

The Growth of Equity Crowdfunding

Crowdfinance options for private companies, and secondary markets for investors, will keep expanding

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Most Americans either don't know what crowdfunding is, or still think crowdfunding is narrowly confined to Kickstarter and other donation- and rewards-based fundraising websites. In polite company, the term "securities crowdfunding" or "equity crowdfunding" typically evokes bewilderment, derision, or fear of fraud, oh my.

Meanwhile, startups and growing companies have raised billions of dollars through equity-based offering platforms on the Internet.¹ Some exuberant pioneers in this new investment class have predicted that crowdfunding will spark a revolution in private capital markets, if not the *redefinition of Wall Street*.²

A moderate optimist, and one with whom we agree, is Duncan Niederauer, CEO of NYSE Euronext (a merger of the New York Stock Exchange and Euronext NV). Niederauer predicted that equity crowdfunding, if properly done, "will become the future of how most small businesses are going to be financed."³ Mary Jo White, the SEC chair since April 2013, said that crowdfunding is "the start of what promises to be a period of transformative change in capital formation."⁴

If equity crowdfunding goes well for issuers and investors, a surging supply (of early-stage equity offerings) and demand (for investment opportunities in those offerings by investors who want to diversify into alternative asset classes) could result in not only phenomenal growth of private capital markets but also "transformative" innovations. Innovation might include not only Web technology that better connects issuers to investors and facilitates disclosures and transactions, but also simplified deal terms, automated valuation "calculators," and new business

¹ Equity-based offering platforms, featuring Regulation D offerings, were at first reluctant to call their operations "crowdfunding" because (before June 2015) they were not open to the "crowd" of non-accredited investors. The SEC generally uses the term "equity crowdfunding portals" in reference to Title III of the JOBS Act of 2012, which allows non-accredited investors to participate, but which has not yet been implemented. Gradually, however, Reg D platforms have come to be referred to in the media, and the crowdfunding industry as well, as equity crowdfunding platforms.

² A December 17, 2013, conference in New York City, cosponsored by Thomson Reuters, was called "Crowdfinance 2013: Redefining Wall Street."

³ "The New Thundering Herd," *The Economist*, June 16, 2012, p. 71.

⁴ Mary Jo White, SEC chairwoman, speech to the 41st Annual Securities Regulation Institute, Coronado, CA, January 27, 2014.

entities (like a Subchapter CF corporation) structured specifically for equity crowdfunding transactions.

The New New Intermediary

Crowdfunding is a method of collecting many small contributions, by means of an online funding platform, to finance or capitalize a popular enterprise. (See “A Brief History of Crowdfunding” here: <http://www.freedman-chicago.com/ec4i/History-of-Crowdfunding.pdf>). Thanks to the phenomenal success of rewards-based crowdfunding platforms like Kickstarter and Indiegogo since 2008, and donation-based sites like GoFundMe since 2010, it was only natural that intermediaries in the angel capital world would adapt the crowdfunding platform infrastructure, harnessing the power of social networking and e-commerce to accomplish the following objectives:

- Unite startups and growing companies with angel investors.
- Announce equity offerings, and disclose risks and deal terms.
- Enable potential investors to collaborate with each other on deal selection and due diligence.
- Facilitate investment transactions.
- Accomplish all that in a matter of weeks or days, sometimes hours, at little cost.

The Jumpstart Our Business Startups Act of 2012 accelerated the growth of equity crowdfunding. **Title II** of the JOBS Act lifted the ban on general solicitation for securities offerings under Regulation D, Rule 506(c), which allows equity crowdfunding platforms to advertise those offerings, and thereby publicize equity crowdfunding itself, much more widely than before. On-platform Reg D offerings are still open only to accredited investors, about 7 percent of the population.

Title III of the JOBS Act will someday let non-accredited investors, the other 93 percent, participate in private securities offerings, but this exemption (also called Regulation CF) has not yet become effective. The SEC *may* issue final rules under Title III this year, although it is possible that Congress will revise Title III before the SEC blesses it. The UK and Australia are way ahead of the USA in letting average or “unsophisticated” investors participate in equity crowdfunding, but investor demand for crowdfunded securities is still fairly weak in those countries.⁵

Title IV of the JOBS Act, which became effective in June 2015, does allow non-accredited investors to invest in “Regulation A+ offerings,” some of which will be made via crowdfunding platforms. The Title IV exemption is structured primarily for growth- and later-stage companies that want to file “mini-IPOs,” not ideal for seed-stage startups since compliance costs alone may overwhelm the amount of capital being sought. Learn more about Reg A+ here: <http://www.accreditedinvestormarkets.com/article/regulation-a-creates-mini-ipos-equity-crowdfunding-confusing-investors/>.

⁵ Richard Swart, “Challenges in SME Access to Capital,” Roosevelt Institute, July 6, 2015 (<https://nextamericaneconomy.squarespace.com/thought-briefs/2015/7/7/challenges-to-sme-access-to-capital>).

Another form of equity crowdfunding is the **intrastate securities exemption**,⁶ where issuers with headquarters in a particular state may sell securities to all investors (non-accredited as well as accredited) who live in that state. At this moment, at least 22 states have such exemptions in place, and at least one more is awaiting the governor's signature. Some of these exemptions are variations of Title III of the JOBS Act, in terms of the dollar limits on raises and investment limits for non-accredited investors. (See a list of intrastate securities exemptions, with raise limits and investment limits for each state: <http://www.freedman-chicago.com/ec4i/Intrastate-Securities-Exemptions.pdf>.)

Securities crowdfunding also includes **peer-to-peer lending** (P2P), more recently known as marketplace lending because true peers (individuals) are being overwhelmed by institutional lenders. Debt-based crowdfunding is a hot sector of the securities markets in the USA and some other countries, including China.

Regulation D Platforms

Issuers have raised tens of billions of dollars through Reg D offering platforms since they launched in 2011 in the USA. These early equity offerings used the Rule 506 exemption under Reg D. That was before the JOBS Act, which most argue will boost overall volume of capital formation, now that the non-solicitation rules have been relaxed. Title II of the JOBS Act prompted the SEC to split Rule 506 into parts:

- **Rule 506(b)** is the “traditional” part, also known as the “quiet deal,” because it retains the ban on general solicitation. For off-platform offerings it permits up to 35 non-accredited investors to participate in each deal. This is where high-tech startups tend to congregate.
- **Rule 506(c)** is the “new” part, because it lifts the ban on general solicitation. But only accredited investors may participate, on- or off-platform. This is where consumer product and retail companies tend congregate.

Title II went into effect in 2013 with the full implementation of SEC regulations. Now you might see 506(b) offerings, 506(c) offerings, and Reg A+ offerings all listed on the same equity crowdfunding platforms. But the tendency among successful platforms these days is to specialize in one kind of exemption or another. So, for example, you will see some tech-oriented crowdfunding platforms with predominantly 506(b) “quite deals.” Consumer product companies naturally tend to gravitate to platforms that focus on 506(c) deals. You will also find platforms that focus on particular industries, such as real estate—which is the hottest sector of securities crowdfunding after P2P.

According to Crowdnetic's *Q1 2015 Report*,⁷ in the first quarter of 2015 alone, the 17 most prominent securities offering platforms (not including P2P) in the United States recorded capital commitments totaling about \$650 million—a 35 percent increase from the previous quarter. These figures represent the performance of offerings under Rule 506(c); they do not include Rule 506(b) offerings, some of which are listed on crowdfunding platforms as well. It is likely that the numbers of 506(b) offerings, and the amount of capital raised thereby, are higher than that of 506(c) offerings. Rule 506(c) allows general solicitation, while Rule 506(b) does not.

⁶ Under Section 3(a)(11) of the Securities Act of 1933.

⁷ <http://www.crowdnetic.com/reports/apr-2015-report> (accessed 7/8/15).

Significantly for the valuation profession, the types of securities offerings that received capital commitments were: equity (62%), convertible debt (22%), straight debt (9%), and other (7%). The capital structure of crowdfunding offerings “remains relatively consistent with previous quarters,” says Crowdnetic.

Regulation A+ Mini-IPOs

Under Title IV, the moribund Regulation A exemption was expanded from a \$5 million raise limit to a \$50 million limit, and for raises above \$20 million (Tier 2 offerings) it preempts blue sky review (i.e., no need for approval by every state in which the offering is made). Blue sky review is still required for offerings under \$20 million in Tier 1. For more details, see the SEC’s “Fact Sheet: Regulation A+,” at <http://www.sec.gov/news/pressrelease/2015-49.html>.

Some Regulation A+ offerings will be listed through online offering platforms. Such platforms may be dedicated to Reg A+ offerings, or they may feature a mix of Regulation D and Regulation A+ offerings. Neither Reg D nor Reg A+ offerings are *required* to go through intermediaries, though.

Before the JOBS Act, Regulation A issuers could sell unrestricted securities to non-accredited as well as accredited investors. The expanded Reg A+ still lets non-accredited investors participate, but it limits their annual investment in offerings above the \$20 million threshold to 10 percent of their income or net worth, whichever is greater. All investors can invest an unlimited amount in Tier 1 offerings up to \$20 million.

Professionals in the securities industry are calling Reg A+ offerings “mini-IPOs,” as issuers are required to go through a scaled-down registration process and file a prospectus-like document called an “offering circular” with the SEC. The benefits of Reg A+ for seed-stage and startup companies seem limited mainly because offerings up to \$20 million still require blue sky review and compliance, which can be costly and time-consuming. Time will tell whether seed-stage and startup companies try to take advantage of Reg A+ rather than (or in addition to) Reg D, intrastate, or someday Title III equity crowdfunding.

Kinds of Equity Offerings on Internet-based Platforms					
	Online Launch	Raise Limit per Year	Investor Status	Investment Limit	Intermediary Required?
Reg A+ Tier 1	2015	\$20 million	All investors	No limit	No
Reg A+ Tier 2	2015	\$50 million	All investors	Depends on income/worth	
Reg D Rule 506(b)	2011	No limit	Accredited only	No limit	No
Reg D Rule 506(c)	2013				
Intrastate Equity Crowdfunding	2013 (Georgia was first)	Typically \$1m to \$2m	All investors	Depends on income/worth	Varies with state
Title III Equity Crowdfunding	Maybe 2016	\$1 million	All investors	Depends on income/worth	Yes: online portals*

* Title III offerings may appear on non-broker-dealer funding portals that are registered with the SEC or on broker-dealer platforms.

“We are still at the first pitch in the first inning of the equity crowdfunding ballgame,” says Madelyn Young, content development manager at EarlyShares, a Reg D platform based in

Miami. Over the next few years we will see how the various JOBS Act financing schemes really work, what kinds of companies use which exemptions, and how investors perceive value in each new opportunity.

Fraud and Crowd Wisdom

Of course fraud is everywhere, and it will infect crowdfunding. So far, though, equity crowdfunding has been remarkably fraud-resistant, not only in the United States but also in the UK and Australia.

Equity crowdfunding issuers and platforms are subject to the antifraud provisions of federal securities law. (Intrastate platforms are subject to state *and* federal antifraud laws.) Platforms that are broker-dealers have an even higher standard for screening out fraudulent offerings. Beyond the legal framework, however, all crowdfunding platforms have something in common that is transformational in terms of fraud prevention: a powerful social networking component that includes various kinds of discussion forums. Crowds—of donors, backers, or investors—discuss, evaluate, and collaborate (on due diligence, for example) on funding platforms.

Ethan Mollick, assistant professor of management at the Wharton School, University of Pennsylvania, concluded in a 2013 study of 48,500 Kickstarter (rewards-based, not equity-based) campaigns that “less than 1 percent of the funds in crowdfunding projects in technology and product design go to projects that seem to have little intention of delivering their results.”⁸ Mollick believes that the low rate of fraud (at least this particular type of fraud) is a result of “the influence of the community,” by which he means the ability of backers and prospective backers to interact with each other on- and off-platform, and with the campaigner/issuer on-platform via open Q&A forums.

Such discussions are similar to those that “take place on other social media sites, blogs, and forums [as well as] Wikipedia and open-source software development,” writes Mollick, whose main areas of study at Wharton are innovation and early-stage entrepreneurship. “These communities play several important roles in improving offerings, preventing fraud, and making crowdfunding successful. In the case of Kickstarter, communities have successfully detected fraudulent projects.”

The kind of fraud that Mollick addresses in his 2013 study is what we call “take the money and run.” There are other kinds of fraud in the context of crowdfunding that he does not address, including intentional or negligent misstatement or omission. But Mollick clearly believes in the wisdom of crowds, in the context of both rewards-based and equity-based crowdfunding.

Secondary Markets for Crowdfunded Securities

Crowdfunded equity investments are generally illiquid because there is no organized secondary market for crowdfunded shares. Secondary markets will emerge, however, not only for private

⁸ Ethan R. Mollick, PhD, “The Dynamics of Crowdfunding: An Exploratory Study,” *Journal of Business Venturing*, 2013. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2088298&http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2088298.

securities in general, but some for crowdfunded shares specifically, as securities crowdfunding grows and evolves.

Congress and the SEC are exploring the idea of allowing venture exchanges to facilitate trading of securities issued by small companies. The proposed Main Street Growth Act, for example, would permit venture exchanges to connect buyers and sellers of small-company securities, but not to process transactions between those parties. The act defines small companies as those—both public and private—with assets under \$2 billion.

CFX Markets will be the first secondary market for crowdfunded shares specifically. CFX “provides an open and secure network to facilitate secondary market transfers of private securities in alternative asset classes,” strictly for accredited investors. (See details at <http://www.joincfx.com>). It is owned by PeerRealty, a real estate securities crowdfunding platform based in Chicago, but it will list crowdfunded shares originating on other platforms as well, including PropertyStake (real estate), CrowdFranchise (franchises), and more in the future.

Accredited Investors Predominate

Because Reg A+ is brand-new and intrastate securities crowdfunding is slow to emerge, the equity crowdfunding world is still occupied mainly by accredited investors under Reg D. This might be comforting to some regulators and investor protection groups, and maybe to some accredited investors who don’t want the world to change.

The world will change. Title III is not dead, though it seems to be hibernating. More states will enact or promulgate intrastate exemptions that welcome non-accredited investors, with investment limits based on their net worth or income. Some of the exclusive bastions of private securities will be blown wide open, and small, inexperienced angel investors will flood in, some wisely and some recklessly funding all manner of startups. The private capital markets will shudder. This is good.

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Freedman and Nutting are coauthors of *Equity Crowdfunding for Investors: A Guide to Risks, Returns, Regulations, Funding Portals, Due Diligence, and Deal Terms*, (Wiley & Sons, June 2015). Website: www.ec4i.com.