Viva La Revolucion: Reg-A, Crowd-Funding Bills Expand Options for Biotechs

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Editor's Note: This is the first in a four-part series, first published in BioWorld Insight, *exploring new fundraising options for small biotechs.*

Attention cash-strapped private biotechs: Whether you're struggling to find a bridge across the valley of death or trapped in a windowless venture portfolio, don't give up hope just yet, because four bills making their way through Congress could revolutionize your options for fundraising.

There's H.R. 1070, which would provide an alternative to the initial public offering (IPO) by letting private firms raise up to $50 million publicly and trade their shares, without the expense of becoming a reporting company. If passed, it "could have an instant catalytic effect" on mid-stage biotechs that are running out of venture support and can't finagle an IPO or acquisition exit, according to William Hicks, a partner with law firm Mintz Levin.

There's also H.R. 2930, which would let private start-ups raise up to $2 million through crowd funding, essentially opening the private markets to non-accredited investors and perhaps providing just enough support to get that preclinical proof-of-concept data you need to hook a venture investor or a pharma partner.

Also in the works are H.R. 2167, which would let private companies have more shareholders before they have to start reporting to the SEC, and H.R. 2940, which would loosen the restrictions on advertising private financings. The momentum is carrying over to small public companies as well: H.R. 3213, introduced just last month, would expand the small company exemptions from Sarbanes-Oxley compliance.

Taken together, these bills could represent salvation for small companies that have been pummeled by venture contraction and macroeconomic forces. At the very least, they provide options, and "when you've got all these choices, people may not give up," Hicks said. "It could just energize the whole system."

Driving Forces

The movement to overhaul small company capital formation evolved out of a confluence of forces.

First, there are the financial pressures with which the biotech industry is all too familiar. Third-quarter biotech fundraising plummeted 48 percent year-over-year and 60 percent quarter-over-quarter. Meanwhile the IPO window is highly selective at best, and gloom-and-doom pervades the venture industry, as illustrated recently by Prospect Venture Partners' fundraising troubles and Scale Venture Partners' decision to exit the health care field. (See *BioWorld Insight*, Oct. 10, 2011.)

Similar problems pervade other industries. Stocks are down. Unemployment is up. Earlier this year, Standard & Poor's lowered its rating on U.S. debt, and a drop in consumer spending prompted macroeconomists to lower their GDP estimates. "The reality has set in that growth is not showing up in the U.S.," Andy Busch, global currency and public policy strategist for BMO Capital Markets, said at the time. (See *BioWorld Insight*, Aug. 22, 2011.)

Things are no better globally, with Greece and Italy hanging on by a thread. But compounding the trouble for small U.S. companies is the fact that regulators have spent the last decade increasing investor protections in the hope of preventing another Enron Corp. scandal. Compliance with new regulations has increased costs for both big and small firms.

"The last decade or so has been pretty antagonistic for small companies being able to raise money to fuel growth," said Tim Ryan, managing director and head of business development for OTC Markets. "What drives job growth is small companies, so now we've got a jobs crisis in this country. Congress is recognizing they have to step in to help."

At the same time, a new generation of entrepreneurs is bucking tradition and helping Congress understand how the system needs to evolve. The massive growth of private firms like Facebook and Twitter has led to the rise of secondary markets like SharesPost and SecondMarket. These systems allow employees who receive stock options in the big private tech firms to get some liquidity by offloading those private shares to venture capitalists, institutional investors or accredited investors. Creating similar liquidity in small private firms could be key in getting crowd funding off the ground.

Some entrepreneurs – particularly musicians and filmmakers – have already tapped into crowd funding as a way to build online support and raise seed financing for their ventures, sparking the rise of sites like KickStarter.com. They're currently prohibited from issuing equity, but many have been successful just by offering a CD, a comic book, a t-shirt, even chicken-catching lessons in exchange for funding a project to turn an abandoned Brooklyn lot into an urban farm. That success got everyone thinking – what if equity was on the table?

Mitchell Littman, senior managing partner with law firm Littman Krooks, noted that the new generation entrepreneurs also take issue with other laws, such as those that restrict advertising a private offering. They've grown up in a world where "everything is out there" in the public domain, and such restrictions are a foreign concept to them, he told *BioWorld Insight*.

"All of these things are related," Littman said, adding that the current system is "beyond archaic" at this point.

Rise of Alternatives

Biotechs have long sought alternatives to the venture-funding-followed-by-IPO model. Some alternatives, like reverse mergers, are well known. Others are less so, like the Form 10 pathway, in which a private firm files a Form 10 to become a reporting company and list its shares on an exchange, then files an S-1 to get liquidity, avoiding the market risk and transaction costs associated with an IPO. (See *BioWorld Insight*, July 25, 2011.)

The new legislation moving through Congress would add to this toolbox of alternatives.

H.R. 1070, which boosts the Regulation A exemption from $5 million to $50 million, would essentially provide another IPO alternative, allowing biotechs to raise money and trade their shares on the OTC without the expense of SEC reporting. Much like a reverse merger or the Form 10 pathway, the Regulation A pathway could be a stepping stone on the way to gaining momentum and eventually coming into reporting compliance and transferring to NASDAQ.

"The IPOs that get out today have gotten so big . . . there's just a crying need for a $30 million to $50 million IPO alternative," Mintz Levin's Hicks said. The Regulation A pathway could "start to bridge this gap," he said, perhaps even bringing back the days of boutique banks like Robertson Stephens and Hambrecht & Quist.

Once private companies start to take advantage of Regulation A, they'll need H.R. 2167 to prevent them from being forced into SEC reporting once they hit 500 shareholders. Most private firms that fall into this trap under current law bite the bullet and go public, like Google.

For earlier-stage companies, crowd-funding bill H.R. 2930 could help fill the translational funding gap. And once companies exceed the crowd-funding cap and need to raise more money privately, H.R. 2940 would let them advertise those private offerings and reach more investors.

H.R. 1070, 2930 and 2940 passed the House earlier this month and are now in the Senate. H.R. 2167 was still in the House as of this writing. All four bills have bipartisan support and are expected to become law.

How they will play out in the biotech industry remains to be seen. Will the general public be interested in crowd funding complex, high-risk, long-term drug discovery projects? With appetite for biotech IPOs anemic at best, will investors want to buy public shares in even earlier-stage, higher-risk Regulation A firms?

After all, many in this industry have said the Darwinian attrition of the last few years wasn't all bad, and that the good companies ought to be able to jump over the increasingly high bars to get traditional venture money or complete an IPO or get acquired. Hicks, however, believes the contraction has been too extreme. "The recession swept a lot of the babies out with the bathwater," he told *BioWorld Insight*. "A lot of very good, high-risk, high-reward companies are not making it." Some of the companies who take advantage of the new funding mechanisms will certainly bomb, but "some should rocket into the stratosphere," he said.

A buy-side investor agreed. "Generally speaking, anything that allows anyone to invest in whatever they want is a good thing," he said. "Just because I don't want to invest in a company doesn't mean other people shouldn't; it doesn't mean the mechanism shouldn't exist. The whole point of biotech is the hope of what might come."

Don't miss next week's BioWorld Insight, *which will explore the opportunities and challenges around the Regulation A pathway. Part 3 will delve into crowd funding, while Part 4 will focus on regulation of new fundraising options.*