Small businesses employ over 40 percent of the U.S. labor force and have provided a disproportionate share of new jobs in recent decades. Yet small companies – promising start-ups and even thriving businesses with positive cash flow – face daunting financing challenges in the post-bubble environment. Banks are leery of lending money as they attempt to shore up their balance sheets, while fewer than 2 percent of businesses seeking early-stage equity are succeeding. No wonder, then, that 60 percent of new businesses are financed with personal and family savings, while 35 percent of existing small businesses use the owners’ credit cards or home-equity loans to finance expansion.

Lawmakers and regulators have generally been reluctant to embrace new technology and financial innovation aimed at enhancing capital markets. But, to the surprise of most, Congress came together in an all-too-rare act of bipartisanship to pass the JOBS Act last spring. The new law blessed securities “crowdfunding” – a means of selling securities to the general public, usually via the Internet – by exempting small issues from traditional regis-
tration requirements. The Securities and Exchange Commission was left to write the rules.

If properly implemented, securities crowdfunding will become the next step in the continuing democratization of finance. But achieving that result will be a matter of trial and error, one in which the SEC must find the sweet spot between maximum flexibility and adequate investor protection. Smart investment structures, meanwhile, can reduce some of the more pressing investor-protection concerns.

CROWD WHAT?
We’ve gotten ahead of ourselves. First, some of the basics about crowdfunding – what it is, how the JOBS Act – the acronym stands for Jump-start Our Business Start-ups – changed things, and what can be gleaned from experience in other countries.

In a crowdfunding venture, entrepreneurs solicit small contributions or investments from like-minded individuals. In addition to providing capital, the crowd may also provide entrepreneurs with both free marketing and feedback on the ventures’ plans.

Crowdfunding ventures that offer no financial return to participants were legal in the United States even before the JOBS Act, and available through Internet platforms like Kickstarter, Indiegogo and Smallknot, which facilitate contributions from the public in return for perks, the effective preorder of a product – or simply the psychic return from supporting a cause. Such ventures run the gamut from video games to films to charitable projects to smartphone applications to a sleep mask promising to teach the art of lucid dreaming. The impact has been striking: with crowdfunding in its infancy, Massolution (a crowdfunding advisory business) estimates that $2.8 billion was raised worldwide in 2012, an 87 percent increase from just a year earlier.

ONE GIANT LEAP FOR THE CROWD... MAYBE
Prior to the JOBS Act, federal law generally prohibited the public sale of securities unless the offering was formally registered with the SEC and complied with numerous regulatory requirements. Crowdfunding initiatives hit barriers wherever investors received interest on loans or entrepreneurs sought to sell equity. For example, the SEC shut down the capital-raising efforts of BuyaBeerCompany.com, a Web site that, starting in late 2009, received more than $200 million in pledges from some 5 million people hoping to become shareholders in an enterprise that would purchase the maker of Pabst Blue Ribbon beer. Some crowdfunding Web sites ran into trouble when they strayed too close to traditional securities-business territory. Thus, ProFounder, a company helping rookie entrepreneurs “provide all documents necessary for compliance with securities and other laws” was prohibited by the SEC from any active role in the offerings process and was eventually forced to close.
The JOBS Act should create some breathing room. Companies will now be able to sell to wider audiences without adhering to traditional SEC registration, disclosure and review requirements. Ordinary retail investors are still limited in the amount of money they can invest – the greater of $2,000 or 5 percent of their annual income or net worth, if either is less than $100,000. Crowdfunding Web sites must either register as broker-dealers or as “funding portals,” the less-onerous registration requirements of which are still being hammered out by the SEC.

There will still be reporting and disclosure requirements, however, with the SEC again in charge of the details. The commission was given nine months to promulgate these new rules, but all signs suggest it will miss the deadline. There are more than two dozen areas in which the SEC is left to fill in the gaps – everything from rules for Web site advertising to shareholder voting rights.

With so many unanswered questions, it remains to be seen just how useful crowdfunding will be in practice. The SEC has cast a skeptical eye toward the concept – after all, the agency has always had the power to provide relief but has refused to do so. This is not entirely surprising: granting exemptions could well increase the exposure of retail investors to Internet con artists. Consequently, few commentators expect the SEC to raise the amount that can be raised for a single company through crowdfunding, or to permit portals themselves to police their own sites.

Prohibitions are not the only tools available to authorities for protecting investors. Market participants themselves could play an important role in enhancing the efficiency and integrity of finance. For example, regulators do not require retail investors to read through the disclosure materials of companies before writing a check, and instead depend on institutional investors to do the heavy lifting. By the same token, there are a variety of avenues whereby crowdfunding portals might be used to reduce the risks of fraud and to encourage creative investment structures that protect both entrepreneurs and the crowd.

LESSONS FROM ABROAD

Equity and debt crowdfunding platforms have already sprung up around the world – potential competition for the fledgling U.S. market, but also a source of real-world experience that could inform regulators. Britain has perhaps the most robust crowdfunding market. Crowdcube, around since February 2011, is the best known British platform. As of late 2012, it had successfully funded 29 equity ventures for the equivalent of $6.8 million.

Other notable equity platforms include Symbid in the Netherlands, WiSeed in France, and the Australian Small Business Offerings Board (Assob), which allows selected small investors to invest alongside accredited investors. In Italy, the government recently announced the legalization of equity crowdfunding, and in South America crowdfunding sites that don’t directly sell securities (think Kickstarter) are flourishing in several countries, including Brazil (though securities crowdfunding has not yet been legalized). Brazil and others may be waiting for the United States to set the pace.

On the debt side, Funding Circle in Britain has raised more than $94 million. Its success offers an important insight – namely, that debt may, under certain circumstances, make a better fit with crowdfunding than equity.

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There are two caveats with respect to debt crowdfunding, however. First, it is probably only viable for existing businesses with proven cash flows. Thus, debt may not be a solution for early-stage startups. Second, Funding Circle provides investors with company credit ratings, a service that may be barred in the United States by the SEC because crowdfunding portals are not allowed to provide investors with advice.

So far, there have been no reports of fraud with equity crowdfunding in Britain, or, for that matter, widespread defaults on debt. That may have something to do with the novelty of crowdfunding – both the platforms and the crowd have been quite selective in the projects they support. For example, only 2 percent of all ventures seeking to raise capital through Crowdcube and 7 percent of those going through Symbid were successful. Meanwhile,
Crowdfunding

Funding Circle has estimated lifetime bad debt at just 3.4 percent – a default rate well below the 11.6 percent rate on loans made by the U.S. Small Business Administration from 2000 to 2011. If these rates are sustained, they will lend support to the argument that the platforms and a discerning crowd are capable of self-policing the ecosystem.

The foreign experience also suggests the importance of coupling the crowd to traditionally accredited investors. For example, WiSeed recently completed the first equity offering that allowed for the complete and profitable exit of crowdfunding investors. WiSeed’s model calls for an accredited investor to perform due diligence on a venture as a preliminary step; then the crowd is given an opportunity to invest in an initial seed round. Assuming that this offering is successful, the original accredited investor makes a second-round investment in the venture. That same investor subsequently offers to buy the crowdfunding shares. The accredited investor benefits from sharing early-stage risk with the crowd, while the crowd benefits from the investor’s due diligence and early-stage investment expertise.

A final lesson from overseas equity crowdfunding has been the success of pooling investors in special-purpose investment vehicles. Symbid, for example, aggregates investors in separate limited liability companies that invest in the firms seeking to raise capital. The LLC investors elect a board, and are thus able to speak with one voice. For its part, the startup avoids the problem of managing relations with hundreds of disparate shareholders, while the simplified capital structure renders it easier for the company to pursue subsequent capital-raising rounds. The catch: U.S. regulators would likely deem such an entity to be an “investment company,” one not covered by the JOBS Act and thus subject to myriad additional regulations.

Smart Investment Structures

While the investors’ risk of fraud is obvious, entrepreneurs, too, expose themselves to risks, including the full weight of private class-action suits and federal sanctions if they fail to comply with procedural hurdles and disclosure requirements. Virtually any shareholder lawsuit with merit can be deadly, and even frivolous ones can generate legal costs that sink a new venture.

Again, overseas examples suggest at least four ways to avoid those pitfalls.

First, entrepreneurs should determine whether debt crowdfunding is a better option than equity. Debt is appropriate for existing small businesses with positive cash flows and provides benefits to both issuers and investors. From the issuer’s perspective, this approach to raising capital, much like WiSeed’s use of accredited investors, avoids the burden of managing relationships with hundreds of small shareholders and does not dilute ownership. And for the investor, debt is both an easier security to value and one that offers an immediate return.

While debt crowdfunding is not for all companies, Funding Circle’s experience shows there will likely be significant issuer demand. But regulators will need to promote debt crowdfunding by allowing portals to provide investors with basic corporate creditworthiness information without running afoul of the prohibition on providing investment advice.

Second, entrepreneurs and portals should be encouraged to couple crowdfunding with investments from accredited investors. The crowd would benefit from the due diligence and management expertise of more sophisticated investors, who in turn would benefit
from the project validation, risk sharing, marketing and feedback of the crowd.

We saw this coupling work well in France with WiSeed’s Antabio transaction and are encouraged by early coupling results in the U.S. with Kickstarter-style nonfinancial return crowdfunding. Smallknot, a community-based crowdfunding portal, recently became a partner with Accion, a microfinance lender; Accion will increase the size of its loans to ventures if they can successfully crowdfund collateral.

Third, we think the SEC should consider a “green-light” model that reduces the regulatory burden on portal-based transactions that couple the crowd with accredited investors. Portals must also be able to offer these opportunities to investors; one can imagine a portal stressing that a bank, an angel network or a community-development financial institution has approved a larger investment contingent on a successful crowdfunding effort.

Finally, we believe that location and networks will matter – a lot. Based on the early results from British equity crowdfunding, a discerning crowd will be far more likely to make an investment in a nearby business. Fundrise, in Washington, has employed a rarely utilized exemption to sell securities to raise $250,000 from local residents, who can see for themselves the commercial property in which they are investing. Beyond the ability to confirm the bricks and mortar visually, the crowd will likely turn to other means of verification, including, for example, researching an entrepreneur through university alumni networks.

Regulators and lawmakers should consequently be creative in promoting portals that offer local equity-investment opportunities or opportunities that originate within well-established networks (like university entrepreneur ecosystems). These sorts of portals should increase investor protection in, as well as the number of, offerings in local communities.

High-growth startups are likely to be an exception to the local-equity-first approach, as they may choose to forego the crowd in favor of less-regulated investments from fewer accredited investors, which are also available under the JOBS Act. Since lifting the general-solicitation ban will bring in accredited investors who are new to the process, regulators should consider creating a baseline of disclosure requirements and investor protection. Indeed, allowing for investment opportunities to be solicited directly via the Internet will likely mean that even the most experienced investors would benefit from basic protection.

**DON’T CROWD OUT THE PORTALS**

It is clear that crowdfunding portals will need to play a central role in vetting and facilitating investment opportunities, as well as in policing fraud. This should not surprise anyone. Web sites in the retail sector work hard to prevent fraud; eBay, for example, maintains a huge database of tracking prices to detect fraudulent offers. When prized products are sold well below market prices – like iPads for $199, for example – eBay’s fraud department tracks the pace of deal-making, as well as the location of buyers and sellers. Amazon, meanwhile, routinely rates third-party sellers by gathering feedback from its customers, much as deal aggregators Orbitz and TripAdvisor do. Established crowdfunding platforms thus routinely gather transaction information and have developed the expertise to intervene proactively to prevent fraud. Indeed, Indiegogo proudly acknowledges that it mines data and develops algorithms geared toward policing the site.

Unfortunately, the JOBS Act does little to harness the capabilities of portals in providing such services. There is little indication that regulators will allow them to share much of
the information they gather on issuers or investors — for example, identifying investors who are serial litigants. If a crowdfunding site wanted to rate borrowers in order to help investors, it would be viewed as effectively “advising” them and would thereby become a broker-dealer in the eyes of securities regulators — a lesson learned the hard way by both Lending Club and Prosper, Web sites that enabled anyone to become a lender. Becoming a broker-dealer would require a crowdfunding portal to register as such and carries compliance costs of up to $100,000.

For their part, broker-dealers are not likely to rush into the vacuum. Portal restrictions are much more likely to push transactions into the world of accredited investors and away from the wider public capital market that the JOBS Act is intended to promote. With the $1 million cap on the money that can be raised in retail crowdfunding, any fees earned by portals would be unlikely to cover the costs of broker-dealer registration and compliance, not to mention the liability that comes with it. Instead, only broker-dealers catering to accredited investors would be able to offer additional information about issuers. Perversely, then, we’d end up with only accredited investors receiving the benefit of portal-sponsored investment protection.

UNLOCKING CREATIVITY

A series of additional reforms are needed to improve crowdfunding as a viable financing tool for today’s new entrepreneurs. At a minimum, we see no reason why rules cannot be better tailored to enhance the capacity of portals to better inform and protect. Companies are already adding warning labels cautioning investors of the high risk of failure for startups — something like the surgeon general’s warning on cigarette packs. Other steps are needed, though. For one, regulators should encourage standardized disclosure formats. And portals should be permitted to apply for relief — perhaps in the form of pre-approval letters from the SEC staff — to present information in new ways in order to make better use of their technology.

It would also make sense to provide exemptions or investment-tax credits to crowdfunding portals seeking to bolster the integrity of their markets. In our view, they should be given incentives to provide easy ways for potential investors to find out whether companies seeking funds have voluntarily subjected themselves to increased supervision and disclosure.

We see little danger, for example, in allowing a portal to post scores for companies that indicate the degree to which they have gone beyond the minimum disclosure required by securities laws, as long as it is made clear to investors that such protections are not foolproof. By the same token, green-light-model exemptions would allow portals to experiment with creative investment structures that coupled the crowd with accredited investors.

Finally, portals should be encouraged to develop technologies to facilitate scrutiny of entrepreneurs and investors. Court decisions have made clear that wealth alone does not make an investor “sophisticated.” Portals should thus be empowered to share information they glean from issuers in order to speak to the objectives and experience of specific classes of investors. Similarly, more information about investors would help to protect entrepreneurs from those hoping to make a cottage industry of crowdfunding litigation.

We now know enough about crowdfunding to know that it could play an important role in reducing barriers to raising capital. The goal now should be to give crowdfunding the flexibility to realize its full potential.