

Testimony  
Of  
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To the  
Subcommittee on Investigations, Oversight and Regulations  
Committee on Small Business  
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Chairman Schweikert, Members of the Subcommittee on Investigations, Oversight and Regulations, staff, ladies and gentlemen, my name is James Goulka. I reside at 2525 W. Lompoc Avenue in Mesa, Arizona. I am the Managing Director of the Arizona Technology Investor Forum, a 501(c)6 entity comprised of 71 accredited investors who collaborate on finding, evaluating, and investing in early stage technology companies. In the 6 years of its existence, we have invested over \$7.25 million of our own money in 29 companies, 24 of which are based in Arizona. Together with our counterpart, Desert Angels in Tucson, we are by far the most active investors in early stage companies in the state. It is an honor to be here to offer my testimony to the Subcommittee. I will be brief.

Most people acknowledge that small businesses drive American job creation and innovation. Whether providing a new cancer diagnostic or a mobile phone app, opening a taqueria or doing contract manufacturing, small businesses hire people, lease space, buy services, and pay taxes.

I want to focus my comments today on a subset of American small business: startups. These are the creation of one, two, or three individuals, who take the exceptional risk of taking something that doesn't exist--an idea—and making it into a reality that solves a problem in a new way, causes new ways of behaving, or, simply, makes life better.

These businesses start out by the investment of time and energy from the founders—so called “sweat equity”—and the capital they can contribute to their new enterprises. Few founders are wealthy: most are middle class; many are young. They use hard-earned savings to start their businesses and live frugally. As they need capital to buy equipment, lease space, pay other people providing them services, they tap their friends and family members who may not know their business idea, but they do know the founders.

Occasionally, a startup can grow sufficiently to generate sales and profits with no additional capital. Such businesses usually serve a gaping need of a customer group for a pre-existing service. These quick successes strengthen our economy and are the bedrock of our local communities.

Others, though, are more uncertain: they may disrupt current practices, they may propose solutions that have never existed before, or they may be creating new market niches. These are the engines of innovation. Think Facebook, Amgen, or, more locally, GoDaddy, Infusionsoft, or Medicis.

These startups, with high potential but equally high risk, soon run out of capital from their friends and families and have to turn to outside investors. In some situations grants, such as SBIR funding from federal agencies or Innovation Challenge Grants from the Arizona Commerce Authority provide important early capital to these businesses.

For capital beyond these sources, founders and other entrepreneurs turn to outside *investors*, people and institutions with capital resources they intend to invest to achieve economic returns.

The most obvious sources of funding for businesses are banks. But, for more than simple transactional offerings like checking accounts, startups are not attractive to banks because they do not meet the banks' fundamental credit criteria. Startups, by definition, have no history, and are completely unpredictable. Most have no profits or collateral. Most entrepreneurs have little personal history with a bank, many have no previous experience as founders, and few are willing or able to provide personal guaranties on loans to their companies. Startups are, in reality, unbankable. And American taxpayers, having experienced the financial meltdown of the past several years, are not enthusiastic about banks taking on this kind of risky business.

We do have investors who are interested in providing capital to this segment: individuals, generally referred to as angels, and institutions, generally called venture capital firms. These are sophisticated individuals and firms who are have the capability to assess the risks of new enterprises, make judgments about them, and accept what they hope are reasonable risks in return for acceptable returns. Importantly, they understand and accept that the risk of total loss of an investment in any private startup is high.

In late 2013 venture capital firms tend to manage funds sufficiently large that they rarely invest in funding rounds of less than \$2 million. Angels, whether investing by themselves or in groups, are the principal source of funding for entrepreneurs seeking their first rounds of outside capital in lesser amounts. The Center for Venture Research estimated that angels invested \$19 billion in 35,000 US companies in 2008. And that was the year when the financial crisis hit.

A major intent of the JOBS Act of 2012 was to increase the opportunity of American startups to raise capital by enabling more people to invest in them. This meant addressing two issues: (a) redefining who could invest in the securities issued by startups; in other words, redefining an angel investor; and (b) changing the rules on how startups—the potential issuers of private securities—communicate with those potential investors.

### **Solicitations—Private and General**

Rule 506 of Regulation D that governs the issuance of private securities had come to be seen by some as a constraint on the ability of issuers to reach potential accredited investors whom they do not know in advance. To address this, the SEC recently subdivided Rule 506 into two sections: 506(b) deals with purely private transactions, and the new Rule 506(c), which relaxes the constraint and enables issuers to publicly advertise their issues--do a general solicitation--in the hope of attracting those unknown investors. In exchange for the freedom to advertise, the issuer must now meet an array of requirements and take the “reasonable steps” to assure itself that the investors are accredited.

### **Definition of Accredited Investor**

Regarding the definition of angel, most angels fit the SEC definition of “accredited investor,” which means meeting a net worth test (of \$1 million not including a residence) or an income test (of \$200,000 in each of the previous two years for a single person. That number increases to \$300,000 for married persons). The intent of the Securities Act of 1933, was to protect the general public from unscrupulous promoters who might cajol unsophisticated individuals into making investments in spurious companies. The concomitant thought was that a sophisticated investor could fend for himself, which he or she would do by careful evaluation of opportunities, collaborating with likeminded investors, and understanding the risks involved. He also has the ability to absorb loss.

Over the past 80 years, the practice arose among angel investors of self-declaration of accredited investor status. This usually takes the form of a document wherein an investor identifies how he/she qualifies as accredited. I have attached the form that the Arizona Technology Investor Forum requires of all members. Most organized angel groups such as ours use a form substantially identical to this. Furthermore, the documents relating to every privately issued security that I have seen includes a substantially similar statement by each investor. This means that at every investment action, each investor restates his/her status as an accredited investor. And further yet, the securities documents of a private issue contain legends clearly stating the riskiness of an investment in those securities. Combined, these make compelling arguments that angels, especially within organized angel groups, but also experienced independent investors, know what they are doing, understand the risks, and meet the intent of the words “accredited investor.”

One would think, then, that the sheer scale of tens of billions of dollars invested by angels each year and current accredited investor practices prove that the system works and would form the baseline for any expansion of the definition of an investor who could invest in privately issued securities. Presumably, that is the case for purely private solicitations under Rule 506(b).

However, the effect of the new rules issued by the SEC in Section 506(c) of Regulation D that go into effect today create serious impediments for the same angels to invest in new issues by private companies if the means of communicating the opportunity is different, i.e. by general solicitation:

- (a) If accredited investors consider investing in a private security which meet the test of a general solicitation, they may be required to provide to the issuer or, potentially, a third party private, highly confidential information in order to buy something for which they are paying 100% cash at the time of purchase.

This contains the absurd notion of an investor disclosing his/her tax return to a relatively unknown person in advance of a transaction that may or may not close. Alternatively, if an intermediary is used, new costs are added to a transaction. These could be substantial, especially given the uncertain requirement for periodic updates. And that does not obviate the potential lost privacy or harmful subsequent disclosure. Many angels polled on the subject state that they will refuse to provide the kind of information required. Thus the rules needlessly shrink the pool of existing investors.

- (b) The onus on collecting that information is placed on the issuer of the securities, with serious sanctions on the issuer if it does not fully comply with these requirements. This includes the potential prevention of fundraising for a year, which would effectively destroy the issuer.

When considering a general solicitation, an issuer now has to weigh the potential benefits of attracting new investors against the costs, most importantly the improbability of reasonably satisfying itself and the SEC that every one of its investors is accredited. In my view, if investors are required to provide the personal information, they will not invest in a deal that is generally solicited. The purpose of relaxing the prohibition on general solicitation will have been defeated.

Fortunately, the SEC included in its rule-making the provision for verification through a “Principles-Based Approach” which contextualizes the investors by their experience, previous knowledge of the person(s), the minimum scale of an investment, and other elements. Ambiguous now, I recommend that this section be more thoroughly defined. There is, in my view, an opportunity to define accredited investor by the traditional self-declared method, supplemented by observations of actual experience, such as previous investing in private transactions and by education in high risk investing. For both of these, organized angel groups such as the Arizona Technology Investor Forum, provide structured and thorough opportunities and programs. Illustrative of this are our multi-step screening process in which nine experienced investors vet all candidates to select the few that members are shown; our Sidecar Funds, which enable new investors to learn by following others, and by our education programs, such as the Valuation Workshop created by the Marion W. Kauffmann Foundation which we are bringing to the membership in October. The Angel Capital Association has provided input to the SEC on how organized angel groups such as the Arizona Technology Investor Forum work and suggest formalizing membership in an organized angel group as sufficient verification of accredited investor status.

Until the rules clear further, the Arizona Technology Investor Forum will limit consideration to private solicitations only, thus ensuring that our members do not find themselves accidentally in situations where they do not wish to be.

These issues are particularly important for Arizona. In our state, we have few venture capital resources, so angels, especially organized angel groups such as Arizona Technology Investor Forum and Desert Angels, are a critical part of the state’s technology ecosystem. Together, we are about 170 investors. Arizona needs, if anything, more angels investing here, so the rules should help attract new investors, not dissuade them from participating.

Thank you for your time and willingness to listen to my testimony.