Can Venture Philanthropy Save Investment Crowdfunding?

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Tuck VC Fellows Presentation

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Historically, US securities laws made it very difficult for small businesses to offer and issue securities to the general public.

- Standard Rule: issuing securities (debt or equity) requires SEC and/or state registration
  - Securities Act of 1933 - registration requirements established
  - Securities Act of 1934 - ongoing reporting and disclosure obligations
  - State Blue Sky laws

- Registration is a very heavy burden for an early stage company
  - Time consuming process involving lawyers, accountants and investment bankers
  - Very costly: often hundreds of thousands of dollars
  - Significant disclosure requirements = competitive disadvantage
  - Burdensome ongoing reporting & compliance

Virtually all small businesses issue securities under one of two registration exemptions: 4(a)(2) + 3(b)1

- Section 4(a)(2) of 1933 Act
- Exemption for non-public offerings. Courts have ruled based on the sophistication of offerees and their ability to bear risks.
- SEC Reg D Rule 506 safe-harbor:
  - Con: Purchasers must be accredited investors + up to 35 'sophisticated' non-accredited investors
  - Con: General restriction on solicitation and advertising
  - Con: Restrictions on secondary offerings
  - Pro: No formal prospectus/circular requirements
  - Pro: no formal ongoing reporting requirements (though often required under bylaws, shareholder rights agreements, or corporate statute)
  - Pro: Blue Sky Preemption
- Comprises 97% of private securities offerings

Virtually all small businesses issue securities under one of two registration exemptions: 4(a)(2) + 3(b)1

- Section 3(b)1 of 1933 Act
- Establishes SEC authority to exempt small offerings
- <u>Reg D Rule 504 </u>defines the scope of this exemption:
  - Pro: No accredited investor limitation
  - Con: $5M issue limit (recently increased from $1M)
  - Con: No preemption of state blue sky laws (but, new ‘coordinated review’ process is available)
- Under this exemption, federal government essentially abdicates to states the responsibility to regulate rule 504 offerings.
- Approximately 2% of exempt securities are issued under rule 504
- <u>Not particularly well suited to public, nation-wide securities issues</u>

Upshot: 87% of the general public is ineligible to invest in the majority of securities issues.

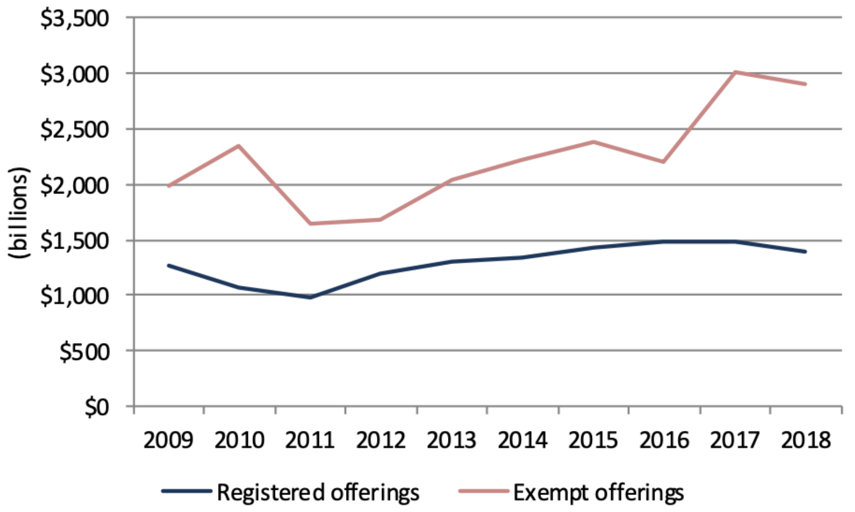
Table 3: Households qualifying under existing accredited investor criteria

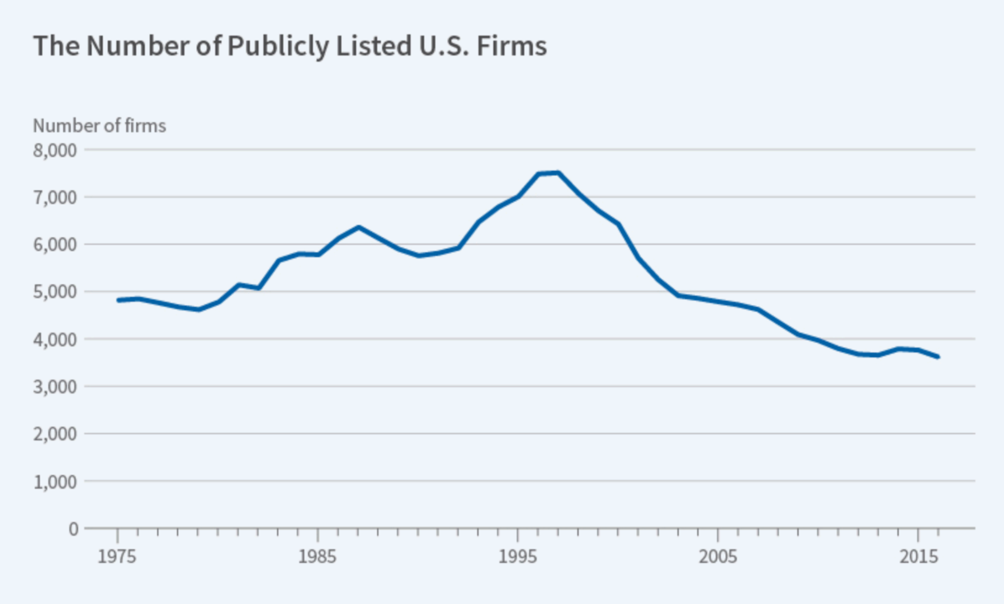
Criterion	Number of qualifying households *(Standard errors are in parentheses)*	Qualifying households as % of U.S. households *(Standard errors are in parentheses)*
Individual income[79] threshold ($200,000)	11.2 million (0.3 million)	8.9% (0.2%)
Joint income[80] threshold ($300,000)	5.8 million (0.2 million)	4.6% (0.2%)
Net worth[81] ($1,000,000)	11.8 million (0.3 million)	9.4% (0.2%)
Overall number of qualifying households[82]	16.0 million (0.3 million)	13.0% (0.2%)

Exempt issues continue to grow, while the public equities market shrinks, limiting options for retail investors.

"It's not possible for the general public to invest in a diversified portfolio of really small, publicly traded companies in the way they could a few decades ago." René M. Stulz, Professor of Finance, Ohio State University

Figure 1: Capital raised in exempt and registered capital markets, 2009-2018





Jumpstart Our Business Startups (JOBS) Act of 2012: A Game Changer?

- Creates 3 new 1933 Act exemptions that make it easier for small companies to publicly solicit funding from the general public.
  - Title II → amendment to section 4a(2) (effective 2012)
  - Title III → addition of section 4a(6) (effective 2016)
  - Title IV → addition of section 3b(2) (effective 2015)

- Cited justifications for JOBS Act legislation
  - Create more opportunities for the general public to invest in early stage, high growth investment opportunities.
  - Drive more capital into innovative, job producing business opportunities.
  - Level playing field for business segments often overlooked by institutional investors (e.g. non-coastal, minority owned, small scale, low multiple).

JOBS Act Title II + Rule 506(c) : "Accredited Investor Crowdfunding"

- Title II amendments section 4a(2) of the 1933 Act
- SEC Reg D Rule 506(c) brought 4a(2) into effect in August, 2012
- 506(c) is very similar to Rule 506(b) with three important exceptions:
  - Issuers may promote/advertise offerings to accredited investors
  - Issuers (or their broker) must verify accredited status
  - No non-accredited investors
- Some of the earliest crowdfunding platforms (e.g. AngelList, EquityNet) take advantage of the 506(c) exemption

Comparison of 4(a)(2) Exemptions

Table 1: Overview of capital-raising exemptions

Type of Offering	Offering Limit within 12-month Period	General Solicitation	Issuer Requirements	Investor Requirements	SEC Filing Requirements	Restrictions on Resale	Preemption of State Registration and Qualification
Section 4(a)(2)	None	No	None	Transactions by an issuer not involving any public offering. *See SEC v. Ralston Purina Co.*[22]	None	Yes. Restricted securities	No
Rule 506(b) of Regulation D[23]	None	No	"Bad actor" disqualifications apply	Unlimited accredited investors Up to 35 sophisticated but non-accredited investors	Form D[24]	Yes. Restricted securities	Yes
Rule 506(c) of Regulation D	None	Yes	"Bad actor" disqualifications apply	Unlimited accredited investors Issuer must take reasonable steps to verify that all purchasers are accredited investors	Form D	Yes. Restricted securities	Yes

JOBS Act Title III + Reg Crowdfund : “Seed Crowdfunding”

- Title III adds a new exemption – section 4a(6)
- SEC Regulation Crowdfunding brought Title III into effect in May, 2016
- Regulation Crowdfund Stipulations:
  - Maximum offerings of $1,060,000 per 12 month period
  - Open to the general public, subject to investor limits
    - < than 107K annual income: 2,200 or the lesser of 5% of annual income or net worth
    - > than 107K annual income: 2,200 or lesser of 10% of annual income or net worth
  - Offering and all promotion must take place through a single online platform operated by a federally registered broker-dealer
  - 12 month restriction on secondary offerings
  - Disclosure (Form C) and ongoing financial reporting requirements. Audited financials required for issuers offering over $535k

Regulation Crowdfund – Typical Fundraise, By the Numbers

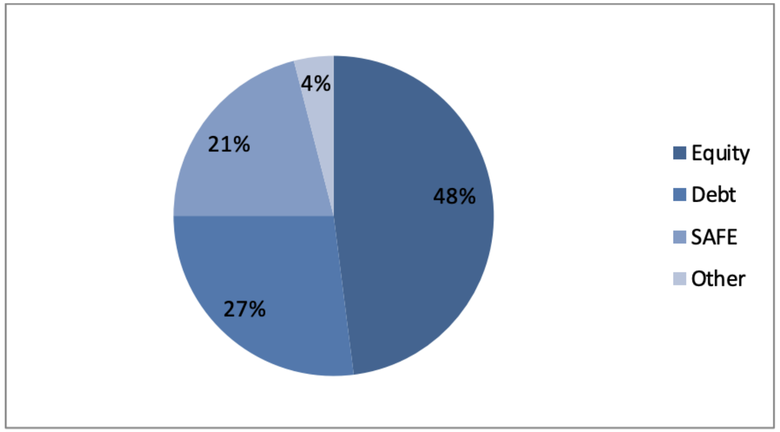
Table 5. Total commitments in offerings funded on the platform during the considered period[95]

Total per investor, per issuer	Median	Average	
All investors	$260	$830	
Non-accredited investors	$250	$600	
Accredited investors	$840	$2,030	
Total per investor, across issuers	Median	Average	
All investors	$490	$1,340	
Non-accredited investors	$300	$890	
Accredited investors	$2,200	$5,750	
Total per investor, across issuers as % of 12-month limit[96]	Median	Average	% investors ≥100%
All investors	17%	34%	6%
Non-accredited investors	18%	33%	6%
Accredited investors	13%	35%	7%
Number of investors per issuer	Median	Average	
All investors	258	416	
Non-accredited investors	214	349	
Accredited investors	41	67	

Table 1. Offering amounts and reported proceeds during May 16, 2016 - December 31, 2018

	Number	Average	Median	Aggregate (in millions)
Target amount sought in initiated offerings	1,351	$69,800	$25,000	$94.3
Maximum amount sought in initiated offerings[41]	1,351	$602,200	$500,000	$775.9
Amounts reported as raised in completed offerings	519	$208,400	$107,367	$108.2

Figure 1a. Security types in Regulation Crowdfunding offerings (number of offerings)

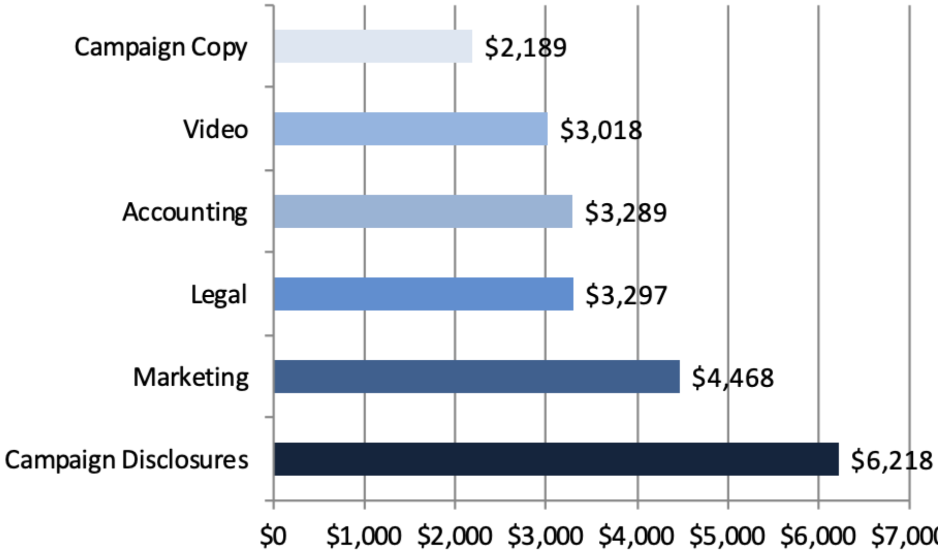


Regulation Crowdfund – Profile of a Typical Issuer

Table 3. Issuer characteristics[52]

	Mean	Median
%: Legal status is "corporation"	63.9%	
Issuer age (months since incorporation)	35.4	21.1
%: Issuer age is ≤3 months	9.3%	
Employees	5.2	3.0
Assets ($000s)	324.2	29.1
%: Issuer has no assets	24.3%	
Revenue ($000s)	301.1	0.0
%: Issuer is pre-revenue	52.7%	
Net income or loss ($000s)	-182.5	-11.2
%: Issuer has a positive net income	9.6%	
Cash ($000s)	78.5	4.4
Debt ($000s)	338.4	12.1
Long-term debt ($000s)	198.1	0.0
Debt/assets	55.4	0.86
%: Issuer has debt	59.0%	
Asset growth	2,953.2%	20.7%
Sales growth	857.4%	40.6%

Figure 3c. Average breakdown of costs (in dollars) per activity[63]



JOBS Act Title IV + Reg A : “Mini IPO”

- Title IV (2012) added a new exemption - section 3b(2) – to the 1933 Act
- SEC Regulation A brought Title IV legislation into effect in July, 2015
- Two Reg A exemption tiers were specified.
- <u>Rules Common to Tiers 1 & 2</u>:
  - Non accredited investors permitted to invest
  - No restrictions on advertising/promoting securities issues
  - No limitation on secondary offerings
  - Special, streamlined registration under form 1-A

<u>Tier 1 Specific Rules</u>

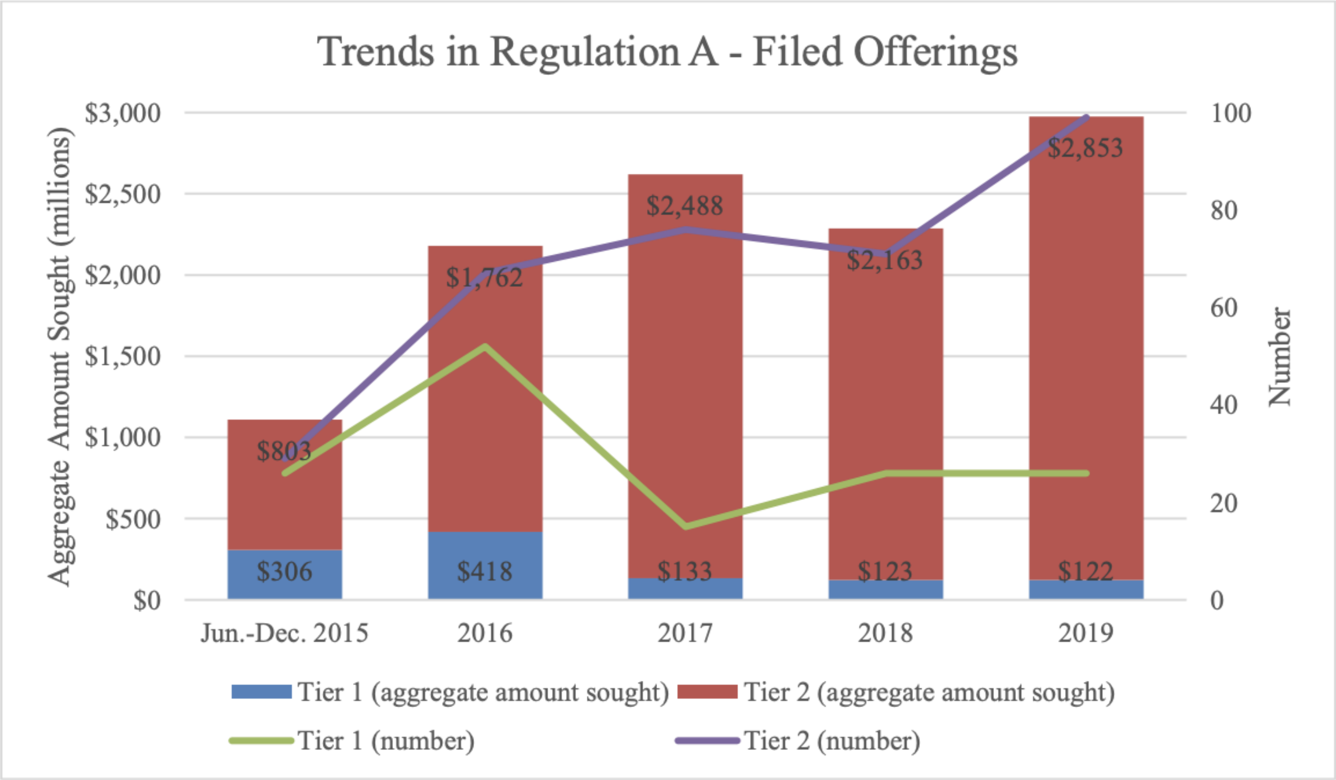
- Maximum of $20M per year
- Subject to Reg Crowdfund max individual investments
- Financial disclosures do not need to be audited (subject to state law provisions)
- Subject to state Blue Sky laws (coordinated review process)

<u>Tier 2 Specific Rules</u>

- Maximum of $75M per year (raised from $50M in March, 2020)
- No limitation on individual investment size
- Financials must be audited (with ongoing, biennial reporting)
- Not subject to Blue Sky laws

Reg A Tier 2 has proven more popular, likely due to Blue Sky preemption

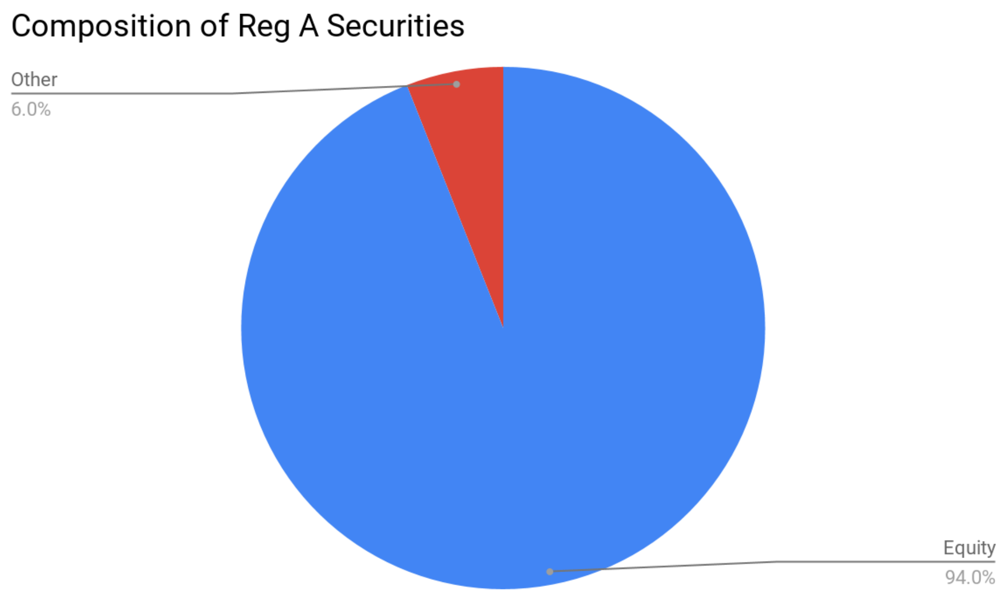
Figure 2. Trends in Regulation A



Reg A – A Typical Fundraise, By the Numbers

Table 4. Capital Sought and Raised under Regulation A during June 2015–December 2019 vs. Existing Offering Limits[22]

	Median per issuer *(Dollar amounts in millions)*	Average per issuer *(Dollar amounts in millions)*	% of issuers with proceeds reaching the existing limit
Amount sought per issuer across filed offerings			
All issuers	\$15.0	\$25.2	33%
Tier 1	\$5.0	\$8.5	15%
Tier 2	\$26.0	\$32.0	41%
Amount sought per issuer across qualified offerings			
All issuers	\$16.3	\$26.1	34%
Tier 1	\$5.0	\$8.2	13%
Tier 2	\$26.0	\$32.3	41%
Reported proceeds per issuer			
All issuers	\$5.0	\$13.4	9%
Tier 1	\$4.1	\$5.9	3%
Tier 2	\$5.5	\$15.4	10%



Reg A – Profile of a Typical Issuer

Table 5. Regulation A Issuer and Offering Characteristics[23]

Variable	Mean	Median
Total assets	\$32,582,700	\$311,500
Employees	38.9	2.5
Age (years since incorporation)	6.6	3.0
Revenue	\$2,642,800	\$0
% revenue >0	47%	
Net income	-\$490,100	-\$14,000
% net income >0	21%	
Cash and cash equivalents	\$1,842,700	\$31,200
Property, plants, and equipment	\$4,677,200	\$0
Long-term debt	\$5,758,900	\$0
% continuous offerings	80%	
% testing the waters	27%	
% offerings with affiliate selling security holders	6%	
States of solicitation	38	51
% equity offerings[24]	93%	

Reg A – Presently Dominated by REITs and asset heavy businesses; Minimal Technology (generally classified under “services”)

Figure 4a. Capital Sought in Qualified Regulation A Offerings, by Issuer Industry[34]

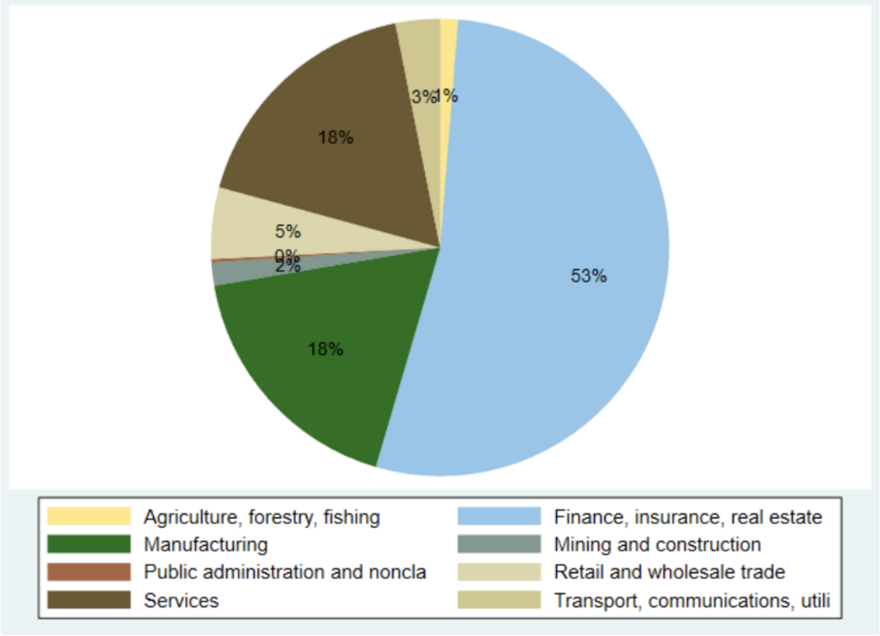
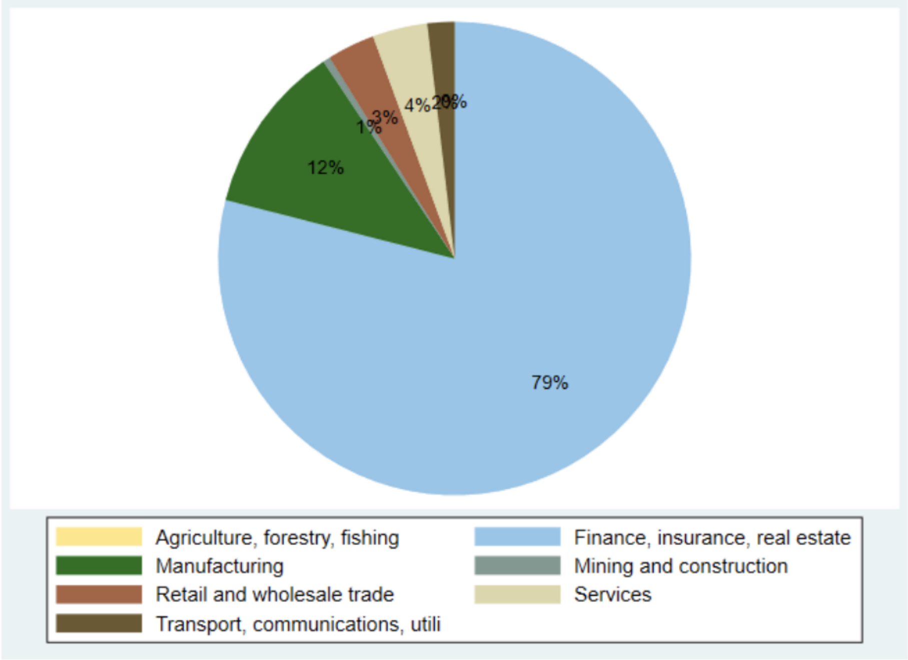
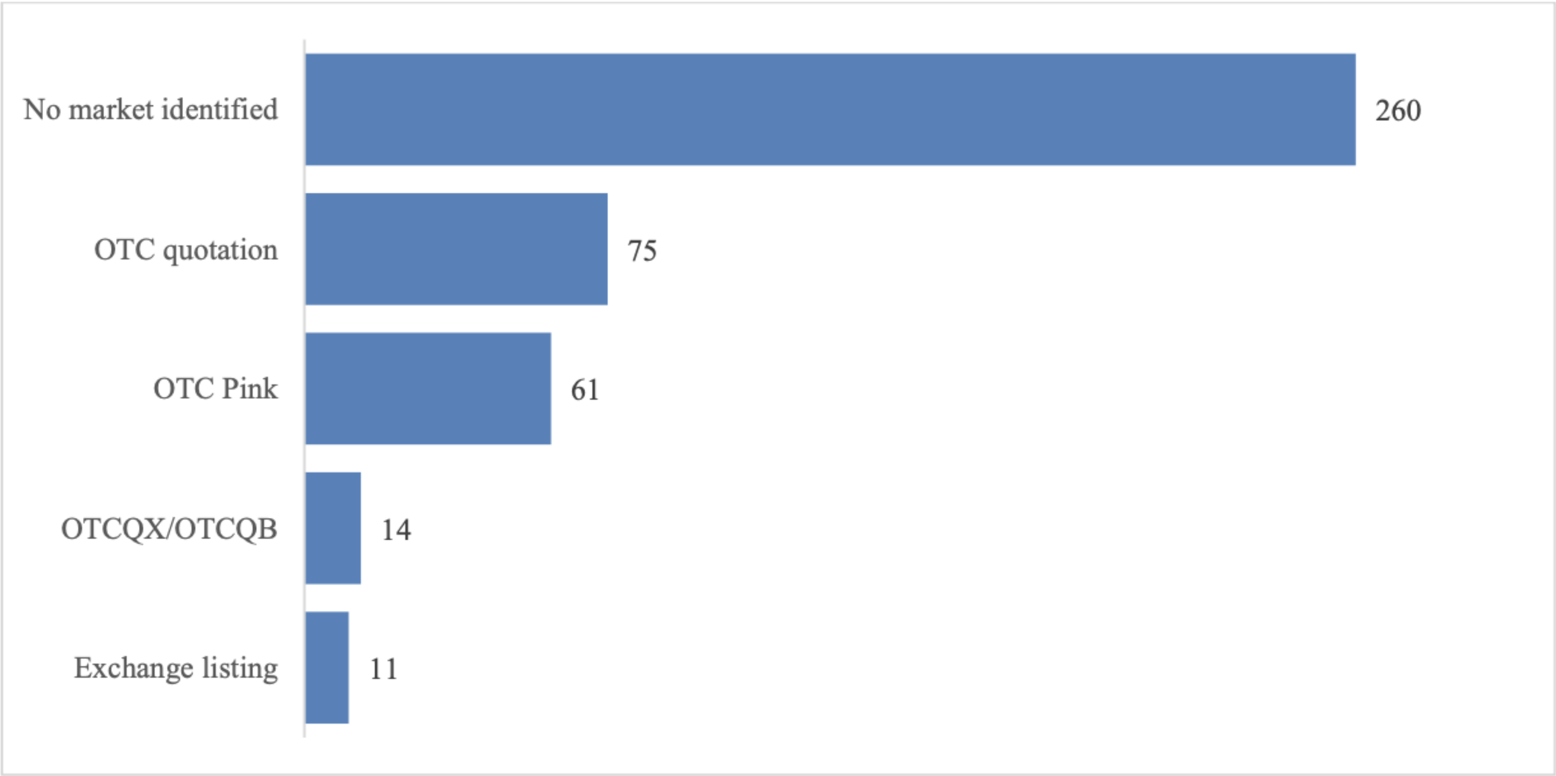


Figure 4b. Proceeds Reported in Regulation A Offerings, by Issuer Industry[35]

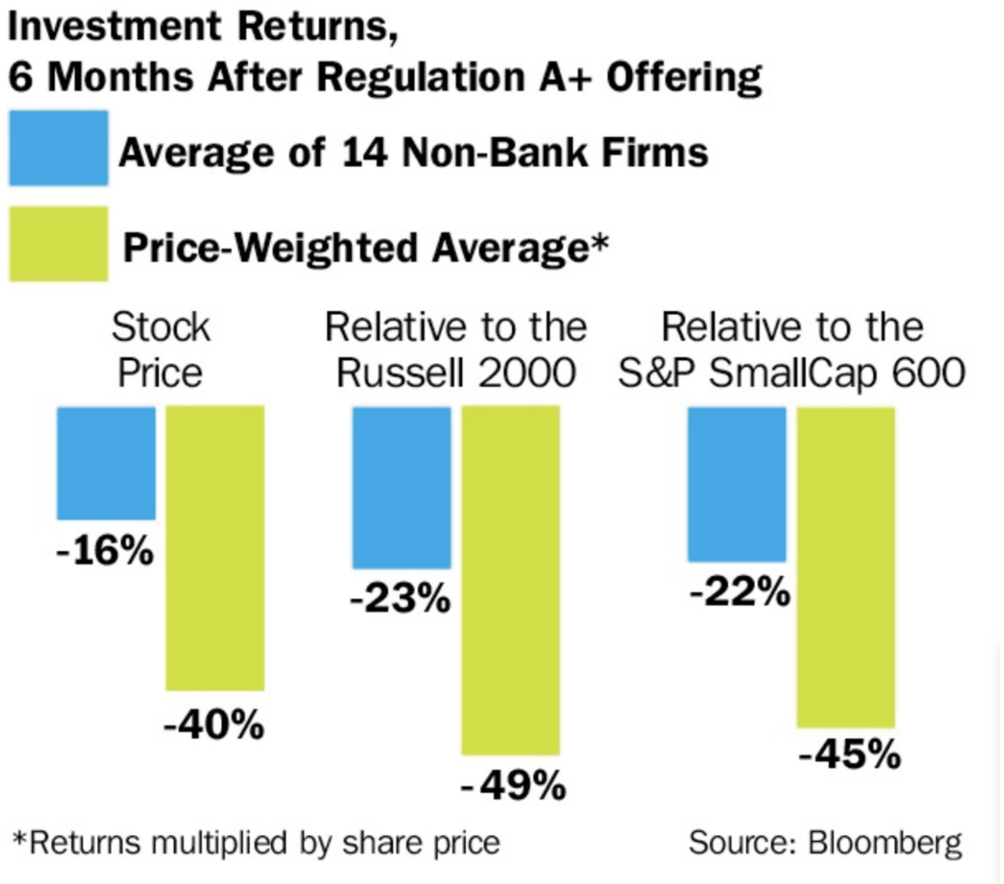


Reg A – Shares can trade on a public exchange, but more often do not.

Figure 3. Secondary Trading Market of Regulation A Issuers



Among the publicly listed Reg A equity offerings, initial performance has been disappointing



Overview of Prominent Federal Securities Registration Exemptions as of 2020

Exemption	Max Size	Non Accredited Participation?	Audited Financials Required?	Blue Sky Preemption?	Advertising/promotion Permitted?	Secondary Issuance Retractions	Max Individual Investment	Ongoing Reporting Required?
Reg D Rule 506(b)	Ulimitted	No	No	Yes	No	Yes	No	No
Reg D Rule 506(c)	Ulimitted	No	No	Yes	Only to certified Accredited Investors	Yes	No	No
Reg D Rule 504	$5M	Yes	No	"Coordinated Review"	Defer to State Law	Defer to State Law	Defer to State Law	Defer to State Law
Reg Crowdfund	$1.06M	Yes	Depends on size of issue	Yes	Limited	12 month holding period	Yes	Limited
Reg A Type I	$20M	Yes	No	"Coordinated Review"	Yes	No	No	No (but state requirements)
Reg A Type II	$75M	Yes	Yes	Yes	Yes	No	Yes	Yes

= Introduced under JOBS Act (Tiles II, III and IV)

Volume Security Issues Filed Under JOBS Act Exemptions Have Grown Since 2015, but Remain Insignificant Overall

	Reg A Tier 2		Reg A Tier 1		Reg Crowdfund	
	$'s Invested	**Offerings**	**$'s Invested**	**Offerings**	**$'s Invested**	**Offerings**
2015	**$8M**	**5**	**$2M**	**10**	**--**	**--**
2016	**$175M**	**85**	**$53M**	**32**	**$13.5M**	**$178**
2017	**$360M**	**85**	**$70M**	**15**	**$71.2M**	**474**
2018	**$675M**	**280**	**$60M**	**86**	**$109.2M**	**680**
2019	**$998M**	**382**	**$44M**	**105**	**$105M**	**735**

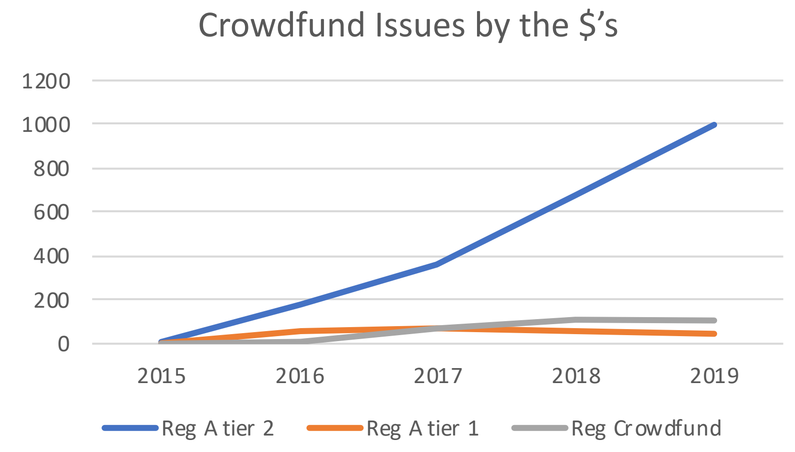
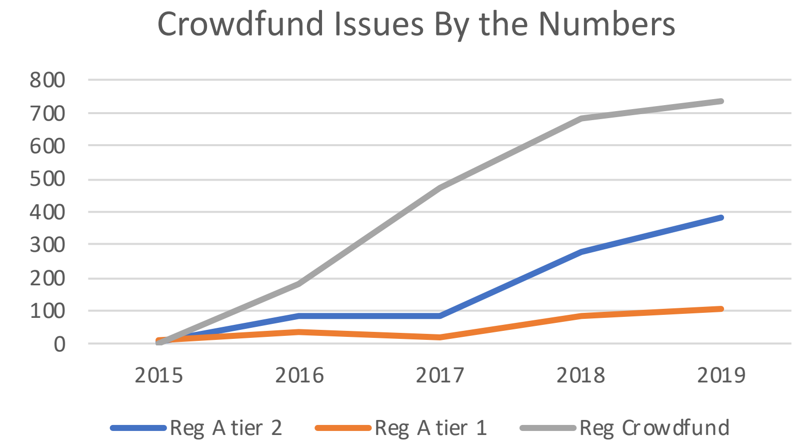


Table 2: Overview of amounts raised in the exempt market in 2018

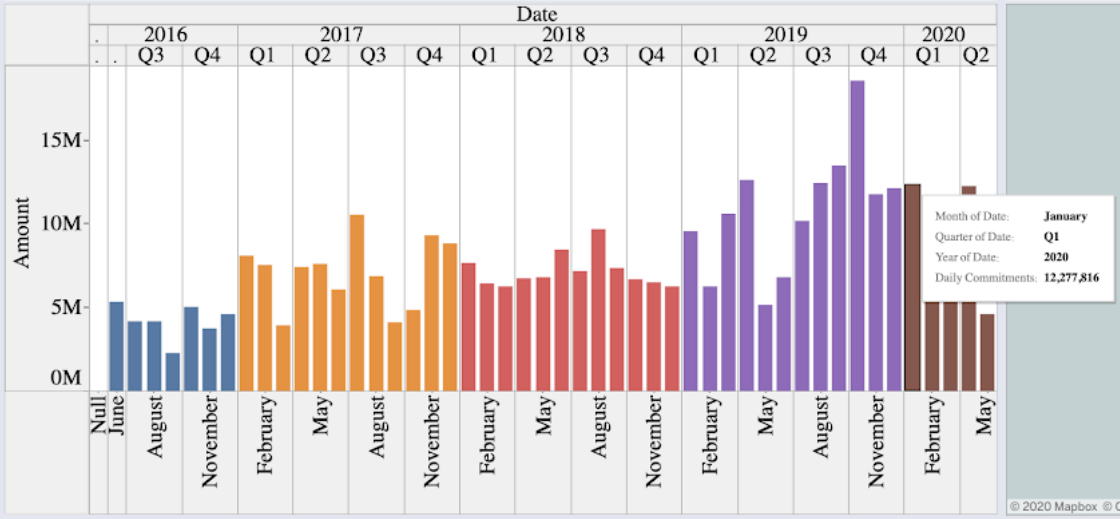
Exemption	Amounts Reported or Estimated as Raised in 2018
Rule 506(b) of Regulation D	$1,500 billion
Rule 506(c) of Regulation D	$211 billion
Regulation A: Tier 1	$0.061 billion[39]
Regulation A: Tier 2	$0.675 billion[40]
Rule 504 of Regulation D	$2 billion
Regulation Crowdfunding; Section 4(a)(6)	$0.055 billion
Other exempt offerings[41]	$1,200 billion



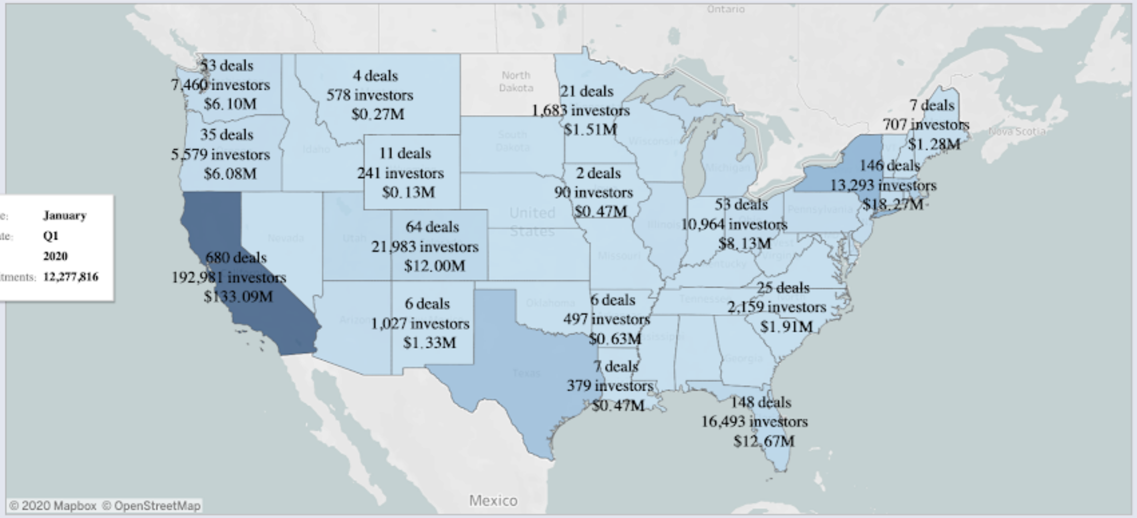
CCLEAR ONLINE INVESTMENT INDUSTRY STATISTICS (All Reg CF, Select Reg A & 506c offerings)

TOTAL COMMITMENTS	TOTAL BACKERS	TOTAL CAMPAIGNS	AVERAGE RAISE	JOBS SUPPORTED
$374,111,321	523,822	2,489	$258,679	12,780

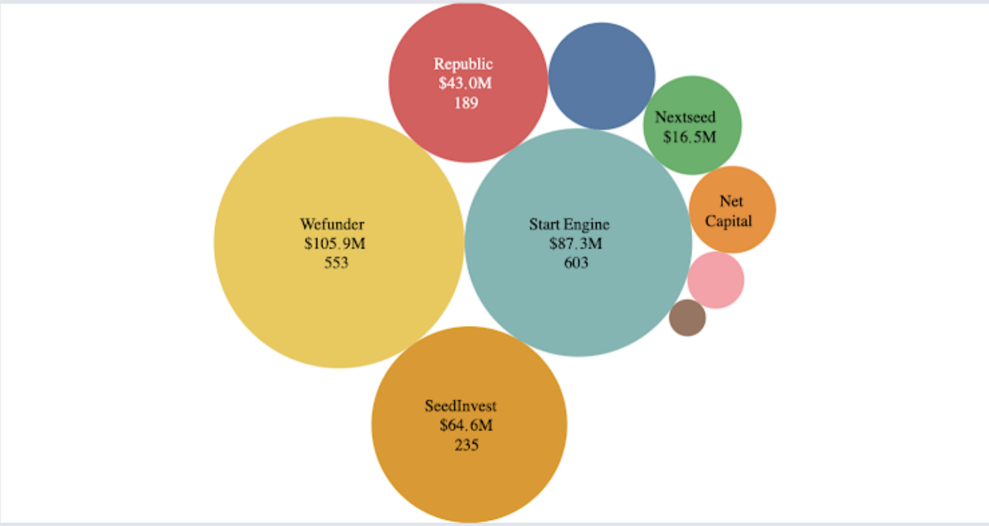
COMMITMENTS OVER TIME



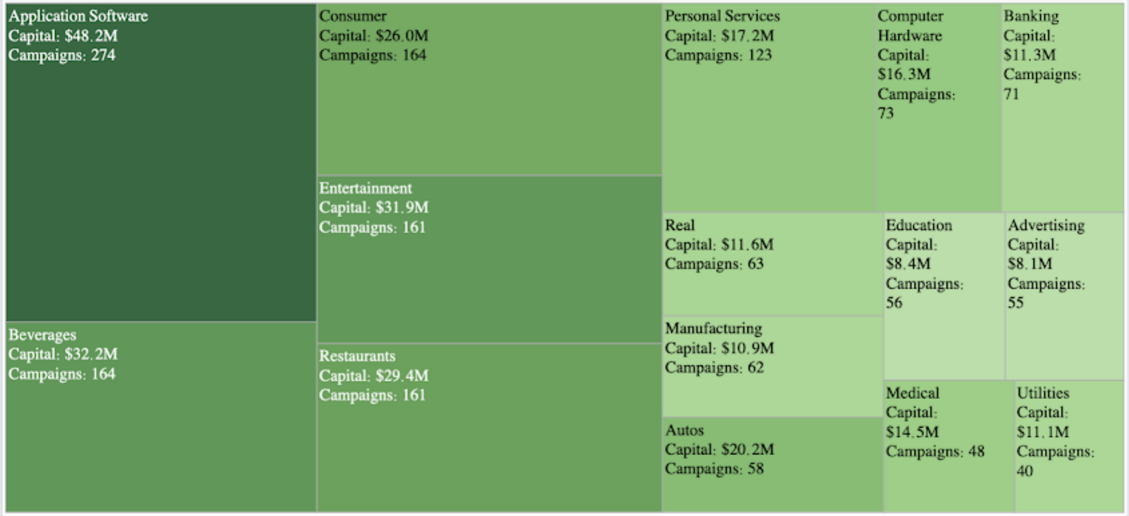
DEALS BY STATE BY QUANTITY AND COMMITMENTS



TOP 10 PLATFORMS BY DEALS, COMMITMENTS



TOP 15 INDUSTRIES BY CAMPAIGNS AND COMMITMENTS



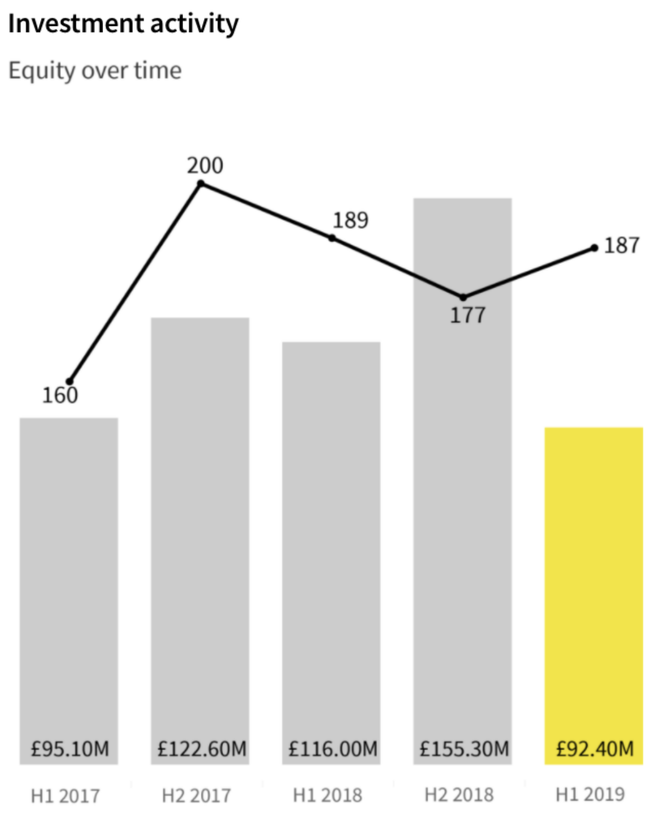
Investment Crowdfunding: An International Perspective

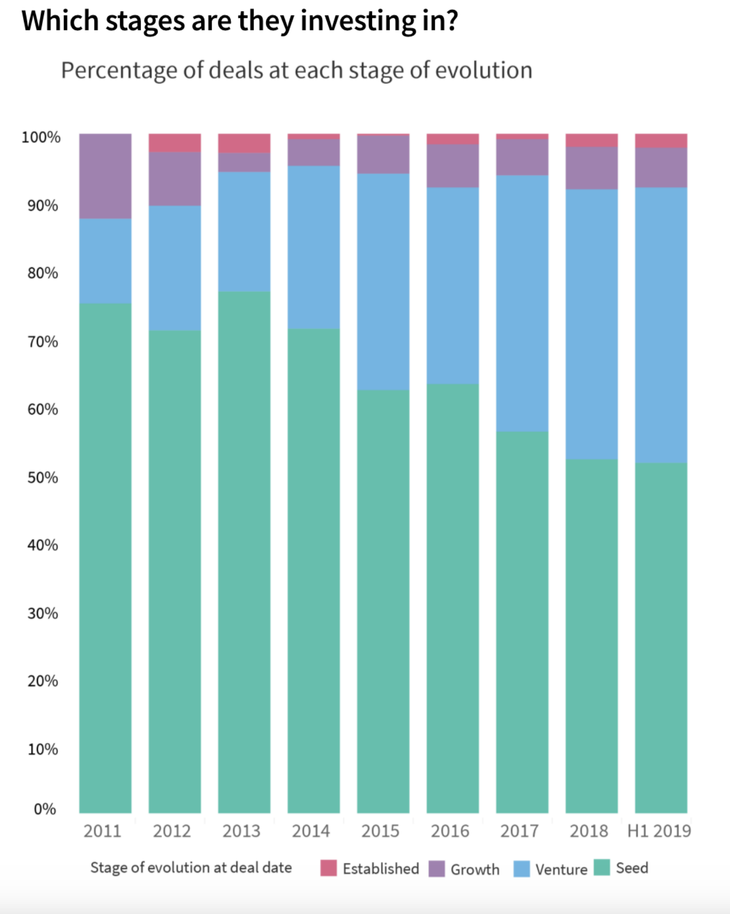
Country	# of CFI Platforms	Country	# of CFI Platforms
United States	344	Brazil	17
France	53	Canada	34
Italy	15	Australia	12
United Kingdom	87	South Africa	4
Spain	27	India	10
Netherlands	34	Russian Federation	4
Germany	26	Belgium	1
		Hong Kong SAR, China	1
		China	1
		United Arab Emirates	1
		Estonia	1

Table 2. Amounts Raised in non-U.S. Crowdfunding Markets in 2016

Country	Exemption Adopted	Amount Raised in 2016
United Kingdom	2011	$335 million (£272 million)[42]
Germany	2011	$49 million (€47 million)[43]
Sweden	2011	$48 million (€46 million)[44]
France	2014	$45 million (€43 million)[45]
China	2014	$460 million[46]

UK Crowdfunding and Reading the Tea Leaves





With a 4-year head start on the US, the UK arguably has the most mature early stage equity crowdfunding infrastructure globally.

Of the over 1,000 startups that have completed crowdfunded investment rounds since 2011, just 5 have seen exits.

Bottom line: for-profit investment crowdfunding has **not** lived up to expectations.

HOWEVER: I believe investment crowdfunding has the potential to be a game changer in the nonprofit world.

Problem: Traditional Nonprofit Financing Structures are not Conducive to Growth

- Traditional instruments of nonprofit financing are inadequate to support meaningful growth.
  - <u>Grants</u>: like equity, except: (1) check sizes are too small, (2) they often come laden with restrictions, (3) grant-making decisions typically reflect a “buy vs build” orientation.
  - <u>Debt</u>: poorly suited to the needs of a growing non-profit: (1) limits ability to take risks, (2) can quickly blow up a non-profits balance sheet when not counterbalanced with equity-like capital, (3) non-profit debt markets tend to be highly pro-cyclical.

- **Consequence: we have an underdeveloped, undercapitalized, inadequately dynamic nonprofit sector, in which key players grow slowly and operate inefficiently.**

- **Grants are too small**: “The average grant among the 100 largest foundations is roughly $50,000, an amount that is insufficient to help a nonprofit grow financially stronger, improve its performance measurements, or achieve any other major steps toward greater sustainability.”

- **Grants often reflect ”buy vs build” mentality**: “The indispensable element behind (traditional grants) is goodwill—the emotional benefit that a person receives in return for his or her money. Accordingly, many…believe the money they contribute to nonprofits should be used to fund the programs that showcase the organization’s work, not to fund the organization itself. Although programs are important, they cannot exist without strong enterprises backing them.”

- **Grants come laden with restrictions**: “Right now in the nonprofit world it's very common to have capital campaigns. And to some extent a capital campaign is like an equity campaign, except that in most cases the nonprofit sector has the funny habit of cordoning off asset classes: these funds are only for bricks and mortar, and these are for endowment. In a period of growth, that's disastrous, because it restricts cash. And cash is the primary hedge against risk.”

- **Debt is not a viable alternative: “**Debt is most successful when it is used to match expenses over the useful life of an asset or to pay expenses before expected revenue is received…for most growing nonprofits, debt alone does not do the trick. ”

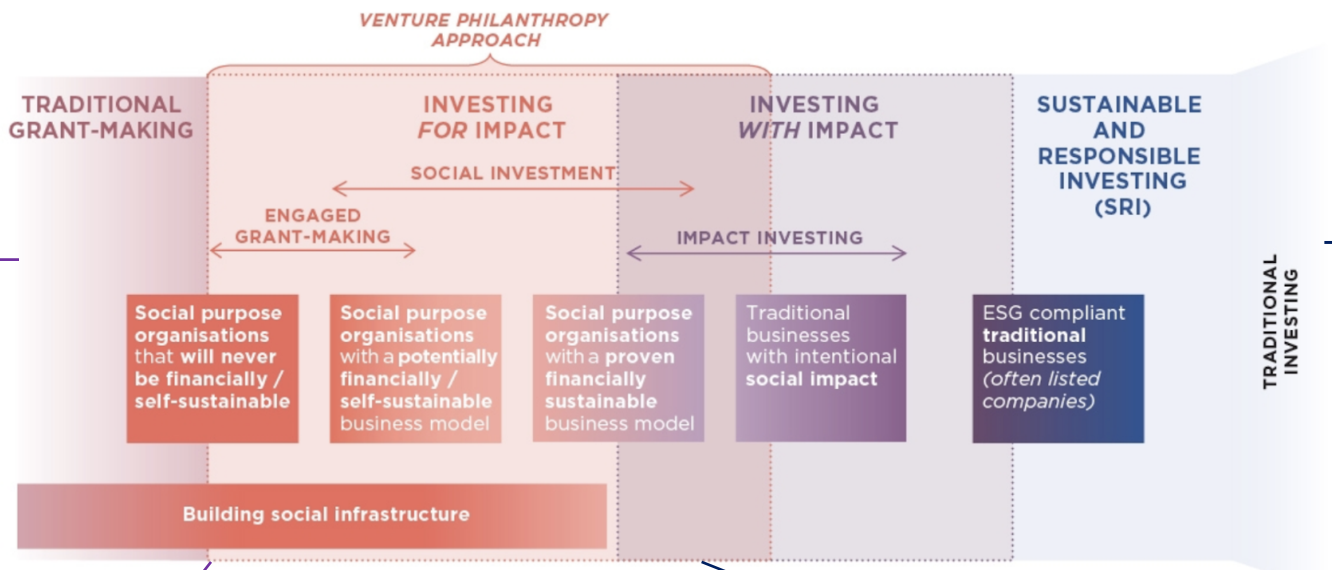
Enter Venture Philanthropy

"Nonprofit achievements with great social payoffs require long term investment. Real change and the real transformation take time. That's something that the current nonprofit setup can take from the venture capital side of this, the notion that you need tangible, accessible cash to fund growth itself."

Clara Miller

President and CEO, Nonprofit Finance Fund

At present, there is no established mechanism for the general public to participate in venture philanthropy investment



<u>Institutional</u>
- Traditional Grants
- Traditional Debt Issues

<u>General Public</u>
- Traditional Donations
- Public Debt Issues
- Donor/Lending Based Crowdfunding

<u>Institutional</u>
- PRIs
- ”Patient Capital” Grants

<u>General Public??</u>

<u>Institutional</u>
- Private Equity
- Venture
- Corporate

<u>General Public</u>
- Public Securities Market
- Equity Crowdfunding

Crowdfunding and Venture Philanthropy: an Ideal Match?

Arguments	Small Business Investment Crowdfunding	Venture Philanthropy Crowdfunding
Helps address a gap in the capital markets?	Argument: levels playing field for minority owned businesses, non-coastal businesses, and low-growth businesses.	Massively undercapitalized nonprofit sector
Contributes positive social externalities?	More innovation? More jobs? More dynamic economy? More open/participatory economy/society?	← All this + stronger social infrastructure
Favorable balance of risk and opportunity for unsophisticated investors	- Often early stage companies with green management and limited financial history - Primary motivation of managers: make money	- Often established nonprofits with experienced management and considerable financial history - Primary motivation of managers: scale impact sustainably

Is there adequate consumer demand for investing in non-profits?

“In talking with people at various equity crowdfunding sites, we learned that social impact companies tend to do well on their platforms. Community members at these sites often invest in a variety of startups each year and tend to prefer companies they believe will be successful and make the world better at the same time.”

Cullen Schwarz

CEO, DoneGood

Crowdfunding Venture Philanthropy & the US the Legal Environment

- Section 3(a)(4): Special exemption permitting nonprofits to issue securities without SEC registration:
  - Important: does not preempt state Blue Sky laws

- Nonprofits cannot issue equity, and exclusively issuing debt can be a significant limitation. However, there are workarounds:
  - Royalty or profit-sharing based security issues
  - Creating a controlled, for-profit subsidiary and issuing equity

- <u>Bottom Line: There are no obvious legal limitation to applying crowdfunding-based securities exemptions and market models that have been utilized in the nonprofit sector.</u>

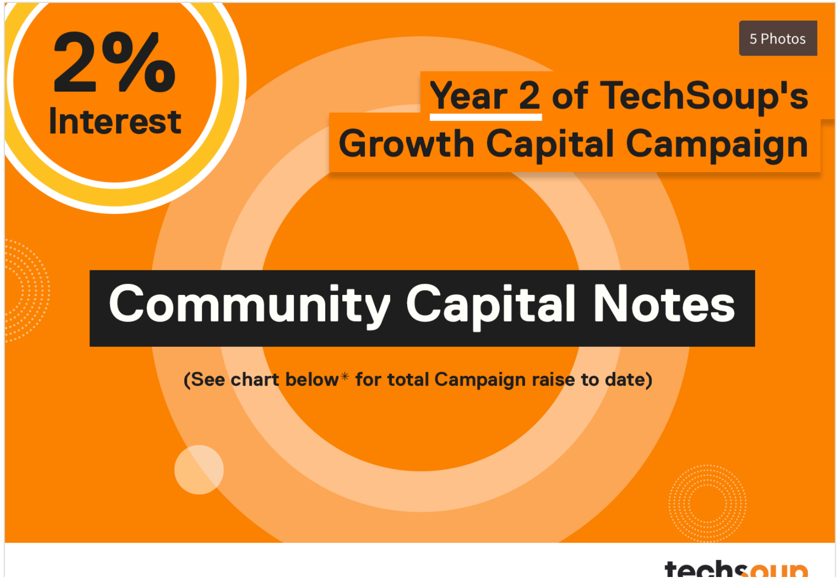
Case Study 1: TechSoup Leverages Reg A Exemption in First-of-its-Kind Nonprofit Crowdfunded Debt Offering

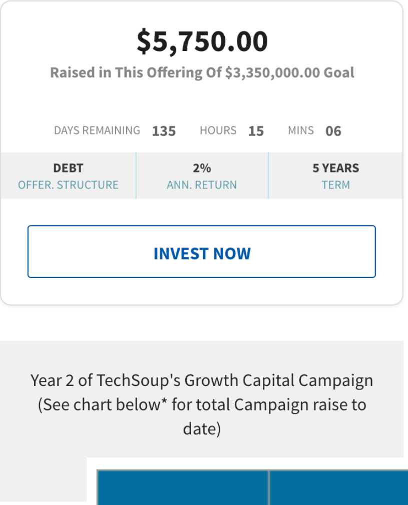
We’ve launched a Direct Public Offering (DPO) which stems from our belief that TechSoup should be financed by people and entities of diverse economic means who care about supporting civil society. Our DPO will allow nearly anyone to invest in TechSoup and receive a financial benefit while helping our organization grow its capacity to support more changemakers worldwide.

TechSoup is the first nonprofit organization that the SEC has qualified to do a Reg A+ Tier 2 offering, which allows us to reach out to our stakeholders in all 50 states and engage them as impact investors…we're hoping it will be a model that other nonprofit social enterprises can use to raise growth capital in the future.

Tech Soup Press Release
January, 2019

Case Study 1: TechSoup Leverages Reg A Exemption in First-of-its-Kind Nonprofit Crowdfunded Debt Offering





Notes	Open to:	Minimum Investment	Maximum Investment	Term	Interest Rate
Community Capital Notes	Anyone*	$50	Aggregate purchase price no more than 10% of the greater of investor's annual income or net worth.	5 year	2%
Patient Capital Notes	Anyone*	$2,500	Aggregate purchase price no more than 10% of the greater of investor's annual income or net worth	5 year	3.5%
Risk Capital Notes	Accredited Investors & Institutions	$50,000	None	5 year	5%

Case Study 2: Cystic Fibrosis Foundation – An Ideal Setup for Equity-like Crowdfunding?

Case Background

- 1988 – CFF grant & donor supported research led to the discovery of the gene responsible for CF.
- Between 1990 and 2000, CFF invested grant & donor proceeds toward various CF related research projects, in exchange for royalty rights to any commercial results of the research efforts. Over time, this resulted in significant organic cash flow to the foundation, adding to donor funding.
- Between 2000 and 2012, CFF leveraged its strong cash position by investing $150M toward a joint venture with Vertex Pharmaceuticals to support the riskiest stages of a CF drug development project. In exchange, CFF secured royalty rights to any successfully commercialized drugs arising out of the JV.
- In 2012, Kalydeco received FDA approval. In 2013, Orkambi receives FDA approval.
- In 2014, CF foundation sold its royalty rights to Royalty Pharma for $3.3 Billion.

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<u>The Scenario</u>

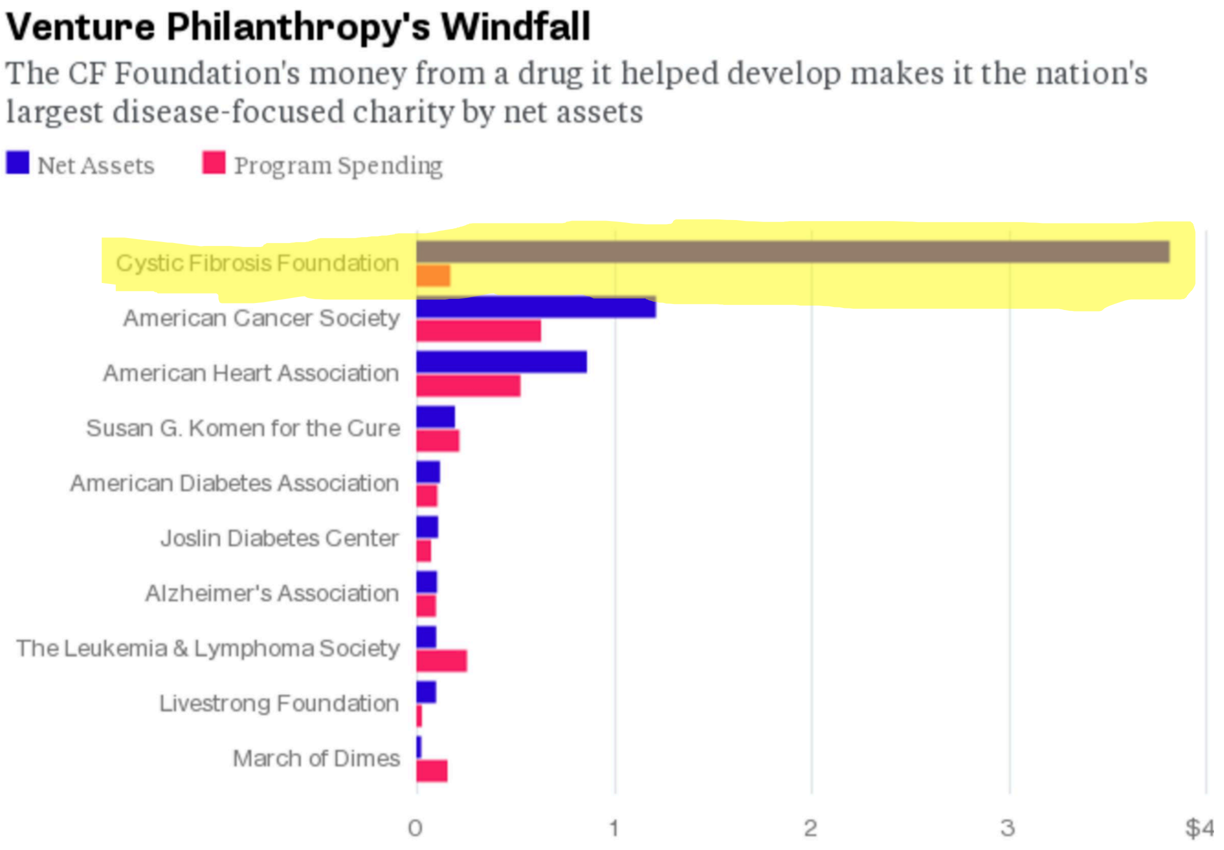
CFF's mission was to facilitate the commercialization of a successful treatment for CF as quickly as possible. This goal was jeopardized by the for-profit pharmaceutical industry's reluctance to put at risk the hundreds of millions required to prove efficacy of a drug that would ultimately serve a relatively small patient population (there are an estimated 30K Americans diagnosed with CF).

Leveraging grants and donations, CFF bootstrapped a business model capable of fronting the risk of developing a drug. The entire process took over 20 years.

<u>Questions to Ponder</u>

Could CFF have raised more capital and achieved its mission sooner if it had offered donors and advocates an opportunity to invest "patient capital" under an equity-like structure? Would this have risked alienating donors or otherwise interfered with traditional fundraising channels? Pretending CFF had pursued crowdfunded investment, how should it think about disbursing dividends/returns to its investors, vs reinvesting in its mission?

Case Study 2: Cystic Fibrosis Foundation – An Ideal Setup for Equity-like Crowdfunding?



Could/should other research heavy foundations consider replicating CFF's venture philanthropy model?

Is investment crowdfunding a suitable tool to facilitate this model for operating and scaling nonprofit impact?