The Life Science Executive’s FUNDRAISING MANIFESTO

BEST PRACTICES FOR IDENTIFYING CAPITAL IN THE BIOTECH AND MEDTECH ARENAS

Dennis Ford
In this chapter, we will provide you with a brief overview of the legal process for a life science company that is considering raising equity capital through public investors. More specifically, we will focus on the process of raising such capital through crowdfunding and initial public offerings (IPOs). This information is not intended to be, nor does it constitute, legal advice. Instead, our purpose is to provide context and background to assist you in making future equity capital-raising decisions as you grow your business. Primarily due to the Jumpstart Our Business Startups (JOBS) Act, the laws and regulations surrounding capital raises for emerging growth companies (EGCs) have been, and may continue to be, subject to change. If you are contemplating, or are currently in the process of, raising equity capital through an IPO, crowdfunding, or other public source of equity capital, we advise you to seek legal counsel to discuss how any of the issues covered in this chapter might relate to your individual circumstances.

First and foremost, for a life science company considering an equity capital raise of public funds, the most important step for each party involved, whether such party is the company, the bank or underwriter, the agent, and/or the investor, is ensuring both that the intellectual property (IP) of the company is sufficiently protected by valid, enforceable patents and that the IP will remain protected for a substantial (or long enough)
period of time. Additionally, the parties will be concerned with the remaining shelf life of the company’s existing IP, and this may impact how much pressure the company is faced with to expand on its existing IP.

Crowdfunding

Since the passage of the JOBS Act, the financial and medical press has anticipated the potential for crowdfunding to revolutionize fundraising for early stage life science companies. Recently, a portal exclusively dedicated to crowdfunding life science and healthcare start-ups launched at Medstartr.com. Although crowdfunding may present an exciting opportunity for your company, this approach has both its limitations and risks.

Models

There are two distinct crowdfunding models. The first is the donation model exemplified by existing portals such as Kickstarter.com. Portals adhering to the donation model post interesting projects, for which individuals then donate largely unlimited sums for no return or, at most, access to discounts or early release of a project’s product. The second model, and the type that the Securities and Exchange Commission (SEC) is tasked with regulating, is an equity-based or investment-based model, which involves an actual investment in an entity that is pursuing the project. Members of the “crowd” that provide funding to the project receive an ownership interest in the entity. This investment model has been highly anticipated by life science investors since it was first authorized in the U.S. under the JOBS Act in 2011. On October 23, 2013, the SEC released its proposed regulations establishing equity crowdfunding. As of this writing, the SEC is seeking public comment on the proposed rules for a 90-day period before determining whether to adopt them and release the final regulations.

Access to Markets

Companies that seek to use investment-based crowdfunding will not be permitted to send out mass solicitations at will. Equity-based crowdfunding
must take place only through brokers or portals that are registered with the SEC; such brokers and portals are a new class of SEC registrant. In addition to registering with the SEC, equity portals will be responsible for conducting due diligence on potential investments, including background checks on directors and executive officers of the company. The portals that are currently active, such as Kickstarter.com, Medstartr.com, and Indiegogo.com, are not equity-based portals but donation portals. The SEC is not involved in regulating such donation portals because the donors do not receive any equity in return for their donations.

Access to Capital

Under the JOBS Act, the aggregate amount of interests sold to equity investors through an investment-based portal in any 12-month period may not exceed $1 million. Individual investors will also have caps placed on their equity investments of (a) the greater of $2,000 or 5% of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000 or (b) 10% of the annual income or net worth of an investor, as applicable, if either the annual income or net worth of the investor is equal to or greater than $100,000. In no event may an individual investor exceed a maximum aggregate investment of $100,000. Given the extremely high costs of clinical trials, equipment, and supplies in the life science industry, these investment caps may prove to be too limiting to add any real value to start-up companies interested in investment-based crowdfunding, especially given the added regulatory hurdles involved in the equity-raising process.

However, due in part to the broker registration costs and due diligence requirements imposed on brokers, it is expected that the fees charged by approved portals may be upward of 10% to 20% of the total amount raised. This exceeds the 3% to 5% fee typically charged by broker-dealers in a registered offering and the 6% to 10% fee typically charged by investment banks running an IPO. Crowdfunding through a licensed platform may therefore be an extremely expensive way to raise what is ultimately a relatively limited and finite amount of equity capital. However, entrepreneurs of some companies that would not otherwise have access to these funds may not view these limitations as a “deal killer.”
Regulatory Hurdles

If a company raises between $100,000 and $500,000 through an equity crowdfunding portal, the JOBS Act requires the company to have its financial statements reviewed by an independent certified public accountant, and if the company raises over $500,000, the company is required to have its financial statements audited by an independent certified public accountant. Reviewed and audited financial statements are costly and are not typically included in the budget for start-up companies raising less than $1 million. Additionally, the company must draft an informational memorandum and file this informational memorandum with the SEC prior to the launch of the crowdfunding offering. Once the offering is concluded, the company (or issuer) will be required to annually file with the SEC and provide its investors with reports of the results of operations and financial statements, as the SEC deems appropriate. These are extraordinarily burdensome regulatory obligations for start-up companies to comply with, particularly if less than $1 million is raised through a crowdfunding offering.

In addition to the financial statement requirements, the SEC has proposed that a company seeking to raise funds through equity crowdfunding would, among other things, be required in its offering documents to disclose:

- Information about officers and directors, as well as owners of 20% or more of the company
- A description of the company’s business and the use of proceeds from the offering
- The price to the public of the securities being offered, the target offering amount, the deadline to reach the target offering amount, and whether the company will accept investments in excess of the target offering amount
- Certain related-party transactions
- A description of the financial condition of the company

Confidentiality

Life science companies are extremely competitive, often possessing sensitive and proprietary information that they want to maintain privately. Crowdfunding portals and the information requirements established by the JOBS
Act will require disclosures (such as those noted earlier) from early stage life science companies. Having a large number of shareholders after a successful crowdfunding campaign will further threaten a company’s ability to keep its information confidential because of the difficulty in regulating the flow of information after it has been released to shareholders.

**Future Funding**

If a company is successful in raising funds through a crowdfunding portal, it may create future issues with the company’s capitalization table. Having 25, 50, or even possibly 1,000 shareholders in a start-up entity can create serious practical and administrative issues for raising the next round of capital, as many state corporation laws provide shareholders with protections such as approval rights over certain actions, one of which may be funding through additional investors. Getting large numbers of shareholders to approve a future round of funding may be so difficult and cumbersome that it may ultimately threaten the long-term viability of the company. Many venture capitalists avoid crowdfunded companies due to the potential problems in obtaining approval for subsequent funding rounds.

**Regulation D**

Aside from crowdfunding, there is one type of change that has officially arrived for early stage corporate funding. Changes to Regulation D Rule 506 have loosened restrictions on publicizing private offerings. This will allow companies to advertise more openly to investors, such as on patient advocacy websites or even in magazines and newspapers. Unlike with equity crowdfunding, Rule 506 investors must be “Accredited Investors” (for an individual this means having an annual income over $200,000 [or $300,000 when combined with the annual income of his or her spouse] in each of the two most recent years or having at least $1 million in assets, excluding the value of the individual’s primary residence). Additionally, institutional investors, such as corporations, partnerships, trusts, banks, savings and loan associations, insurance companies, and employee benefit plans, may be accredited investors as long as certain dollar thresholds and other requirements are met. Significantly, unlike the limits placed on equity
crowdfunding portals, a Regulation D Rule 506 offering does not limit the amount of equity raised.

**Initial Public Offering**

**Regulators**

If you are in the mid to late stages of capital raising, you may be interested in transforming your life science company from a private to a public one, through an IPO. In addition to filing your offering with the Financial Industry Regulatory Authority (FINRA) and the SEC to have your shares traded after your IPO, you will need to have your shares registered and listed on a national exchange, typically either the New York Stock Exchange (NYSE) or the NASDAQ Stock Market (NASDAQ), or registered and quoted on an over-the-counter (OTC) bulletin board or marketplace. NYSE and NASDAQ have similar, but not identical, listing requirements, including minimum equity and market value of shares requirements, as well as ongoing corporate governance and other requirements for your company once you have completed your IPO. The OTC has much less stringent eligibility requirements for quoting securities, which are essentially limited to having registered the shares with the SEC; however, the OTC has significant limitations on trading activity as compared to a national exchange.

**Securities**

The security that is most commonly offered to public investors in an IPO is “common stock.” The rights and privileges of common stockholders are set in the company’s charter, which is filed in its jurisdiction of incorporation. However, other types of securities may be offered, either in conjunction with one another or alone. These include (i) warrants, which are usually exercisable to purchase common stock at a certain set price, (ii) units, which are a combination of multiple securities, and (iii) preferred stock, which is similar to common stock but has certain distinguishing rights, often related to voting rights or shareholder protections.

When considering an IPO, an important question aside from how much capital you want to raise is what percentage of your company do you want to sell? Or put another way, how much of your company do you want to
retain? One way to maintain control over your company after selling shares to the public is to retain preferred stock with voting rights that results in treatment of the preferred stockholder as a majority shareholder. Another way would be to sell only a small percentage of the outstanding shares, such as between 20% and 50%. Maintaining such control has the added benefit of providing your company with an exemption from some of the myriad corporate governance and other requirements imposed by national exchanges after the completion of an IPO (as noted earlier). If your company remains a “controlled company,” which means a company in which more than 50% of the voting power for the election of directors is held by an individual, a defined and disclosed group, or another company, your company will be exempt from certain of these ongoing requirements, including the requirement to have a board of directors composed of a majority of independent directors.

**Offering Process**

So you have decided to undergo an IPO. Assuming you are a U.S.-based entity, you will prepare and file a Form S-1 registration statement with the SEC (foreign corporations would use a Form F-1). Historically, the filing process entailed publicly filing your registration statement with the SEC from the outset, allowing the public and your competitors to know your plans and see your disclosures at this early stage. The JOBS Act has changed this equation. Now an EGC, defined as any issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year, can initially submit confidential draft registration statements to the SEC and go through the comment letter and response process outside the public eye. While any and all confidential draft registration statements will become public information as soon as you publicly file a Form S-1 registration statement (which as a rule must be at least 21 days prior to the commencement of your road show for the offering), the ability to handle the SEC review process behind the scenes allows you to delay publicly disclosing your position to competitors and affords you a level of confidentiality should you decide to abandon the IPO prior to publicly filing.

There are many fees involved in an IPO, such as registration fees to each of the SEC and FINRA, which are based on the maximum aggregate offer-
ing price (total number of shares offered multiplied by the per-share price of the shares). You will also pay an initial listing fee (and subsequently pay continued listing fees) to the exchange on which your company is listed. There will be legal, accounting, printing, road show, travel, insurance, indemnification, and other miscellaneous expenses. But the largest up-front expense will generally be the underwriting commission. The underwriters will generally command anywhere from 6% to 10% of the offering proceeds, in addition to other negotiated fee reimbursements.

Federal securities laws impact the ability of a company undergoing an IPO and its employees and representatives to make public statements or other communications during the periods prior to and following the filing of a registration statement. The SEC has been vigilant in addressing perceived violations of these legal requirements (see Figure 2.1 and Figure 2.2).

<table>
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<tr>
<th>Generally Permissible</th>
<th>Generally Impermissible</th>
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<td>1. Dissemination of information about products and services, including:</td>
<td>1. Any publicity intended to or likely to stimulate investor or dealer interest in the company or its stock</td>
</tr>
<tr>
<td>a. Product and service advertisements consistent with past practices</td>
<td>2. Issuing forecasts, projections, or predictions or opinions concerning valuation, revenues, earnings, etc.</td>
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<td>b. Factual information on business developments (e.g., press release regarding the acquisition of additional properties) consistent with past practices</td>
<td>3. Distributing written material relating to the company’s business (except factual information distributed in the ordinary course and consistent with past practice and previously used product advertising)</td>
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<td>c. Technical articles in the technical press</td>
<td>4. Any significant increase in product and services advertisements or promotion without review of counsel</td>
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<td>2. Stockholders’ meetings—answering factual questions from stockholders</td>
<td>5. Interviews, speeches, and articles in the popular press</td>
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<tr>
<td>3. Announcement of intention to file (if in accordance with SEC Rule 135)</td>
<td>6. Discussions with analysts or stockholders except for unsolicited inquiries regarding factual matters consistent with past practices</td>
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<td>7. Adding new information regarding the company (other than factual matters consistent with past practices) or its securities to the company’s website</td>
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<td>8. Posting information about the company (other than factual matters consistent with past practices) or its securities on social media</td>
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*Figure 2.1: Rules regarding communications before public filing of the registration statement*
Generally Permissible | Generally Impermissible
---|---
1. Items 1 and 2 above | 1. Distributing any written materials with the preliminary prospectus (unless free writing prospectus approved by working group and in accordance with all applicable SEC rules including any filing requirements)
2. Distributing preliminary prospectuses | 2. Distributing (or assisting others to distribute) any written materials intended or likely to stimulate investor or dealer interest in the company or the stock
3. Making oral statements about the company or oral “offers” of the stock | 3. Making oral statements or “offers” to potential investors that violate the “antifraud” provisions of the law (or selectively disclosing information not generally available to all investors in the preliminary prospectus)

**Figure 2.2:** Rules regarding communications after filing and before effectiveness of the registration statement (waiting period)

**Testing the Waters**

The JOBS Act expanded permissible communications by EGCs by permitting an EGC, or any person authorized to act on behalf of an EGC, either before or after the filing of a registration statement, to “test the waters” by engaging in oral or written communications with potential investors that are qualified institutional buyers or institutions that are accredited investors to determine whether such investors might have an interest in a contemplated securities offering.

Typical water-testing activities may resemble a road show presentation where management and the underwriters meet with potential investors and give a presentation describing the company and the proposed offering. Because the anti-fraud provisions of the Securities Act still apply, water-testing presentations should be vetted with counsel and should be prepared with the same degree of diligence as a traditional road show presentation. Additionally, it should be expected that during an SEC review of the company’s registration statement, the SEC likely will request a description of any water-testing activities and will request copies of any materials that were provided in connection with such activities.
Summary

Both crowdfunding and IPOs can be effective strategies for growing your company and helping move it forward to the next phase of its development. One is a relatively new, untested method, and the other has been undertaken by many companies, providing countless examples you can research and learn from. Strongly consider the pros and cons of each, as well as where you are in the timeline of your company, and of course, always retain legal counsel before taking any steps to raise public funds, as the regulatory burden is high and any illegal action, even unknowingly taken, could be detrimental for you and for your company.

Robert H. Cohen is a partner in McDermott Will & Emery’s Corporate Department. He focuses his practice on transactional and securities work for a broad range of clients, including initial and follow-on public offerings, registered direct and PIPE financings, private placements, bridge financings, and equity line and reverse mergers. Bob has extensive experience in the areas of mergers and acquisitions, joint ventures, 1933 and 1944 Act representation, and licensing and distribution arrangements. From his years of experience, Bob has developed industry-specific knowledge across numerous markets, particularly in the life science industry, having represented the financing and mergers and acquisitions activity for pharmaceutical and medical device companies.

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1 Please feel free to contact us for a copy of The IPO and Public Company Primer: A Practical Guide to Going Public, Raising Capital and Life as a Public Company. Coauthored by McDermott partners David Cifrino, Tom Conaghan, and Tom Murphy, this 350-page guide provides detailed information about the IPO process, including the significant changes to the IPO process made by the JOBS Act, and being a public company. You can also get a copy from our website at http://www.mwe.com/files/Uploads/Documents/Pubs/The-IPO-and-Public-Company-Primer.pdf.