A Brief History of Crowdfunding

Including Rewards, Donation, Debt, and Equity Platforms in the USA

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Crowdfunding is a method of collecting many small contributions, by means of an online funding platform, to finance or capitalize a popular enterprise. Crowdfunding gained traction in the United States when Brian Camelio, a Boston musician and computer programmer, launched ArtistShare in 2003. It started as a website where musicians could seek donations from their fans to produce digital recordings, and has evolved into a fundraising platform for film/video and photography projects as well as music.

ArtistShare's first crowdfunding project was Maria Schneider's jazz album "Concert in a Garden." Schneider offered a tiered system of rewards. For a $9.95 contribution, for example, a backer got to be among the first customers to download the album upon its release in 2004. Fans who contributed $250 or more (in addition to receiving an album download) were listed, in the booklet that accompanied the album, as participants who "helped to make this recording possible." One fan who contributed $10,000 was listed as executive producer.

Schneider's ArtistShare campaign raised about $130,000, enabling her to compose the music, pay her musicians, rent a large recording studio, and produce and market the album (it was sold exclusively through the ArtistShare website), which won a 2005 Grammy Award for best large jazz ensemble album.

Rewards-based Crowdfunding Blasts Off

Thanks to ArtistShare's success, more rewards-based crowdfunding platforms were launched, the most prominent of which were Indiegogo in 2008 and Kickstarter in 2009. In addition to the arts (including fine art, comics, dance, design, fashion, film and video, music, photography, creative writing, theater), these sites host funding campaigns for social causes (animals, community, education, environment, health, politics, religion) and entrepreneurs and small businesses (food, sports, gaming, publishing, technology).

From its launch in 2009 through October 2015, Kickstarter hosted more than 265,000 funding campaigns, of which 36 percent were successful. The 95,200 campaigns that succeeded raised a total of $1.76 billion from more than 9.7 million backers. About 27,900, or 29 percent of the successful campaigns, raised more than $10,000; and about 2.6 percent raised more than $100,000. The business categories with the most successfully funded projects on Kickstarter are music and film/video, followed at a distance by art, publishing, games, design, theater, and eight other categories. Kickstarter charges a fee of 5 percent of the funds collected in a fully funded campaign.

Not all projects are funded, of course. In an all-or-nothing funding model, 36 percent of Kickstarter projects are fully funded based on their stated goals and deadlines, while the majority walk away with nothing. All-or-nothing means that if a project does not reach its stated funding goal within a stated campaign period, the campaign fails and the funders' credit cards are not charged—and the platform earns nothing. (Indiegogo allows both all-or-nothing and keep-it-all campaigns. In the latter, the project may keep all the funds it raises even if the goal is not reached.)

One of the most outrageously successful, and subsequently famous, Kickstarter campaigns was the Pebble smart watch. A group of entrepreneurs in Palo Alto, CA, created a digital, customizable wristwatch that runs downloadable sports and fitness apps, and connects wirelessly to an iPhone or Android smartphone. The team sought $100,000 during the funding period spanning April and May 2012. With a pledge of $99 or more, backers could pre-order the Pebble watch, the retail price of which was estimated at $150. Pledges of $220 or more were rewarded with two Pebble watches, etc. The campaign raised a whopping $10,266,845 from 68,929 backers (average pledge $149).

Another phenomenally successful crowdfunding campaign has been the Coolest Cooler, which raised $13,285,000 from 62,000 backers on Kickstarter in 2014. The company's funding goal was $50,000.

Many backers pledge amounts less than the minimum required to get a reward. In other words, rather than expecting a tangible reward, they simply want to support the project team and/or their product. To run a successful crowdfunding campaign, "you don't want to merely sell people a product, you want to sell them a dream," says one successful Kickstarter campaigner.

New rewards-based crowdfunding sites are emerging that focus on a narrow product category or niche market. Experiment.com (formerly called Microryza), for example, is a crowdfunding site for scientific research projects; funders are rewarded with "insight behind the science." Teespring is a Kickstarter-inspired site for designers of custom t-shirts. Plum Alley is a rewards-based crowdfunding site for women entrepreneurs.

Significantly, all rewards-based crowdfunding campaigners retain their intellectual property rights: patents, trademarks, and copyrights. In other words, Kickstarter is not a producer or publisher or marketer, but a sophisticated intermediary that connects campaigners with backers and enables them to communicate among themselves in order to assess the merits and prospects of the campaign.

Backers assume risks. Even when projects are fully funded, there is no guarantee that the entrepreneurs will fulfill their promises to backers, or do so on time. Two prominent studies found that at least 70 percent of projects miss their delivery deadlines. Kickstarter does not mediate or intervene when funded companies fail to keep their promises.

You might expect that giving hundreds of thousands of dollars to a bunch of startups in exchange for promises of products that haven't yet been marketed would result in a high occurrence of fraud. The fraud rate appears to be quite low so far, however. Ethan Mollick, assistant professor of management at the Wharton School, University of Pennsylvania, concluded in a 2013 study of 48,500 Kickstarter projects 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." Keep in mind that Mollick studied only one kind of fraud—"take the money and run"—and there are other kinds, such as making false or misleading statements in a campaign.

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 and with the campaigner, via questions, comments, and responses on the crowdfunding campaign's discussion forum, and in particular "discuss the merits and probability of success of each project."

The continuous presence of the crowd and its highly social nature serve as a kind of screen or deterrent against possible abuses. Anyone considering contributing or investing a significant amount of money in a crowdfunding campaign should read *The Wisdom of Crowds*, by James Surowiecki (Anchor, 2005). Here is an article about equity crowdfunding, titled "Wisdom of the New Crowd": http://www.accreditedinvestormarkets.com/article/wisdom-of-the-new-crowd/.

Debt-based Crowdfunding

Have you tried to get a bank loan lately? Credit has dried up measurably for small borrowers since the 2008-2009 financial crisis. Debt-based crowdfunding—also known as peer-to-peer lending (or simply P2P) and more recently "marketplace lending"—has taken up some of the slack.

Debt-based crowdfunding emerged as an investment vehicle in 2006 in the United States, and a year earlier in the UK. The debt version of crowdfunding lets individual borrowers apply for unsecured loans (not backed by collateral) and, if accepted by the platform, borrow money from "the crowd," then pay it back with interest. P2P platforms generate revenue by taking a percentage of the loan amounts (a one-time charge) from the borrower and a loan servicing fee (either a fixed annual fee or a one-time percentage of the loan amount) from investors. The application process is free for borrowers. Investors earn interest on each loan (or package of similar loans), assuming the borrowers make timely payments.

From the borrower's point of view, getting a P2P loan can be simpler, quicker, and cheaper than borrowing from a bank. It is cheaper (that is, fixed interest rates are generally lower) because most of the P2P platform's services (application review and verification, credit check, loan disbursement, payment processing, collection, compliance and reporting, etc.) are automated. This results in lower overhead.

Only a small percentage of applications are approved. For example, Lending Club (launched in 2006 in San Francisco), the largest P2P platform in the world in terms of issued loan volume and revenue, has an approval rate of about 10 percent.

Interest rates are high enough to generate strong returns for investors (assuming sufficient diversification of their loan portfolios)—potentially better returns than traditional money markets and bonds, with less volatility than stocks—and a fairly reliable monthly cash flow of interest and principal payments throughout the term of the loan. In October 2013, Lending Club was charging borrowers a rate of 24.44 percent for its riskiest loans, sliding down to 7.65 percent for its least risky ones.

From the investor's point of view, although the minimum investment can be as low as $25, P2P platforms are more complex than rewards-based platforms because they involve securities regulated by the SEC. Unlike the Kickstarter experience, you'll need to spend quite a bit of time learning how the P2P system works, what the possible risks and returns are for each particular lending opportunity, and what kinds of secondary markets exist before you commit your money to a single borrower or a package of loans. (P2P investors do not have to be accredited.)

Each borrower whose application is approved on a P2P platform receives a credit-risk score and interest rate set uniquely by that platform, acting as an intermediary between borrower and investor. Higher risks must yield higher rates to stay attractive, of course. Investors can select individual creditworthy borrowers based on their risk/rate profiles, in addition to other characteristics such as reason for the loan (debt consolidation, home improvement, major purchase, car finance, healthcare expense, small business expense, vacation, etc.). Alternatively, investors may select a package of dozens, hundreds, or even thousands of loans in the same risk/rate tranche, which allows diversification among many borrowers. In all cases, the risk for investors is that one or more borrowers will default, so that some or all of the investor's capital may be lost.

As of October 2013, Lending Club alone had serviced more than 200,000 loans for well over $2.7 billion, with an average loan size of $13,490. The platform has paid investors $243,817,000 since its launch. Its default rates have varied from about 1.5 percent for the least risky borrowers to 10 percent for the riskiest. Update: As of September 2015, Lending Club's total cumulative loan issuance was more than $13.4 billion, and the most commonly reported loan purpose was refinancing other debt.

Given its historical rates of interest and default, Lending Club projects returns to investors of about 5.6 percent for prime consumer notes in the least risky tranches and 9.2 percent in the riskier tranches. So for example, according to the Lending Club marketing pitch, "if you invested $100,000 in 36-month, grade C notes [Lending Club's ratings range from grades A through G] providing an aggregate 9.5 percent net annualized return, you would receive approximately $3,200 each month in cash payments," which you can withdraw or reinvest.

The growing popularity of P2P, especially since 2009, started attracting institutional investors such as insurance companies and pension funds, which accelerated growth further. (In fact, because so many institutional investors now invest, some people refer to P2P now as marketplace lending.) Some P2P platforms, including Lending Club and Prosper (the second-largest P2P platform, also launched in 2006 from San Francisco), pay referral fees to financial advisors who direct investors to those platforms. In 2013 Google invested $125 million in Lending Club. And as the ultimate sign of commercial validation, Lending Club went public on December 10, 2014, raising over $1 billion and nailing down a valuation of almost $9 billion.

Donation-based Crowdfunding

Large charitable organizations began collecting donations online long before Web-based crowdfunding emerged. But by 2010, new donation-based crowdfunding sites allowed very small organizations and individuals to solicit donations from the crowd. Examples range from local organizations set up for a Little League team's travel expenses to a championship tournament, or for a high school choir's trip abroad, to disaster relief and emergency fundraising.

GoFundMe, launched in 2010, is a pioneer in donation-based crowdfunding. As of October 2013, the GoFundMe platform has enabled its users to raise $120 million in 350 campaigns, from 1.4 million donors. The platform takes 5 percent of each donation. Users also pay a processing fee on each transaction. As of October 2015, GoFundMe campaigns had reached the $1 billion plateau.

When teenager Farrah Soudani was critically injured in the Aurora, Colorado, movie theater massacre in November 2012, her family, friends, and social networking connections donated $171,525 in 15 months, via 6,088 donations, on the GoFundMe platform to help pay her medical expenses. Farrah and her unemployed mother had no health insurance at the time.

Equity Offering Platforms (under Regulation D)

Given the success of donation- and rewards-based crowdfunding in the decade up to 2010, it was inevitable that intermediaries in the capital raising profession would try to accomplish similar objectives—matching startups with angel investors using the power of the Internet, disclosing information and deal terms, and facilitating the investment transaction—all online. It is a streamlined process compared with the old version. It typically took eight to twelve months for an entrepreneur to find angels who were interested in the offer and to negotiate a deal, whereas the time can sometimes be measured in weeks or days (sometimes hours) on equity offering platforms.

The first Regulation D equity offering platforms, which emerged around 2011, were governed by Regulation D of the Securities Act of 1933. Among the most prominent and successful of those early Reg D platforms (which operate under the Rule 506 exemption of Regulation D) are MicroVentures, which launched in 2011 and focuses on technology companies; and CircleUp, launched in 2012, focusing on consumer products and retail.

Reg D platforms allow issuers to raise an unlimited amount of capital in each offering. But issuers can sell equity through Reg D platforms *only to accredited investors*, not to "the crowd." Thus many securities professionals do not refer to Reg D offerings as crowdfunding. Over the past few years, however, the media and eventually securities pros have started referring to online Reg D offerings as crowdfunding.

Title II and General Solicitation. Before the JOBS Act of 2012, issuers of private securities under Rule 506 could not advertise their offerings or generally solicit investors. Based on Title II of the JOBS Act, the SEC split Rule 506 into two parts (effective on September 23, 2013):

> **Rule 506(b)** allows an unlimited number of accredited investors and up to 35 non-accredited investors to participate in each offering, but maintains the prohibition on general solicitation. Rule 506(b) deals are sometimes called "quiet deals." Accredited investors can "self-certify" their accredited status.
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> **Rule 506(c)** limits an offering to accredited investors only, and lifts the ban on general solicitation. It also requires issuers of securities, and by proxy Reg D platforms, to "take reasonable steps" to verify each investor's accredited status. So investors may be required by an offering platform to submit tax returns or bank statements, for example, or a confirmation letter from a lawyer, banker, or financial advisor.

After Title II went into effect in September 2013, some (not all) Reg D platforms permitted their issuers to engage in general solicitation if they chose to make 506(c) offerings. CircleUp did, MicroVentures did not, for example. One disadvantage of opening up a Reg D platform to 506(c) offerings is that investors might be spooked by the need to submit documentation, or engage their professional advisor, to verify their accredited status. Platforms that stuck with the 506(b) quiet-deal structure could still let their investors "one-click certify." Some Reg D platforms feature both 506(b) offerings and 506(c) offerings.

General solicitation includes announcing and advertising many details of a securities offering to the public (including the amount being raised, price per share, percent of equity, etc.); and directing investors to the platform where they can find more information and disclosures, and make the purchase.

According to Crowdnetic, in the second quarter of 2015 alone, the 17 most prominent securities offering platforms (not including P2P) in the USA recorded capital commitments for 506(c) offerings totaling about $765 million—an 18 percent increase over the previous quarter. The types of securities offerings that received capital commitments were equity (69%), convertible debt (20%), straight debt (9%), and other (2%). Those figures do not include 506(b) "quiet deals," which are likely much higher in numbers and dollars.

The implementation of Title II spawned a sustainable surge of new accredited angel investors. In the two years starting September 2013, the number of accredited investors participating in Regulation D offerings increased by about 50 percent, according to Offerboard. General solicitation will continue to pull in tens of thousands more accredited investors each year, out of the several million who have heretofore been sitting on the sidelines. (Here are three reasons why we believe this surge is sustainable: http://www.accreditedinvestormarkets.com/article/surge-of-new-angel-investors/.)

Direct v. Indirect Investment. One of the features that distinguishes MicroVentures from CircleUp and many other Reg D platforms is that for each deal, MicroVentures pools investor money into a single entity, a limited liability company, which then executes the purchase of equity shares. In this arrangement, investors buy membership units in the LLC rather than investing directly in the issuer. That way, the issuer adds only one entity to its capitalization table. A cap table is a spreadsheet that lists all the company's investors, showing when each one invested, the amount of each investment, and how much equity each investor holds, among other data.

Most issuing companies, especially those that plan to raise capital from venture capital firms in the future, prefer to keep the cap table as simple as possible. Small issuing companies that do not have full-time investor relations staff may prefer to avoid having to respond to inquiries from many investors so they can focus on building the business and earning a profit. Thus the platform-created LLC provides a "buffer" between the company and its investors.

It is important to distinguish the fund-like LLC entity (in the Reg D platform context) from a venture capital fund. VC funds are typically blind pools where individual investors do not select portfolio companies in which to invest. Each MicroVentures LLC, by contrast, invests in only one issuer, and the investors who buy LLC units have selected that particular issuer in which to invest.

Title III Equity Crowdfunding

The JOBS Act established a new kind of angel investing under Title III of the Act. Title III crowdfunding portals (and broker-dealers that offer private securities under Title III) are open to participation by non-accredited as well as accredited investors. This can transform private capital markets, because it allows tens of millions of potential investors to participate where only 8 million or so could participate before.

From a regulatory point of view, Title III crowdfunding portals are only distantly related to Reg D platforms. From a technology point of view, they are siblings: Most Title III portals will be derived directly from Reg D platform infrastructure. (From here on, references to crowdfunding portals are meant to include broker-dealer platforms that feature Title III offerings.)

Title III amended the Securities Act of 1933 and added Section 4(a)(6) to the Act. Some lawyers and regulators may refer to equity crowdfunding as Section 4(a)(6) crowdfunding, but (partly because that's hard to remember) most people call it Title III crowdfunding or simply equity crowdfunding. Following is a summary of the most important provisions of Title III, a.k.a. Section 4(a)(6), as it relates first to issuers, second to investors, and finally to intermediaries—portals and broker-dealers.

The SEC issued final rules under Title III on October 30, 2015. Equity crowdfunding portals can open their gates to investors in April 2016. Here is a summary of the rules for issuers, investors, and intermediaries:

Title III Provisions for Issuers. To make an offer of equity on a crowdfunding portal or broker-dealer platform under Title III, the issuer must be a private company based in the USA. Investment companies, including mutual funds and private equity funds, may not raise capital via crowdfunding portals. Here are some additional highlights:

- An issuer may raise up to $1 million in any 12-month period through equity crowdfunding portals that are registered with the SEC and FINRA. (In 2014 some members of the House of Representatives proposed new legislation that would increase the annual limit to $5 million.)
- Issuers seeking to raise $100,000 or less must provide certain financial data derived from tax returns (if any) and financial statements certified by the company's principal executive officer. Those seeking between $100,000 and $1 million in capital must provide financial statements reviewed by an independent accountant. If a company seeks to raise more than $500,000 more than once, after the first time it must have the financial statements audited by a CPA.
- Issuers may sell shares to an unlimited number of accredited and/or non-accredited investors in a deal, within the $1 million raise limit.
- Issuers are permitted to publish a notice advertising certain specific offering terms and directing investors to the crowdfunding portal where the offering is being conducted. (This is not equivalent to general solicitation.) Additional communications with potential investors regarding offering terms must take place through the crowdfunding portal.
- Issuers must file offering information with the SEC. After a funding round is complete, issuers may have to file annual reports with the SEC (and share them with investors).
- Issuers may participate in equity crowdfunding offerings and Reg D offerings at the same time; these would be known as parallel offerings.

Title III Provisions for Investors. The amount of money that an investor can plow into equity crowdfunding deals each year depends on the investor's net worth and/or income. Congress set these limits to help prevent catastrophic losses from being incurred by inexperienced investors in high-risk investments.

- Starting April 2016, individuals with an annual income or net worth, excluding the value of their primary residence, of less than $100,000 may invest the greater of $2,000 or 5 percent of their income or 5 percent of their net worth (whichever is less). In any case, anyone can invest at least $2,000 in equity crowdfunding each year.
- Individuals with an income or net worth, excluding the value of their primary residence, of $100,000 or more can invest up to 10 percent of their income or net worth (whichever is less), but not more than $100,000 per year.
- Investors may self-certify that they are not exceeding their investment limits; in other words, they do not have to submit tax returns or other documentation to prove it.
- When registering on a funding portal, investors must demonstrate (by means to be determined) that they understand the risks of private equity investments.
- Investors must hold shares for at least one year after purchasing them via equity crowdfunding, with some exceptions (for example, they may sell shares back to the issuer or to an accredited investor).

Title III Provisions for Intermediaries. All funding portals that are not broker-dealers must register with the SEC and a registered national securities association (currently FINRA is the only one). In addition:

- Registered funding portals that are not broker-dealers may not offer investment advice or make recommendations to, or solicit investments from, individual investors.
- Broker-dealers and funding portals may establish objective criteria for accepting and rejecting issuers that apply to their funding platforms (i.e., they may "curate" their offerings based on, for example, industry niche or geographic location). Broker-dealers and funding portals may, in addition, use undisclosed subjective criteria as well (i.e., they may select offerings that are perceived to have the best chance of success and return on investment).
- An intermediary may not aggregate or pool investors' funds into a single investing entity. (Proposed legislation in the House of Representatives would allow single-entity pools.)
- Intermediaries must provide "investor education" content on their portals that helps investors understand, among other things, the risks of investing in private equity, including loss and illiquidity.
- Intermediaries must conduct background checks on officers, directors, and 20 percent equity holders of each issuer, as a means to reduce the risk of fraud. Intermediaries must disqualify an issuer if one of its officers, directors, or "participants" (such as promoters) in the offering is a "bad actor," as defined by the SEC (e.g., convicted felon, person subject to a finance-related injunction or restraining order, person subject to SEC disciplinary action, etc.).
- SEC has indicated that intermediaries may be liable in an offering where there is a fraudulent or intentionally misleading statement or omission made by an issuer. The extent of liability will be clarified over the next few weeks (after October 30, 2015).

What to Expect with Equity Crowdfunding

In May 2014, the Committee on Financial Services in the House of Representatives formally proposed revisions to Title III, known officially as the Equity Crowdfunding Improvement Act of 2014. The Improvement Act would increase the raise limit for issuers from $1 million to $5 million, and liberalize other provisions of Title III to ease the costs and burdens for issuers.

Title III was perhaps the most controversial part of the JOBS Act, because it opened the riskiest area of alternative investing to tens of millions of investors who, because they were not wealthy, were presumed to be less sophisticated investors.

Writing in the *Harvard Business Review's* HBR Blog, Larry Downs said "crowdfunded equity financing has the potential" to cause "Big Bang Disruption." Duncan Niederauer, CEO of NYSE Euronext (a merger of the New York Stock Exchange and Euronext NV), opined shortly after the JOBS Act was passed that equity crowdfunding "will be the future of how most small businesses are going to be financed." In the media, financial pundits have alternately predicted (a) that Title III crowdfunding, populated mostly by investors who are inexperienced in private capital markets, would herald a glorious democratic revolution in the private capital markets, or (b) that it would be an inglorious train wreck. Starting in April 2016, we shall see.

Intrastate Exemptions

Meanwhile, at least 22 states and the District of Columbia, led by Georgia, Michigan, and Wisconsin, began allowing intrastate equity crowdfunding (not regulated by the SEC) with the participation of non-accredited investors. See a list of those states, with limits on capital raises and investment amounts, here: http://www.freedman-chicago.com/ec4i/Intrastate-Securities-Exemptions.pdf.

In some other countries, most notably UK and Australia, lightly regulated equity crowdfunding platforms welcomed all investors, with minimal or no restrictions based on net worth or income. In those countries, equity crowdfunding is largely flourishing, with hardly any instances of fraud (although their definitions of fraud are different from ours). The biggest equity crowdfunding platform in England, CrowdCube, facilitated the funding of 143 companies in its first two-and-a-half years—a respectable number but not a tidal wave of investing like we have seen in P2P lending. And in 2014 the Israeli platform OurCrowd heralded the world's first IPO completed by an equity-crowdfunded tech startup, ReWalk Robotics.

Title IV – also known as Regulation A+

In March 2015 the SEC issued final rules under Title IV of the JOBS Act, colloquially known as Regulation A+. The rules went into effect in June 2015, and companies added Reg A+ to the growing list of financing options for private companies.

Under Title IV, the moribund Regulation A exemption was expanded from a $5 million raise limit to a $50 million limit, and it now preempts blue sky review (i.e., no need for approval by every state in which the offering is made) for offerings over $20 million, in "Tier 2." Blue sky review is still required for offerings under $20 million in "Tier 1."

Non-accredited investors were already allowed to invest in Reg A deals. But Title IV, while expanding the size of such deals, restricted the amount that non-accredited can invest 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.

Some Regulation A+ offerings will be listed through online offering platforms. But Reg A+ offerings are not *required* to go through intermediaries. Moreover, these new offerings are allowed to "test the waters," measuring potential interest by investors, before undertaking the obligations of an offering.

According to the SEC, as of October 28, 2015, only 34 companies have applied to file Reg A+ offerings, and only three have been qualified by the SEC.

There has been much confusion in the media about Reg A+, as some reporters have referred to it as "an opportunity for non-accredited investors to buy equity in startups," whereas Title IV was originally structured mainly for growth- and later-stage companies that are not quite ready to file IPOs. New York securities lawyer Brian Korn calls Reg A+ the "minor leagues for IPOs," and others refer to it as the "mini-IPO," 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 very 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.

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