is one-size-fits-all: it's the same number regardless of where the investor lives. As a result, the threshold may be unreasonably high for areas with much lower cost of living than is found in densely populated urban centers where the $200,000 income requirement is more commonly met. Some prospective investors may be barred from private placement by Regulation D because of this rule, but in my experience restricting investors to only accredited investors has helped ensure all parties are protected. Similarly, as described above, sticking with investors that are clearly able to "fend for themselves," like accredited or corporate investors, helps keep my capitalization table uncomplicated. As much as I believe my companies deliver value for our investors, it's important that they have support if something goes wrong.

Small Business Administration loans

Small Business Administration (SBA) backed loans are a key avenue for many businesses to access needed capital. They are very low-interest loans, allowing businesses to fully invest in their ideas and growth instead of worrying as much about repaying interest. I know that other members of the App Association have successfully leveraged SBA loans in growing their companies. SBA guarantees several types of loans, including microloans, working capital loans, refinancing of business debt, and other options that are flexible for a business's needs.

A major limitation to SBA loans is that, consistent with traditional loans, they require some form of physical asset to secure. For brick-and-mortar businesses, this is less of a problem, but for businesses like mine that deal almost entirely with software, the physical asset requirement is not a great fit. I wonder if other avenues could be explored for businesses like mine that fit the software model a little better but provide similar benefits for small software companies. For example, some states have "angel tax credits" that allow angel investors to claim a credit for some of their investment in a business. Angel investors do make use of some federal incentives including those related to capital gains or to write off investment losses. However, a federal version of credits for angel investments themselves might also help encourage investment in your congressional districts and in areas that have seen little or no startup investment by locals.

Conclusion

Our current system has a number of avenues businesses can travel to access growth capital, from crowdfunding to private credit to private placement of securities. All of these options have regulations in place to protect investors and businesses, but in some ways those regulations can impede the normal flow of capital. We should consider the impact each regulation has on small

businesses especially, and look for ways to make starting, growing, and selling businesses easier for everyone. I believe this cycle of creation is our secret sauce, and I appreciate the opportunity to participate in the policy debate about how best to protect and improve it.