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# Crowdfunding Biopharmaceutical Innovation

Caution should be taken when planning  
to crowdfund a biopharmaceutical startup.

SETH MAILHOT, PAUL JONES, AND CAMERON FIELD

**E**ntrepreneurs in the biopharmaceutical industry face extraordinary funding challenges. While raising risk capital for any new venture is hard work, raising early-stage financing for new biopharmaceutical businesses is particularly difficult. Such ventures generally need tens of millions of dollars of development-stage risk capital that is used over timeframes that often stretch to 10 years or more.

The Jumpstart Our Business Startups (JOBS) Act, a law passed by Congress and signed by President Obama in 2012, includes provisions aimed at promoting private sector job growth, including several provisions intended to make it easier for entrepreneurs to raise risk capital. Chief among those are provisions instructing the Securities and Exchange Commission (SEC), the federal agency that regulates the sale of stock and other securities by businesses,

to develop rules permitting entrepreneurs to “crowdfund” their businesses. This article explores the importance of those crowdfunding provisions in the JOBS Act.

## CROWDFUNDING AND THE JOBS ACT

Some readers may be familiar with crowdfunding websites such as Kickstarter.com and indiegogo.com. On

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**SETH MAILHOT** is an attorney leading the FDA Regulatory practice, and is a member of Michael Best & Friedrich LLP’s Transactional Practice Group in the Washington, D.C. office, [samailhot@michaelbest.com](mailto:samailhot@michaelbest.com). **PAUL JONES** is an attorney at Michael Best & Friedrich LLP in Madison, WI and is Of Counsel to the Business Practice Group and Co-chair of the Venture Best team, [pajones@michaelbest.com](mailto:pajones@michaelbest.com). **CAMERON FIELD** is an attorney at Michael Best & Friedrich LLP in the Madison, WI office and a member of the firm’s Transactional Practice Group., [cfield@michaelbest.com](mailto:cfield@michaelbest.com).

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## IPOs Surge in 2013, but Fade at Year End

Biopharmaceutical companies seeking early-stage financing are turning to various outlets, including government grants, angel investors, philanthropic groups, and research and patient advocacy groups. Disease-based foundations also provide capital, particularly for therapies for rare diseases or unmet conditions.

The funding story for life-sciences companies in 2013 has been initial public offerings; 49 companies completed IPOs on US exchanges through November, raising a total of \$6.7 billion. At the end of November, these companies produced an average return of 34.6%. Therapeutics companies, which comprise three quarters of these offerings, rose an average 39.7% from their IPO price.

Several factors contributed to the surge in IPOs. Public biotech stocks have outperformed the general market and investors warmed to biotech IPOs. The JOBS Act, passed in April 2012, eased regulatory demands on companies seeking to raise capital through initial public offerings.

The pace of IPOs slowed in November when four companies completed initial public offerings, seven postponed their offerings, and one company withdrew its deal. The slowdown, however, can be attributed to profit taking as year-end approaches, reported G. Steven Burrill, CEO of Burrill & Co., a life-sciences investment firm, in a press statement.

“The slowdown is not a sign that the window for life sciences IPOs is closing,” says Burrill. “It is just a sign that investors looking for a quick return are leaving the sector. Now these companies have to focus on the fundamental healthcare and biotech investor who has sustained the industry from inception. These long-term holders can once again find reasonably priced deals and more rational price appreciation.”

Globally, capital raised through IPOs is up 242% compared to the same period in 2012, with 57 IPOs completed by the end of November 2013 compared to 34 in 2012.

Source: Burrill and Company

—Editors, *BioPharm International*

those sites, companies that want to raise money for a project can pitch their project to the general public, and hopefully raise money to fund it. These two crowdfunding platforms have generated the most publicity and donations, with Kickstarter reporting more than \$700 million in donations to fundraising campaigns.

These platforms have historically only offered donation-based crowdfunding, where individuals provide money to fund a project in exchange for just about anything except an ownership interest in the project. New regulations in the JOBS Act pave the way for crowdfunding websites to move beyond donation campaigns to allow start-ups to attract actual investors.

Unlike the donation-based system that originated with crowdfunding platforms, investment crowdfunding, or equity crowdfunding, will allow funders—now investors, really—to maintain an interest in

and share profits with a business seeking funding for its operations. New websites are emerging such as CircleUp, Crowdfunder, and AngelList that connect startups with investors.

The JOBS Act tasked the SEC with developing two sets of crowdfunding rules, one for “accredited” investors (i.e., wealthy investors) and one for “unaccredited” investors (everybody else). This article focuses on the rules the SEC is advancing for accredited investors. There are three reasons for this focus. The first is because the rules for accredited investors are further along in the process. The second is because there is greater clarity with the rules for accredited investors at this stage of the regulatory process compared to the rules for unaccredited investors. Third, the unaccredited investor rules will almost certainly put sharp limits on both the overall amount a startup can raise via crowdfunding (likely

\$1 million in any 12-month period), and the amount a startup can raise from any given unaccredited investor (i.e., a couple of thousand dollars to perhaps a couple of tens of thousands of dollars per investor in most cases). These limitations will be problematic for entrepreneurs with large capital needs, such as most biopharmaceutical entrepreneurs.

### CHALLENGES IN CROWDFUNDING

In the crowdfunding model, entrepreneurs would put information about their new company on a website, including the documents investors need to sign to make an investment, the terms of the investment, and where to send the money. Under the accredited investor crowdfunding rules, these materials can be made available to unaccredited investors, but only accredited investors can actually make an investment. And therein is the first big problem for the entrepreneur: how

do you make sure that you only let accredited investors invest?

Historically, the SEC's rules regarding sales of securities by privately held companies have favored sales to accredited investors. Under these rules—which remain in effect for private companies that don't engage in crowdfunding—companies could rely on “self-accreditation” of accredited investors. In practice, this meant that unless a company had reason to believe that an investor was not accredited, it could rely, in terms of the SEC being satisfied that an investor was accredited, on the investor's personal written assurance that the investor was in fact accredited.

Under the new crowdfunding rules, self-accreditation is no longer enough. What is enough is not entirely clear, but by way of example, the SEC suggests that obtaining an investor's tax returns, or a certified personal financial statement, would suffice. Few investors, however, would be comfortable disclosing either their tax returns or personal financial statements to strangers, including entrepreneurs. Worse, the SEC has indicated that if a private company does use the crowdfunding rules in its capital campaign, it has to apply this new accreditation standard to every investor in the deal, even those that were not part of the crowdfunding campaign.

It is likely that over time less problematic alternatives will develop for determining accredited investor status pursuant to the crowdfunding rules. Several websites have already appeared promising to develop procedures for validating accredited investor status themselves, and certifying that status to companies engaged in crowdfunding campaigns. But unless, and until, these third-party sites pass regulatory muster, as well as market acceptance, the current “safe harbor” of accreditation by tax return or financial statement

disclosure will likely limit the use of crowdfunding for most startup companies.

Another feature of the new crowdfunding rules that will likely limit their appeal to most early-stage businesses is a requirement that entrepreneurs file with the SEC all of the materials on the website or otherwise disclosed to potential investors 15 days before those materials are shared with investors. This rule will be problematic for many entrepreneurs, who are accustomed to updating and otherwise modifying their investor pitches and materials on a regular basis. The authors, having been a part of dozens of startup capital campaigns, cannot recall a single one where the materials given to or pitched to potential investors did not change week to week, if not day to day. Under the new rules, every such change would require 15-days advance notice to the SEC, a period that could increase if the SEC had any questions about the material or wanted changes to the material.

Yet another problematic aspect of the new crowdfunding rules is a requirement that offers be made through intermediaries, who themselves must provide disclosures to investors regarding the level of risk of the offering, and basic information about the issuer, including financial statements, its officers, directors, 20% shareholders, and the specific risks related to the offering. Issuers requesting less than \$100,000 are required to have the CEO of the issuer certify the accuracy of the issuer's financials. Issuers seeking to raise between \$100,000 and \$500,000 are required to have a certified public accountant certify the accuracy of the issuer's financials. Issuers seeking to raise more than \$500,000 are required to make their audited financials public.

A number of crowdfunding intermediaries are already setting up for business. But until those sites have established a solid track record with the SEC and issuers, it is hard to say what kind of information, and what detail, will satisfy the SEC. One thing is certain, though: the services provided by those intermediaries will not be provided for nothing. Someone, probably the issuer but perhaps the investor (or maybe both), will have to provide some money for the services provided by these intermediaries.

### CAUTION IN CROWDFUNDING

Entrepreneurs thinking that they will ultimately want to bring venture capital into their business should know up front that venture investors are particularly cautious about investing in deals with shareholder lists that include numerous individuals investing small amounts of capital. Those concerns are amplified if the smaller investors paid a price significantly higher than what the venture capital investor would be willing to pay. The authors' own experience as both a venture capital investor and counsels to the same includes several examples of otherwise promising young companies that failed because venture investors were unwilling to get involved in a company with a shareholder population that included a number of accredited but less than sophisticated investors that paid too high a price for their shares.

The emerging crowdfunding option opens up a potentially significant new fundraising avenue for entrepreneurs. But it will be several years before the kinks are worked out (or not) and until they are, entrepreneurs, particularly those with capital intensive projects such as biopharmaceutical businesses, should think long and hard about whether crowdfunding makes sense for them. **BP**