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CROWDFUNDING

A GUIDE TO

RAISING CAPITAL ON THE INTERNET

STEVEN DRESNER

CROWDFUNDING

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CROWDFUNDING

**A Guide to Raising Capital
on the Internet**

Steven Dresner

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To Max, Joshua, and Harry

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Acknowledgments

It is my hope that this book accurately reflects the present state of crowdfunding and the nascent business of raising capital on the Internet. My coauthors and I began this project long ago with the idea that we'd be writing mostly about the deal-making aspects of crowdfunding. That is, writing about investment crowdfunding as our priority with other topics such as rewards-based crowdfunding as a secondary—and distant—interest. However, as the project developed (and as rules from the Securities and Exchange Commission were slow to materialize) we began to contemplate a book that captured a more well-rounded perspective on crowdfunding with a view toward what comes next.

Because of the rapidly changing industry we aimed to depict in the pages of this book, my coauthors and I were faced with a challenging task. I offer my coauthors gratitude for rising to the occasion and putting up with all the changes I requested as the project evolved. As with all collaborative texts (of which I've done a handful), it is only because of the hard work put forth by everyone involved in the project that this book went from idea to reality. So to my collaborators, thank you for participating and in the process, helping to define an exciting topic.

Although he is not officially listed as an editorial contributor to this book, I'd like to especially thank Todd Anderson. Todd had been our primary researcher on this topic at DealFlow Media. And because of this, I dragged him into the project to help coordinate the massive amount of not-so-glamorous work that's involved in making a book. Fortunately, Todd was excited to help out. He overdelivered every step of the way.

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And in the tradition of saving the best for last, I send all of my love to my boys, Max, Joshua, and Harry. Words aren't enough to express my gratitude. You guys have sacrificed more than anyone else. For you I want nothing but peace, love, and happiness.

Steven Dresner

Introduction

Crowdfunding, sometimes called crowd financing or crowd investing, is generally defined as the collective cooperation by people who pool their funds, usually via the Internet, to support efforts initiated by other people or organizations. Crowdfunding supports a variety of purposes, from disaster relief to publishing books, to artists seeking support from fans to political campaigns, to funding a startup or small business.

This book addresses the market dynamics now catapulting crowdfunding into the mainstream. It should be distinguished from the many crowdfunding white papers, how-to guides, and promotional materials on the Internet in that our cast of contributors—who were carefully selected to represent a variety of market participants—went about this project without bias. We intended to make a professional text accurately reflecting the present state of crowdfunding with a view toward what’s coming next. In this regard, we hope you find value in these pages.

Whether you’re an entrepreneur seeking capital for your first startup or a corporate development pro at a large company, an angel investor or a hedge fund manager, a securities attorney, tax accountant or consultant, you’ll definitely need to understand the crowdfunding phenomenon. So the sooner you delve into this topic, the better off you’ll be. Fortunately, my coauthors and I are presenting you with the first professional book of its kind—a comprehensive treatment on the topic of raising capital on the Internet.

The book comprises three sections. “The Business of Crowdfunding” offers historical context along with a snapshot of the present market. “Preparing for Your Crowdfunding Campaign” provides business planning suggestions. “Understanding the Framework of Rules and Regulations” offers a discussion of legal and other technical issues. While the book can serve as a guide while you jump around from topic to topic, it was designed to read from front to back and offers a considerable amount of foundational material at the beginning. So with this in mind, let’s start at the start and take a quick tour through the sections that follow.

Historically, crowdfunding is well known for helping to raise charitable donations. But now crowdfunding serves much more than just nonprofits. It's receiving very mainstream attention from both commercial and social entrepreneurs now that social media, online communities, and micropayment technology make it straightforward for sourcing donations from a group of potentially interested supporters, or for raising capital from investors at very low cost for new business opportunities. Jason Best and Sherwood Neiss do a fantastic job of exploring the roots of crowdfunding in the first chapter, "Crowdfunding: A Historical Perspective."

Whether crowdfunding is directed at profit-oriented investment opportunities, charitable purposes, or artistic efforts, it is at its core a pooling of resources at the grassroots level with a framework for rewards and for the purpose of initiating an investment—and where common desire and trust are the most important driving forces for participation. Karen Kerrigan, in "Understanding the 'Crowd,'" provides a backdrop for the discussions in this book covering the importance of social media in this new area of finance.

An entrepreneur seeking to use crowdfunding for something such as seed financing typically makes use of online communities to solicit pledges of small amounts of money from individuals who are not professional financiers. A range of variations are possible.

The solicitation could call for backing an idea with no direct material return for those making a pledge. This is common in artistic patronage and the activities of charity fundraising. Sometimes a threshold pledge approach is used, in which all pledges are voided unless the threshold amount is reached before a deadline. Another approach invites a display of sponsorship in return for the cash pledged. The solicitation could involve offering a non-interest-bearing loan as in microfinance. Or some kind of quasi-equity investment could be offered, although any such arrangement would need to avoid falling under any applicable financial regulations governing public offerings of securities. In "A Statistical View of Crowdfunding," Carl Esposti gives a 360-degree view of the marketplace with special attention to the geographical considerations and demographics of popular crowdfunding models. Andrew Dix and Charles Luzar also round out a comprehensive view of the modern crowdfunding market in "Current Market Dynamics."

Crowdfunding allows good ideas (which do not always fit the pattern required for conventional financing) to attract cash through an approach to "the crowd." If the appeal to the crowd is successful, an enterprise can not only secure seed funding to begin its project, but also obtain evidence of backing from potential customers and benefit from word-of-mouth promotion. Joy

Schoffler gives an overview of building and maintaining online relationships in “Communicating with your Investors or ‘Backers’.”

One theme covered in several areas of this book includes unique aspects of business planning since crowdfunding can entail disclosing an idea in public when the idea might be at a very early stage—thus vulnerable to poaching by competitors. The promoter needs to consider the risk of the idea being copied and developed by better financed competitors who can get a quicker start. David Feldman in “Business Planning in Preparation for a Crowdfunding Campaign” and Michael Allan in “Protecting Your Intellectual Property” kick off the second section with a comprehensive look at the planning that should take place prior to launching a crowdfunding campaign. Reginald Chambers’s “Understanding Your Investor Options” and “Alternatives to Crowdfunding” by David Burton complete the section with discussions covering other approaches to financing a fledgling business or new idea.

Other important concerns related to crowdfunding are the limitations imposed by securities laws, since soliciting investments from the general public is most often illegal unless the security for sale has been filed with an appropriate regulatory authority, such as the Securities and Exchange Commission in the United States or similar agencies in other countries. According to Section 5 of the U.S. Securities Act, it is illegal to sell any security unless such a sale is accompanied or preceded by a prospectus that meets the requirements of the Securities Act.

While debate continues as to whether a particular activity constitutes a sale of a security, any crowdfunding arrangement in which people are asked to contribute money in exchange for a share of potential revenue or profits based on the work of others, or that involves some kind of ownership in the work of others, or contemplates a financial incentive such as an interest-bearing loan, would likely be considered a security. Consequently, the solicitation of the investment would have to be registered with a regulatory agency unless it qualified for one of several exemptions (e.g., Regulation D of the Securities Act of 1933). As this book was going to press, the SEC was soliciting comments on its equity crowdfunding rule proposals, which were introduced in late 2013. These rules contemplate a number of possible amendments to the securities laws to permit investment crowdfunding, with certain safeguard limitations that would allow for raising limited amounts of money through crowdfunding while using such mass communication techniques as social media without the usual regulatory filing requirements. In the last section of this book, Joan MacLeod Heminway provides a comprehensive discussion of relevant securities rules in her chapter, “The Legal Aspects of Crowdfunding

and U.S. Law.” Jeff Lynn and Kristof De Buysere follow with “Crowdfunding Laws Based on Global Jurisdiction,” which covers the more flexible regulatory framework in Europe.

In “Living with the New Reg D and Its Impact on Pitch Events and Demo Days,” Kiran Lingam, Trent Dykes, and Megan Muir round out the most technical section of the book with a timely discussion of how the SEC’s new rules on general solicitation and advertising affect what’s commonly referred to as “pitch events,” where companies solicit investment from a group of qualified investors.

Crowdfunding, like crowd sourcing (which is the act of sourcing tasks to a group of people), is very much related to online communities and social networks. The crowd can already exist as a community but it can also suddenly form from disparate groups around the world who happen to share an interest in funding a person, project, event, campaign, or business enterprise. The Internet allows for information to flow around the world, increasing awareness in such situations. In the book’s afterword, Jon Medved and Zack Miller provide some forward-thinking considerations relating to making investments in globally based crowdfunded companies.

In the same way that social networking changed how we allocate time, crowdfunding will change how we allocate capital. Crowdfunding, generally speaking, is simply the merger of group funding and social networking. While group funding dates back millennia, the social networking aspects of crowdfunding are quite new and are a major driving force behind this revolutionary form of financing.

Building on social networking, crowdfunding creates a vehicle for people to invest or pledge money to projects for which they have an interest, a passion, or some other kind of attachment. In doing so, it creates a marketplace opportunity for a diversity of players. Whether financing a new movie, a fashion line, a sailing adventure, a startup business, or the next Olympic athlete, crowdfunding is in play everywhere. It is my hope that this book serves as a catalyst to begin your exploration of this fascinating area of finance.

PART I

The Business of Crowdfunding

CHAPTER 1

Crowdfunding: A Historical Perspective

Jason Best and Sherwood Neiss

Crowdfund Capital Advisors

Crowdfunding, simply put, is pooling the financial resources of many individuals to convert an idea into a project or business. Instead of relying on a few large donors, it requires many small ones. This chapter steps back in time to understand what happened to this form of financing, why it's "new all over again," and why it's emerging as one of the hottest topics in global business financing. It reviews the risks that led to changes in U.S. financial laws in the early twentieth century and how these laws had the unintended consequence of shutting off capital markets to many startups and small businesses. It discusses how advances in the Internet and technology have allowed us to safely go back to where we started. Today's crowdfunding enables anyone to use the Internet to gauge the value of people's ideas and use online reputations and their own judgment and experience to make their own decisions about which ideas have the best chance for success.

Crowdfunding Isn't New

Crowdfunding is a new way to do something old. It uses the Internet to facilitate capital formation in much the same way that communities financed transactions as far back as 3000 B.C. Prior to the advent of banks and other financial institutions, wealthy families and rulers provided loans to individuals

in communities to finance everything from businesses to infrastructure. Financial instruments not unlike simple loan documents used today were created as promissory notes. Interest rates were determined based on how well individuals knew each other and how much capital was needed. Risk was a function of relationship and ability to execute. Default came with a heavy toll.

While difficult to relate the experiences of 5,000 years ago to today, life in the United States in the late nineteenth and early twentieth centuries offer some examples of American institutions and icons that emerged from the crowd. In the 1930s, before the Great Depression, banks existed primarily to finance infrastructure and the activities of governments. This was ushered in by the Industrial Revolution that led to a change in farming techniques. In order to adapt, farmers were forced to take loans for equipment. Other businesses faced similar technology shifts and access to capital was the same challenge.

Building and loan associations were one of the answers to how to provide capital to businesses and individuals. Groups of people deposited their savings into an association. When the association gained enough money, it financed activities for its members, mainly through mortgages. This system helped many working-class people buy homes. Unlike banks, these associations made their investments based primarily on the interests of their members instead of on the promise of the greatest returns and security. Associations, however, tended to serve small groups or communities and didn't offer many of the services that banks did.

In 1876, crowdfunding was used to finance one of the United States' most iconic monuments, the Statue of Liberty. The citizens of France paid for the statue, and the citizens of the United States paid for the pedestal. Citizens in both countries held meetings, theater performances, art auctions, prize-fights, and rallies to raise money. Frédéric Auguste Bartholdi, the Statue of Liberty's architect, offered a miniature version of the statue with the name of the buyer engraved on it in exchange for a donation—a "perk" when compared to today's crowdfunding.

Despite being \$250,000 short, newspaper publisher Joseph Pulitzer used *The World*, a New York City daily newspaper, to mount a fund drive, promising to print the name of each donor. Pulitzer's plan worked and millions of people around the country began donating whatever they could including a kindergarten class in Iowa that sent \$1.35.

Why? Because these people believed in the project and wanted to give back; they wanted to be a part of history and be a part of something bigger than themselves. These are the same reasons people give to crowdfunding today. Times might have changed but core beliefs have not.

Why Crowdfunding Disappeared

In the early 1900s, the main role of investing in startups and small businesses fell into the hands of wealthy families like the Morgans, the Vanderbilts, and the Rockefellers. Starting in 1911, the process of raising capital from the public was enforced by each state under so-called blue sky laws. With these laws, states regulated the offering and sale of stocks to protect the public from fraud. The specific provisions of these laws varied among states, but they all required the registration of all securities offerings and sales, as well as the registration of every stockbroker and brokerage firm. Providing a structure was a benefit; lacking an infrastructure to monitor, police, and hold people accountable opened the doorway to fraud.

In 1915, the Investment Bankers Association told its members that they could ignore blue sky laws by making securities offerings across state lines through the mail. Allowing solicitation via a mechanism as opaque as the mail opened up the floodgates to fraud. Because the markets weren't regulated at the federal level, shady stockbrokers started to issue stocks in dubious, fictitious, or worthless companies and sell them to people in other states, using the mail as their means of communication.

This ushered in a period replete with snake oil salesmen and grifters moving from one opportunity to the next and debunking Americans out of their savings. During the 1920s leading up to the Great Depression, which began in 1929, the marketplace was full of exuberance. Stock prices kept going up, reinforced by shady brokers. Tempted by promises of riches and easy credit, many investors started to borrow money to buy essentially worthless stocks. Greed drove them to neglect the risks and believe unreliable information about the securities in which they invested.

During the 1920s approximately 20 million large and small shareholders set out to make their fortunes in the stock market. Of the \$50 billion in new securities offered during this period, approximately half became worthless as a result of the stock market crash in October 1929.

When the stock market crashed, public confidence in the markets collapsed. Investors large and small, as well as the banks that had loaned to them, lost great sums of money in the ensuing Great Depression. For the economy to recover, the public's faith in the capital markets needed to be restored, so Congress held hearings to identify the problems and search for solutions.

Congress passed the Securities Act of 1933. This law and the Securities Exchange Act of 1934—which created the U.S. Securities and Exchange Commission (SEC)—were designed to increase public trust in the capital markets by requiring uniform disclosure of information about public

securities and establishing rules for honest dealings. The main purposes of these laws can be reduced to two common-sense notions:

1. Companies publicly offering securities for investment must tell the public the truth about their businesses, the securities they're selling, and the risks involved in investing.
2. People who sell and trade securities—brokers, dealers, and exchanges—must treat investors fairly and honestly, putting investors' interests first.

Congress established the SEC to enforce the newly passed securities laws, to promote stability in the markets, and, most important, to protect investors. The Securities Exchange Act of 1934 requires that issuing companies register distributions of securities, such as stocks, with the SEC prior to interstate sales of these securities. This way, investors have access to basic financial information about issuing companies and risks involved in investing in the securities in question.

The SEC was founded in an era that was ripe for reform. The 1933 and 1934 laws set the way in which the capital markets would function for the next 50 years. Having a mechanism where information was centrally stored and accessed by the public was required; today, this is facilitated by the Internet.

Regulation D, Sarbanes-Oxley, and Regulatory Reform

From 1933 to 1982, the way business was conducted in the U.S. capital markets stayed relatively unchanged. In 1982, the SEC adopted Regulation D, which established three exemptions from the registration requirements under the Securities Act of 1933. An exemption enables some companies, in certain situations, to issue securities without the requirement to register them with the SEC provided they follow all the rules. Included within Regulation D's definitions was the notion of an accredited investor. The SEC adopted two definitions of an accredited investor, one based on net worth and the other based on income:

1. *Net worth criteria.* Under the net worth definition, an accredited investor is someone who, at the time when he purchases a security, has a net worth of \$1 million or more, not including the value of his primary residence. (Note that net worth could be the individual's net worth alone or that of himself and his spouse.)

2. *Income criteria.* Under the income-based definition, an accredited investor is someone with individual income above \$200,000 during the two most recent years or with joint income (with a spouse) above \$300,000 in each of the two most recent years. This person also should expect to achieve a similar income in the current year.

Prior to the 2012 Jumpstart Our Business Startups (JOBS) Act, a company issuing stock to investors had to restrict the number of unaccredited investors it included in a securities offering. If you were starting a small business raising less than \$5 million in securities in 2010 and wanted equity investors, you could have only 35 unaccredited investors. (You could have an unlimited number of accredited investors.) This structure allowed your closest supporters, such as friends and family, to become equity owners in your business while preventing you from reaching larger numbers of your network to ask them if they would like to invest in a business that might carry significant risk. This was one of the measures that attempted to address the pumping-and-dumping schemes leading up to the Great Depression.

Unfortunately, the side effect of this regulation was that small investors found themselves largely shut out of some of the most lucrative, albeit risky, investments such as technology startups. As a result, small businesses and startups found themselves fairly restricted when trying to raise funds. Plus, the underlying implication of the definition is that small investors are, by virtue of their smallness, less educated, sophisticated, or knowledgeable about risk than larger investors—a notion that is flawed when considering scandals such as the one involving Bernie Madoff.

The 1990s and early 2000s saw the rise of a whole new level of financial engineering. That was the creation of financial structures and instruments that allowed corporations greater flexibility (and much greater risk) in their investments. Most of the time, the “flexibility” was really code for “leverage,” or the practice of betting on the direction of a stock’s or other financial instrument’s movement. The larger the bet on the direction, the larger the risk if the stock moved in the opposite direction. When corporate bets worked as planned, companies showed significant gains. However, when these bets soured, the results could be disastrous. Two examples follow.

Enron was an energy, commodities, and services company based in Houston, Texas. Between 1995 and 2000, it was called one of America’s most innovative companies. It filed for bankruptcy in December 2001, and several of its top corporate officers were later convicted of financial crimes. These executives were hiding huge losses in offshore accounts that were not

reported in Enron's financial statements, and their financial "engineering" ultimately caused the company to collapse. Thousands of employees lost their jobs, and millions of Enron shareholders lost billions of dollars. At the time, it was the largest corporate failure in U.S. history, and it was all due to a handful of executives playing fast and loose with company money to enrich themselves.

In July 2002, just seven months after Enron's demise, WorldCom also declared bankruptcy after using fraudulent accounting and aggressive finance practices to hide losses and inflate revenues. Again, the company's collapse led to thousands of lost jobs and the elimination of billions of dollars of stockholder value.

With back-to-back, multi-billion-dollar business failures that were based on accounting and finance fraud, the federal government was pressed to enact significantly enhanced financial regulations. As a result, the Sarbanes-Oxley Act of 2002 (commonly referred to as SOX) was the largest overhaul of federal securities laws since the 1930s. It covered a wide range of corporate governance, accounting, industry analyst relations, and financial reporting issues.

Although well intentioned, SOX had enormous unintended negative consequences for businesses in the public capital markets. These negative consequences were most profound for small businesses that were interested in going public to raise capital. Because SOX treated all companies (regardless of size, industry, geography, or market) exactly the same, all companies faced a similar burden related to regulatory costs. This setup may seem reasonable at first blush, but imagine a mom-and-pop store trying to achieve the same reporting and accounting standards followed by a Fortune 500 company. It can't be done.

Effectively, SOX ensured that if your business was worth less than \$100 million, it made zero financial sense to go public because in order to execute an initial public offering (IPO), you'd spend millions of dollars on accounting and administration, and your annual compliance fees would be well over \$1 million. SOX effectively closed the IPO market for all but the largest corporations and dramatically reduced small businesses' access to capital. Startups and small businesses were restricted to seeking funding from an elite group of wealthy venture capital investors who for the past decade have determined who among America's businesses were worthy of funding. This, of course, left out the other 27.5 million businesses that needed access to capital as well, the majority of which are not high-tech startups but local mom-and-pop businesses that are profitable, yet still find it difficult to gain access to capital.

The Modern Era

With the rise of the Internet and e-commerce, the foundational tools were in place for nonprofits to begin raising money online as well as offline. As individuals gained experience and trust in completing transactions online, it enabled them to save time, save money, and extend their reach into more geographies, sectors, and interests across the globe.

In 2005, an organization named Kiva was founded to use the Internet to source microloans from people in the United States to entrepreneurs in the developing world. Individuals in the United States were able to visit the Kiva web site and directly interact with individuals in the developing world and participate in loans as small as \$100 to \$1,000 that would enable those entrepreneurs to purchase a cow, a motorbike, an oven—some means by which they could build a business to lift their families out of poverty. Lenders in the United States knew the names of the people they were lending to, as well as their circumstances, and received a photo and a way to monitor their progress, via the Kiva web site, as they built their business and repaid the loan. This allowed people who wanted to feel directly connected to other people they were helping to satisfy that deeper human need of being part of something larger than you are on your own.

Then, in 2008, the United States and every other country were hit with the global financial crisis, causing substantial financial damage to individuals and businesses. Among the many negative outcomes of this crisis, the loss of investment capital in small and medium-sized business was deep and profound. Raising capital or being accepted for a bank loan always was a challenge, but in the wake of the financial crisis, it became virtually impossible. Banks were generally not even lending to profitable, successful businesses. Most of the time, the business needed to have the amount of the loan (or greater) in assets before the bank would consider lending to the business. In other words, banks were only lending money to people who did not need it. Unfortunately, due to the SEC regulations written in 1933 and 1934, there were very few avenues for businesses to gain access to capital.

Shortly after the modern financial crisis began, in 2009, the web site Kickstarter was begun by Perry Chen out of a desire to help musicians and artists raise money for their projects. Perry had a band, so he understood what it was like to need money to tour or record music and that if these artists and musicians were able to tap into their fan base and supporters to each pitch in small amounts of money, they could help artists to reach their goal, and they could provide something back (a perk or thank you gift) for their

contribution. This usually took the form of the output of the artists such as a CD, a DVD of the film being produced, a T-shirt, and so on. This was the rise of the “micro-patron of the arts.”

The third technology element that led to the rapid adoption of crowdfunding was the rise of the social Web, otherwise known as “Web 2.0.” Web 1.0 was consuming information and completing transactions. With Friendster, MySpace, and later LinkedIn, Facebook, Twitter, and Instagram, the Web became a place to not only consume information and complete transactions, but also a place to share interests, communicate with friends, and build relationships with people that you may not have initially known in person, but with whom you could create a relationship online.

The rise of the social Web was crucial to the success of perks-based crowdfunding. It enabled people to not only make their donations, but also amplify the power of those donations by making it very easy to spread the word to friends and family via social networks about a project they believed in and encourage their networks to participate as well. This not only increased the success of campaigns, but it also increased the scale and utilization rates of perks-based crowdfunding platforms like Kickstarter.

In August 2010, a group of successful entrepreneurs were talking about how frustrating it was for small—sometimes even profitable—businesses in the United States and around the world to access capital. To them, it seemed crazy that people could give away money on web sites like Kickstarter to artists and musicians and lend money to entrepreneurs in the developing world on web sites like Kiva, but it was illegal to use the Internet to raise investment capital for entrepreneurs and business owners in the United States. It didn’t make sense that the securities laws had not advanced to the Internet Age and the same tools such as the Web and social media, which were a daily part of our lives, could not be used to raise money from their communities. It didn’t make sense that the Regulation D exemptions excluded crowdfund investing online because this would require raising money with public solicitation from unaccredited investors. Investors were asking themselves the same question, “Why can’t I invest in businesses in my community or entrepreneurs I believe in?”

This marked the creation of Web 3.0 where the social Web meets capital formation. This was also the creation of the term crowdfund investing so as to make a clear distinction between perks-based crowdfunding and securities-based crowdfunding. That was the jumping off point for the team of entrepreneurs to create the Startup Exemption Framework that would form the basis of the crowdfunding legislation in the 2012 JOBS Act. Sitting at a dining room table with the Regulation D language, they created the framework

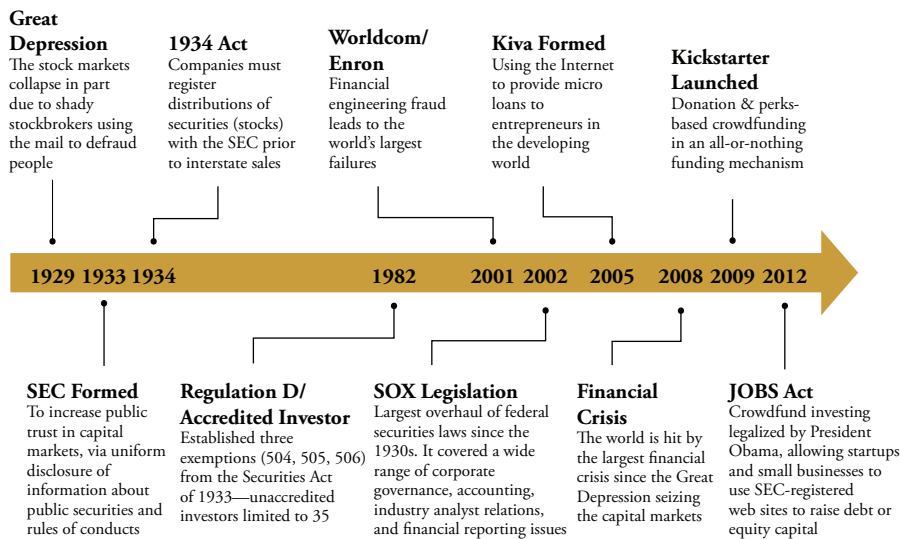
that would enable entrepreneurs and small businesses to raise up to \$1 million per year from an unlimited number of investors.

From there, this group of entrepreneurs talked with securities attorneys who told them not to waste their time—the laws had not changed in 77 years and there was nothing they could do about it. But they pushed forward anyway and met with the Small Business Division of the SEC, who said, “We don’t make those kinds of changes, you’ll need an Act of Congress.” Instead of quitting or just complaining about the problem, they took an entrepreneurial approach and took their solution, the Startup Exemption Framework, to Capitol Hill to advocate for its passage. By putting a stake in the ground, they were able to engage the White House and both Democrats and Republicans in the House of Representatives and Senate in debate and discussion on how to create legislation to pass crowdfunding to help address the critical needs facing the United States at that time—increasing jobs, innovation, and entrepreneurship. With good timing, teamwork from many people, and amazing amount of luck, this legislation was able to pass both houses of Congress with wide, bipartisan majorities, and on April 5, 2012, 460 days after they began walking the halls of Congress, these entrepreneurs (including the authors of this chapter), attended the Rose Garden ceremony at the White House to watch President Obama sign the JOBS Act. Their work was embodied in the third part of the JOBS Act, otherwise known as “Title III.”

Obviously, in creating a new asset class and a new industry that would be regulated by the SEC, a trade association needed to be formed. So this same group of entrepreneurs cofounded the Crowdfunding Regulatory Intermediary Advocates so that the industry could engage with the SEC and the Financial Industry Regulatory Authority (FINRA, the organization responsible for securities regulation in the United States), with a unified voice and so that crowdfunding platforms could work together to create an orderly market for crowdfund investing. They also formed the Crowdfunding Professional Association to provide networking, education, and collaboration among startups, small businesses, and investors.

The SEC took the first step to regulating crowdfunding during the summer of 2012, when it released the final rules relating to Title II of the JOBS Act. Title II of the JOBS Act required the SEC to lift the ban on general solicitation to accredited investors. The final rules allow entrepreneurs to use public means like the Internet or even an aerial banner to solicit investments in their businesses provided that they prove the investor is accredited. Prior to this, the burden of proof was on the investor, and self-certification of one’s accreditation was all that was needed. Now the burden has shifted to the issuer. While some opponents say that that the forced disclosure will deter

FIGURE 1.1 A Timeline Leading to Crowdfund Investing: Regulation that Didn't Scale Down. . .



investments, proponents see third-party providers like accountants certifying forms for investors in order to keep personal information confidential.

The final rules also included a class of individuals otherwise known as “bad actors” from partaking in these offerings. The intent is to reduce fraud in the marketplace. All offerings must be submitted 15 days before they go public with the SEC. The specifics regarding these latest changes are covered later in this book.

The elimination of the ban on general solicitation went into effect at the end of September 2013. It is yet to be determined the impact this will have on both investments and investors.

As of the writing of this book, the SEC has not yet released draft rules for comment related to Title III, Crowdfunding, and so the history is still unfinished. The crowdfund investing industry has been actively engaged with both the SEC and FINRA to provide comment and perspective as those bodies contemplate rules for the crowdfunding legislation.

In the meantime, the world has not waited on U.S. regulation. The United Kingdom has equity- and debt-based crowdfunding platforms in operation, and Italy has passed crowdfund investing legislation and has final rules that restrict the types of issuers to technology-related companies and require a lead angel investor. While seen as a first mover, Italy has also been critiqued for leaving behind those most in need of capital: mom-and-pop businesses. Many other countries are also looking at how they will institute crowdfund investing for the benefit of their citizens. Also, development organizations including the World Bank are actively working on models for crowdfunding that will fit in the developing world. Are there ways for developing countries to leapfrog the developed world in this new asset class? An often-cited example of this from the past would be the way in which cell phones came to China and connected vast numbers of people who never had telephone service via landline before.

Another issue that development organizations are attempting to solve is “the last mile problem” for delivering resources and capital to businesses and entrepreneurs. In many countries around the world, leaders of governments face the same challenge. That is, how to use funds that have been earmarked for entrepreneurship, innovation, or jobs and deliver funding to the “right entrepreneurs” that will be successful. While there is no way to do that with anything approaching 100 percent accuracy, the question becomes whether these organizations can leverage crowdfund investing and/or crowdfunding to create “signals” from the crowd that an entrepreneur is worthy of greater investment. The World Bank and national governments are exploring how this might take shape. One example of a government that is already moving

forward is in the United Kingdom, where the government has created a £20 million (US\$30 million) fund to coinvest with debt-based crowdfunding site Funding Circle.

Could this provide another opportunity for a new technology or business process to fix inefficiencies in a market? And if it does, what is the opportunity to create an entire ecosystem for crowdfunding? At the beginning of the social Web, there were only the social networks themselves. Once Facebook opened its application programming interfaces to developers and encouraged companies to create applications that could be used with Facebook, a massive ecosystem was created that has formed thousands of companies that has yielded hundreds of exits for entrepreneurs that created value in the ecosystem. It is our belief that we are already seeing the birth of the Web 3.0 ecosystem and we are excited to watch it grow.

One could say that the history of crowdfunding is measured in hundreds, if not thousands, of years. Crowdfund investing, however, has a very brief history and interesting prospects for success with potential risks that the industry and governments must work together to address. It creates new challenges for entrepreneurs, business owners, investors, and regulators. Those challenges also create business opportunity for savvy entrepreneurs, who can bring new technology solutions to address these market opportunities both here in the United States and globally. This is the birth of a new asset class, and we believe that if the industry can get it right, it will unlock significant opportunity for innovation, entrepreneurship, and economic growth.

CHAPTER 2

Understanding the “Crowd”

Karen Kerrigan

SBE Council

Access to startup and growth capital has remained a central challenge for entrepreneurs for the two decades that I have been advocating for their interests. Yes, capital has flowed a little more freely during healthy economic periods, but for the most part, the inability to tap into growth capital—even in good economic times—has hindered many promising enterprises. The past five years or more, in particular, have not been kind to entrepreneurs. The financial crisis followed by the Great Recession, lingering policy uncertainties, and a fragile economic recovery have made it more difficult for entrepreneurs to finance their businesses. However, tremendous change and innovation are emerging in the financing space, which makes this a very exciting time to be an entrepreneur.

Heeding the cries of entrepreneurs and the startup community about the lack of available capital, Congress and President Barack Obama came together to advance a policy solution in 2012—the Jumpstart our Business Startups (JOBS) Act—which allows entrepreneurs to raise investment capital via crowdfunding. President Obama signed the JOBS Act in April 2012, and as of this writing, entrepreneurs and investors are eagerly waiting for the SEC to approve Title III regulations associated with the law that finalize the ground rules for crowdfunding.

Positive headway was made by the SEC with respect to Title II of the JOBS Act, which lifts the antiquated ban on general solicitation. As of September

23, 2013, entrepreneurs seeking investment capital were given the green light to publicly market their offerings to raise capital to accredited investors. This is a significant change in the startup ecosystem, as entrepreneurs can communicate their financing needs more openly to access capital. There are 258,000 active accredited investors in the United States, and another 8.5 million Americans qualify as such according to a July 2013 study by the Government Accountability Office. Entrepreneurs can reach more investors, and investors can reach more deal flow. So while it has been frustrating to watch the SEC dither over the rules for an extended period of time, ongoing publicity generated by the JOBS Act delay, along with robust advocacy efforts to get it implemented, come with a silver lining. This activity has sparked a major interest in crowd financing, and there has been a significant increase in gift- and rewards-based crowdfunding. In addition, crowd investing among accredited investors is beginning to take shape, and with the rule change on general solicitation taking effect, the market will continue to develop nicely. Hopefully, the SEC will not disrupt the pace and development of crowd investing with new or onerous rules that work against the intent of the JOBS Act. Complex and burdensome rules will undermine the efficiency and accessibility of crowd financing for entrepreneurs and startups.

According to *The 2013 Crowdfunding Industry Report* by research firm Massolution, crowdfunding has raised \$2.7 billion globally in 2012, an increase of 81 percent over 2011. The firm estimates that \$5.1 billion will be raised in 2013, with a greater share of these raises going to entrepreneurial endeavors and businesses. So the good news is even with the delay in the implementation of the JOBS Act, businesses are increasingly raising funds through crowdfunding. The experiences of these entrepreneurs who have successfully raised capital through gift-, donation-, and rewards-based crowdfunding provide a wealth of information and “how to” strategies for successfully raising capital via this method. Best practices are emerging. In addition, as noted earlier, various crowdfunding platforms are currently connecting promising businesses with accredited investors, which will create more opportunities, more knowledge, and more options for entrepreneurs.

Quality Entrepreneurs and Ideas

Raising money via crowdfunding is not a walk in the park. Kickstarter reports that 44 percent of projects using its platform reach their full funding goal, while the percentage is considerably lower on other platforms. Kickstarter requires you to raise 100 percent of your goal in order to receive the funds.

(This is a JOBS Act requirement for equity-based crowdfunding as well.) About 33 percent of technology projects are funded. So there is no guarantee that your business or innovative idea will acquire the capital it needs simply because you have posted your need and a profile on a crowdfunding platform. However, the benefits and opportunities presented by crowdfunding are abundantly clear in terms of exposure and access to a greater pool of investors, which has made it a very exciting development for entrepreneurs. The crowd just has to believe in you, your idea, or your plan for business growth.

Crowdfunding democratizes access to capital. You can pitch your concept to many potential investors, regardless of where you live. You don't have to live in Silicon Valley or New York City, or work endlessly to try to break into closed venture capitalist (VC) networks where you would have a slim chance of being funded anyway. You can leverage your social network to financially support your business. With equity- and debt-based crowdfunding, “ordinary” investors in your community or those located across the country can find you and invest in your enterprise. “Experienced” angels and VCs may find you on a crowdfunding platform as well. The bottom line is that you will succeed or fail in your fundraising efforts based on the strength and viability of your concept or business, not because you could not get a pitch session with some VC.

While crowdfunding gives you access to a nationwide network of potential investors, the expectations of the crowd will be quite high. Entrepreneurs must be adequately prepared to showcase their potential and competency in an increasingly competitive environment. Quality businesses and quality ideas matter to crowd investors. In fact, a recent study by Wharton professor Ethan Mollick (*The Dynamics of Crowdfunding: Determinants of Success and Failure*, April 2013) confirms what crowdfunding supporters like myself have been advocating both pre- and post-JOBS Act all along—that the collective “wisdom of the crowd” will effectively select, vet, and invest in quality entrepreneurs and ideas.

In his review of over 2,000 Kickstarter projects, Mollick found that both “amateur” and professional investors look for the same things and cues in making an investment. Mollick notes, “Although the amateurs and the experts differ in many ways, they are ultimately assessing whether early stage entrepreneurial ventures have the ability to succeed at their goals by looking for signals of quality.” So the same signals of quality “that are used by VCs to assess the viability of new ventures are also used by crowdfunders.”

What does this mean for entrepreneurs and small business owners who are looking to crowdfund their expansion, a new product or service, or distribution of a product to new markets? Everything about your business—the

brand, the team, the plan, the pitch, and you—must convey quality, preparedness, and success.

This was validated in Mollick's study where he reviewed the commonalities of successful crowdfunded projects. Mollick found that entrepreneurs or creators who could demonstrate a history of success and had influential third-party endorsements were more successful in raising capital. Preparedness—having an effective video and a prototype on display, for example—were factors that also mattered. Essentially, the crowd is collectively setting high standards and expectations for entrepreneurs who seek their investment dollars. Therefore, it is necessary that the entrepreneur who wants to crowdfund be able to convey competitiveness, credibility, and preparedness. He or she must have a viable, quality idea or business.

Entrepreneurs must also understand what crowdfunding is all about. I am amazed by the number of entrepreneurs I encounter who are uneducated about crowdfunding, or have no clue as to where the general trends in financing are headed. A major transformation is under way. Crowd financing will mature into an important funding tool for entrepreneurs. Business owners need to get used to transparency and become more competent users of social media, video, and other technological tools to engage with customers, suppliers, potential clients, and financiers.

Obviously, the best way to become more familiar with crowdfunding is to visit a variety of online platforms that cater to various niches. Search for a small business or entrepreneurial project, and “invest” in one that you find worthy. You can contribute small amounts (or larger dollars if you like the “perks”) to see how communication and engagement take place. Learn from the successes and mistakes of the entrepreneur seeking funding. Give them some feedback and see how they respond. By entering into this space, you will quickly get a feel for the culture of crowdfunding, and what is expected from entrepreneurs who want to raise money from the crowd.

Working on the Fundamentals for Crowdfunding: First Things First

Traveling around the world gives me the opportunity to meet with women, young people, and a cross-section of people who are struggling in difficult conditions. Yet they have hope. They want to be successful entrepreneurs. They want to know the “secret sauce” of what it takes to be successful in business. In reality, of course, the attributes of successful entrepreneurs are not that secret. It takes great passion, a lot of discipline, perseverance, patience, an

open mind, flexibility, a commitment to excellence, and serving the customer well to become successful in business.

Many business owners could easily take their enterprises to the next level if they worked on, for example, their communication and leadership skills and networked outside of their comfort zones. If entrepreneurs embrace change rather than fear it, they may spot and seize opportunities in the marketplace. Being flexible and open to new ideas allows entrepreneurs to more quickly pivot when conditions warrant. Having an inquisitive nature helps entrepreneurs better understand their market and their customer, and will help foster an environment for innovation. Engaging the customer produces new insight and new innovations and strengthens business viability and the prospects for growth. If an entrepreneur plans on crowdfunding, all of these skills and practices will be necessary if he or she wants to be successful raising money from the crowd.

Chance Barnett, founder of the platform Crowdfunder, has identified critical areas that entrepreneurs need to develop if they want to crowdfund successfully. First and foremost, said Barnett, entrepreneurs need to develop a deeper level of fluency and mastery around personal communication. "This really boils down to understanding how to pitch yourself and your company to investors, and the core of that is being able to tell a powerful story with a compelling narrative about your business that is credible," said Barnett.

Successful entrepreneurs have fantastic communication skills. They are, indeed, masters at sharing their vision. Their ability to communicate moves a team of people toward a common goal, and their passion is contagious. They are crisp at telling their story and getting their message across. Barnett recommends that entrepreneurs take stock of their personal communications skills. Ask friends, family, employees, customers, and colleagues for feedback. How can you improve or strengthen your oral delivery, or the style in which you communicate? Are you engaging, or is the conversation one-sided? Being able to convey your story and effectively engage—within the business plan; in person; through video, e-mail, and social media; and through direct communications with potential investors—is a key step toward gaining the interest and support of potential investors.

Sherwood Neiss, a successful entrepreneur and cofounder of Crowdfund Capital Advisors, underscores the importance of being an effective communicator in his book *Crowdfunding for Dummies*. He writes, "In the video pitch online, the entrepreneur has to be engaging, assertive with their message, and must win over the crowd in order to gain investors." Being an effective communicator also means being an efficient one. You will need to answer questions in a timely manner from investors, or quickly address conversation

threads among crowdfunders who may not fully grasp your business plan. “The speed, frequency, and consistency of entrepreneurial communication with investors will determine the investor’s confidence in an entrepreneur,” says Neiss.

Barnett also recommends that entrepreneurs learn to speak the language that investors speak. Understanding the language will help entrepreneurs more effectively communicate and help them to structure crisp and informative online presentations, business plans, and video pitches. According to Barnett:

If you take the time to sit and listen to two investors talk to each other about an investment opportunity, they describe a business in a completely different way than how an entrepreneur would describe a business. They can size a business up in just two or three minutes. That’s because investors talk and think through a specific formula for a business. This formula includes the overall market potential, the management team’s experience, the current and future cash flow and underlying economics, and the ultimate end game or exit strategy for the company and investors.

Barnett adds that investors invest in people. Of course, the strength of an idea is important in sizing up the overall investment, but investors must have confidence in the entrepreneur’s ability to execute. With that, it is important that entrepreneurs build some form of history and trust with investors. Demonstrating a track record of success will certainly help to earn investment dollars. This must be spotlighted and affirmed through third-party endorsements and a strong social network of people who believe in the entrepreneur.

Social media has become a powerful influence in today’s society and in the marketplace. Strengthening one’s “social capital” is a key undertaking that will pay dividends in crowdfunding. Successful entrepreneurs in general have well-developed support networks. They know how to nurture critical relationships with people who can help them. Entrepreneurs who have completed successful crowdfunding campaigns effectively deploy their social capital and leverage it through social media.

Entrepreneurs need to take stock of their social capital—that is, the sum and value of all the relationships that exist around the business owner and their company. These are relationships that produce economic benefits. These individuals may include your advisers, influential friends and clients or customers, management team, investors, media connections, and any other person that may be economically valuable. Perhaps you have taken stock of your social capital, but have not fully connected with them through social media.

Your personal social network is a powerful and necessary tool for executing a successful crowdfunding effort. These are people who will validate you as a successful entrepreneur through endorsements and direct investment. As Barnett notes, social capital is “the ‘social proof’ that comes from real people who an investor or contributor might already know, and showing their support for you is one of the most foolproof points of validation you can have.”

Such validation comes from real success, which is not only affirmed by endorsements but also communicated through the business plan. Successful entrepreneurs plan. They know what they want to achieve and have a road map to get there. The plan, as well as the success of the business itself, demonstrates that they have carefully and strategically organized their planning efforts. Of course, there are many resources for entrepreneurs that will help develop that solid business plan, and many of the crowdfunding sites offer such guidance and templates. A well-developed and organized plan will address key fundamentals to build investor confidence—expertise, traction, and potential to scale.

The bottom line is that in order to meet crowd investor expectations, the entrepreneur will need to prove past success and show a convincing path of greater success to be achieved through investment dollars. If a business owner cannot yet document and point to these milestones at their current stage, Barnett recommends that entrepreneurs keep plowing away to improve the business. Focus on serving customers by making their lives better, and find profitable ways to reach and acquire them at scale. “If you can do both of those things well, most everything can be improved along the way,” adds Barnett.

Finding a Solution, Filling a Need

The beauty of crowdfunding is its sheer simplicity—it creates what people want. It directly connects creators and entrepreneurs to consumers, the market, willing investors, or buyers. No expensive market-testing middlemen, gatekeepers, or naysayers. The crowd will decide if you engage them.

If entrepreneurs haphazardly throw their ideas or projects to the crowd they can expect harsh feedback or, worse, deafening silence. Still, that’s the benefit of having access to a ready-made focus group: entrepreneurs can get feedback from the masses without having to spend a boatload of money or lose their shirts on expensive mistakes. The platforms that are dedicated to specifically serving businesses and entrepreneurs are also building communities of investors, advisers, and experts—ecosystems in themselves to assist and

educate the businesses and entrepreneurs they serve. When business owners create a profile on these crowdfunding platforms, they are accessing networks that will ready them for growth and investment capital.

Obviously, an effective learning tool for understanding what makes for a successful crowdfunding campaign is to look at a variety of success stories. The media have focused on the million-plus-dollar successes—for example, the Pebble watch, an app-enabled customizable wristwatch, which raised \$10 million on Kickstarter even though the goal was \$100,000. And there's Elevation Dock, a practical and user-friendly iPhone dock that raised nearly \$1.5 million, with an original goal of \$75,000. Both of these projects are tremendous success stories, again demonstrating that crowdfunding responds to what people want. In the case of Pebble and the Elevation Dock, incoming funds from the crowd essentially preordered product, providing an infusion of capital to manufacture the orders.

The preorder method of crowdfunding has become an increasingly popular strategy for entrepreneurs and innovators that want to test their product as the “next big thing.” In fact, specialized platforms like Crowd Supply have emerged to better serve this market by hosting product campaigns, offering expertise, and selling products that began their life on a crowdfunded campaign from other sites. Crowd Supply also helps successful crowdfunding campaigns (conducted on other platforms) maintain momentum by taking preorders that may spill over from the close of that campaign. Shopstarter offers the same service. Crowd Supply also offers fulfillment and shipping services to any business that needs to ship products generated from a crowdfunding campaign. The emergence of new businesses and services that focus on e-commerce, customer relationship management, fulfillment, and back-end support for crowdfunded products and companies speaks to both the current success and promising future of crowdfunding.

The experiences of crowdfunding pioneers who tap into the crowd to test or validate market potential of their products are disrupting the consumer product marketplace. The experiences of these preorder pioneers offer valuable lessons for entrepreneurs about how to test a product through crowdfunding, how to market a crowdfunded product, how to navigate a successful preorder campaign, how to preserve momentum, and how to ultimately build a sustainable business once a successful campaign comes to an end. An article by Mark Hayes on Shopify (“How to Run a Successful Campaign on Kickstarter”) touches on some of these issues by asking some of the most successful fundraising campaigners on Kickstarter what they did “right” or “wrong” during, or following, their campaigns. These responses are insightful.

What They Did Right

Pebble watch founder Eric Migicovsky believes the best thing they did was to post their “use cases” showing exactly what their smartwatches could do on their Kickstarter page. The customizable wristwatch (using apps) connects to iPhone and Android smartphones using Bluetooth, and alerts users to e-mails and messages. The “use cases” were actual photos demonstrating practical uses for the Pebble. “We knew that no one really wakes up in the morning with a desperate urge to buy a smartwatch, so it was our job to figure out exactly how to explain to future users how they will be able to use Pebble,” said Migicovsky in his interview on Shopify. Migicovsky also turned to a reliable source. He asked his mom “a lot” about her opinion.

Successful entrepreneurs probe and ask questions. They ask friends, family members, and potential customers what they think about their idea. That is how they fine-tune their marketing efforts, as Migicovsky did with the Pebble watch. They show how their product or service meets a need or solves a problem. As the most successful crowdfunding campaign to date in terms of dollars raised, Pebble obviously did a lot of things right.

Dave Petrillo and Dave Jackson, creators of Coffee Joulies, were not even aware that a very basic customer relationship management practice they signed off on would end up being their most critical asset. The developers of polished stainless steel beans that regulate coffee temperature were too busy with their crowdfunding campaign to appreciate their wise decision making:

The best thing we did was to allow potential customers to opt-in to our email list between ending our Kickstarter campaign and starting to sell using Shopify. We didn’t even know it at the time, but building and using a solid email list is one of our company’s most valuable assets. When the time came to sell again, sending emails to this list was easy and of enormous value.

Important details can be missed in the daily grind and chaos of a startup. It is important that entrepreneurs not forget what they are trying to do. As Peter Drucker said, “The purpose of a business is to create a customer.” Crowdfunding allows entrepreneurs to capture significant and valuable data that can lead to more sales and help grow the businesses. Potential customers who express an interest in your product or service are gold.

Eddie Tsai, who used Kickstarter to validate the demand for a moustache tie clip (TsaiClip) before investing money, said, “Publicity really gave us credibility.” A feature on one influential blog created a “snowball effect . . . and the next thing you know we’re featured on big sites like Uncrate, Cool Material,

and *Handlebar* magazine,” which seem to be important media hits if you are selling moustache tie clips.

Entrepreneurs who think big about their idea or business will do things that help them achieve big goals. Using the media to drive interest in your business is an underutilized strategy for many entrepreneurs. And as Tsai proved with the media coverage that TsaiClip received, you don't have to be interviewed on CNN or CNBC to make a splash. Niche media and blogs may better suit your market niche. If you have a unique product in the pipeline, paired with a compelling backstory, the potential is there for media exposure. Getting that exposure will help validate your business or idea and bolster your crowdfunding campaign.

Rob Ward and Chris Peters are two Australians who recently made tailgate parties a lot more interesting. They developed an iPhone case beer bottle opener, called Opeⁿa. They believed they had an immediate hit with the product, and that hunch was validated on Kickstarter. They quickly moved to the next steps:

One thing that really worked in our favor was making sure our online store was 100% ready to go live as soon as our Kickstarter project finished. We received a heap of press on the last day of our funding period and knew tons of people would be going to our Kickstarter project page only to find that the project had ended. Not wanting to lose all those potential backers, we re-directed them to our ecommerce store to allow them to pre-order our products.

Planning ahead and being proactive? Indeed, attributes of successful entrepreneurs. With turnkey e-commerce sites like Shopify, Big Cartel, Big Commerce, and Vendder, successful crowdfunded startups have no excuse not to quickly transition to a “real business.” Successful business growth is about momentum, and thankfully twenty-first-century entrepreneurs can scale up more effectively and efficiently with the support of firms and technology that cater to helping them do just that.

What They Did Wrong

Ramos Alarm Clock, founded by young engineers around the New York City area, is an innovative and sharp-looking alarm clock that was a hit on Kickstarter. The young entrepreneurs learned a lot from their startup success. Paul Sammut, cofounder of Ramos, told Hayes:

We've made decisions that were based on a mindset used to dealing with prototypes. One thing we're constantly being reminded of is doing something

once or twice is completely different than doing it 500 to 600 times. We offered things to customers at the onset of the project that seemed easy to do, but ended up adding a great deal of complexity to the manufacturing process. I would recommend a serious analysis on how to simplify your product and keep variations to a minimum when starting out on launching a mass produced product.

I was quickly reminded of one acronym when I read the Ramos story: KISS (Keep It Simple, Stupid). As Sammut noted, in hindsight, perfecting the core product should have been priority one. Offering customers a choice of colors on Kickstarter is one thing, but promising variations of a new product right out of the block can present problems, and expensive ones. Sammut also learned the difficulties associated with communicating with several hundred supporters, particularly when you don't have the support staff to do that. Entrepreneurs who plan for growth and expect growth are proactive in having a plan in place for multiple "what if" scenarios like: What if my crowdfunding campaign is successful? Do we have the capacity to handle it, and can we deliver on what we promise?

Jesse Phillips founded NeuYear, a whole-year calendar that people could put on their wall. His Kickstarter campaign was a great success, and he did many things right, like sell a lot of calendars. But he also missed a big opportunity, as he explained to Hayes:

One mistake I made is still haunting me today—I didn't do any consumer research with my product, if I had, I would have learned that many people prefer a dry-erase calendar. So I've missed out on thousands of sales because the product is unusable by several people that otherwise would be interested. I'm going to make a dry-erase version next year, but will they ever come back to find out? Probably not. If I had simply taken the time to put my product in front of people and get feedback, I would have created a much more usable product. Instead, I was too scared of what people thought, that I just decided to launch on Kickstarter and not ask for opinion.

Phillips's admission speaks to the importance of market research, even in its simplest form—such as asking friends, families, and colleagues. What question would he have asked? What would make the product more useful and practical? Still, Phillips offers an encouraging note about mistakes:

Mistakes are NOT a bad thing (usually), they are an education. In other words, don't delay starting just to avoid all mistakes. You'll never have all the information and make the perfect decisions, so it's better to do your research, then jump in and make some mistakes and learn from them!"

Hopefully, Phillips has overcome his fear of asking people what they think.

There will always be missed opportunities in business. The benefit of having advisers and mentors is that you can limit these misses. These are the type of “what if” and “did you think about this” conversations that entrepreneurs will be having with investors, potential investors, and advisers on crowd-investing platforms. This type of dynamic is already occurring on platforms that connect entrepreneurs with accredited investors. The ecosystem is developing nicely on crowd-investing platforms that will eventually link entrepreneurs to all investors, and it will kick into full gear once the SEC finalizes the JOBS Act rules.

How Small Business Owners Can Prepare for Crowd Investing

The best way to prepare for equity- and debt-based crowdfunding is to start getting organized right away. And why not try a gift- or donation-based crowdfunding raise if it makes sense for your business? If you do, work hard to make it a successful outing. The experience will validate your business plan or idea and will be positive information to share with potential investors in the future. If your business would best be served by an equity raise or debt, there are practical steps to take that will prepare you for equity- and debt-based crowdfunding once the SEC finalizes the rules to allow this to happen.

Research crowdfunding platforms to see which ones align with your business or industry needs. There are new and industry-specific platforms coming online at a rapid pace, and the platform space will continue to evolve as crowdfunding and crowd investing mature. Consider setting up a profile on a crowd-investing platform, where you can immediately begin to network with their community and build relationships and trust with potential investors.

Develop a plan for the capital you would like to raise. How much do you need, and how will you specifically use that to grow or expand your business? How will you create a return for investors? If you are looking to raise investment dollars, as either equity or debt, you need to show investors how you are ultimately going to return profits to them. Depending on the kind of business you have, that return takes a different form. A steady and stable business with existing revenues might offer investors debt. Here, you will give investors a return through regular debt repayments for a specified period of time or up to a predetermined amount of return above the original loan amount. A potential high-growth company might require an initial incubation period prior to revenues, yet has the potential to scale and be valued by

potential acquirers at many times its annual revenues. In this case, equity funding might be a fit.

Build your social capital. Connect with networks through social media. Again, these are your advisers, management team members, influential customers and clients, consultants, colleagues, and others who can validate your competency and success as an entrepreneur. How can you strategically use them in a crowdfunding campaign?

Strengthen your social media network. Social media is not a fad, and although you may not currently realize return on investment by employing it (or perhaps you have not measured its value), crowdfunding is flourishing because of social media. If you've ignored your Facebook, Twitter, and LinkedIn accounts, develop a simple plan for tweeting, retweeting, posting, liking, and sharing once or twice a day. Do you have a new product or service or a special promotion? Did a special customer stop by with great news? Did your business hit a milestone or special goal? Who is your employee of the week? Share the news on social media. The average person spends just over three hours a day on social media. Your social network and their friends and followers could be your next investors.

Post regular updates about your business. Primarily, I am referring to updates on the crowdfunding sites where you have registered. You can begin to build a story of traction around your business and build trust and relationships with investors, other entrepreneurs, experts, and advisers who have also joined these platforms. The platforms are social networks in themselves. Connect with people with whom you share an interest or people who can help your business.

Communicate goals and milestones through your updates. Let people and your network know when you have achieved or exceeded goals. These updates build trust with and gain the attention of potential investors.

Be investment ready. The JOBS Act requires issuers to incorporate as a corporation or corporation that elects S status. You will need to prepare a financial statement and keep it updated. If you plan to raise \$500,000 or more, your company will need an audit (JOBS Act mandate).

What will your "deal" look like? Find a mentor who has raised money, and learn all you can. Seek legal guidance, and research resources you can use, like documents on DocStoc.com that show you actual documents used to raise money. Value your company, so you can value shares.

Think big. Do you have a mind-set for growth? If you do, you will instinctively gravitate to the people, resources, information, training, and networks that will help you succeed. That outlook and confidence will be conveyed in your crowdfunding campaign.

Learn to think like an investor. As noted by Chance Barnett, the founder of Crowdfunder (and an angel investor and business adviser) earlier in the chapter, it is important that entrepreneurs learn the language of investors and understand how they think. Entrepreneurs in search of investment capital would be wise to study up on investors and why they make the decisions they do. When crowd investing gets off the ground, experienced investors will have an impact on crowd intelligence and thought, which means new investors will be influenced rapidly by them. Barnett shared his personal experiences about this with the members of my organization:

A helpful way to think of this is that you have to talk to the “two brains” inside each potential investor’s head: on one hand, you have to win over the more “rational” brain that wants to see value or return for their funding. It’s your plan and the value you’re going to bring to them that sells the deal. Thus, your plan has to be credible. On the other hand, you also have to win over the more “emotional” brain. This brain wants to feel good and has its own personal reasons for making a decision. It’s the story that you create and tell around your campaign that stimulates this brain. When you can talk to, stimulate, and satisfy both brains, dollars begin to flow.

A Radically Transformed Environment

I am very excited about the potential reach and impact of crowdfunding and crowd investing. You can be anywhere in the country and raise money on a platform. A key finding in Mollick’s study shows that crowdfunding is less concentrated than VC funding (which typically occurs in startup clusters). This means high-growth businesses and startups don’t necessarily have to be where the money is, which is great for economic development in inner cities, small towns, and rural areas. As crowdfunding develops, it can help local economies thrive through local investment. Now that ordinary people can invest in the businesses and projects they believe in, a larger pool of people will engage in investing and ideally do so in their local communities.

In addition, where women entrepreneurs have typically received a scant amount of total venture capitalist (VC) dollars (4 to 9 percent), Mollick found that out of the successfully run crowdfunded projects on Kickstarter, those run by women were 15 times higher than projects backed by VCs tracked by VentureSource. Crowdfunding has less gender bias than VC selection. Crowdfunding and crowd investing appear to be more gender neutral.

It is also exciting to see diverse people of all ages raising money for their businesses, ideas, and projects through crowdfunding. The United States and

the world need more entrepreneurs. Lack of capital access is a major barrier for entrepreneurs worldwide, and crowdfunding is a promising solution to unlock latent capital to help spur entrepreneurship.

In the United States, we are experiencing a major shift in entrepreneurship. People over 50 years of age are now starting businesses faster than any other age group in America. In fact, 40 percent of the self-employed in our country are over 50, which is a 20 percent jump from 1990. According to AARP, 80 percent of Baby Boomers plan to work after retirement, and many plan to start their own businesses. All trends point to robust crowdfunding among these encore entrepreneurs. They have the networks, the savvy, the wealth, and the social media acumen to successfully participate in crowdfunding and crowd investing.

My recent favorite crowdfunding success story is Happy Canes by Grandma Pearl. In the case of 89-year-old Pearl Malkin, who successfully raised over \$5,000 (goal \$3,500) for her Happy Canes business on Kickstarter, she sees a need in the market for accessorizing those “dismal black canes.” Her awesome video and profile page, developed by grandson Adam, showcases the Happy Canes brand, which is a comical, straight-talking “Grandma Pearl” (Malkin herself). The funds she successfully raised will go toward developing new designs, buying more decorative flowers, and perfecting the manufacturing process, which now consists of Grandma Pearl hand-decorating each cane. She may look to outsource or hire senior citizens in her community.

As demonstrated by the Happy Canes success story, crowdfunding is a great fit for a small-scale business in need of startup or expansion dollars. Grandma Pearl quickly reached her fundraising goal because she had a compelling video, a great story, and some unique “perks” that go along with various contribution levels. The profile page links to punchy telephone messages left by Grandma Pearl for grandson (and vice president) Adam that they decided made great “perks” for contributors.

Grandma Pearl’s story and successful crowdfunding campaign hit the major media, and something tells me there’s more in store for Grandma Pearl—after all, she is the brand.

Senior entrepreneurs could be the next big thing that sweeps the country, and their impact may be powerful. People over 50 are also becoming very comfortable with social media. In fact, according to Pew Research, people over 50 are the fastest-growing demographic on social media, surpassing the teen demographic as “power users” just a few years back. Their powerful social capital—derived from their sheer numbers, tremendous wealth, and educational attainment—will be a powerful asset for crowdfunding their businesses.

Crowdfunding has transformed how capital is raised and deployed. But crowdfunding is transforming more than the flow of capital—it is changing how products and services come to market and empowering people to create and fund solutions that governments, corporations, and other large institutions have failed to solve.

Crowd investing will do more than provide entrepreneurs access to a larger pool of potential investors. It will save entrepreneurs time and money through a structured and standardized process. And more than that, entrepreneurs will have access to educational resources, experts, and advisers—embedded within the crowd-investing ecosystem—that will help our nation produce stronger and more competitive businesses.

What a great time to be an entrepreneur. What a great time to be an investor.

CHAPTER 3

A Statistical View of Crowdfunding

Carl Esposti

Massolution

As pointed out in Chapter 1, crowdfunding as a tool for capital formation is by no means a new discovery. The willingness within a population to get behind commonly beneficial ventures is and has always been an integral, if not puzzling, chapter of societal evolution—integral because we are reminded of how powerful our joint effort and support can be; puzzling because the provision of goods and services that are commonly beneficial (such as public goods) often entail what economists would call a “free-rider problem.”

The free-rider problem emerges when individuals can benefit without necessarily contributing. As individuals, we are faced with the option to free-ride on a daily basis; this also happens when we are surfing crowdfunding campaigns. Campaigns asking for donations to solve a common problem without offering anything in return perfectly illustrate an area where free-riding should make success impossible. When we are faced with the option of letting someone else take responsibility for solving common problems, one would expect that no one would take that responsibility. And yet these ventures are the building blocks of the crowdfunding industry!

What this tells us is that there are aspects of human behavior that have not been captured completely by the traditional economic view that we are consistently acting in our own self-interest and everything we do can in one way or another be understood as a purely rational and self-centered response

to the circumstances we are in. Crowdfunding should thus be considered with the field of behavioral economics in mind.

If crowdfunding is not a new phenomenon, why did it take until 2012 for MIT to name it one of the most promising disruptive developments, and for U.S. President Barack Obama to sign into law the Jumpstart Our Business Startups (JOBS) Act, which includes a title specifically on crowdfunding?

The answer is technology. Today, we have access to a range of online tools that allow for social interaction and communication that was not possible before the dawn of Web 2.0. It has never been easier to reach and collaborate with a large audience (i.e., “the crowd”) and efficiently raise awareness of individual campaigns. The use of the social Web 2.0 is the true disruption—online crowdfunding as we know it today, and as it is treated in this book, is nothing short of technology catching up with the crowd’s willingness to engage, support, create, and decide.

This chapter is largely informed by Massolution’s *2013CF: Crowdfunding Industry Report* and our analysts’ and researchers’ subsequent fieldwork. Additional analyses have been made for this particular text based on Massolution’s C-STEP™ methodology.¹

The Marketplace

Crowdfunding refers to any kind of capital formation in which both funding needs and funding purposes are communicated broadly via an open call in a forum, where the call can be evaluated by a large group of individuals, commonly called “the crowd.” The outreach is referred to as a crowdfunding “campaign,” and the person or company who is in charge of the campaign is referred to as the “campaign owner.”

An open call in the context of crowdfunding (and crowdsourcing in general) is understood as a call to action; for example, a call for support or capital, where the message is not targeted at any specific intended recipient. This line of communication serves as an indirect stakeholder screening, since the communication is established via the interested recipients’ feedback as opposed to direct communication established by the sender.

1. *Crowdfunding—Social Transformation and Economic Performance (C-STEP™)* is a research methodology that facilitates analyses and assessments of crowdfunding’s applicability across regions and verticals. It provides a unifying framework for strategizing, mechanism design, implementation, and execution against any goal.

A crowdfunding campaign is an open call in which the sender is the campaign owner, the recipient is any member of the crowd that decides to support the campaign, and the communication is predominantly established via a “crowdfunding platform” (CFP), supported by the campaign owner’s personal means of communication and outreach.

In a Web 2.0 context, the availability of personal communication channels has expanded rapidly, which has fundamentally changed the nature of open calls, and thus the nature of crowdfunding.

The Crowdfunding World Map

In 2012, more than 1 million campaigns successfully raised capital from the crowd. In terms of funding volume, the market grew 81 percent in 2012 to a total volume of \$2.67 billion. Compared to 64 percent growth in 2011, crowdfunding is accelerating.

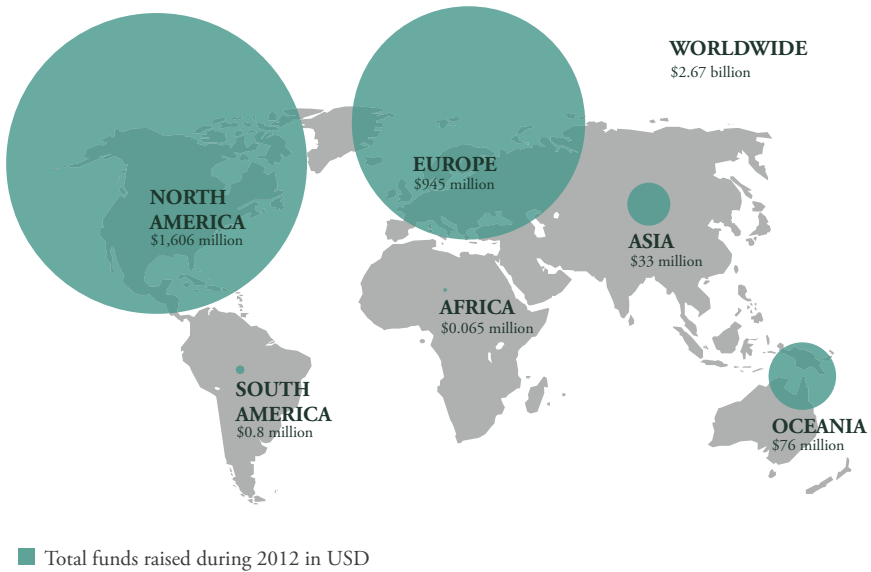
The best way of understanding this development is by looking at the microlevel, that is, by considering one of the triggers of crowdfunding success, the “third-level acceleration.”

When a campaign owner reaches out for support, the initial channels mainly include friends and family—people who have a close emotional tie to the campaign owner. Getting the support from these people serves several purposes: (1) initial capital is raised (although it is generally limited); (2) a signal of integrity is sent to spectators outside the campaign owner’s own circles; and (3) the campaign owner leverages the outreach of the initial group.

The latter purpose (leveraging the outreach of others) contributes to an escalation of the outreach effort, which translates into an exponential increase in support, if the campaign can appeal to the crowd in terms of raising capital, as well as raising awareness. The emphasis on the third level stems from the fact that, in order to harness the support of strangers, the campaign has to appeal to people who are three social links (and beyond) away from the campaign owner.

When raising awareness at the microlevel entails this network adaptation, awareness of online crowdfunding and crowdfunding platforms will follow the same acceleration. The increase in global crowdfunding volumes is therefore best explained by acceleration in the global awareness of the model itself.

Although crowdfunding lends its opportunities of accessing capital in a growing number of countries all over the world, North American (especially those in the United States) and European platforms have raised far more capital than platforms elsewhere (see figure 3.1).

FIGURE 3.1 Global Crowdfunding Volumes; The Crowdfunding World Map

Source: 2013 CF: *Crowdfunding Industry Report*. Copyright © massolution 2013.

North American platforms raised in excess of \$1.6 billion, which is a 105 percent increase compared to 2011. In 2011, the North American crowdfunding market grew by 86 percent.

European platforms raised close to \$945 million, which is a 65 percent increase compared to 2011. The bulk of the global acceleration thus stems from European CFPs, whose growth in 2011 was 42 percent.

One possible explanation for the additional growth in North America is that CFPs are not faced with the same language barriers as the European CFPs. This creates more impactful home market effects for CFPs in, for instance, the United States.

As a financing option for commercial enterprises, crowdfunding is a relatively new phenomenon. The market is in the midst of a transition from philanthropic ventures' requests for support to for-profit companies offering investment opportunities. The global distribution of funding volumes is therefore very likely to change due to the emergence of commercial crowdfunding.

North America and Europe still account for more than 95 percent of the total market. Crowdfunding in Asia and Oceania is accelerating, however, though the aggregate 2012 funding volumes are below \$50 million and \$100 million, respectively.

Regions where the financing gap is widest are obvious candidates for the disruption crowdfunding represents. South America, Africa, and Asia, which all have benefited from microfinance initiatives motivated by these financing gaps, are most likely to show leniency in terms of allowing new financing mechanisms and to boost entrepreneurial ventures in this space.²

In South America and Africa, CFPs are emerging as well, and, as expected, the acceleration is much higher than in the regions where crowdfunding is more established. Crowdfunding markets outside North America and Europe accelerated from a 59 percent growth rate in 2011 to 125 percent in 2012.

Crowdfunding Models

The majority of funds are raised via CFPs that focus on one of the four main models: donation-, rewards-, lending-, or equity-based crowdfunding (see figure 3.2). The most popular one is lending-based crowdfunding, which in 2012 grew 111 percent to a total of \$1.2 billion. The volume and growth mainly stems from crowdfunded microloans and local small and medium-sized enterprise (SME) loans.

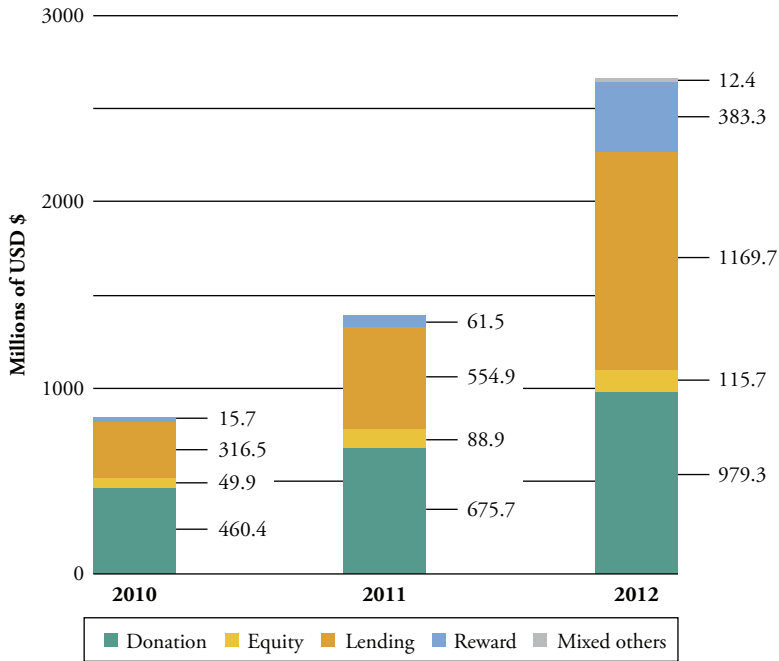
At this point, it is important to note the difference between crowdfunding and microfinance. Crowdfunding refers to funding where support (or investment) can be scaled down; that is, the volume is created due to mass support, while microfinance refers to a situation where the sought aggregate amount is scaled down.

The problem that microfinance is solving is related to due diligence costs on the part of the financier. If it takes efforts to access the risk/reward structure of a proposed deal, then the deal itself must be of a scale that can justify these efforts. Individuals with very low financing needs cannot produce that signal, and microfinance institutions have thus created mechanisms to reduce the due diligence efforts prior to granting a loan, for instance.

At the intersection between crowdfunding and microfinance, we find crowdfunded microloans and microdonation campaigns, for example. Campaigns of this type are popular, especially because the crowdfunders often do not have to wait for the support of others before the campaign is successful, and in some instances the impact can be made instantly.

In previous years, donation-based crowdfunding represented the highest volumes, but the growth in funding volumes for this model was only 45 percent; the total volume was \$979 million. As explained in the introduction to

2. Several use cases can be found on Crowdsourcing.org.

FIGURE 3.2 Growth by Crowdfunding Model

Source: 2013 CF: *Crowdfunding Industry Report*. Copyright © massolution 2013.

this chapter, donation-based crowdfunding exemplifies how individuals are willing to engage beyond their self-interest. Online crowdfunding that makes use of donations in recent years has been very successful for social causes (as explained later in this chapter) and especially for disaster relief campaigns.

The adoption of equity-based crowdfunding is limited since securities regulations in most jurisdictions are still pending. There are, however, countries where the model is allowed, and here the funding volumes reached a total of \$115.7 million in 2012, which is an increase of 30 percent compared to 2011. In the United States, nationwide crowdfunding will be made possible once the Securities and Exchange Commission (SEC) formulates clear rules based on Title III of the JOBS Act, but states such as Georgia and Kansas have already put intrastate crowdfunding regulation in place. Intrastate crowdfunding means that the campaign owner is incorporated in the given state and that the crowdfunders consist solely of residents in the state.

Crowdfunding without financial returns (donations and rewards-based crowdfunding combined) raised \$1.4 billion, which is an increase of 85 percent compared to 2011. Since donation-based crowdfunding grew 45 percent, the remaining growth stems from campaigns where a nonfinancial reward is offered in return for funding—in some cases, this model is augmented with the option to donate. The popularity of rewards-based crowdfunding can best be explained by startups' and SMEs' adaptation of the model. The path from prototype to marketplace drastically shortens for products and services that appeal to the crowds.

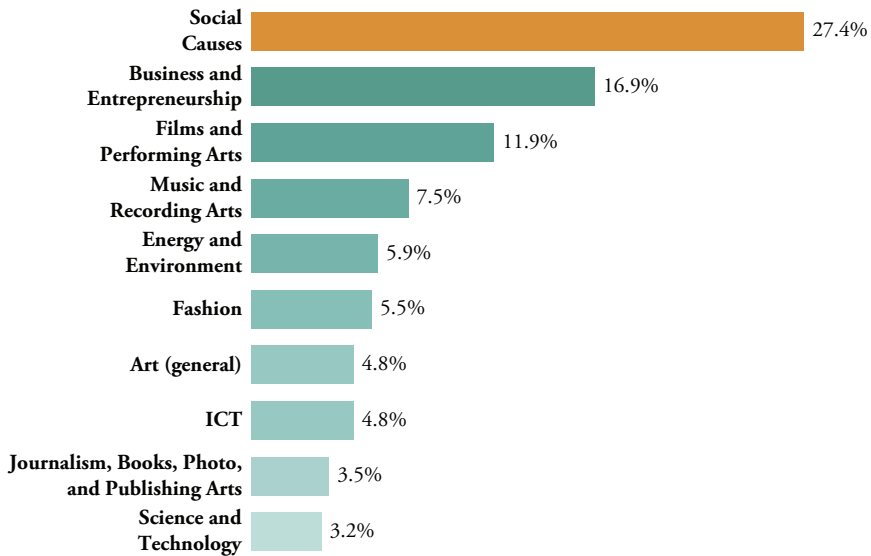
The first movers with rewards-based crowdfunding were recording artists, publishing artists, and performing artists. Even today, the prevalence of creative campaigns leads people to think that crowdfunding is applicable only for certain kinds of campaign owners. However, as evidenced by crowdfunding data, there is absolutely no support for that notion.

The reason crowdfunding has been successful for creative and independent artists is linked to the communication required for success. Any prospective campaign owner who is able to leverage his or her network and transform social capital into financial support and outreach support can be successful. For entrepreneurs who wish to utilize crowdfunding, this translates into network management. To be successful, a campaign owner needs to reach the customer base and work from the point of view that this particular crowd needs to be (and feel) involved in the campaign owner's activities.

Although crowdfunding first gained popularity as a way to fund creative, philanthropic, and social endeavors, its application for entrepreneurial ventures has gained traction as well, especially for crowdfunding models with financial return (see figure 3.3).

Social Causes is the most active category (27.4 percent) followed by Business and Entrepreneurship (16.9 percent), and the two major art categories: Films and Performing Arts (11.9 percent) and Music and Recording Arts (7.5 percent). Energy and Environment (5.9 percent) is the emerging category among the five most active categories.³

3. Massolution measures platform activity across two parameters: the number of successful campaigns and the funding volumes within individual categories. From these parameters we derive comparable statistics across 15 categories. The 10 most popular are presented in the bar chart. Zero percent resembles no activity within the sample, while 100 percent resembles high activity across the entire sample for a particular category. See Figure 3.3.

FIGURE 3.3 Crowdfunding Platform Activity across the 10 Most Active Categories

Source: 2013 CF: Crowdfunding Industry Report. Copyright © massolution 2013.

Financial versus Nonfinancial Return Crowdfunding

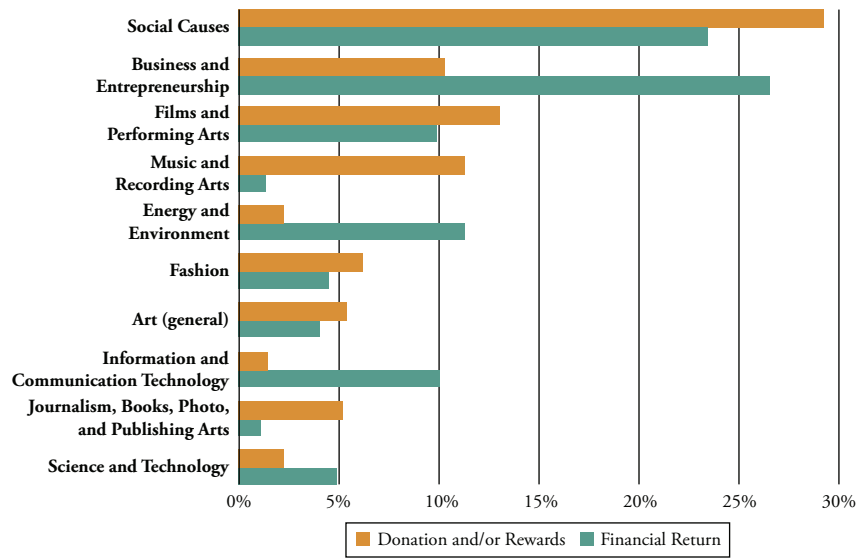
If we inspect the most active categories to see which crowdfunding models are driving activity, several interesting observations can be made (see figure 3.4).

The high level of activity in the Social Causes category is driven by all crowdfunding models, which leads to the conclusion that crowdfunding in itself has an engaging effect, and an appeal to common or social challenges.

The activities in the Business and Entrepreneurship and in the Energy and Environment categories are mainly driven by crowdfunding models that offer some kind of financial return. This can be explained by the for-profit mind-set of the campaign owners in these categories and the fact that, especially for campaigns in the Energy and Environment category, it is challenging to establish a suitable reward structure. However, emerging CFPs within this niche might take that particular challenge and create a crowdfunding model that does not rely on financial return within the Energy and Environment category.

When we compare the two major art categories, it is interesting to see that Film and Performing Arts makes use of both financial and nonfinancial

FIGURE 3.4 Financial versus Nonfinancial Crowdfunding Activities



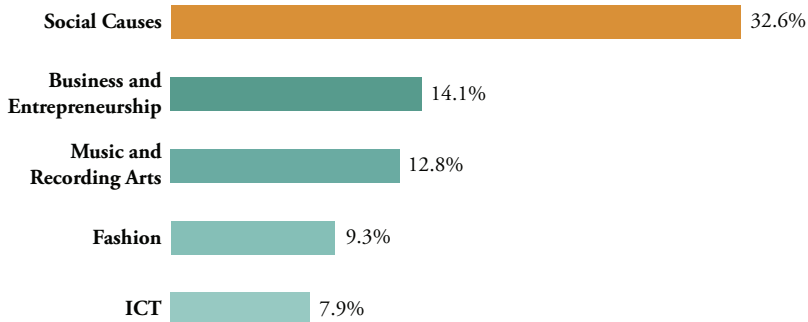
Source: 2013 CF: Crowdfunding Industry Report. Copyright © Massolution 2013.

crowdfunding, while the activity in the Music and Recording Arts category is mainly driven by nonfinancial crowdfunding; reward-based crowdfunding is especially popular in the latter category. The concentration on nonfinancial crowdfunding can be explained by cultural biases among recording artists or by the relatively low funding requirements in this category.

Donation-Based Crowdfunding

Nonfinancial crowdfunding is popular, especially the donation-based model. It is applied across all of the biggest categories except for Energy and Environment.

As expected, the Social Causes category has more activity on platforms using this particular model. Business and Entrepreneurship has less, which is explained by the for-profit mind-set of most of the campaign owners in this category. This model is also very popular for creative projects outside the Recording and Performing Arts categories (see figure 3.5).

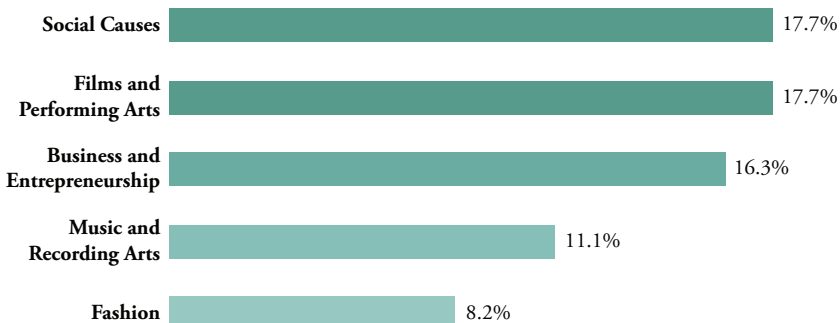
FIGURE 3.5 Donation-Based Crowdfunding Activity

Source: 2013 CF: Crowdfunding Industry Report. Copyright © massolution 2013.

Rewards-Based Crowdfunding

The crowdfunding model that, beyond any doubt, gets the most media attention is the reward-based model. Activity within this model (where the crowdfunders are offered a tangible, nonfinancial return) is more evenly spread out, as artists, entrepreneurs, and businesses adopt this funding model.

Social Causes is again the most active category. In fact, the activity across the different categories using rewards-based crowdfunding is more or less similar to the overall picture, except for the Energy and Environment category, where rewards-based crowdfunding is still nascent (see figure 3.6).

FIGURE 3.6 Rewards-Based Crowdfunding Activity

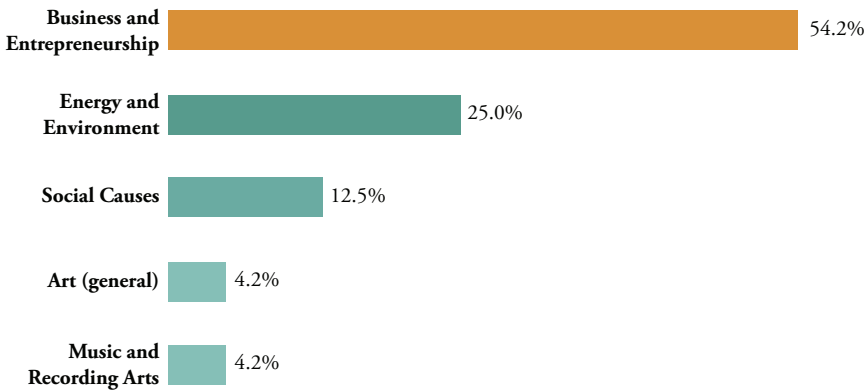
Source: 2013 CF: Crowdfunding Industry Report. Copyright © Massolution 2013.

Lending-Based Crowdfunding

The simplest financial agreement one can think of is a loan. These agreements promise a predetermined repayment schedule and, commonly, an interest payment as well. The expected total repayment is thus capped at the time the lender and borrower decide on the terms of the agreement. Lending, therefore, will not provide the high potential of other financial agreements, and for this reason, lending-based crowdfunding is mostly used by small (and relatively stable) businesses.

The Business and Entrepreneurship category is therefore the most active category in lending-based campaigns, followed by Energy and Environment campaigns. Social Causes and creative ventures are less active in the use of this model, presumably because they cannot guarantee the required repayment (see figure 3.7).

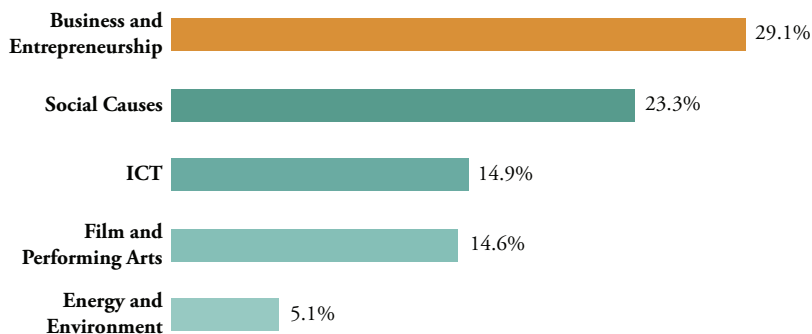
FIGURE 3.7 Lending-Based Crowdfunding Activity



Source: 2013 CF: Crowdfunding Industry Report. Copyright © Massolution 2013.

Equity-Based Crowdfunding

Not surprisingly, most of the activity within the equity-based crowdfunding space relates to commercial enterprises. The Business and Entrepreneurship category is the most active, followed by Social Causes, which is less active on equity-based campaigns when compared to other models. Information and Communications Technology (ICT) campaigns have been separated from the Business and Entrepreneurship category because campaigns in this particular category are expected to be the front-runners of equity-based crowdfunding (see figure 3.8). The reasons for this are not related to the particular risk structure of campaigns in this category, but merely due to the fact that crowdfunding is better recognized by both prospective campaign owners and crowdfunders interested in these industries.

FIGURE 3.8 Equity-Based Crowdfunding Activity

Source: 2013 CF: Crowdfunding Industry Report. Copyright © Massolution 2013.

The Market Outlook

There is an unprecedented number of new CFPs getting ready to launch. Based on recent surveys, the geography and scope of these can give us an exclusive look into the crowdfunding market of tomorrow. Besides the analysis of prelaunch platforms, their geographical distribution held against the same distribution, but for launched platforms, gives us an indirect measure of market maturity.

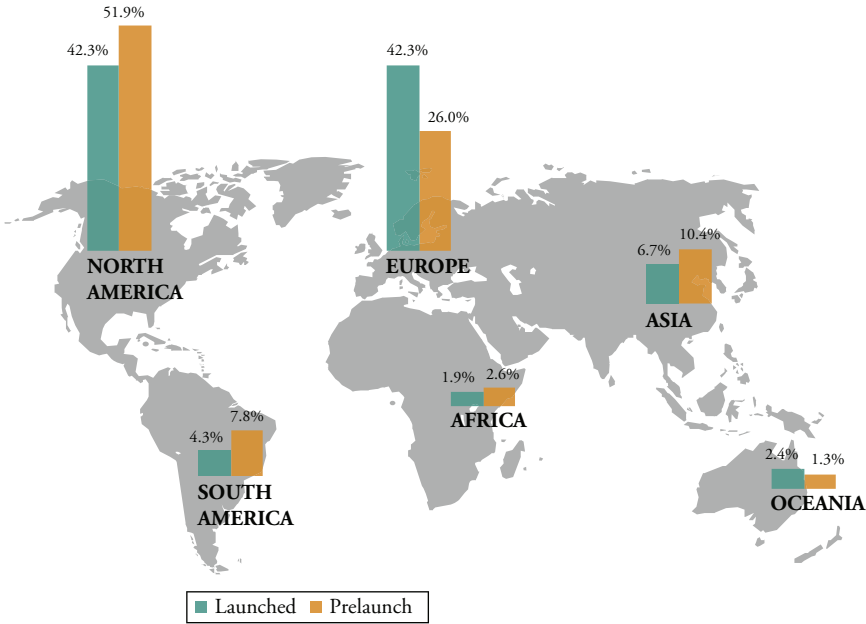
Not surprisingly, North America and Europe account for the majority of CFPs. In the survey sample, 84.6 percent of the active CFPs divide evenly between these two continents. Asia and South America are represented with 6.7 percent and 4.3 percent of active CFPs, respectively, while Oceania accounts for 2.4 percent and Africa 1.9 percent. Prelaunch CFPs break down in the same way, except for the placement of Oceania and Africa; they are distributed as follows: North America (51.9%), Europe (26%), Asia (10.4%), Oceania (1.3%), and Africa (2.6%) (see figure 3.9).

The difference between the percentage of launched CFPs and the percentage of prelaunched CFPs is interpreted as a maturity metric in a given region. North America is a young market because the regulatory frameworks around crowdfunding with financial returns have yet to be determined (in both the United States and Canada). Therefore, we have a relatively large part of the CFPs in this region still preparing to launch.

In Europe, however, the regulatory frameworks are not surrounded by the same uncertainty, which means that market entrance is determined by the competitive advantages of individual prelaunch CFPs.

The same image presents itself in Asia, South America, and Africa, where the regulatory uncertainty prevents many new CFPs from launching. Oceania,

FIGURE 3.9 Global Distribution of Launched and Prelaunched Crowdfunding Platforms



Source: 2013 CF: Crowdfunding Industry Report. Copyright © Massolution 2013.

however, is home to one of the most established CFPs offering equity-based crowdfunding and a range of relatively mature platforms for nonfinancial return. There is very little regulatory uncertainty compared to North America, Asia, South America, and Africa, which means that Oceania (together with Europe) can be regarded as a more mature crowdfunding region.

The overall observation when inspecting prelaunch CFPs is that tomorrow’s crowdfunding market will be much more flexible, in the sense that campaign owners will be able to choose between many different crowdfunding models on the same platform.

While close to 55 percent of the current CFPs offer just one type of crowdfunding (one of the main models), only 37.5 percent of the prelaunch CFPs will structure themselves this way. By and large, the type of crowdfunding being planned by prelaunch CFPs is more flexible and stretches across more crowdfunding models. An important observation is that crowdfunding with a financial return (equity, lending, and royalty-based) seems more popular, which can best be explained by the increased attention to crowdfunding as an alternative to the traditional channels of entrepreneurial finance.

The most persistent trend in the crowdfunding industry is the platforms’ attention to specific types of campaign owners. Platforms offering

rewards-based crowdfunding see an especially high value in assuring a common niche or industry is serviced. Examples include platforms concentrating on video games, recording art, performing art, real estate, food and beverages, fashion, journalism, and so on.

While it is natural to think that an emerging platform will decide on a specific niche simply to separate its service from the rest of the market, there is another reason why this trend is likely to prevail—it helps to build a repeated crowd on the platform.

Having crowdfunders visit a platform, not because they have been invited onto a specific campaign by its owner, but because the campaigns on the platform appeal to an individual crowdfunder's taste, creates vital value. The value comes to the platform and its campaign owners, but also for the crowd itself, as the communication around individual campaigns is more efficient when everyone shares an interest across all campaigns.

Given the range of basic crowdfunding models, we have seen that CFPs do not necessarily stick to one model. Nothing prevents a CFP from offering several models simultaneously, and the interesting question is which combinations of models will add new value.

While financial products can reach a level of overwhelming sophistication either because they are tailored to match a specific investor risk profile or because they reflect a contractual agreement in a complex environment, the next level of sophistication in the crowdfunding market will be tailored to meet the needs of campaign owners. This speaks to the increased industry focus discussed above and, thus, our prediction is that CFPs will advance their crowdfunding models to match what the campaign owners have to offer in return in different future states of their companies.

In the beginning of this chapter, we touched on the crowdfunding disruption and the technological advances that have facilitated this disruption. We would submit that the popularity of crowdfunding cannot be written off as a fad, but should rather be understood as a technological advancement that enables us to engage with and support each other in a much more powerful way than we could before.

The vast variety of communications tools nicely illustrates how important it is to stay in touch with friends and also create new connections—and, in some cases, even spend time with complete strangers. The latter point is a radical behavioral shift that is much more important for the evolution of crowdfunding (as well as crowdsourcing) than one might think. Today, this kind of communication is rather commonplace in public chats and online forums, for example.

On a large scale, this speaks to a cultural shift—at least online. We are getting more comfortable communicating publicly and do not necessarily need formal introductions before reaching out to each other. We are more comfortable with calling on the crowds—what we refer to as an “open call.” Individuals’ and companies’ comfort with open calls contributes significantly to the popularity of crowdfunding.

In this context, crowdfunding is best understood as a progression of the crowdsourcing model. The use of distributed network technologies to enable digital labor forces to overcome both common and commercial challenges is already widespread. Enterprises, startups, and governments alike are leveraging these technologies to crowdsource everything from microlevel work all the way up to engaging the crowd in ideation processes.

The awareness of crowdsourcing’s potential is already well established and its use by entrepreneurs is a source of continuous discovery. The ingenuity among entrepreneurs to leverage existing social networks and platforms specialized in the crowdsourcing space seems limitless, and lends to the conclusion that technology has caught up with the ubiquitous desire to convert social capital into commercial value. Crowdsourcing converts social capital into solutions; crowdfunding converts social capital into financial support. The evolution of the crowdfunding model is thus destined to augment the outreach for funding with the additional benefits of the crowdsourcing model.

CHAPTER 4

Current Market Dynamics

Andrew Dix and Charles Luzar

CrowdfundInsider

Crowdfunding has only truly entered the common lexicon within the past few years. However, the concept of crowdfunding has been around for quite some time. The advent of the Internet and the ubiquitous nature of always-connected devices has engendered a new paradigm. This altered environment is one where the power of crowdfunding may manifest the force of a diverse group of individuals to empower a single idea for success.

The advent of the two most popular crowdfunding platforms today—Indiegogo and Kickstarter—have captured the imagination of entrepreneurs and innovators across the United States and around the globe. These two platforms have harnessed technology to create a revolutionary new movement for capital formation.

Indiegogo cofounder and CEO Slava Rubin has frequently mentioned in his presentations how crowdfunding predates the Internet. His favorite example, which is used elsewhere in this book, is one of the Statue of Liberty, which, while donated by our allies, the French, lacked sufficient funding for installing and erecting upon its delivery to the shores of the United States.¹

The governor of New York at the time, Grover Cleveland, had decided against using public funding. Other cities such as Boston and San Francisco,

1. Slava Rubin, *How to Raise \$1 Million in 30 Days* (Video). Crowdfund Insider, August 30, 2013.

seeing a unique and historic opportunity, clamored for the privilege of paying the balance needed to erect the statue. But this is where the crowd was brought to aid in the creation of one of the most iconic statues in history.

In 1884 famous newspaper publisher Joseph Pulitzer used the most advanced technology of the time to communicate to the masses, the printing press. With his broadsheet, the *New York World*, and his distribution network of newspaper carriers, Pulitzer took it upon himself to encourage the public to support the cause to pay for the pedestal and save the honor of New York City.

The crowdfunding campaign ran for about five months and eventually raised the required amount by garnering the support of over 160,000 donors. Supporters included a diverse demographic of New York's population of the day, including children, businessmen, the wealthy, and the poor. All were brought together to support a singular cause, finally raising \$101,091, estimated to be about \$6.3 million in today's dollars.²

If you take that \$6.3 million and compare it to the most successful crowdfunding campaigns through 2013, the campaign for the Statue of Liberty would make it into the crowdfunding Hall of Fame, having surpassed every successful campaign on Indiegogo and all but two on Kickstarter.

While platforms like Kickstarter and Indiegogo have driven the phenomenal growth in the industry, these two dedicated competitors represent only a portion of the industry. Crowdfunding has quickly evolved into different industry segments, which may be divided into different categories and then into subcategories.

Kickstarter, Indiegogo, and RocketHub are examples of rewards-based crowdfunding platforms operating in the United States. Outside of the United States there is a growing list of parallel web sites that operate in a fairly similar fashion to the U.S. portals. One such example is Pozible, which has its roots in Australia but recently landed on the shores of the United States. The crowdfunding platform got its start in 2010, when it was originally operating under the name of Fundbreak. Pozible raised A\$5.8 million in 2012 from 1,903 projects.³

The crowdfunding industry, while presently widely known because of rewards-based offerings, may be categorized further. The following are the most accepted descriptions of the various industry segments:

- Rewards-based crowdfunding
- Investment crowdfunding (or crowd investing)

2. "The Statue of Liberty and America's Crowdfunding Pioneer." BBC, April 24, 2013.

3. www.pozible.com/blog/article/index/94.

- Debt crowdfunding (or lending/loan-based)
- Equity crowdfunding
- Charity/donation crowdfunding

As the industry has moved rapidly, we have seen further segmentation for vertical or niche expansion, and we will experience much more as time goes on. Today, there are crowdfunding platforms that target a growing list of industries. Following is a list of many of the categories targeted by vertical web sites:

- Real estate
- Film
- Solar and green energy
- Travel
- Education
- Concerts and events
- Book publishing
- Games
- Hardware
- Apps and software
- Fashion
- Lobbying and politics
- Sports
- Journalism
- Science
- Medical
- Beer
- Agriculture
- Mining

This list will continue to grow and change. Successful segments will entice competition while those categories which cannot generate sufficient momentum will wane and consolidate into the more established platforms.

Rewards-Based Crowdfunding

Rewards-based crowdfunding is exemplified by the two market leaders, namely, Kickstarter and Indiegogo. Kickstarter is widely acknowledged as the larger of the two even though Indiegogo was officially founded in 2008, a year earlier than Kickstarter.

Kickstarter has always been rather forthcoming in its success, having raised over \$900 million since its launch, as of December 2013.⁴

Rewards-based web sites effectively operate in a similar fashion with two distinct differences that we will address in a bit. To encourage supporters to “donate” their money for the project, cause, or product, campaign organizers provide a “reward” for backers. Rewards for these crowdfunding campaigns have truly spanned the spectrum of perks. They commence with a simple thank you for helping out and rise to receipt of high value products or the right to claim you are an executive producer on a forthcoming film.

The majority of campaigns have an established time frame to raise the requested funds, creating an imperative dynamic where the organizers or “crowdfunders” must apply their strategy to facilitate the biggest raise possible. Presently, Kickstarter campaigns may be scheduled for anywhere from 1 to 60 days. The maximum number of days is 60 for Indiegogo as well. The majority of campaigns are scheduled to run for 30 days or more. Typically, a well-structured or professional campaign has set an attainable goal, where funding of at least 30 percent has been committed by known individuals prior to launch.⁵ Capturing momentum out of the gate for the crowdfunding campaign aids in assuring success in the fundraising initiative. A successful launch hitting the 30 percent funding mark captures the attention of potential backers creating a herd mentality, thus improving the probability of success.

Some rewards-based crowdfunding campaigns have launched simply to establish market feasibility, which has led to a new term being applied: *pretail*. These pretail campaigns, discussed in more detail later, have been orchestrated by well-funded companies that simply want to test the water for market expansion or product demand. The up-front cost of launching a pretail crowdfunding campaign is far less than traditional market studies followed by a complete market rollout. Sampling for user support or consumer interest by using an established rewards-based platform has quickly become the smart strategic approach for innovative companies.

While both Indiegogo and Kickstarter are the dominant rewards-based platforms today, they are not identical twins. Strategically, Kickstarter has decided they will offer only “all-or-nothing” campaigns. This means crowdfunders who set a goal must meet or beat that goal to receive the allocated funds. Indiegogo alternatively allows for “flexible funding.” On Indiegogo, a crowdfunder may choose to launch a campaign that is either “all-or-nothing”

4. According to Kickstarter Stats. See www.kickstarter.com/help/stats.

5. “Guarantee Crowdfunding Success: A Must Do List.” Crowdfund Insider, July 15, 2013.

or “flexible funding.” For a crowdfunder uncertain about the level of commitment from known supporters or those that question marketability of their project, a flexible campaign may offer a more palatable approach.

The other distinct difference between the two market leaders is the fact that Kickstarter incorporates a level of curation on projects allowed on its platform. There are certain categories that are explicitly not accepted, and crowdfunding campaigns are regularly rejected due to the underlying nature of the project being deemed unacceptable by Kickstarter management. There have been multiple high-profile campaigns rejected by Kickstarter that subsequently went on to successfully raise their required funds on competing platforms or even by self-crowdfunding using a white-label option.

Indiegogo has relegated merit decisions for the act of crowdfunding to the crowd, and in some respects is a more pure example of the crowdfunding phenomenon.

Investment Crowdfunding

Investment crowdfunding is expected to boom around the world. In fact, the text in your very hands is something of a prelude to what many expect will be a whole new era of raising capital online. Many prognosticators predict incredible numbers as efficiencies delivered by new technologies leveraged by crowdfunding portals generate a seismic shift in the capital allocation process.

However, the reality of funding of early-stage companies or startups is stark. Most capital raising is based on geographic location and driven by personal contacts. After the friends, family, and credit cards are tapped, startups hit their regional support networks and local angels. The fact that startups are centered in specific communities such as the San Francisco Bay area or New York City—number one and two on the venture capital list—is no coincidence.⁶ Proximity helps. However, great ideas for a promising business should not be defined by a zip code, but driven by the merit of the idea and creators that are building it. Investment crowdfunding has the potential to fix all of this.

Equity Crowdfunding

Investment crowdfunding—or, as some call it, crowd investing—has been slow to take off in the United States. Other countries such as the United

6. “San Francisco Dominates VC Financings, New York City Number Two.” Crowdfund Insider, October 2, 2013.

Kingdom and the Netherlands have been first to actually allow investors to participate in ownership in startups or small companies using crowdfunding platforms.

In the United Kingdom two platforms have dominated the narrative for investment crowdfunding from the equity side. Crowdcube and Seedrs are two equity crowdfunding platforms that have launched in recent years. Crowdcube launched its platform first—without regulatory approval—allowing the web site to capture first-mover status. Seedrs awaited regulatory approval and followed the Crowdcube launch. Both platforms have experienced phenomenal success in a short period of time. While sharing many similarities, there are differences between the two trailblazing web sites.

Seedrs focuses more on startup businesses, not exclusively but sufficiently, to lower the amount raised. Seedrs also takes a nominee approach, where the platform holds the shares for the investor. As a nominee, it represents the shareholder's interests. It also requires crowdfunded offerings to provide regular updates for its investors. Seedrs recently announced their platform will offer pan-european equity crowdfunding in a move to boost market share. Simultaneously Seedrs organized a self crowdfunding round raising over £2 million in capital to aid their expansion plans. This amount stands as the largest equity crowdfund offering every in the UK.

Crowdcube has targeted both startups and later-stage businesses, which has allowed larger investment rounds on its platform.⁷ Upon the completion of a successfully crowdfunded offering, investors hold and control the shares and the relationship with the platform has ended. Smaller investors may only hold nonvoting shares, while larger investors may be able to purchase shares with voting rights.

Both platforms have benefited from highly incentivized tax subsidies enacted by the U.K. government. The Seed Enterprise Investment Scheme (SEIS) and Enterprise Investment Scheme (EIS) grant most investors the ability to write off a significant portion of their investment in these risky businesses.⁸ In certain situations, investors may experience minimal risk, which has fueled some discussion regarding heightened valuations for these small companies. Regardless, the government support was brought about in recognition of the overwhelming benefits a successfully operated, entrepreneurial venture may bring to the domestic economy, by increasing jobs and generating additional tax revenue.

7. <http://www.crowdfundinsider.com/2013/12/27642-seedrs-closes-self-crowdfunding-round-equity-raise-record/>. Crowdfund Insider, December 3, 2013.

8. "How the UK Uses Tax Relief to Boost Entrepreneurs." Crowdfund Insider, June 20, 2013.

In Australia the Australian Small Scale Offerings Board (ASSOB) has been touted frequently as an equity crowdfunding trailblazer. Having been active since 2005, many small companies have taken advantage of the Australian process for listing their company for registered investors. The curated platform crowdfunds up to \$5 million for unlisted companies. The platform has raised over A\$135 million to date.⁹

In the United States, the story has been rather different. One may differentiate between accredited investor platforms and nonaccredited or “popular” crowdfunding platforms. The latter has yet to see the light of day as the Securities and Exchange Commission (SEC) has delayed final legalization. Proposed regulations were released by the SEC and have entered a public commenting period where interested parties may express their opinion. The final approval of equity crowdfunding is expected to occur in 2014. Advocates of popular crowdfunding have consistently cited examples of the success experienced so far outside the confines of the United States. Regulators for their part feel the delay in final approval is merited due to the risk potential for uneducated investors.

Accredited platforms—those that accept investments from individuals who may claim \$200,000 per annum in salary or \$1 million in net worth beyond their primary residence—have begun to flourish.

The market for private placements for equity investments has always been active in the United States. What has changed is the technology deployed to solicit accredited investors and the ability to advertise, which was finally allowed on September 23, 2013. The advertisement of private placement offerings is commonly referred to as “general solicitation.” Ongoing questions as to requirements associated with portals in using general solicitation and the possibility of falling under an operation that must have a broker-dealer license has caused some platforms to pause and hold off on the celebration.

At one recent gathering of industry professionals, an attorney from Bingham McCutchen was quoted as stating, “The private fund community and practitioners were concerned that there may be a ‘gotcha mentality’ at the SEC with respect to the practices [of general solicitation].”¹⁰

With the test regarding whether a broker-dealer registration is required being rather broad, refinement of rules is not only needed but expected in forthcoming months.

Based in California, FundersClub is one of a new breed of accredited equity portals that boasts almost \$9 million raised by its members, a number

9. Per ASSOB website <http://assob.com.au/>.

10. Wilczek, Yin, “SEC Scrutinizing Development of Platforms Engaged in Reg D Offerings, Official Says”, BNA, September 26, 2013.

accompanied by the over \$100 million raised by FundersClub companies.¹¹ The web site incorporates a curation process that aims to deliver a very high quality early-stage company. Members may invest as little as \$2,500 to \$5,000, which is far lower than a more institutional-size investment. FundersClub has partnered with some high-profile startup investors such as Sequoia Capital, Andreessen Horowitz, Y-Combinator, and Union Square Ventures—all legends in the VC world.

Web sites like SeedInvest, RockThePost, and CircleUp have quickly established the viability of their solicitations as they begin to promote their offerings to the accredited crowd. While changes in Regulation 506(c) offerings allowing general solicitation may allow the platforms to promote their investment opportunities, the process is still somewhat convoluted, due to ongoing questions regarding the verification of accredited status, and is subject to change by the SEC in the near term.

Ongoing questions regarding general solicitation for platforms facilitating private placements have created an air of hesitancy for those platforms wishing to advertise their offerings. With the SEC still ruminating over final regulations and some questioning whether they will backtrack on some of their forthcoming requirements, as of this writing, the regulatory environment is still somewhat obfuscated.

Debt-Based Crowdfunding

Debt- or lending-based platforms have emerged both in the United States and abroad. In the United States, one debt-based platform, Somolend, caught a wave of promise early on—only to suffer as the State of Ohio targeted the fledgling business for alleged infractions transgressing state securities laws.

Alternatives such as LendingClub and Prosper have experienced greater success. The leader, LendingClub, founded in 2007, has funded over \$3 billion in loans as of December 2013. This amount is accompanied by over \$270 million in interest paid since inception.¹²

Prosper, which stakes claim to “America’s first peer-to-peer” lending marketplace, opened its doors in 2006. The company began its existence allowing lenders and borrowers to set interest rates in more of an online auction style. The company altered its strategy in 2010,¹³ and now it sets the rates directly.

11. FundersClub, see <https://fundersclub.com/>.

12. Lending Club, see <https://www.lendingclub.com/info/statistics.action>.

13. Prosper Marketplace, see www.prosper.com/.

Prosper offers loans from \$2,000 up to \$35,000 and has posted interest rates from 6.73% to 35.36%.¹⁴ Rates change constantly, but with a historically low interest rate paid to savers, one quickly grasps the incentive for investors to try their hand at peer-to-peer lending. Prosper claims almost 2 million members and over \$740 million personal loans funded.¹⁵

Applicants may complete an online form, which takes less than one hour, and submit for approval. If the listing is accepted, the offer is open until funded or until a 14-day period leads to the listing expiration. All applicants are given a "Prosper Rating," a proprietary rating system that aids in a consistent evaluation process. If a loan is funded, Prosper takes a closing fee ranging from 0.50 percent to 4.95 percent.

Kiva, a microfinance operation based in the United States, continues to experience growth within the lending sector. Since its founding in 2005, the nonprofit entity has generated almost half a billion in loans as it tries to alleviate poverty around the world. The platform has an over 99 percent repayment on its loans and operates in 72 different countries around the world.¹⁶

In the United Kingdom, which was a leader in peer-to-peer lending, several platforms have established themselves in a market that is largely unregulated as of this writing. The U.K. regulatory authority, the Financial Conduct Authority, is scheduled to review the operations of peer-to-peer lending web sites, but in the interim and with the lack of a governmental barrier, more than a few platforms have quickly emerged to fill the space.

Launched in 2005, Zopa is offering loans up to £15,000 for individual borrowers. Zopa has facilitated loans of over £440 million, with over £165 million in the last year alone. Funding Circle has loaned an incredible £200 million since inception in 2010. Over 55,000 individuals have registered on the platform ready to offer their funds, encouraged by the higher rate of return they may capture by directly lending to a business or individual. Applicants may borrow from £5,000 up to £1 million on the peer-to-peer lending web site.¹⁷

There are more web sites in Europe that are offering similar arrangements for investors and borrowers alike. With improvements in technology and verification processes, the peer-to-peer lending space is expected to grow dramatically over the coming years.

14. Ibid.

15. Ibid.

16. Kiva, see www.kiva.org/about.

17. Zopa

Charity/Donation Crowdfunding

Charity and donation crowdfunding platforms have quickly become an extrapolation of nonprofit agencies that have previously acted as the conduit for donors hoping to help those in need. Today, crowdfunding campaigns are quickly established on diverse platforms to aid those who have experienced unimaginable tragedy or are simply in need of some basic assistance or financial aid during a hardship. Longer-duration crowdfunding operations for nonprofits have become ubiquitous.

A good example of a high-profile effort to support those enduring a tragic situation was the Boston bombing event in the spring of 2013. Dozens of people were injured. More than a few lost limbs and were impaired for life. Charity crowdfunding campaigns blossomed on multiple platforms as friends, families and strangers came together to help those in need during a tragic time for the United States. Web sites like GoFundMe, Indiegogo, and GiveForward experienced dozens of charity fundraising efforts.¹⁸

Today there are dozens of charity crowdfunding platforms in the United States and more around the world. The emotional aspect and the interconnectivity of the Internet allow those enduring difficult times to reach beyond geographic constraints to raise funds from around the world for causes both large and small.

Watsi, a 506(c)(3) nonprofit, has established its web site as a low-cost, high-impact crowdfunding platform to pay for medical care for people in need around the world. The web site transfers 100 percent of funds raised and is supported, for free, by companies such as Stripe, Heroku, Google, Teespring, and more.¹⁹ Founding donors include Y Combinator legend Paul Graham, Ron Conway (one of the first investors in Google), Joe Greenstein, and many others. These people and companies who have been successful in their industries are giving back by helping the poor with life-changing medical treatments everywhere in the world.

Kiva, mentioned previously, while facilitating loans that pay interest, does not take any cut on the process. It survives only via grants and the support of lenders. Leveraging the power of the Internet and its worldwide network of microfinance organizations, the peer-to-peer platform has provided loans to people who cannot access the traditional banking systems, all with an over 99 percent repayment rate.²⁰

18. "Boston Searches for Answers to Bombing, Crowdfunding Comes to Support." Crowdfund Insider, April 19, 2013.

19. Watsi FAQ, see <https://watsi.org/faq>.

20. Kiva, see www.kiva.org/about.

Donation platform Fundly has claimed over 45,000 campaigns registering over \$320 million raised as of this writing in late 2013.²¹ The platform allows the user to create and manage a crowdfunding project supported by donations for just about anything—from medical care for a loved one to local charities and trips and adventures, the list continues. If you feel your need is compelling enough that you can capture the interest and support of friends, family, neighbors and more, you can quickly launch a campaign on this web site.

There are more than a few platforms taking a similar approach. Crowdfunder claims to have helped over 100,000 people pool funds for everything.

Niche Crowdfunding Platforms

Niche crowdfunding platforms have an established place in the crowdfunding world of today. Some of the more prominent platforms are those that target popular industry segments on both the investment- and rewards-based sides.

Real Estate

Niche real estate platforms are expected to grow into a substantial business. As an asset-based investment platform, pooled investors may invest in prevetted projects and capture passive income with relatively small investments. Deals that have previously been available only to connected individuals may soon be a common asset class. For now, domestic platforms are offering these deals only to accredited investors.

Realty Mogul, Fundrise, and Prodigy Network are some of the better-known names in the space. Economies of scale allow these platforms to generate sufficient funds while minimizing transaction fees, thus creating better returns for the investor. While there has been some comparison drawn to real estate investment trusts (REITs), in reality, these types of funds tend to be enormous, with little connection between the actual asset and the individual investor. The developing crowdfunding model allows for investors to select the specific property they want to invest in, engendering a more intimate relationship with the project and investor, while also allowing for more hands-on due diligence than a REIT.

Prodigy Network is a global operation. This platform recently crowdfunded what is expected to be the tallest building in Bogota, Columbia. Over

21. Fundly, see <https://fundly.com/>.

3,100 investors supplied \$171.8 million to help finance the project.²² Prodigy has claimed the title of largest crowdfunding campaign ever with this project.

IBISWorld estimates the global real estate market to be more than \$5.2 trillion.²³ There is plenty of room for real estate crowdfunding platforms to create efficiencies and deliver superior returns for investors.

Alternative Energy

Alternative energy projects have captured success around the world. Many platforms tout their combined objective of solid returns on the investment while promoting clean energy and protecting the environment. Dutch platform Windcentrale claimed the fastest and largest alternative energy crowdfunding campaign ever. In September 2013, 1,700 Dutch households purchased 6,648 shares, raising €1.3 in just 13 hours for a wind turbine project in Holland.²⁴ Each €200 share in the turbine represented approximately 500k WH of electricity a year, which is the average annual household consumption in the Netherlands.

SunFunder, Mosaic (U.S. based), Abundance Generation, and TrillionFund in the United Kingdom are examples of other growing solar energy platforms. Most of these platforms are structured as debt with a defined yield. SunFunder strives to finance projects in the third world, where access to energy is frequently cited as a significant cause for slow development and poverty.

Hardware

The strategic concept of pretail has gained steam and is increasingly viewed as an efficient methodology to capture market interest prior to substantial investment, especially in the hardware and technology segment. Many high-profile tech products, such as the Pebble smartwatch, discovered phenomenal crowdfunding success but were then challenged with the needs of a massive product rollout. Creating a design and requesting a prototype is the easy part. Coordinating mass production, maintaining quality, and structuring a cost-efficient shipping and delivery operation is pretty tough. Companies are

22. "Crowdfunding for Real Estate: Buy a Slice of a Skyscraper." *Bloomberg BusinessWeek*, January 24, 2013.

23. "Crowd Funding for Aspiring Real Estate Moguls." *Forbes*, January 25, 2013.

24. "Windcentrale Raises €1.3 Million, 1700 Dutch Households Get Wind Turbine." *Crowdfund Insider*, September 23, 2013.

now cropping up where hardware products are crowdfunded on the platform in association with facilitating manufacturing. As many products are manufactured outside the United States, it is definitely of benefit to have someone who has done it before.

Platforms like Dragon Innovation and HWTrek have moved in to fill this gap. Dragon, based in Boston, has created partnerships with some large companies like GE and Arrow Electronics. HWTrek based in Taiwan has direct relationships with some of the largest electronic manufacturers in the world. Pegatron, one of the contractors for Apple, has signed up with HWTrek. HWTrek envisions a future where crowdfunders may pretail on their platform and then do a second crowdfunding round on Kickstarter or another platform. This way, if the product is successfully launched on HWTrek, a successful launch on Kickstarter, Indiegogo, or another web site will mean product delivery may be measured in weeks as opposed to months or years for some successfully crowdfunded products today.

Film

Film is an interesting category because it is very high profile and there is substantial money in it. Film and Video is the number two category on Kickstarter. Out of the \$900 million successfully raised on Kickstarter, film and video accounted for over \$183 million of the total, or over 20 percent.²⁵ Film and Video is a very important category for both Kickstarter and Indiegogo. While Indiegogo does not publicly release category numbers, estimates indicate film and video plays a crucial role in their business model. Both platforms have created strategic partnerships with film industry organizations and offered up segmented sections of their web site for film.

Kickstarter breaks down this category further into five subcategories: Animation, Documentary, Narrative Film, Short Film, and Web Series. Some of the highest profile campaigns have been from film. The *Veronica Mars* movie (\$5.7 million), films by Spike Lee (\$1.4 million) and Zach Braff (\$3.1 million) have generated much controversy and interest alike. The epiphany that the industry was being changed forever is highlighted by the fact that three films crowdfunded on Kickstarter were up for Oscars this past year. One such film, *Inocente*, won the Academy Award for best documentary short. They raised \$52,527 on Kickstarter to help make their film. Kickstarter publishes multiple curated pages focusing only on film, including the Sundance Film Festival, Shooting People (the Network for Independent Film), Directors

25. Kickstarter, see www.kickstarter.com/help/stats.

UK, Rooftop Films, and more. In its effort to remain competitive, Indiegogo has established partnerships with Raindance Film Festival and Backstage, a talent tool matching actors and crews to projects. Indiegogo's most funded film to date has been *The Bounceback*, which raised just over \$638,000.

Seed&Spark is a purely independent film crowdfunding web site. The platform is unique in that while backers may support a film by crowdfunding it, they may also support it with in-kind assistance. Once a film is completed, backers may view the film directly on their video distribution platform. To view the film backers must pay or use credits. Seed&Spark is a selective platform and reviews every film before inviting the project on the portal.

A unique angle occurred on equity platform Seedrs. A respected fund manager, Nicola Horlick, put together an equity campaign to raise £150,000 for 10 percent equity in a new venture entitled Glenthams Capital.²⁶ The startup fund management company was put together to oversee a \$100 million fund (if it hit its goal), which would then provide financing for Hollywood films.

Crowdfunding films has quickly become an effective risk mitigation strategy while maintaining more creative control. An established director can pitch a concept to the crowd and garner support, which indicates a dedicated audience.

Concerts/Events

Brazilian platform Queremos proved the viability of its model in South America. Now it has moved north and launched WeDemand to crowdfund concerts and events. The platform's social model allows demand to be measured prior to the promoters committing to a venue. If the demand is not there, no event takes place. Artists can register on the web site for free and see if they have enough fans in a given market to schedule a performance.

Online ticketing web site Picatic claims to have successfully raised over \$2.7 million for approximately 6900 events.²⁷ Events are structured as a custom Web page, where the user manages ticket pricing and direct sales to gather crowdfunds for just about any event except concerts, including book clubs, cooking, business, and more. It has a focus on scheduling book authors for specific gatherings.

26. "Glenthams Capital Fund Management Company Crowdfunds with Seedrs, Will Create Fund for Films." Crowdfund Insider, July 30, 2013.

27. Picatic, see <https://www.picatic.com/>.

Book Publishing

Many crowdfunded books have migrated toward Kickstarter and Indiegogo, but a startup out of New York has created an alternative, more personal platform for book crowdfunding. PubSlush wants to help struggling authors get that first publication out the door, both in print and as an e-book. It has created customized tools to aid in the process and will work with an author directly to help run a successful campaign. As part of its strategy, it also wants to be the portal of choice for independent book publishers that do only a few projects a year. PubSlush believes it can drive scale and innovate this market.

Beer

It was inevitable that an entrepreneurial type would start a company to crowdfund beer and breweries. Crowdbrewed has experienced some initial success with its rewards-based approach. CraftFund, on the other hand, wants to provide equity investments for fledgling breweries. With the craft brewery industry hovering around \$8.7 billion annually,²⁸ the startup may have found a solid niche once the SEC allows nonaccredited crowdfunding. The iconic offering for breweries is from the United Kingdom, where craft brewery BrewDog in Scotland has self-crowdfunded multiple times. It is doing another offering scheduled to close in January 2014 and quickly raised £3 million out of a £4 million goal.

Apps

Appbackr claims to have crowdfunded over \$1 million to develop and market new apps.

AppsFunder claims that nearly half of its funders receive their return in less than 6 months, as it allows a revenue share model for successfully funded apps.

Education

Instagrad is a crowdfunding web site for education that allows you to encourage friends and family to give gifts of education for your children. Once your child's page is created, gifts may be made at any time. You may also associate your 529 plan with this platform.

28. "Local Breweries Expand, More Will Open." *The Business Journals*, August 29, 2013.

Pave is a fascinating education platform. The web site believes that everybody wins when young talent is combined with the resources and wisdom of experienced people. Pave allows individuals to invest in the future of young people. It is a type of impact investment, where a sponsor may pay for part of a young person's education, but once the person enters his professional existence, he is expected to pay back the contribution with interest. While detractors have likened it to servitude, the majority notes that direct funding for those who have direction and ambition may be more productive and fulfilling than just facilitating student loans.

Market Testing with Rewards-Based Crowdfunding

As a means of capital formation, crowdfunding is becoming an increasingly utilized tool when seeking funding for creative projects, products, and causes. However, one of the principal benefits of crowdfunding has little to do with dollars and cents. With roots in the crowdsourcing movement, crowdfunding can provide valuable insight into the size (or existence) of the market for a product or service.

Pretail: The Consumer Comes First

Pretail and *precommerce* are terms that have been used to describe a seismic shift in how companies bring new products to market.²⁹ Pretail defines a customer-centric approach to commerce that highlights feedback and customer involvement both before and during the process of going to market. This feedback helps to inform decisions made during the development of products and services.³⁰ By optimizing products or services based on the desires of the crowd, a pretail campaign can help entrepreneurs capture more customers and increase customer satisfaction, even before they've actually sold anything at all!

Here is some key terminology of relevance to this movement:

- *Pretail*: A mode of consumption that leverages crowdfunding platforms to test the market for products and services while raising valuable capital. Synonym: *precommerce*.

29. "Trend Briefing: PRETAIL." *Trendwatching*, October 1, 2013.

30. "The Rise of Pre-Commerce." *Fast Company*, April 25, 2013.

- *Presumer*: Contributors to pretail-focused crowdfunding campaigns that want to support and receive an innovative product or service they believe in; presumers are driven both by need and by passion.³¹
- *Custowner*: The equity-focused counterpart to the presumer, “custowners” are both customers and equity investors in the early-stage companies they believe in. This constituency will be enabled by Title III of the JOBS Act, which legalizes equity crowdfunding for nonaccredited investors.

In the Industrial Age, consumer markets favored entrepreneurs and companies with the funding necessary to test consumer sentiment ahead of delivering a product or service. Companies that could afford expensive up-front market research in the form of focus groups, survey data, and other methods have had a clear advantage over smaller companies operating on smaller budgets.

In addition, manufacturing costs have traditionally provided a high barrier to entry to consumer markets. This has only served to add to the advantages large, resource-rich companies have over their smaller, nascent counterparts.

In today’s Information Age, many free or low-cost marketing tools have found markets of their own. Services like LaunchRock give entrepreneurs the opportunity to collect contact information for potential customers ahead of launching a product or service. To a similar point, terms like *minimum viable product* (MVP) have emerged to describe levels of production that are robust enough to adequately test market demand for a product or service without incurring unnecessary levels of risk by overdeveloping a product or service early.

Technological advances and cost-effective labor in overseas markets have also driven this barrier to entry lower over the past 20 years. Today, aggregate costs of manufacturing and technology are lower than they have ever been in many verticals. Advances in areas like 3-D printing technology have made it easier to perform rapid prototyping of hardware projects, and the proliferation of the Internet has broken down communication barriers between product designers and cost-effective overseas manufacturers.

Crowdfunding can be leveraged as a way to accomplish the goal of market testing while simultaneously raising the capital necessary to bring a product or service to market. Capital secured via crowdfunding campaigns can be used to create tooling for future manufacturing or complete research and development on a new product.

31. “PRESUMERS.” *Trendwatching*, October 1, 2013.

To a varying degree, crowdfunding platforms offer methods by which campaign contributors can submit and share their ideas about the campaigns they back. Savvy project creators use this feedback to shape their products or services.

Crowdsourced Feedback

Rewards-based crowdfunding platforms like Indiegogo, Kickstarter, and RocketHub all provide platforms that facilitate discussion between entrepreneurs and their presumers.

As an example, Kickstarter provides two methods by which campaign creators can interact with presumers. Kickstarter's backer update system gives campaign creators the ability to craft updates made up of text, images, and video. The project creator has the ability to specify permissions on these updates. Updates can either be publicly available or locked down to "backers only." Contributors to a campaign are notified of new updates via e-mail and can comment on specific updates.

In a backer update posted to Kickstarter on September 26, 2013, video game developer Stainless Games notified backers of video game *Carmageddon: Reincarnation* that additional, downloadable content for the upcoming video game would be available for an additional cost. Backers were quick to take issue with the approach, pointing out that the campaign page had promised backers "every update of the game as it's released, for FREE." The response to this backer update resulted in Stainless Games revising their approach and promising downloadable content free of charge to backers of their Kickstarter campaign. This news was shared in a subsequent backer update, and backers in turn voiced their support of the move. Crisis was averted.

Backers also have a way of contributing discussion about campaigns via a campaign-specific commenting board. Each Kickstarter campaign has its own comment board. Participation is limited to the campaign's contributors.

RocketHub also provides a commenting feature, but a key difference is that RocketHub's comments are threaded; in other words, project creators have the ability to respond directly to comments, and those responses are offset to the right to visually indicate that they are replies to a previous comment. This is opposed to Kickstarter's linear commenting approach. Another unique aspect of RocketHub's commenting platform is that commenting isn't limited to backers of a campaign. Anyone with a RocketHub account can comment on a campaign.

The Pitfalls of Crowd Wisdom

Often, the concept of crowd wisdom³² is cited as a strength of the crowdfunding movement. *Crowd wisdom* is a term highlighting the opinion of the collective. Some, like Morehead Scholar and *New Yorker* financial journalist James Surowiecki, suggest that the aggregate answers of a group of individuals prove to be superior to the answers of any one individual in a group, even when that individual member may be considered an “expert” on the subject being discussed.

However, there are pitfalls to the idea of crowd wisdom that crowdfunding project creators should be aware of when weighing the crowd’s feedback. Some of these pitfalls include:

- *Groupthink*. Groupthink is a general term and psychological phenomenon where members of a group come to incorrect assumptions or decisions based on a desire to find conformity within the group.
- *Bandwagoning*. A more specific permutation of the groupthink phenomenon; as any one member of a group assumes a falsehood to be true, it becomes more likely that additional members of the group buy in to the same falsehood.
- *The Dunning-Kruger effect*. A cognitive bias in which unskilled individuals errantly rate their own abilities higher than the average.
- *Illusory superiority*. Similar to the Dunning-Kruger effect, illusory superiority is another cognitive bias that causes individuals to overestimate their own positive qualities and underestimate their negative qualities.

Project creators need to be careful when weighing feedback from the crowd. The crowd’s feedback undoubtedly provides a valuable means of collecting and aggregating the wisdom of the crowd, but the crowd’s caveats and the psychological biases of the individual should be taken into consideration.

Managing the Crowd’s Feedback

Feedback from the crowd is a great resource for project creators, but managing that feedback can be a challenge. Entrepreneurs tend to be passionate about their projects, but it is important to expect criticism when launching a crowdfunding campaign. The ability to accept and respond to criticism is an extremely important skill to bring to any crowdfunding campaign.

32. “Crowdfunding: Crowd Wisdom, Mob Mentality.” Crowdfund Insider, April 19, 2013.

Phenomena like bandwagoning and illusory superiority can combine to create a runaway train of false assumptions or misconceptions. A perfect example of this came during a Kickstarter campaign for a football-themed video game called Gridiron Thunder.

Early in the campaign for Gridiron Thunder, project creator MogoTXT was able to secure thousands of dollars in pledges from a relatively small number of backers. The campaign received numerous \$10,000 pledges. Some in the crowd accused MogoTXT of creating fake Kickstarter accounts and self-pledging the funds to make the campaign appear more successful than it actually was. As it turns out, San Francisco-based MogoTXT had the support of people like Scott Fujita, a former NFL linebacker and Super Bowl champion. A \$10,000 pledge netted backers the chance to go to a VIP Super Bowl party. Eight people pledged at that reward level.

That didn't stop the crowd from piling on in the Kickstarter comments, calling for Kickstarter to suspend the campaign. One commenter said it was "hilarious that this continues to run." Another backer searched the Web and found a pending lawsuit against a person with the same name as Andrew Won, MogoTXT's CEO. That issue was raised, and MogoTXT was forced to respond. MogoTXT even threatened a defamation lawsuit against one backer in their own Kickstarter comments, leading to a rush of news articles debating the merits of just such an act!³³

There are tangible examples of faulty crowd wisdom on display on popular crowdfunding platforms. Project creators should be prepared to deal with any vitriol in a way that diffuses negativity and keeps the focus on the project. In addition, project pitches should be crafted in a way that addresses any logical loopholes proactively whenever possible. Asking a friend to play the cynic and pick a project apart before the official public launch is a great exercise to take part in before launching a campaign.

Examples: Pretail in Action

Here, we will examine some notable examples of pretail-focused campaigns launched on crowdfunding platforms. All of the following campaigns were dual efforts in both fundraising and market testing. Not all were successful, but it is important to note that failure is part of the pretail movement. Not all products will find a market.

33. "MogoTXT Threatens Legal Action against Backer on Gridiron Thunder Campaign Page." Crowdfund Insider, August 30, 2013.

The Ubuntu Edge

The Indiegogo campaign for the Ubuntu Edge was perhaps the most ambitious rewards-based crowdfunding campaign in the short history of Internet-enabled crowdfunding. Canonical is a company based in the United Kingdom that is responsible for developing and maintaining Ubuntu, a popular open-source operating system for computers, tablets, and phones based on Linux.

Canonical launched a campaign on Indiegogo seeking \$32 million to create the Ubuntu Edge, a cutting-edge smartphone with state-of-the-art specifications. The smartphone was designed to run a smartphone-specific version of Ubuntu. The phone could also be plugged into a monitor and paired with a keyboard and mouse, allowing it to be used as a normal desktop computer. Specs included a sapphire glass screen, 4 GB of RAM, 128 GB of storage, and stereo speakers.

The campaign ended up raising \$12,814,196 in 30 days, coming in almost \$20 million short of its goal.³⁴ Despite this failure to be fully funded, the money raised represents the second-largest total ever pledged via a single rewards-based crowdfunding campaign to date. (The most-funded single campaign ever belongs to Star Citizen,³⁵ a video game that has raised over \$30 million using a white-label crowdfunding solution called IgnitionDeck.)

Reasons for the failure vary, but one reason may have to do with Canonical's pricing strategy. Early-bird units were available for a \$600 pledge, but subsequent units became more and more expensive, eventually reaching as much as \$895. This created decreasing incentive for backers to pledge over time. Canonical would later revise its strategy and lock pricing for units at \$695, but by then the \$32 million goal was unattainable.

The Freedom of Information Act (FOIA) Machine

The not-for-profit Center for Investigative Reporting (CIR) launched a Kickstarter campaign in order to raise funds for its FOIA Machine. The software project aimed to create a "TurboTax for government records," an online tool journalists could use to expedite requests made pursuant to the Freedom of Information Act.

By the time the project launched, FOIA Machine had already done beta testing and boasted over 800 signups from people interested in using the system. Kickstarter was used as a means of introducing the project to the public, garnering additional funding, and testing the market for just such a solution.

34. "Ubuntu Edge Fails: The Winners and Losers." Crowdfund Insider, August 22, 2013.

35. Star Citizen, see <https://robertsspaceindustries.com/funding-goals>.

The CIR secured matching grants from the Knight Foundation and the Donald W. Reynolds Journalism Institute at the University of Missouri. These matching grants promised further funding for the project based on the response to the Kickstarter project. By the time the project ended, the CIR had raised over \$50,000 from over 2,000 backers, proving the market for the FOIA Machine. Both grants, totaling \$25,000, were secured. This brought total funding for the project to \$78,654.

Today, the FOIA Machine³⁶ is working and available at www.foiamachine.org, in part thanks to contributions from Kickstarter backers.

Spira Running Shoes

Andy Krafstur walked away from a career as a lawyer to focus on his dream of creating a running shoe that minimized leg fatigue. He tested a crude prototype of a running shoe with springs in the soles and was pleased when his legs were not fatigued after hours of playing basketball. The concept for the Spira shoe was born.³⁷

By the time Krafstur launched a crowdfunding campaign on RocketHub, he had already completed all of the research, design, and tooling for production. He turned to RocketHub in order to raise funds to purchase inventory. The campaign was also meant to supplant any costly marketing effort.

The campaign was a success, having raised \$42,000 on an original \$25,000 goal. Television channel A&E took notice. A&E had developed a partnership with RocketHub called Project Startup, which aimed to connect budding entrepreneurs with their audience in order to facilitate successful startups. Through the Project Startup program, Krafstur was able to license and develop a *Duck Dynasty*-themed shoe.³⁸ At the time, *Duck Dynasty* was the most popular reality show on cable television.

A second campaign was launched on RocketHub for this new shoe. The shoes and the accompanying crowdfunding campaign were pitched in a commercial that aired during an episode of *Duck Dynasty*. The result? The campaign went on to raise \$493,991 from 3,667 backers, almost 5 times the original \$100,000 goal. The campaign ended on November 19, 2013.

36. FOIA Machine, see <https://www.foiamachine.org/kickstarter/>.

37. RocketHub - Ultralight 3 Spring Running Shoe by Spira!, see www.rockethub.com/projects/9463-ultralight-3-spring-running-shoe-by-spira.

38. RocketHub - Spira Duck Dynasty Camouflage Shoe with WaveSpring Technology, see www.rockethub.com/projects/29837-spira-duck-dynasty-camouflage-shoe-with-wavespring-technology.

Broker-Dealers Entering the “Accredited” Crowdfunding Space

A broker-dealer is a firm or person who trades securities on behalf of customers or executes trades for its own account. The relationship between all crowdfunding portals—both accredited and nonaccredited—with broker-dealers has been an ongoing discussion since the signing of the JOBS Act in April 2012. The process has been convoluted by multifactorial challenges. First, the definition of which transactions require broker-dealer involvement is rather broad. Furthermore, the allowance of general solicitation has added more fuel to the fire as promoting a deal is one of the areas where a broker-dealer is required—or maybe not. Much discussion occurred in 2013 revolving around the debate of whether a crowdfunded deal requires a broker-dealer. Since popular crowdfunding—or crowdfunding for nonaccredited individuals—is still not regulated by the SEC as of this writing, the point is moot. Until the SEC releases its inclinations as to how it intends on regulating popular crowdfunding along with additional requirements, there is simply little gained by speculating.

In a speech given in April 2013, David W. Blass (Chief Counsel, Division of Trading and Markets at the SEC) shared some of the internal debate that is occurring at the SEC³⁹:

Introduced by the JOBS Act, funding portals are intended to perform limited functions for crowdfunding offerings. Because their functions are limited (for example, they do not come into possession of customer funds or securities or provide investment advice), funding portals receive lighter regulatory treatment, including being subject to a customized set of rules under FINRA’s rulebook (as compared to fully registered broker-dealers) and receiving an exemption from broker registration with the SEC. Needless to say, the staff is continuing to think through the appropriate registration and regulation structure for funding portals, and learning from that experience to see if there are opportunities to extend the approach to other types of brokers whose activities are limited.

Blass went on to describe some of the challenges with broker-dealer requirements:

39. David W. Blass, Chief Counsel, Division of Trading and Markets, SEC, “A Few Observations in the Private Fund Space.” April 5, 2013.

As this group knows quite well, absent an available exemption or other relief, a person engaged in the business of effecting transactions in securities for the account of others must generally register under Section 15(a) of the Exchange Act as a broker. The test for broker-dealer registration is broad and depends on various activities a person performs in one or more securities transactions. Some examples of activities, or factors, that might require private fund adviser personnel to register as a broker-dealer include:

- Marketing securities (shares or interests in a private fund) to investors,
- Soliciting or negotiating securities transactions, or
- Handling customer funds and securities.

Now there are good arguments to be made that crowdfunded private placements for accredited offerings do not require broker-dealer involvement, but in a more recent writing it was clear the SEC is “closely scrutinizing the development of online platforms in the wake of relaxation of the general solicitation ban.” While the spirit of lifting the ban may be clear to most, the enforcement angle may be up for interpretation. As part of this more recent presentation, Blass⁴⁰ stated that “depending on how the platforms operate and are set up, they may trip” into broker-dealer registration requirements. He also warned that if the platforms are creating a secondary market, they have to be wary of exchange registration requirements, the violation of which can have very serious consequences.

Blass’s reference to platforms is a direct inference to crowdfunding platforms using the Regulation D Private Placement regulation to offer shares in companies. The best regulations are simple, clear, and concise. The SEC has led with partially mitigating requirements regarding general solicitation while not completely clarifying the role of a broker-dealer requirement.

Many accredited crowdfunding platforms do not have an association with a broker-dealer or possess the necessary licenses on staff. Some accredited platforms do have associations with broker-dealers, which probably increases transactional cost.

Firms like I-Bankers Direct, CircleUp, and MicroVentures are broker-dealers. White-label provider CommunityLeader has created a partnership with Benjamin & Jerald, and they have jointly launched cTrade as an accredited and authorized broker-dealer solution for crowdfunding portals. Other platforms have announced partnerships with broker-dealers like

40. Yin Wilczek, “SEC Scrutinizing Development of Platforms Engaged in Reg D Offerings, Official Says.” *BNA*, September 26, 2013.

Los Angeles-based Crowdfunder and its association with WestPark Capital. EarlyShares has partnered with Point Capital Partners.

Crowdfunding platform SeedInvest clearly states it is not a registered broker-dealer and does not give investment advice. ReturnOnChange, RockThePost, and WeFunder are not broker-dealers.

Expectations are growing that traditional banks and funds will soon move into the space. While some may look to partner or develop their own transactional platforms, others will license white-label applications that may scale seamlessly and quickly.

One may predict that over the next five years, all investment banks will be engaged in crowdfunding in one form or another as financial companies acquire successful first movers or develop their own portals.

Crowdfunding as a Political Tool

Crowdfunding as a political tool has not yet captured significant traction in the crowdfunding industry. This is expected to change. Simply look at President Obama's 2008 presidential campaign fundraising breakdown⁴¹:

- 3 million online donors
- 6.5 million donations made from those 3 million
- Of those 6.5 million, 6 million were for \$100 or less
- Total amount raised online: \$500 million

In 2012 these numbers improved.⁴² President Obama's team raised \$690 million online. This number also includes some high-dollar event giving that was processed online, but the majority of contributions were small dollar amounts.

Depending on how you define crowdfunding, one may claim that Barack Obama ran the most effective crowdfunding campaign of all time.

To date, there is no specific vertical to fund only political campaigns, but certainly we can expect white-label providers to be a significant presence in forthcoming elections. The ability to quickly customize and scale a fundraising effort for a never-ending list of campaigns is sure to come.

41. "Obama Raised Half a Billion Online." *Washington Post*, November 20, 2008.

42. "Exclusive: Obama's 2012 Digital Fundraising Outperformed 2008." *Time*, November 15, 2013.

Indiegogo segments a political category on their crowdfunding platform. Strategically, Indiegogo has supported political campaigns, while Kickstarter has veered from this path. Indiegogo went so far as to do an analysis of funding trends for the 2012 political cycle using data from their own platform.

Probably the most well-known political initiative to date was regarding Turkey. In June 2013, a group of Turkish organizers coalesced to support the growing movement of Turkish citizens responding to a heavy-handed government action. The spark was small—a park being turned into a mall—but action on the part of the government inspired millions to protest. As part of the organizers’ push to apply worldwide political pressure on the Erdogan (Turkish prime minister) government, a group created an Indiegogo campaign to raise \$53,800 to pay for a full-page advertisement in the *New York Times*. The crowdfunding campaign ran for seven days and closed at \$108,371.⁴³

This brilliant success in capturing the emotion of the moment to motivate thousands to support a similar goal is emblematic as to the potential for crowdfunding in the political arena.

Canada-based Fundrazr has also targeted the political category. The company lists many local crowdfunding campaigns along with other affiliated efforts.

Fundly, one of the world’s largest crowdfunding platforms, posts contributions of over \$321 million as of this writing. The “crowdfunding for good” platform is a pure donation web site. Just about any type of donation campaign is accepted, from churches to clubs, events to trips, from politics to natural disasters—the platform lists them all.

Fundly lists many political fundraising projects. Most are smaller attempts to raise funds for local races, but it is clear the web site wants more national campaigns. Fundly has partnered with Bloomerang, a CRM provider, to provide “all-in-one fundraising tools.”⁴⁴ Maintaining donor relationships is an important aspect of all charity and political fundraising.

In the fall of 2013, a political web site for lobbying was launched. The platform is a hybrid crowdsourcing plus crowdfunding operation. iLobby wants to be a “political persuasion” application. The web site intends on catering to small businesses and trade associations, creating a forum for internal discussion and debate. With constituent mapping included, the

43. “Turkish Democracy Runs Crowdfunded Full Page Plea in *NY Times*. Crowdfund Insider, June 8, 2013.

44. “Fundly Announces Partnership with Bloomerang.” Crowdfund Insider, June 4, 2013.

combination of technology and social networks makes this startup an interesting play.

With a lame duck president and what is expected to be a very heated election cycle in 2016, we can expect a dramatic shift to crowdfunding for politicians as well as issues-based campaigns to occur in the next few years.

Fraud in Noninvestment Crowdfunding

Fraud in noninvestment crowdfunding is one of the most cited criticisms of the crowdfunding industry. Fraud absolutely happens in noninvestment crowdfunding, and more often than many people may realize! Here, we will define fraud in the context of crowdfunding with a specific focus on rewards-based crowdfunding. We will examine the risks project creators expose themselves to when engaging in fraudulent activities on crowdfunding platforms. We will cite specific examples of crowdfunding fraud, and we will explore strategies that project creators can use to protect themselves and ensure that they don't become part of the proverbial problem. Finally, we will explore the topic of fraud in investment crowdfunding, including what the industry is doing to try and prevent it.

Defining Fraud

Fraud is loosely defined as “deception made for the sake of personal gain.” When narrowly defined and applied to crowdfunding, fraud is the act of lying to or deceiving users of a crowdfunding platform in the hopes of enticing funding from the crowd.

In September 2012, Kickstarter made a change to their project guidelines that aimed to reduce or eliminate instances of fraud on their rewards-based crowdfunding platform. The change was announced in a blog post by Kickstarter⁴⁵ cofounders Perry Chen, Yancey Strickler, and Charles Adler entitled “Kickstarter Is Not a Store.”

The change mandated the inclusion of a “risks and challenges” section for each and every crowdfunding campaign to be listed on their platform. It was now mandatory for project creators to discuss risks and challenges in an open and transparent way. In the cofounders' words, the change was made to “reinforce that creators' projects are in development.” They encouraged potential

45. Perry Chen, Yancey Strickler, and Charles Adler, “Kickstarter Is Not a Store,” Kickstarter Blog, September 20, 2012.

campaign contributors to use this section in an effort to gauge the likelihood that a project creator could deliver on his or her promises.

Developing a new product or bringing a new service to market can be extremely risky and the road to success can be wrought with challenges. However, diminishing those risks and challenges in hopes of generating more crowdfunding cash constitutes fraud.

There is no such thing as a “little white lie” when soliciting strangers for money. Transparency and honesty are paramount, and if those two tenets cannot be maintained while seeking funding, the campaign creator should look to improve their likelihood of being successful before turning to the crowd for funding. The right time to launch a crowdfunding campaign is when the campaign creator is certain that they can deliver on the promises they make, and when they can discuss the risks and challenges involved without turning potential contributors away.

The Risks of Fraudulent Crowdfunding

So what can happen to a project creator when he or she engages in fraud? Each crowdfunding platform will specify expectations for project creators within their terms of service. Indiegogo specifies expectations in a section of their terms called “Special Rules Regarding Perks.” Relevant information from their web site follows.

You agree:

- a. All Perks must be lawful and otherwise comply with this Agreement.
- b. To fulfill all Perks and to respond promptly to all questions and comments regarding Perks. If you are unable to fulfill a Perk, you will work with the Contributor(s) to reach a mutually satisfactory resolution which may include, without limitation, issuing a refund promptly.
- c. Indiegogo is not liable nor responsible for the fulfillment of Perks, the failure to fulfill Perks, the quality of the Perks and as otherwise disclaimed or limited by this Agreement.

Furthermore, Indiegogo’s terms specify that the campaign creator or owner is “liable, jointly and severally, with the Beneficiary for the Campaign and accountable and liable for the use of the Contributions other than as described in the campaign (“Misuse”).

This follows a common pattern on crowdfunding platforms. In short, platforms are careful to avoid any liability on behalf of campaign creators.

By including the aforementioned passages in their terms of service, Indiegogo specifically places liability at the feet of the campaign creator.

As a campaign creator, you incur the responsibility of doing one of two things: delivering on rewards or providing refunds. Anything short of these two outcomes exposes the creator to the risk of legal liability.

Fraud provides the basis by which legal action can be justified by a campaign's contributors. Inaccuracies in a campaign's pitch can be used to seek financial restitution in the wake of a failed crowdfunding campaign. Because of the costs associated with seeking legal action and the relatively small sums of money each individual contributor usually pledges, legal action against campaign creators is a rare occurrence. However, it is important to realize that the risk is there.

Outside of the realm of legal liability, also note that most crowdfunding campaigns live online in perpetuity. Failure to deliver on a campaign can affect a campaign creator's legitimacy, trustworthiness, and even his or her employment.

If a campaign creator isn't 100 percent positive about their ability to deliver on rewards, that isn't a hard barrier preventing the creator from launching a campaign. However, it is extremely important to be transparent about that concern in the campaign's description. Backers deserve to know and understand the risks before deciding to contribute. Failure to provide a full and accurate account of the risks involved with a campaign can push a campaign into the world of fraud.

Examples of Rewards-Based Crowdfunding Fraud

Here are three examples of crowdfunding fraud. Each is a unique case and presents a different take on what constitutes fraud in the world of rewards-based crowdfunding. Some examples are more egregious than others, but all would constitute fraud under any pragmatic definition of the term.

Kobe Red Beef Jerky

The Kickstarter project for "Kobe Red Beef Jerky" was created by an outfit calling itself Magnus Fun Inc. The creators of another Kickstarter project for a crowdfunding documentary called *Kickstarted* reached out to Magnus Fun in order to secure an interview about their campaign. Before a final agreement could be reached, an announcement about an agreement was posted to the Kobe Red Beef Jerky campaign page. This spurred the *Kickstarted* team onward, and as they dug further into the campaign

they found various inaccuracies and suspicious facts surrounding the campaign. These facts were posted to *Kickstarted*'s web site and to a thread on Reddit. Kickstarter subsequently canceled the campaign before funds were released.

The Handibot

The original Handibot was successfully funded on Kickstarter, and the team behind the campaign subsequently said they were in the final stages of delivering on their rewards. However, in what is becoming an alarmingly regular occurrence, a fraudster created a copycat campaign. This campaign was launched on Indiegogo instead of Kickstarter, but was subsequently revealed and suspended by Indiegogo's in-house fraud detection team.

The Doom that Came to Atlantic City

The Doom that Came to Atlantic City promised to be a Monopoly-like board game developed by the Forking Path, a self-described "entertainment development house and publishing company." The campaign raised over \$120,000 on Kickstarter on a meager \$35,000 goal; 1,246 backers pledged funds to the campaign. The Forking Path would fail in their effort to bring the game to fruition, but failure isn't fraud. In this case, a backer update notifying backers of the project's failure included the revelation that some of the funds raised were used for "moving the company back to Portland," a use of funds that was never disclosed in the original product description. Many backers (and some in the media) took issue with this fact, and comments posted to the relevant backer update suggest that many backers have filed fraud complaints through the Oregon Department of Justice. The project creator states that he has begun the process of refunding backers and insists upon his desire to rectify the situation.

How to Protect Yourself

The easiest way for a crowdfunding campaign creator to seek protection is by being transparent and honest with backers. If backers are notified of all of the risks and challenges ahead of their decision to contribute, campaign creators should be protected from any future risk.

There is an old adage, "underpromise and overdeliver." This adage is one that campaign creators should take to heart. As an example, many crowdfunding platforms require project creators to estimate a delivery date for rewards.

Project creators should buffer their estimates in order to hedge against any risk involving unforeseen circumstances in the run-up to delivery.⁴⁶ Making any promises to the crowd with the knowledge that those promises are unlikely to be attainable could be interpreted as making fraudulent claims.

It is also important to note that launching a rewards-based crowdfunding campaign is a business endeavor. As with any business, the protection of assets is a chief strategy that should be employed.

In the United States, the creation of a limited liability company (LLC) or corporation is a great way for many crowdfunding project creators to keep clear separation between business assets and personal assets. Costs and benefits will vary from state to state, but LLCs and corporations are generally cost-effective business structures and take only moderate expertise to set up. In my home state of Ohio, filing for an LLC is a matter of filling out a simple form and paying a small \$125 filing fee. Having this clear separation can also be beneficial for tax purposes. (Yes, crowdfunding contributions are subject to income tax!)

In the event of legal action on behalf of jilted backers, the company would then be the subject of said action. The personal assets of the project creator would be protected from liability. There's more information in other chapters of this book on setting up the appropriate entity in anticipation of a crowdfunding campaign.

No Fraud in Investment Crowdfunding? (Not Yet at Least)

Globally, fraud in the nascent investment crowdfunding industry is generally nonexistent. As an example, the Australian Small Scale Offerings Board (ASSOB) has been in operation since 2007.⁴⁷ As of this writing, about three hundred companies have been funded on this equity crowdfunding platform. There hasn't been a single case of fraud. A similar absence of fraud has been reported on platforms like Crowdcube and Funding Circle. There have also been no cases of investment crowdfunding fraud reported from U.S.-based platforms that cater to accredited investors.

Does that mean that crowd investing will never see a case of fraud? Consider that at the time that this data was compiled, zero cases of fraud were reported based on a sample size of a few hundred successful crowdfunding

46. "Why 84% of Kickstarter's Top Projects Shipped Late." *CNN Money*, December 18, 2012.

47. Niederer, Paul, Prevention of Fraud in Equity Crowdfunding, November 30, 2013. See <http://paulniederer.com/2013/11/prevention-of-fraud-in-equity-crowdfunding/>.

campaigns. Title III of the JOBS Act aims to open equity crowdfunding to the general public in the United States. Participants in the crowdfunding industry hope to facilitate many times this number of deals. As the size of the industry grows, fraud detection will become more difficult.

There are companies gearing up to provide fraud detection and vetting services for equity crowdfunding deals. One such company is Virginia-based CrowdCheck. This company plans on facilitating due diligence on equity crowdfunding offerings once U.S. regulations allow equity crowdfunding for nonaccredited investors.

In short, it stands to reason that the deregulation of Internet-enabled investment will result in an increased risk of fraud. Regulators will seek to balance the risks of fraud with the need to generate access to capital for small and emerging companies. The frequency of fraud in crowd investing will certainly serve to shape future regulations across the globe. This is a fact that the crowdfunding industry is acutely aware of, and industry participants operating in good faith will be vigilant in tackling this concern now and in the future.

Additional Resources

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PART II

Preparing for Your Crowdfunding Campaign

CHAPTER 5

Business Planning in Preparation for a Crowdfunding Campaign

David Feldman

Richardson & Patel

As we know, before companies may sell equity through crowdfunding, the U.S. Securities and Exchange Commission (SEC) must pass rules to implement the provisions of the Jumpstart Our Business Startups (JOBS) Act. The JOBS Act crowdfunding provisions require the SEC to pass rules, after which companies can raise money. But as of this writing, equity crowdfunding is not yet available.

That said, companies should start thinking about how to get ready for crowdfunding when it does arrive. The first question, of course, is going to be which companies will find crowdfunding attractive? One key provision in the JOBS Act states that a company considering a crowdfunding round must not have raised money in the 12 months prior to doing so. More specifically, the act states that any crowdfunding plus other money raised cannot exceed \$1 million in the 12 months prior to the raise. So you can, for example, raise \$500,000 before crowdfunding then raise another \$500,000 in a crowdfunding round. But if you have raised \$1 million within the past 12 months, crowdfunding will not be available.

This is important because it means that many companies will find they are not eligible for crowdfunding. Many of my clients are raising money on an ongoing basis. These companies will not qualify. Who will qualify? Very early stage companies, maybe even doing their very first round of financing. I believe, having worked with Congress in developing the JOBS Act, that this was the main purpose behind crowdfunding—to help new companies raise money at a time when it is most difficult to do so, that is, at the beginning.

However, there are certainly many other companies that may find themselves able to use crowdfunding. A biotech company that raised \$10 million that covered its expenses for a year may want to use crowdfunding to raise the next \$1 million and allow friends and others to participate in ownership of the stock by investing smaller amounts. Other, similar companies may seek to increase their shareholder base, which is important if you are planning to go public at some point. Others might be retail operations offering their customers a chance to invest in their favorite store.

Therefore, most ongoing operating businesses that consistently and actively raise capital probably will not be eligible for crowdfunding. But so many early stage companies will. Therefore, the purpose of this chapter is to help provide some basic advice to startups and near-startups on how to get together a business plan, budget for it, define their market opportunity, prepare projections and forecast, and how to deal with the audit of financial statements that is required if you move to a crowdfunding round of at least \$500,000. Luckily, the JOBS Act is fairly specific in its requirements about a number of these things.

Writing a Business Plan Disclosure Document

There are countless books out there on how to put together a solid business plan. For a startup, the biggest challenge is that everything you are writing about is prospective and, frankly, somewhat speculative as to what you plan and expect for the business.

When I was in law school, a friend and I bought a radio station. But to do so we needed to raise some money. For that, I put together my first business plan. It took about a month. Sadly, I became a true entrepreneur through that venture since we ended up selling the station for a loss after operating it for four years. And it taught me an important lesson about business plans that I often tell clients: *The most important ingredient*

in your business plan is making sure to plan for the plan not going according to plan.

My partner and I found, however, that writing the plan forced us to do some real thinking and strategizing that, frankly, we hadn't really done to that point. How are we going to staff the business? What target markets are we pursuing? And much more, especially regarding the financial side of things. So use the exercise as a way to actually develop your strategy and business goals rather than just sitting and figuring out what you think investors want to hear.

The JOBS Act actually specifies the information you will need to put together, at a minimum, for investors in equity crowdfunding transactions. You will not be able to take money from investors until they have had the information for at least 21 days. The information also will have to be filed with the SEC. This will be required regardless of how much money you are raising through crowdfunding.

The mandatory items include basic information, description of the business, description of your financial condition, the amount you seek to raise and a description of the use of proceeds of the offering, and the price at which you are selling securities or a method for determining the price and your capital structure. While this is the minimum, the JOBS Act also gives the SEC discretion to require more information, so upcoming rules may add to this list.

Basic Information

The JOBS Act will require you to include in your disclosure document your company's name, legal status, physical address and web site address. You will also need to include the names of the directors and officers (or people performing similar roles) and anyone holding at least 20 percent of your securities. This is fairly straightforward. When I work with clients on putting this together, we may decide to include biographies of the key members of management even though the statute does not require it.

Description of the Business

While the JOBS Act is not more specific, I assume that this section is meant to cover those topics typically reviewed in a business plan, including a business

summary, market analysis, marketing and sales, and detailed product or service description. This will likely be the largest section of the disclosure.

To do a business summary, some like to refer to the “elevator pitch” that every company should develop. If someone asked you to describe your company in one minute or less, what would you say? That kind of ability to step back and view the big picture is critical in developing a solid summary. Frankly, many investors don’t even read past this overview of your business.

Think about the essence of your planned business. Some are fairly straightforward. My radio station plan said, hey, we’re buying this particular radio station for this cost and we plan this music format and this plan for managing and marketing it. But I have another client who sat with me in our first meeting and said, “It’s going to take some time for me to explain our business to you.” In the world of executive overviews, that’s not great news.

Obviously, you want to hit the highlights. Don’t hide from major challenges your business might face. This would include things like your company’s planning to enter a very crowded field but you believe you have a superior product. Note that even with honest disclosure, you have the right to put a legitimate positive, nonmisleading spin on your plans.

Both in the overview and elsewhere in the document, try to avoid statements that editorialize or constitute opinion or would be difficult to prove: “We know that no other company can do what we plan to do” or “We have devised the finest widget the world has ever known” or “Our management is highly respected in their industry.” Also try to avoid technical language, opting for plain English wherever possible. You want to try to keep away from the risk that your reader’s eyes will glaze over.

Next, the market analysis can be critical. Describing the geographic market we were entering in purchasing our radio station, we talked about the demographics of the local population, the likely popularity of different types of music, and so on which took some effort and research. We got as much information as we could about the various other stations in the market.

Hopefully, you understand your market enough to provide that information. If not, get online and find it. How large is the market you are entering? How crowded? How fragmented? Are the players large or small? Examining your competitors openly is important. You probably should list several of your key competitors, even if they are very large.

Your description of your planned marketing and sales strategy comes next. I was a marketing major at the Wharton School of Business and still believe that pretty much every business should have marketing at the center of its strategy. It’s the reason I loved the radio business, since it was almost entirely a

marketing-driven operation—no gizmos being manufactured, no growth of a service business through massive overhead (read: law), and the like.

Marketing is not just about sales. Sales is a component of marketing, and the sales strategy flows from the marketing strategy. The key to this section is asking the simple question: What unmet need in the marketplace are we going to satisfy? It's not enough that you may have a cool technical advance. What if the market doesn't care? Some of us of a certain age remember amazing technologies that flopped in the marketplace such as Quadraphonic stereo and the Sony Betamax. More recently we have seen the effort to develop and promote 3D television fail.

Some businesses are more about doing something in a different way. Bill Gates of Microsoft did not invent the personal computer, just software to run it. Lots of other people did that. He was different because he was open to letting his software run on anyone's computer. Most others, including Apple, allowed their operating software to run only on their own hardware.

So it is important that you have something special, and that you believe and can explain why the market clearly wants and needs that special thing. When you move to discussing sales strategy, you want to develop your "unique selling proposition." Major law firms are pretty darn successful and profitable, but they only recently developed and implemented modern marketing techniques. If you look at the web sites of any 10 large law firms, you cannot really tell them apart. Frankly, that means they are doing it wrong.

It's critical to distinguish your product or service from that of your competitors. Why do you choose a particular shampoo or airline? You might choose one over the other because something in their marketing and implementation appeals to you as opposed to their competitors. Make sure also to talk about your plan to ramp up a team for marketing and sales assuming you achieve the projections you will be supplying. Some use outside representatives, others in-house salespeople. Now is the time to start making decisions like that, or you will not be able to properly budget how to run the business.

Your product or service description comes next. Again, if you are selling something fairly technical or hard to describe, you still need to find a way to explain it to a nontechnical person. Especially with crowdfunding, the whole purpose is to allow anyone to invest, regardless of income, investing experience, or intelligence. Thus, you have to assume that simple individuals may be reading what you prepare. If it takes a little more language to walk a reader through a description of what you do, then do so. The JOBS Act does not require or suggest that the SEC will be reviewing these offering documents. But they may decide to do so, so keep that in mind as you write.

When you are having an issue deciding what to include or not include in the document, it might help to use the SEC term *material*. If something

is material, in general it should be included. What is material? It's something that a reasonable investor would consider important in making their investment decision. Every day as a securities lawyer I help clients figure out what is material. My standard: If we spend more than five minutes trying to decide if something is material, it probably is.

The JOBS Act requires some listing of "risk factors" affecting your business, as will be discussed later. Frankly, an uninformed reader, after looking at most companies' risk factors, would never invest! It's all the doom and gloom of bad things that can happen, such as the company's dependence on its key management, major competitive challenges, the need to raise money to operate, the loss of a key technology, and so on.

But risk factors also create a small insurance policy against potential complaints later by investors if they are unhappy. Yes, the likelihood that a group of people who all invested a few thousand dollars (as the JOBS Act limits) and a total of \$1 million would seem unlikely to band together to bring a lawsuit, and even more unlikely that any decent class action litigation attorney would take a case involving only \$1 million, but stranger things have happened. The purpose of risk factors is to avoid hearing later, "You didn't tell me X. If you had told me X, I would not have invested."

Description of Financial Condition

At a minimum, the JOBS Act requires (1) if you are raising \$100,000 or less, delivering your most recent income tax return and financial statements, certified by the CEO to be true and correct in all material respects; (2) if you are raising between \$100,000 and \$500,000, the financial statements have to have been reviewed by an independent public accountant based on procedures that the SEC will establish; and (3) if you are raising between \$500,000 and \$1 million, financial statements that are audited by an independent accounting firm. It is not required in the JOBS Act that this accounting firm be registered with the US Public Company Accounting Oversight Board as are accountants that audit public companies.

But the act says you need a description of the company's financial condition *and* the financial information previously noted. It is not clear what the drafters of the bill were thinking about in asking for a description of financial condition. But if we analogize to what is required of public companies, that would include a discussion of your liquidity and capital resources, and possibly a comparison of current to prior periods in terms of revenues and expenses, if you are not a startup, of course.

One of the most common reasons businesses fail is from lack of sufficient capital to operate. So in your financial condition discussion, it is going to be important to analyze your cash needs and the sources of the cash you intend to raise. Will money come from operations? Selling securities? Borrowing? If you are a startup, you have ideally prepared conservative projections that show how much cash you will require to run the business. In this discussion you talk about the potential sources of that cash.

Of course, most entrepreneurs, especially in startups, secretly laugh when you ask them what they expect the business to do in its first few years. There are many uncertainties in early-stage businesses, and it is by definition highly speculative to forecast where the business will head. But plan you do anyway, and all you can do is the best you are able.

It is true that this plan will be reviewed primarily by average, probably not very experienced, investors. But when I look at a business plan and financial information, it is not as much to get a sense of what I think the business is going to do, but rather to get a sense of what *you* think is going to happen. I know that there is much that's unknown as you plan a new company. But where you think things are headed is very important information to me. Do I think you're being reasonable and rational? Often, the main reason companies lose financing opportunities is they think the company is more valuable than it is. Keep this in mind as you put this information together.

Use of Proceeds and Offering Amount

The JOBS Act says you need to describe “the stated purpose and intended use of the proceeds of the offering” as well as “the target offering amount, the deadline to reach the target offering amount, and regular updates regarding the progress of the issuer in meeting the target offering amount.”

Of course, it makes sense to determine how much money you seek to raise before you lay out how it will be spent. As mentioned, you will not be able to raise more than \$1 million a year through crowdfunding. Many experts expect that startups may choose to keep their initial crowdfunding raise to less than \$500,000 to avoid the expense of preparing audited financial statements. So we may see quite a number of \$499,999 fundraising efforts once equity crowdfunding is permitted. You would still be able to raise another \$500,001 through non-crowdfunding efforts if you desire in the months leading up to the raise. Interestingly, the JOBS Act does not limit how much money you can raise *after* the crowdfunding round is completed.

But determining the money you need is not just about looking at the limits under the act. It is a more formal process of reviewing your business plan to assess what additional funds are necessary. Often, an accountant can help figure this out. It will flow from the projections you create. Maybe you don't need \$1 million or even a full \$500,000. The two axioms most people follow that seem incongruous are: (1) try not to take more money than you need, and (2) make sure to raise every penny you really do need, assuming things may not go as well as hoped.

The reason for not raising too much, if you expect your company to grow, is that when you raise money later, presumably it will be at a higher purchase price, resulting in less dilution to your ownership. But at the same time you need to be sure you have the cash you need. It is a tough balancing act.

Once you know how much you are raising, you must describe what the money will be used for, known as the "use of proceeds." Again, the JOBS Act is not specific. In most cases it probably will not be sufficient to just say the money is for "general corporate purposes." You can delineate items such as marketing, research and development, and the like. You also should be able to include a disclaimer making clear that your plans and intentions could change, requiring you to alter the mix.

How do you decide how to allocate the funds? That should flow from your projections, which, as will be discussed later, will include essentially a budget for expenses. But in this case it can make sense to keep in mind what you think the investors are looking for when you decide how to plan to spend the money. For example, in some cases it is not seen as a good use of proceeds to pay off debt or buy out a shareholder. Investors like to see the funds being put to use to grow the company. Developing and marketing your product or service are things investors like to see. If the money is going to give senior executives raises, that also may not be seen favorably. Again, you will likely receive the least friction from potential investors if the money goes right into those things that will lead directly to growth.

Valuing Your Company: Pricing Securities and Understanding Capital Structure

The JOBS Act also requires you to clearly state in your offering materials the price at which you are offering securities. If you are not sure yet, it should include a way to figure out the price. If you haven't set the price, you will need to redistribute the offering materials when you make a decision about the price.

Determining the price is essentially the exercise of discerning what your company is worth. This is very difficult and yet possibly the most important decision you will make in structuring your crowdfunding offering. There are easily a dozen different legitimate methods to value a business. For an early-stage company, which we assume are the most likely to use crowdfunding, you don't really have any historical financial performance to help you determine value. Therefore, you need to be forward looking and use your projected future performance to figure it out.

Most venture capitalists will tell you they look at where you think the company will be, say, in three years. As an example, let's say you plan to be at \$2 million in earnings at that time. A common method of valuing a business is as a multiple of earnings. What multiple applies varies greatly by industry, whether or not the company is public, and the state of the economy and merger-and-acquisition market. Sometimes the multiple is as low as 2 to 3 times or can be as high as 10 to 12 times earnings.

So you work with your advisers to try to determine what the "market" multiple is out there currently for companies in your industry. Let's say it's 4 to 5 times in our example. So if you average that to 4.5, then you can argue that your company is worth \$2 million (the earnings amount) times 4.5, or \$9 million. But you should note that most investors will not just let the value of your company be what you are hoping it will be three years from now, assuming your projections are achieved in full.

There are generally several downward adjustments to the valuation strictly based on a multiple of future earnings. First, there is a "discount" factor solely related to the fact that your projection is about three years from now, and there has to be a reduction to reflect the fact that you have to wait three years, if everything goes well, to achieve the projection. In our example, let's say that discount is 15 percent. So that brings your \$9 million valuation to \$7.65 million.

The second adjustment is to deal with the very large risk that you will not achieve what you are projecting. It would be one thing if the valuation were based on your past performance, since that is factual. Your projections are speculative at best. Years ago I helped run a small venture capital firm. For early-stage companies, if we were comfortable with their projections, we typically cut that valuation in half. Many investors and investment banks apply different approaches. But plugging that into our example, we would be at a \$3.825 million valuation today.

That seems like quite a reduction from the original \$9 million. But remember that in the example the company is essentially a startup. The next step is to figure out what percentage of the company you are giving investors.

Once you know how much is being invested and what your valuation is, it's a simple mathematical calculation. In our example, the \$3.825 million valuation is called the "premoney value." The value of the company is increased dollar for dollar by the money you are raising. So if you raise \$1 million in the crowdfunding round, the "postmoney value" would be \$4.825 million (\$3.825 plus the \$1 million raised). So what percentage should the \$1 million receive? You take the \$1 million over the postmoney value of \$4.825 million and you get about 20 percent of the company to be sold to crowdfunding investors.

So a company hoping to have \$2 million in profits in its third year will sell about 20 percent for \$1 million. Again, this is just one approach and one example, and situations vary widely. The final thing you have to figure out is the price of the actual security you will sell to people. This will depend on a number of factors. If you are a limited liability company, the owners are called members and they own membership interests. The interests can be expressed as shares or other numerical units but are more commonly expressed simply as a percentage ownership. So that would be easy in our example. If \$1 million buys 20 percent, then a \$100,000 investor buys 2 percent, \$10,000 buys 0.2 percent, and so on.

In a corporation you sell shares of stock. Of course, in some cases "derivative" securities can be sold such as preferred stock or a convertible debt obligation. But let's stick with simple shares of common stock. Once you determine with your advisers how many shares of stock you would like to have outstanding (various factors weigh into this), you issue the right percentage to people. So if you want to have 500,000 shares of stock outstanding at the end, then the crowdfunding people get 20 percent or 100,000. So if \$1 million buys 100,000 shares, each share costs \$10 (1 million divided by 100,000 shares). That is the price of the security you are offering, which the JOBS Act requires you to disclose.

The JOBS Act also requires you to describe the ownership and capital structure of your company. This just means you talk about who owns the equity and debt of your business. If you borrowed money from a bank, that would be disclosed. While there is not clear final guidance as of yet, presumably you would talk about how many shares or interests you have outstanding. The law does require you to talk about the terms of the securities you are offering and how they compare to other company securities, *how* you came up with the value discussed earlier, how you may value securities in the future, and the risks related to various matters. You would also describe any other securities, such as stock options, that you may have issued.

Risk factors they require relate to minority ownership, corporate actions such as a sale of the company, and transactions with related parties. You may choose to add more risk factors, but try to avoid generic things like “the economy may go up and down” or “our industry is highly cyclical.” Risk factors generally should be specific to your company.

Reviewed versus Audited Financial Statements

Deciding how much to raise depends in part on whether you want to deal with the cost and time needed to have your financial statements reviewed or audited by an independent accounting firm. If you raise less than \$100,000 in a JOBS Act crowdfunding round, this will not be necessary. As mentioned earlier, a review is necessary if you are raising between \$100,000 and \$500,000, and an audit is required for raises between \$500,000 and \$1 million.

The JOBS Act does not specify how far back the financial statements are supposed to go. If you raise less than \$100,000, there is a requirement for the last year’s tax return. One could interpret that to mean that’s as far back as the financials should go as well. Public companies generally have to go back at least two years or to inception if that is less than two years ago.

If no accountant is involved, when raising below \$100,000, the company prepares its own financial statements, presumably including at least a balance sheet, profit-and-loss statement, statement of stockholders’ equity, and statement of cash flows for the past year. This is, however, not specified in the JOBS Act. It is also not clear whether “notes to the financial statements,” typically rather long and explaining some of the entries and accounting policies, are also to be included. There is a requirement, as mentioned, that the CEO certify that the financials are “true and complete in all material respects.”

What is a review, required when raising between \$100,000 and \$500,000? In a review, the accountants look at the actual financial statements themselves, but not any of the backup documents, receipts, and the like, that brought about the numbers. They check and ask questions based on the financial statements but do not review any work papers.

An audit, required above \$500,000, is another thing indeed. Here, the auditors look at many, but not all, of the agreements and work papers that led to the numbers in the financial statements. They also get information from your bank as to cash balances and a letter from your attorney that there are no lawsuits pending or threatened. This can take some time, usually requiring

auditors to spend at least several days at the company's offices reviewing things. If there is inventory to look at, they usually will.

All that said, if your company is very early stage, there is simply less to include in the financial statements or audit. But even when a new company doing virtually nothing gets audited, there are certain procedures that still have to be followed. If your company is less than one year old they will simply audit the part of the year that you have been in existence.

Why is the audit required then? Does it really provide useful information to investors if the company is only a few months old? It might not. And in other nonpublic offerings to both accredited and up to 35 nonaccredited investors, you are not required to audit the financial information if it is not material to the investor. An accredited investor is someone, generally, with at least a \$200,000 income or \$1 million net worth not counting their primary residence.

I surmise that in fashioning the JOBS Act language the lawmakers were concerned that, even though only \$1 million can be raised, it can be raised from a potentially large group of people. For example, if you raise \$1 million in chunks of \$250 from each investor, you would have 4,000 investors. So while the amounts are still small, presumably Congress worried about the risk of so many people not getting the right information. Remember, in other private offerings you typically cannot go past 35 nonaccredited investors.

Make sure when you select accountants to prepare your financial statements (if you do not do them yourself or with someone internal) and auditors to audit them that you shop around. Try to find ones who have experience in your industry and experience working with “development stage” companies. Shop on price as well, of course, but don't just go with the cheapest if there is a concern about the quality of their work. Some service providers you will encounter might have flexibility and be willing to be paid in stock rather than cash. An auditing firm cannot do this or it jeopardizes their independence. And their payment cannot be contingent on your raising money—you have to pay them when their work is done. Make sure you have enough cash for this.

Budgeting, Projections, and Forecasting

In a perfect world, when you prepare projections and budgets, you will do so with the assistance of an accountant. They will talk to you about your plans and expectations, how things work in your industry, how you plan to ramp up, and the like. In the end you will find that some numbers you plug into a projection are based on solid financial facts, and others will be not much more than an educated guess.

Also, in a perfect world you don't have, as some like to say, two sets of projections—a “real” one that you budget from and another that you show to potential investors. This, obviously, would be misleading and potentially actionable, so I would certainly advise against doing so. That said, some companies prepare multiple projections based on different assumptions of where revenues go or assuming different staffing or expense levels, and then present all the projections to investors.

As you see, then, so much is about what assumptions you make about the business in preparing this forward-looking information. What will your revenues be? Who even has a clue? In our radio station example, we did a few things to forecast our potential advertising sales. First, we managed (legally) to find out what other competitive stations were charging for their time. Then we decided on how many salespeople we were going to start with (two). Then we said if each salesperson makes three or four sales of at least \$X per week, where are we at? These were both key assumptions—how many people and how often they will make sales. We gauged this by talking to a few people we knew who had experience as radio salespeople.

This also helped us figure out some of our costs. We had a sense of what we would have to pay the salespeople, what other in-house staff were necessary, and the like. We had decided on a particular music format, which was satellite delivered. As a result, we had a fixed cost monthly for the DJs we used since we just paid the satellite company delivering syndicated content.

As mentioned, with some forethought and research you can get a decent sense of your costs and maybe even your top line. So how do you do that for years 2 and 3 and maybe even beyond? Most suggest predetermining a particular rate of growth in both revenues and expenses and working from that. Will your business ramp up quickly? Will it take a few years? What is realistic to expect, and, equally important, what will investors likely accept as reasonable?

If you honestly believe that your business will go from \$0 to \$100 million in revenue in three years, who knows, you may be right. But there is pretty much no business I can think of where that is even likely. Therefore, even if you believe it, delivering it to investors as your projection could turn them off, especially if your valuation is based on meeting that projection and therefore is very high. The so-called “hockey stick” projections might indeed represent a realistic scenario, but investors rarely believe it.

Back when I was in the venture business, we were interested in investing in a consumer product company which gave us what they said were very conservative three-year projections. They were overwhelmingly achievable, they said, and they felt very confident about that. Then we suggested tying

most of their compensation to achieving even 75 percent of their projections. When they strongly objected to this, we walked away from the deal since we knew they really were not as confident as they said about the projections.

The next question to determine is whether your budget and projections are to be cash based. The two basic methods of accounting, as we know, are cash and accrual. In cash-based accounting, all revenues and expenses are booked based solely on cash in and out of the door. The money has to come in from sales of a product to count it as a sale. You must book an expense when you pay it, not before.

Accrual accounting is more theoretical and can include a number of non-cash items, especially in expenses such as depreciation and amortization. In accrual you book a sale when the product is shipped from your possession, not when money is received. And you book an expense when it becomes due whether you've paid it or not. You should discuss with your advisers whether to budget and project based on cash or accrual accounting.

Conclusion

There is still much information to come from the SEC when the crowdfunding rules are ultimately passed. Based solely on the JOBS Act itself, however, it is clear you are going to have to put together a solid, well-thought-out disclosure document for the investors and for filing with the SEC. Take your time to use the exercise to actually plan for the future growth of your business.

CHAPTER 6

Protecting Your Intellectual Property

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Intellectual property (IP) assets can be—and often are—the most valuable assets of businesses throughout the world. IP is the driving force behind the fast-growing innovation that we see on a daily basis. IP generally relates to creations and ideas that legally qualify to receive exclusive protection for their creators. Examples of IP include patents, copyrights, trademarks, and trade secrets. From smartphones and tablets to music, books, logos, and secret ingredients, IP personifies the creativity and ingenuity that fuels innovation. Despite the importance of IP, the general public often misunderstands what constitutes IP, and when and how to protect IP rights.

Failing to identify, define, and ultimately protect IP rights can mean the loss of any such rights. This risk is particularly heightened on crowdfunding platforms, given that the nature of the process involves publicizing a creation, innovation, or idea to the masses—without any confidentiality or nondisclosure safeguards.

This chapter is designed to provide an introduction to intellectual property and convey some best practices for protecting it on crowdfunding platforms.

The Importance of Protecting IP on Crowdfunding Platforms

Although the concept of crowdfunding is not new (the Statute of Liberty was funded through a public rewards-based offer), the advent of the Internet and

the plethora of rewards-based crowdfunding web sites has made the concept of crowdfunding more popular. Traditionally, an individual or small business looking for funding would seek money from banks, venture capital funds, or other private funding sources such as friends and family. In each case, even relatively unsophisticated fund seekers would ask prospective lenders or investors to sign a contract known as a nondisclosure agreement (NDA). The basic premise of an NDA is that the party receiving information about an idea, concept, or innovation shall keep that information confidential and shall not use or disclose that information without the permission of the disclosing party. Agreements such as an NDA allow inventors to share details concerning their ideas or inventions without fear that valuable IP rights therein will be taken.

Crowdfunding on platforms such as RocketHub, Indiegogo, and others offer inventors and project creators the ability to quickly and efficiently promote their project to a variety of potential funding sources. Crowdfunding sites can also be used as initial indicators of whether a project is worth pursuing before substantial investments are made to further develop the project. For example, strong financial support will tend to let you know that your idea may do well once it is completed.

While there are significant efficiencies gained through such promotion, lost are the traditional protections offered by an NDA. Indeed, it would be logistically difficult, if not impossible, to require all potential project backers to sign an NDA before viewing a project. It would be even more difficult to enforce any breaches of the NDA. Put simply, what modern crowdfunding platforms make up for in efficiencies, they lack in confidentiality protections—and IP loss is the resulting risk.

Not all projects are the same. The publication of some projects could result in the loss of significant IP rights; however, other project postings carry little risk that IP rights will be lost. Thus, it is important for all users and potential users of online crowdfunding platforms to have a working knowledge of the basic types of IP, risk of disclosures, and the means to protect IP rights.

IP protection is an important practice that the United States and other countries recognize and enforce. Such protection incentivizes the public to continue to create new ideas while providing peace of mind that the time, energy, and money invested in creating the new idea will not be wasted if the idea is truly protectable and the creator is indeed the true originator. Without this structure, intentional theft of IP would run rampant, and innovation would be stagnant as innovators would be less inclined to spend resources developing new technology that could be copied immediately.

Patents: Protecting Ideas

New ideas are formed every minute of every day by people across the world. These ideas are the backbone of the progression of technological advances that we have seen over time and will continue to see in the future. Some ideas may be in the form of an electronic or mechanical device, or some “handy-dandy” gadget that you may see on an infomercial. Others may be computer software–related advances that you may not see or physically touch, but that enhance the speed and efficiency of the products and services in our society. In either event, every effort should be taken to protect these concepts before they, or information about them, are submitted to a crowdfunding web site. The most common means of protecting these ideas is with a patent.

A patent is a legal monopoly given to an inventor for his or her invention. A patent gives an inventor the right to exclude others from making, using, importing, selling, offering to sell, and importing into the United States the subject matter claimed in the patent.¹ A patent is essentially a contract between the inventor and the public, which gives the inventor the right to exclude others from using the invention in exchange for the novel, innovative contribution to society. The protection lasts 20 years from the earliest effective filing date of the patent.²

Patentable subject matter may include a new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof.³ The average person may typically think of an invention as a physical device that they can use in their everyday lives such as a smartphone, the latest trendy piece of exercise equipment, or something that you may find at a Brookstone store. However, the “process” category of patentable subject matter is fairly broad and opens the door to protecting the methods in which tasks are performed. For example, the method in which a search engine delivers relevant search results, the process a smartphone utilizes in executing an application, and the manner in which a global positioning device (GPS) monitors one’s position and provides real-time directions are potentially eligible for patent protection, depending on how such methods are claimed. In today’s computer software–driven world, these processes are an important type of subject matter that is currently patentable that inventors should be made aware of.

1. 35 U.S.C. § 271.

2. 35 U.S.C. § 154(a).

3. 35 U.S.C. § 101.

The Nuts and Bolts of Patents

A patent derives from a patent application that is submitted to the United States Patent and Trademark Office (USPTO) by the inventor(s) and reviewed by a patent examiner.

A patent typically includes the following elements:

- A detailed description that gives the specific details of how to make and use the invention.
- Claims that define the scope of the invention.
- Drawings that help illustrate important aspects of the invention.⁴

It is important to understand that the detailed description may disclose multiple examples of the invention; however, only the embodiments that are *claimed* define the invention.

The type of application that is reviewed by the patent examiner is called a “nonprovisional” patent application, which includes the aforementioned elements of a patent that have yet to be approved by the patent examiner. The goal of the inventor is to show in the nonprovisional application that his or her invention is new, useful, and nonobvious in view of what was known in the art during time the application was filed. If this can be accomplished, the patent examiner should allow the application and issue a patent.

In the examination process, the patent examiner reviews the nonprovisional application and will likely issue an “office action.” The office action details reasons why the examiner believes the applicant is or is not entitled to a patent. Typically, in instances in which the examiner rejects the claims, the examiner does a search to identify prior art that precludes the patentability of the nonprovisional application. This means that the prior art is relatively identical or similar to what the applicant claims is novel and was already in the public domain prior to the filing of the nonprovisional application. After receiving an office action that discloses why the application is not allowed, the inventor has the opportunity to amend his or her patent claims to get around the prior art, or the inventor can simply traverse the rejections by arguing why he or she believes the examiner’s position is incorrect. There can be additional office actions issued by the patent examiner and subsequent responses filed by the inventor until the patent examiner eventually allows the nonprovisional application and a patent is issued. Alternatively, the inventor may abandon his or her application after

4. 37 C.F.R. § 1.53(b).

failing to convince the patent examiner that the application is deserving of a patent.

Crowdfunding Risks and the Provisional Patent Application

Patent protection is particularly critical to the crowdfunding domain. Once an inventor discloses his or her invention to the public, U.S. patent law gives the inventor up to one year to file a patent application on the invention before losing the right to obtain a patent to the invention.⁵ Fundamentally, the inventor's own public disclosure of the invention will become "prior art" under U.S. patent law, which the patent examiner can use against the inventor to reject the claims of the nonprovisional application. Thus, if an individual uploads his or her invention to a crowdfunding web site, he or she will have one year to file a patent application for the invention or will be forever barred from receiving patent protection for the invention.

One mechanism that inventors can use to guard against this time bar is to file a "provisional" application. Provisional applications are less formal and are generally less expensive to file than nonprovisional applications, as they are not examined by the patent examiner. An inventor has one year to file a nonprovisional application after filing the provisional application.⁶ The advantage to a provisional application is that the inventor can use the filing date of the provisional application as the presumed date of his or her invention even though the non-provisional is filed at a later date.⁷ Thus, public disclosures of similar technology that are made after the filing date of the provisional but before the filing date of the nonprovisional cannot be used to preclude the patentability of the invention.

The provisional application gives the inventor the ability to disclose his or her invention on a crowdfunding site while having some form of protection against copying by others up to a one-year period. During this time, the inventor can determine if his or her invention will be well received by the public before investing the resources to file a nonprovisional patent application. As with a nonprovisional application, it is good practice to file the provisional application prior to disclosing the invention to the public.

5. 35 U.S.C. § 102(b).

6. 35 U.S.C. § 119(e).

7. 35 U.S.C. § 119(e).

The America Invents Act

Recent changes to the U.S. patent law have further enhanced the need for crowdfunding participants to protect their ideas before disclosing them on such web sites. These changes were enacted into law on September 16, 2011, through the America Invents Act (AIA). The AIA changed the U.S. patent system from a “first-to-invent” system to a “first-to-file” system, which is in line with how the majority of other countries operate. In the previous system, in situations where two parties claimed to be the first to invent the same claimed subject matter, a patent would be awarded to the party that could provide evidence showing that it was the first inventor. Essentially, the party that had evidence to establish the earliest date it conceived of the claimed subject matter would be awarded the patent. This date of conception could even predate the filing date of the patent application. However, under the new first-to-file system, a patent may be awarded to the party that simply filed its patent application before another, regardless of who was the first to actually conceive of the claimed subject matter.

This “race to the patent office” is a material new change to the U.S. patent laws, with significant implications to the crowdfunding space. Thus, it is imperative that users of crowdfunding web sites seek patent protection for their inventions prior to disclosing them to the public in view of the new first-to-file system. Otherwise, a member of the public could potentially prevent the true inventor from obtaining protection for his or her invention. For example, imagine a scenario in which an inventor is seeking funds to help manufacture her invention through use of a crowdfunding site. If she presents the idea to the public without patent protection, a member of the public could potentially steal her idea and file a patent application on the technology before the true inventor does. The thief’s patent application would have priority over a subsequently filed application from the true inventor under the first-to-file system even though the thief did not “invent” the claimed subject matter.

The only recourse the true inventor would have would be to try and prove the member of the public stole her idea, which may be very difficult to prove. The difficulty arises in that the true inventor would have to first become aware of the patent. There are millions of patents that are currently enforceable. Thus, the likelihood the true inventor would even be aware of the patent is low. Most important, the true inventor would have to provide credible evidence of the theft. This may be hard to prove when the invention was exposed to a significant number of people on a crowdfunding platform. The cost associated with such an investigation could easily go beyond what

the average person could afford to spend. Thus, to guard against this unfortunate situation, an inventor should seek patent protection before disclosing his or her invention to the public on a crowdfunding web site.

One would be well advised to consult with an intellectual property attorney and likely file a provisional application before any public disclosures are made on crowdfunding platforms. While there are additional costs in doing so, the benefits far outweigh the risks. Securing early protection for an invention is critical to maintaining valuable IP rights.

Copyright: Protection of Creative Works

A patent does not protect all types of ingenuity. Think about the creative works of writers, photographers, and composers. Artistic works, however, do not comprise a “process, machine, manufacture, or composition of matter”—the subject of patent protection. Stated differently, patents protect ideas, whereas copyrights protect creative works.

The United States, of course, has recognized the need to incentivize the efforts of artists to continue to generate works of art that the public has grown to appreciate. Accordingly, writers, photographers, composers, and the like are able to seek protection of their works in the form a copyright. A copyright covers original works of authorship. Examples of works of authorship that can be copyrighted include musical works, literary works, motion pictures, architectural works, sculptural works, and choreographic works.⁸ A copyright provides its owner the exclusive right to:⁹

- Reproduce the work.
- Perform or distribute copies of the work to the public.
- Create derivative works of the copyrighted work.

The basic protection of a copyright lasts the life of the author plus an additional 70 years.¹⁰

Unlike patents, copyrights protect the expression of the idea and not the idea itself. Accordingly, once the artist reveals his or her work to the public,

8. 17 U.S.C. § 102.

9. 17 U.S.C. § 106.

10. 17 U.S.C. § 302.

he or she may only prevent others from copying the form in which the work is displayed. A copyright does not protect against works of common or public information, and does not protect against works that are not fixed in a tangible medium.¹¹

Copyright protection begins automatically upon creation of the work. Thus, no formalities, such as registration or publication, are required to receive protection as with a patent.¹² However, there are certain benefits that come with having a federally registered copyright. Such advantages include:

- Creating a public record of the claim of copyright.
- Establishing a necessary requirement before filing a copyright infringement suit.
- Establishing a *pima facie* case of validity of the copyright.
- Increasing the available remedies in an infringement case such as the recovery of statutory damages and/or attorney fees.

Crowdfunding Risks with Copyrightable Material

The benefits of federal registration should be considered by every artist before they uploading their work to a crowdfunding web site—despite the built in protections for artistic works. For example, a member of the public could certainly steal a work of art that is uploaded to a crowdfunding web site and use the work of art without the artist's permission. The artist could bring suit against an alleged thief to prevent further use of the work and to collect damages only if his or her work is federally registered.

In another example, imagine a situation in which two artists are claiming to be the true originator of the same work of art. If one artist has a federal registration over the work and the other doesn't, the artist with the registration will be presumed to be the true owner of the work in the eyes of the law even in situations in which he or she is not. The presumption of validity that is attached to a federally registered copyright also comes in handy when asserting a copyright infringement suit. An alleged infringer (defendant) in these suits may attempt to argue the copyright is "invalid" and was mistakenly granted by the Copyright Office for various reasons; however, because the copyright is presumed to be valid, the alleged infringer has an uphill battle to establish that the Copyright Office erroneously issued the copyright. The

11. 17 U.S.C. §§ 102, 108.

12. 17 U.S.C. § 408.

law assumes the Copyright Office, just like the USPTO, did a thorough and complete job in investigating the validity and worthiness of copyright before issuing such exclusive rights to an artist. An accused infringer will likely have to present clear and convincing evidence to suggest otherwise, which can be a tough burden to meet.

Even under circumstances in which an artist has not obtained a federal registration for their creative work, one good practice is to at least place the public on notice of the owner's rights to the work by using the "©" symbol, the word "Copyright," or the abbreviation "Copr." with the work. Typically, this is done by using the copyright symbol, word, or abbreviation, followed by the year of first publication, and then followed by the name of the owner of the copyright.

Trademark: Designations of Source or Origin

A trademark is a property right that protects words, phrases, symbols, sounds, scents, or colors used to identify the source of a good or service.¹³ The word *Google* used for an online search engine, the phrase "Just Do It" used by Nike, and the chimes and the peacock symbol used by NBC are all examples of trademarks. A trademark can represent a company's identity and reputation, as the public will tend to associate the mark with the source of goods. There is no limit for protection of a trademark as long as the mark is in use and renewal applications are timely filed and granted.¹⁴

Trademark rights arise from the use of the mark. Thus, there is no requirement to register a mark with the federal or state government in order to receive trademark protection. However, as with copyrights, there are certain benefits to having a trademark registered with the USPTO. Such benefits include:

- Providing prima facie evidence of the validity and ownership of the mark.¹⁵
- Providing constructive notice regarding the ownership of the mark.
- Extending rights throughout the entire United States instead of only the local area in which the mark is actually used.

13. 15 U.S.C. § 1121.

14. 15 U.S.C. § 1059.

15. 15 U.S.C. § 1115.

- Allowing others to find the mark in a search so they know the mark is already in use.
- Allowing the mark to become eligible to be incontestable after five years of exclusive use.¹⁶

Crowdfunding Risks with Trademarks

Trademark rights are based on use. After all, a trademark is intended to denote source or origin. And, the public will not likely relate a mark to a particular source unless that mark is in use. The real risk of designation loss on a crowdfunding website comes in the scenario where a project creator is promoting a particular product or a branding or marketing strategy for that product that has not yet been implemented. For example, consider the entrepreneur who is seeking funding for a new project with a catchy, stylized and unique designation. If the entrepreneur had not sold, manufactured, or marketed any product or service featuring the new designation, it is arguable that she has not yet made “trademark” use of her catchy new designation. And, given that trademark rights are based on use, she has not yet likely established any rights in that brand. Thus, she runs the risk that someone else sees the branding and actually uses the mark before her, thus establishing a priority of rights in the trademark. Filing a trademark application prior to seeking funding, even if it is based on one’s “intent to use” the trademark, will help to protect the potential loss in the example above.

Preliminary trademark evaluation is also a smart business decision defensively. For example, a project creator that uses the trademark of another in connection with a project or product promotion might find herself as a defendant in a trademark infringement lawsuit—particularly if the project or product becomes a commercial success. Conducting a trademark search is always a good practice in general, but in particular before use on a crowdfunding platform. A search will help identify whether there are other marks in use that are close to or identical to the trademark you selected. Searches can help guard against the unfortunate event of having to change the mark due to another’s prior use of it after considerable resources have been spent associating the mark with the particular goods or service—and also avoid litigation. A search can include federal and state trademark records, business names, product names, and domain names. Once one is relatively confident there have been no other uses of the mark, the mark owner can put a “TM” superscripted on the mark everywhere it is used to put the public on notice

16. 15 U.S.C. § 1065.

that the owner is using the mark as a brand. A mark owner can only use the “®” symbol on the mark after the USPTO grants the registration.

Trade Secret Protection

The aforementioned types of IP—patents, copyrights, and trademarks—are each given to creators and innovators based on their upfront disclosure to the public of the subject matter that entitles them to receive protection. With a patent, an inventor must explicitly disclose to the public the details of how to make and use the invention in exchange for the exclusive right to exclude others. Creators of copyrights and trademarks inherently disclose the protected works for the public’s enjoyment and to identify the source of a good or service, respectively.

However, there are certain aspects of a company’s business that it may not want to disclose to the public or, more important, to its competitors. A company, entity, or individual may decide to retain certain business practices for itself, without disclosing them, in order to maintain an advantage over its competition. Such confidential information may be related to, for example, the ingredients of a sauce or beverage, or the formula of a cleaning product. In any case, the protection of such information is generally referred to as a trade secret.

A trade secret relates to information that companies keep secret, which may help give them an advantage over their competitors. The majority of the states in the United States follow the Uniform Trade Secrets Act (UTSA) when determining whether information is a trade secret. The UTSA states that information can be a trade secret if¹⁷:

- The information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and
- Reasonable measures have been taken to maintain its secrecy.

An example of a trade secret is Coca-Cola’s secret soda formula. There is no limit for protection of a trade secret as long as the company takes adequate measures to ensure its secrecy.

17. U.T.S.A. § 1 and Comments.

Trade secrets do not have the exclusive effect as patents. As such, a trade secret owner cannot exclude others from utilizing a trade secret once it has been disclosed to the public. A trade secret provides the owner recourse against someone only for misappropriating, stealing, or improperly disclosing the secret. However, the owner of a trade secret has no recourse against someone who either independently discovers information subject to the trade secret, or reverse engineers a work to discover information subject to a trade secret.¹⁸ Thus, if someone independently takes your “secret sauce,” analyzes it to discover its ingredients, and then recreates it based on such analysis, the trade secret owner can do nothing to prevent the reverse-engineer from using the trade secret or informing others of the trade secret.

Crowdfunding Risks with Trade Secrets

Under no circumstance should a trade secret owner disclose the trade secret to the public via a crowdfunding web site, as the rights to a trade secret generally terminate upon its public disclosure, even through accidental, unintentional, or even intentional public disclosures.¹⁹ The inability to share a trade secret on a crowdfunding web site should not present any challenges to trade secret owners, as they should be able to provide a wealth of other information about their work without having to disclose the trade secret.

There are, however, exceptions to the public disclosure rule. Disclosure of a trade secret to a person under a confidentiality agreement will not render the trade secret part of the public domain. However, a public disclosure of the trade secret by someone obligated to maintain its secrecy under a confidentiality agreement will still terminate its owner’s rights to the trade secret. Thus, it is highly suggested that one share trade secrets only with individuals he or she can truly trust. The disclosure of a trade secret to employees of the trade secret holder also does not automatically render the trade secret as part of the public domain; but, again, an employee’s public disclosure of the trade secret outside of the company may potentially extinguish the rights to the trade secret.

In short, the most important aspect of establishing trade secret rights is determining what you want to claim as a trade secret according to the classification standards under the UTSA. More specifically, an assessment must be made as to whether the information derives independent economic value and provides advantage over the competition by it not being readily ascertainable

18. Comments to U.T.S.A. § 1.

19. Comments to U.T.S.A. § 2.

by others. Once that determination is made, the rest is simple: maintain the secrecy of the information, and most certainly do not upload such information to a crowdfunding web site.

IP Portfolio Management: A Best Practice

Whether you are a first-time crowdfunding participant or a sophisticated entity using crowdfunding to test interest in a product or idea, it is critically important to be aware of the various intellectual property rights that are at issue in a given project and to understand the pros and cons of using those IP assets in an online crowdfunding campaign. Indeed, some projects involve multiple types of IP.

The development of an IP portfolio is an important step in identifying all possible IP assets and what steps have been taken to protect those assets. If your project or product becomes a commercial success, and even if not, the work building this type of schedule could prove financially rewarding should you try to sell your concept—or, better yet, sell your company—someday.

And particularly in the patent space, the successful development and management of one's patent portfolio is critical to the success of emerging companies and technologies. Consider taking meaningful steps to develop a formal program geared to the development of a strong patent portfolio. Such steps include:

- Identifying key developments early.
- Actively utilizing patent protection to safeguard the developments.
- Developing products/services strategically to minimize infringement issues regarding third-party patents.

Taking these measures demonstrates business savvy and legal sophistication to investors and competitors.

As this chapter illustrates, IP rights come in various forms and carry different risks based on the unprotected disclosure on crowdfunding platforms. It is critically important to have a basic understanding of IP rights and protections before moving forward with an online crowdfunding campaign.

CHAPTER 7

Understanding Your Investor Options

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Extending the crowdfunding model to investors that expect a financial return is a significant departure from the perk-based model of crowdfunding, where contributors only expect the campaigner to deliver the promised perk. The relationship between an investor and a business is a long-term proposition where investors will have an impact on the future operations of the business.

Under the perk-based model, it is possible for online users to contribute to risky ventures with material uncertainty as to whether the business will be able to deliver the perk. Expanding crowdfunding to investment is an even higher stakes and riskier proposition than perk-based crowdfunding in large part because investors will expect more than just the delivery of a perk; they will expect a future financial return. In addition to these increased expectations, there is the inherently risky nature of investing in early-stage and small private businesses since they often provide fewer disclosures and historical information to investors compared to more mature and/or public companies. As a result, investment crowdfunding requires greater regulatory oversight to protect investors.

When policy makers in Washington got behind the crowdfunding provisions of the JOBS Act of 2012, they were motivated to provide access to capital for small businesses while protecting investors. Regulators want investors to have adequate disclosures and safe platforms free from fraud such that they can properly assess investment opportunities. Making certain investors

earn a return on their investments via crowdfunding is *not* an objective of regulators. Investors will still be able to lose money the old-fashioned way—by making bad investment decisions on perfectly legitimate businesses with adequate disclosures. Businesses that plan to utilize investment crowdfunding should undertake the endeavor with full understanding that they will have to manage investors' expectations carefully, as the relationship between the business and investors will be strained if the investors do not get their expected returns.

This chapter explores key considerations a business should weigh before deciding to bring on investors via crowdfunding.

The Decision to Bring on Investors

The decision to seek third-party capital from outside investors is an important step in the evolution of a company, as it will have a significant impact on the business' future success. Entrepreneurs should carefully consider the cost and benefits of having investors.

A business generally should bring on investors when (1) it can no longer achieve its goals through the owners' funding the business themselves, (2) it does not generate sufficient cash to fund growth, (3) it is not well suited for perk-based crowdfunding, or (4) it is looking for a sizeable fundraise beyond the typical perk-based crowdfunding campaign.¹ Bringing on investors has certain advantages in that the right investors can provide growth capital, experience and skills to help grow a business. Typical projects for which businesses tend to seek outside investors include:

- Purchasing new equipment or facilities.
- Developing or launching new products or services.
- Paying down high-interest debt.
- Undertaking a major marketing initiative.
- Accessing new customers or markets.

Benefits

There are many positive aspects to having outside investors in your business. They can be champions for your business, helping it to succeed. Moreover,

1. According to a recent Massolution study, the average campaign sizes globally in 2012 were \$2,300 for perks, \$4,300 for debt, and \$190,000 for equity. *2013CF: The Crowdfunding Industry Report at 34*: <http://www.crowdsourcing.org/research>.

investors often have a broad network of contacts that can be helpful to your business. In the particular case of crowdfunding, where a business may have a larger number of investors than those businesses that simply raise institutional money, a crowdfunded business will have a group of evangelists that will be active in promoting the business in which they have invested. This can be immensely helpful to an early-stage business that is still trying to establish itself in the marketplace. Certain other benefits for bringing on investors include:

- In the event the business is issuing debt, the interest expense is tax deductible.
- Outside investors usually do not require control over the day-to-day operations of the business.
- If a business is raising equity capital and it is not preferred equity with dividend payments, then the business does not have to pay back investors until there is a liquidity event (e.g., merger, acquisition, initial public offering, etc.).
- Having equity holders can make it easier to borrow additional funds because the perceived lender risk is lower, as they have an equity cushion below them in the capital structure since debt holders are senior to equity holders in the capital structure of a business, meaning debt holders get paid before equity holders in the event of a bankruptcy.

Drawbacks

Despite the numerous benefits for bringing on investors, there are certain drawbacks that entrepreneurs should be aware of before raising capital from investors. A primary drawback is the potential dilution of an entrepreneur's ownership interest in the business. Unlike perk-based crowdfunding, where contributors to a campaign simply get a perk of some kind in exchange for their cash contribution, to the extent a business is raising equity financing, the entrepreneurs will be giving up a portion of the ownership in the business to investors.² Despite this significant drawback, not all businesses are well suited to the perk-based model. To date, ideas and business that have a sufficiently high "coolness factor" (e.g., artistic works, community development-focused initiatives, high-tech gadgets, etc.) have been able to successfully raise funds

2. To the extent a business is issuing debt or revenue-sharing arrangements via crowdfunding, businesses will not be giving a portion of the ownership interest in the business but instead a portion of future cash flows in the form of periodic payments.

via the perk-based model despite a lack of financial gain for the contributors.³ Businesses that do not have a sufficient “coolness factor” or that are looking to raise larger amounts of money will likely want to consider investment crowdfunding, as campaigns that offer a financial return to contributors tend to be considerably larger on average.⁴

Management teams should also be aware of the obligation to manage their communications with numerous shareholders that is a part of any securities crowdfunding offering. Investors will want to be updated periodically on the operations of the business and whenever any significant material event happens with the business (e.g., selling the company, acquisition of a competitor, launching a new business line, etc.). Even with assistance from crowdfunding platforms, this can be a significant undertaking that could distract management teams from the daily operation of the business.

Another key consideration unique to crowdfunding is having numerous investors (potentially hundreds or thousands of people) in the business’s capital structure. To the extent the business may want or need to subsequently raise institutional money to buy out the crowdfunding investors, having to first get approval from so many investors may be unappealing. Some platforms are looking to mitigate this concern by aggregating the crowdfunding investors into a voting trust, where the trustee is the actual and sole record holder of all of the crowdfunding shares, or have all crowdfunding shareholders enter into a shareholder agreement that sets out the terms and conditions under which shareholders agree to vote. An additional option may be to aggregate crowdfunding shareholders into a limited liability company (LLC), but platforms pursuing this approach and other aggregating mechanisms should be leery of being deemed an “investment company” and becoming subject to the regulatory regime of the Investment Company Act of 1940.⁵ Dealing with one entity would be more appealing to institutional investors, as it would make it easier to communicate with the numerous crowdfunding investors.

3. Thaya Brook Knight, Huiwen Leo, and Adrian A. Ohmer, “A Very Quiet Revolution: A Primer on Securities Crowdfunding and Title III of the JOBS Act,” *Michigan Journal of Private Equity & Venture Capital Law*, November 2012: 136.

4. *Supra* note 1.

5. A company (e.g., a corporation, business trust, partnership, or limited liability company) that issues securities and is primarily engaged in the business of investing in securities is considered an “investment company” subject to the Investment Company Act of 1940 unless it has 100 or less investors or each of its investors have a substantial amount of investment assets. See www.sec.gov/answers/mfinvco.htm.

General Obligations to Investors

Taking on investors results in certain responsibilities that all business owners should be aware of before making their decision. Entrepreneurs should always remember that the relationship with investors could last years with a requirement for periodic updates on the status of the business's operations. Moreover, the regulatory obligations that are imposed upon taking on investors are significant.

When investing in debt, most investors will be focused on getting cash yield with some potential for appreciation to the extent there is a market to trade the debt instruments. As the risk associated with the security being offered increases (from debt to hybrid instruments that combine debt and equity features to pure equity), investors expect to be compensated by a higher return on investment for the additional risk. Additionally, investors will want to keep closer tabs on how their money is being used and will expect to be updated regularly on the progress of the business. Under Title III of the JOBS Act, there is a requirement for businesses that have raised funds via crowdfunding to provide the SEC and investors reports on its financials and the results of operations.⁶ Satisfying this requirement and dealing with investor expectations are significant obligations that entrepreneurs should weigh carefully.

Regulatory Obligations

There are material risks involved with investing in small businesses given that (1) these investments are generally illiquid since the resell market for these securities is limited, and (2) approximately 66 percent of new businesses either fail or cease to exist within 10 years of formation.⁷ Unlike sizeable publicly traded companies that have large amounts of information readily available and research analyst coverage, small private businesses occupy a more opaque portion of the investment ecosystem. Thus, there tends to be more losses that occur due to fraud and self-dealing, exposing investors to disproportionate risk.⁸

6. The new Section 4A(b)(4) of the Securities Act of 1933 as provided under the JOBS Act Title III, requires an issuer at least annually to file with the SEC and provide to investors reports on of the results of operations and financial statements of the issuer. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012), Section 302(b).

7. Small Business Administration, Office of Advocacy. www.sba.gov/sites/default/files/sbfaq.pdf.

8. See Jill E. Fisch, "Can Internet Offerings Bridge the Small Business Capital Barrier?" *Journal of Small & Emerging Business Law*, 1998: 58. See also William K. Sjostrom Jr., "Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings." *Florida State Law Review*, 32(1), 2004: 42.

The instances often referenced by regulators with respect to the potential pitfalls of direct marketing of securities to retail investors are (1) the abuses in the penny stock market in the 1980s and (2) the “pump-and-dump” fraud schemes resulting from the 1992 amendments liberalizing Rule 504 of the Securities Act of 1933 for small offerings.⁹ As a result, regulators are focused on protecting retail investors and have imposed a number of obligations on platforms and issuers involved with investment crowdfunding.

Although the crowdfunding exemption for accredited investors under Title II of the JOBS Act is not overly burdensome, the crowdfunding exemption under Title III of the JOBS Act for offerings that include nonaccredited investors will have significant regulatory obligations once the SEC finishes its rulemaking and it becomes effective.¹⁰ Additional SEC rules will come on top of the investor protections already written into Title III of the JOBS Act, which include, among others:

- Issuers can raise no more than \$1 million in a given year.
- An issuer’s financials must be reviewed by an independent public accountant if raising between \$100,000 and \$500,000 and must be audited if raising more than \$500,000 (the SEC has to issue rules detailing the requirements of the audit).
- Issuers are required to disclose annually to the SEC and investors their business operations and financials.

9. During the 1980s, there was significant penny stock fraud where companies that were not backed by any assets, earnings, or employees began changing hands as investors were promised significant returns. Although a few of these stocks did yield returns, most of them were completely fraudulent, with the company disappearing upon completion of the IPO. Separately, through revisions of Rule 504 of the Securities Act of 1933 in 1992, the SEC removed the \$500,000 cap on sales of securities in states that do not require registration and removed the general solicitation and resale restrictions as a part of the SEC’s small business initiatives. See Small Business Initiatives, Securities Act Release No. 6924, 57 Fed. Reg. 9768 (proposed Mar. 20, 1992); Securities Act Release No. 6949, 57 Fed. Reg. 36,442. Pursuant to this revised Rule 504, “pump-and-dump” schemes proliferated whereby issuers of securities were making prearranged sales of securities to investors in states that did not have registration or disclosure requirements. In connection with this effort, dishonest broker-dealers would undertake a cold-calling effort to “pump” the price of the securities by creating an appearance of significant demand for the securities and then selling them to unwitting investors at escalating prices. Once all these shares were sold or “dumped,” the artificial market demand and price of the securities would collapse, causing significant losses to investors. The pre-1992 Rule 504 was restored in 1999. See Revision of Rule 504 of Regulation D, the “Seed Capital” Exemption, Securities Act Release No. 7655, 64 Fed. Reg. 11,090 (Mar. 8, 1999).

10. The SEC rules for Title II of the JOBS Act became effective on September 23, 2013, and the proposed rules for Title III of the JOBS Act were released on October 23, 2013.

These obligations are significant and businesses should fully consider them before undertaking to raise funds through crowdfunding.

Nonaccredited versus Accredited Investors

The SEC historically has been particularly concerned about the protection of nonaccredited investors, assuming they tend to be less sophisticated than accredited investors. As a result, the restrictions and disclosure requirements related to offerings to non-accredited investors tend to be more onerous, which will be the case with crowdfunding offerings that can include nonaccredited investors under Title III of the JOBS Act once it is implemented. Management teams should factor this into their analysis as they consider the type of offering they are undertaking. Given the potentially broader marketing reach of a Title III crowdfunding offering once it becomes available relative to a Title II accredited investor only offering, there may be valid reasons to take on the more onerous Title III obligations. However, the relatively modest Title III investor investment caps included in the JOBS Act might mean a significant number of investors may be necessary to raise sufficient funds, and any business will have to effectively manage this large number of shareholders.¹¹

With respect to accredited investors, issuers and platforms should continue to monitor SEC rulemaking around the definition. Other than Dodd-Frank legislation amending the definition of accredited investor such that a person's primary residence cannot be included in the \$1 million net worth calculation, the definition of who is an accredited investor has remained unchanged over the past few decades.¹² According to a 2007 SEC release, if the thresholds were adjusted for inflation as of July 2006, the \$200,000 individual income and \$300,000 joint income tests would be increased to approximately \$388,000 and \$582,000, respectively, and the \$1 million individual net worth test would be increased to approximately \$1.9 million.¹³ Given that the definition of accredited investor has not been adjusted for inflation, it likely includes a significant number of investors that

11. Individual investors under a Title III offering have the following annual aggregate caps: (i) if an investor's annual income or net worth is less than \$100,000, the cap is the *greater of* \$2,000 or 5 percent of income or net worth; and (ii) if an investor's annual income or net worth is equal to or greater than \$100,000, the cap is 10 percent of annual income or net worth, not to exceed \$100,000. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012), Section 302(a).

12. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), Title IV, Section 413(a).

13. SEC Release No. 8828, August 3, 2007.

are not sophisticated in investment matters, a fact that has not been lost on regulators. It should be noted that in accordance with the Dodd-Frank Act, starting in 2014 and every four years thereafter, the SEC is required to review the accredited investor definition in its entirety and to amend the definition as it deems necessary.¹⁴ Thus, platforms and businesses planning to rely on Title II accredited investor crowdfunding should be mindful that the definition may change in the coming years, potentially impacting the scope of Title II investors.

Title II crowdfunding can be utilized only if all of the investors are accredited. The advantage of Title II crowdfunding is that there is no limit on the size of the offering that can be made, and the restrictions and disclosure requirements are significantly less than what has been required for offerings to investors under Title III of the JOBS Act. As a result, the regulatory burden on a business undertaking an offering to accredited investors (and maintaining ongoing disclosures to such investors) is not as significant as it will be when nonaccredited investors are involved.

In addition to the aforementioned obligations, businesses will also have exposure to significant liability. Under Title III of the JOBS Act, the legislation allows for a cause of action under the new Section 4A(c) of the Securities Act of 1933 that is specific to crowdfunding offerings, imposing liability on the issuer for a material misstatement or omission of a required disclosure. There is no intent/knowledge requirement for the issuer of the securities to be held responsible. The new 4A(c) liability is in addition to the general anti-fraud provisions of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, all of which would apply to a crowdfunding offering.¹⁵ A business would be wise to seek legal counsel before undertaking a securities crowdfunding offering in order to best protect itself from potential liability.

Investor Education Obligations

Before a business decides whether to reach out to retail investors via crowdfunding, it should consider the potential knowledge base of the investors since the less an individual understands about investing, the more likely they will not fully appreciate the risks associated therewith (and thus potentially have unrealistic performance expectations). Research has shown

14. SEC Release Nos. 33-9287; IA-3341; IC-29891; File No. S7-04-11, February 27, 2012.

15. Michael L. Zuppone, "Demystifying the Recently Enacted Crowdfunding and Private Offering Reforms: Opportunities for Issuers and Investors," April 2012. www.paulhastings.com/publications-items/details/?id=11BF2A26-8AA5-6986-8B86-FF00008CFFC3.

that many Americans have a gap in their knowledge of financial matters. In a 2009 survey of American adults, respondents answered an average of only 2.72 out of 5 financial literacy questions correctly, with 48 percent of those respondents not knowing that investing in a mutual fund generally provides a safer return than investing in a single stock.¹⁶ In a 2001 survey of American adults, only 52 percent of the respondents knew that mutual funds do not pay a guaranteed rate of return; and only 56 percent knew that, over the long term, stocks offer the highest rate of return.¹⁷

Under Title III offerings of the JOBS Act, platforms are required to provide information about the risks of investing in small businesses and to provide investor education materials.¹⁸ Businesses undertaking crowdfunding, however, should also be cognizant of the individuals they permit to become investors in their business, allowing only those investors that have an appreciation for the risks associated with investing and harbor realistic expectations for the business and its potential for financial returns. When investors have unrealistic performance expectations, it can cause problems for businesses down the road after funds are raised. It may be prudent for management teams to utilize crowdfunding platforms that properly educate and screen investors and that allow management teams to decide the individuals they want to include as investors in their business.

Additionally, in order to foster knowledge sharing and to help investors formulate a realistic expectation of the performance of an early-stage business, crowdfunding intermediaries can include an electronic bulletin board that allows potential investors and other members of the public to communicate about each offering.¹⁹ An earlier version of the House crowdfunding bill included this bulletin board requirement, but ultimately it was not included in Title III of the JOBS Act.²⁰ However, the SEC's broad authority under

16. Applied Research & Consulting LLC, "Financial Capability in the United States: Initial Report of Research Findings from the 2009 National Survey, December 1, 2009: 40–41. www.finrafoundation.org/web/groups/foundation/@foundation/documents/foundation/p120536.pdf.

17. Marianne A. Hilgert, Jeanne M. Hogarth, and Sondra G. Beverly, "Household Financial Management: The Connection between Knowledge and Behavior." *Federal Reserve Bulletin* 313, July 2003.

18. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012), Section 302(b).

19. Testimony of C. Steven Bradford before the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs, United States House of Representatives; Hearing on the JOBS Act—Importance of Effective Implementation, June 26, 2012.

20. See Entrepreneur Access to Capital Act, H.R. 2930, § 2(b), 112th Congress (as passed by House, November 3, 2011) (proposed sections 4A(a)(12) and 4A(b)(11) of the Securities Act).

the JOBS Act to write additional rules “for the protection of investors and in the public interest” has allowed the SEC to contemplate a bulletin board requirement for funding portals under Title III.²¹ Even if rules are not written to require open forums, businesses may be well served to seek platforms that enable this sort of open communication, as it could potentially mitigate some of the headaches businesses face when investors are not properly educated. Allowing the public to share knowledge about particular entrepreneurs, businesses, or investment risks through open communication channels can help protect investors from both fraud and poor investment decisions.²² Additionally, openness of this sort would allow users of crowdfunding platforms to take advantage of “the wisdom of crowds,” which, according to journalist James Surowiecki, is the idea that “even if most of the people within a group are not especially well-informed or rational, [the group] can still reach a collectively wise decision.”²³

Maximizing Investor Participation

Before moving forward with an investment crowdfunding campaign, entrepreneurs should take the time to understand the motivations of the individuals that will be potential crowdfunding investors in their business. For many of these investors, the decision to invest will not be strictly based on potential financial return.

Funders participating in perk-based crowdfunding sites historically have tended to not look at the contribution as simply a transactional experience, but as more of a “social and relationship-based” experience.²⁴ As Indiegogo

21. Supra note 18, See also Release Nos. 33-9470; 34-70741; File No. 57-09-13.

22. See C. Steven Bradford, “Crowdfunding and the Federal Securities Laws,” *Columbus. L. Rev.*, 2012: 134–136.

23. James Surowiecki, *The Wisdom of Crowds: Why the Many Are Smarter than the Few and How Collective Wisdom Shapes Business, Economies, Societies, and Nations* (New York: Anchor, 2004). The diverse knowledge of an individual can accrue to the benefit of the entire crowd. For example, in the wake of the BP oil spill, a tattoo removal expert from Las Vegas was able to become one of 10 finalists (from about 350 applicants) for the 2010 X Prize Foundation’s Wendy Schmidt Oil Cleanup X Challenge dedicated to higher efficiency cleanup of oil spills than the current industry standard. www.fastcompany.com/1812665/fast-talk-how-tattoo-artist-became-tech-entrepreneur.

24. Statement of Danae Ringelmann, Congressional Hearing: “Innovation and Micro Financing,” Committee on Small Business Subcommittee on Investigations, Oversight and Regulations, June 5, 2013.

founder Danae Ringelmann stated to members of Congress, “[w]hen people fund what matters to them, they’re not just buying bread or activity trackers in advance, they’re creating their own reality around them . . . often times for as little as the price of a cup of coffee. As a result, they’re more engaged and empowered.”²⁵ As a result of these intrinsic social/relationship-based factors, over \$1 billion was raised in 2012 from people that have no expectation or desire for financial return.²⁶ Research by Indiegogo, one of the first and largest perk-based crowdfunding platforms, has suggested that people fund campaigns for four reasons:

1. People—they like the person or team running the campaign.
2. Passion—they are passionate about the idea or project.
3. Participation—they want to be part of something bigger than themselves.
4. Perks—they want the perk.²⁷

The first three elements (people, passion, and participation) have been detected in investment crowdfunding campaigns globally and will likely be present to some degree for many investors involved in U.S. investment crowdfunding.²⁸ Thus, businesses undertaking investment crowdfunding, particularly businesses with social impact, should factor these potential investor considerations as they develop their crowdfunding campaign.

Another important element of crowdfunding is the appeal it will have for the investors that live in the same community as the business seeking funding.²⁹ It is likely that investors on crowdfunding platforms will benefit from local vetting of deals, with investors in the area of the business being able to assist in the diligence of the business and management team. Moreover, if there is a critical mass of local investors initially involved in a crowdfunding campaign, it can serve as a signal of trust and quality for nonlocal investors.³⁰ Additionally, the advantage of having local investors is it helps mitigate any potential adverse selection problems (e.g., only second-rate businesses utilize

25. Ibid.

26. In 2012, \$979.3 million and \$383.3 million were raised for donation-based and perk-based crowdfunding, respectively. Supra note 1, 25.

27. Supra note 24.

28. See the guidelines for crowdfunding success issued by UK equity-based crowdfunding platform, CrowdCube. www.crowdcube.com/blog/2011/01/06/seven-steps-to-crowdfunding-success/.

29. Amy Cortese, *Locavesting: The Revolution in Local Investing and How to Profit from It* (Hoboken, NJ: Wiley, 2011).

30. Supra note 1 at 84.

crowdfunding, while the best companies get funding through more traditional means such as banks and venture capital).

Additionally, there is the benefit that a close bond between a business and its local investors often results in the local investors being evangelists for, and initial customers of, the business. This is significant for a business in its early days since it helps the business to raise its local profile and fosters increased community engagement in the business. Local investors also tend to benefit because businesses will feel a greater obligation to succeed and help the community.

In addition to the importance of leveraging local investors, it is equally important for management teams to leverage their social networks. This notion was supported recently by University of Pennsylvania Professor Ethan Mollick's study of almost 50,000 crowdfunding campaigns on Kickstarter, which found that those campaigners with more than 1,000 Facebook friends tended to have greater success.³¹ It is important that individuals who have strong ties with entrepreneurs invest in the business early in the crowdfunding process, which builds trust and social proof for other investors that have weak or no ties to the entrepreneur. On current perks-based site Indiegogo, campaigns that tend to have the greatest success get the first 30 percent of their funds from people within their network.³² Moreover, the U.K. equity-based platform Seedrs also showed with its data that those businesses that are able to mobilize at least 30 percent of their "network" of investors (e.g., friends, family, and other members of their external network outside of the funding platform) have a significantly better chance of being funded.³³ To slightly offset the need for management teams to have a huge social networking presence prior to undertaking a crowdfunding initiative, businesses should select crowdfunding sites that are true platforms that have active investors and are able to properly connect investors to opportunities of interest.

Capital Spectrum

Before raising funds via crowdfunding, entrepreneurs should understand (1) the varying motivations of investors based on the type of capital in which

31. Ethan R. Mollick, "The Dynamics of Crowdfunding: Determinants of Success and Failure," *Journal of Business Venturing*, June 26, 2013. Available at SSRN: <http://ssrn.com/abstract=2088298> or <http://dx.doi.org/10.2139/ssrn.2088298>.

32. Congressional hearing: "Innovation and Micro Financing," Committee on Small Business, Subcommittee on Investigations, Oversight and Regulations; Statement of Danae Ringelmann, June 5, 2013.

33. See <http://blog.seedrs.com/2013/07/01/in-crowdfunding-momentum-is-king/>.

they are investing and (2) the cost of that capital. The types of capital usually provided via crowdfunding platforms are revenue-sharing arrangements, debt, and equity. Investors in revenue-sharing arrangements and debt tend to focus more on cash yield and are less focused on upside. Since equity holders are taking on greater risk in part because they rarely get any cash yield and have to wait for an infrequent and uncertain liquidity event at some indeterminate point in the future, they have higher return-on-investment expectations. An investor's calculation of cost of capital is largely driven by an assessment of the risk associated with the investment opportunity, which can be partially offset based on the type of capital being provided. Management teams need to assess the range of investor expectations and the potential cost of the capital before they decide whether to pursue a revenue sharing, debt, or equity crowdfunding campaign.

Revenue Sharing

In the context of crowdfunding, revenue sharing agreements are simple contracts in which a business agrees to pay investors a percentage of their gross revenue on a set periodic basis until those investors achieve a predetermined return on investment.³⁴ This means that for every good sold or service provided, investors will get a small percentage of each sale. Once investors achieve the predetermined return on their investment, they will receive no further payouts from the business.³⁵ A revenue-sharing arrangement is not a security instrument and, unlike debt and equity holders, usually would not have any claim on the assets of a business in the event of a bankruptcy. The advantages of entering revenue-sharing agreements with investors are that (1) the entrepreneur does not have to give up any ownership interest in the business, which is the case when equity is issued; and (2) the payments will fluctuate with the revenue the business generates as opposed to the fixed interest payments typically utilized with debt instruments.

Several of the key disadvantages of revenue sharing are that (1) relative to debt, it is higher risk since returns are tied to the revenue generation of the business, which can be unpredictable; and (2) it can be a long-term investment proposition if the business does not have any immediate revenue. These disadvantages tend to make revenue sharing more expensive than debt, resulting in investors requiring a greater return on investment to compensate them for the increased risk (but it still tends to be cheaper than equity, which has more inherent risks).

34. See crowdfunding platform Bolstr: www.bolstr.com/investors.

35. Ibid.

Debt

Debt is a loan from an investor and an obligation to repay the principal of the loan plus interest to the investor. The interest payments occur at fixed intervals over a set time period. Debt is at the top of the capital structure of a business, meaning that in the event a business becomes bankrupt the debt holders will get paid before equity holders and usually before revenue-sharing contract holders. From the perspective of the investor, being at the top of the capital structure decreases the risk of debt instruments relative to equity and revenue sharing, resulting in debt investors generally requiring a lower return hurdle than with equity or revenue sharing. Additionally, equity is riskier since it does not receive fixed periodic cash yield payments like debt, and liquidity for equity holders, as previously noted, usually comes only when a major liquidity event transpires, such as a sale of the company or a recapitalization of the business (e.g., taking on debt to pay off equity holders, selling a minority interest in the business, or accessing the public markets).

There are certain advantages for issuing debt securities. The obligation to satisfy fixed payments can help add discipline to the management team and make it easier to forecast expenses since interest payments usually do not fluctuate. Additionally, as previously noted, debt has the advantage of having its interest payment expense being tax deductible. Finally, debt holders do not get any board representation or voting rights.

Debt also has material potential drawbacks that should be considered. Debt is essentially a gamble on the business's future ability to generate sufficient cash to pay back a loan plus interest. A downturn in the economy or business could make it extremely hard to make debt payments. Moreover, the required periodic interest expense payments for debt instruments can soak up cash from the business, constraining management's ability to allocate its resources to other high-priority items. Also of note is that if a business defaults on a loan, it may have to give up control of day-to-day business operations to the debt holders, depending on the covenants governing the debt arrangement.

Equity

Equity investors expect the highest return on investment since they are at the riskiest part of a business' capital structure—the bottom. In the event of a bankruptcy, equity investors get paid only after all obligations to debt investors are satisfied. Moreover, since equity investors receive cash distributions only at the election of management, the liquidity events are far more

infrequent, if ever, than with debt or revenue sharing. As a result of this higher risk, the cost of capital for equity holders is higher than with revenue sharing or debt instruments.

From the company's perspective, the big advantage with equity is that the investor bears all of the risk. If a business fails, the equity holders are not entitled to any cash payments. After an equity issuance, there is more cash in the business with no fixed cash yield requirement, which allows management to focus on allocating cash to growth initiatives. Equity investors must take a long-term view on the business and understand that building a business takes time.

From the perspective of the business, there are several disadvantages to issuing equity. A primary disadvantage is that it dilutes the management team's ownership interest in the business. Also, equity holders get voting rights in the business and potentially board representation and control over significant decisions for the business depending on their percentage ownership of the business, all of which could allow them to exert some level of control over the business (e.g., over decisions related to executive compensation, sale of the business, acquisition of another business, going public, etc.).

Crowdfunding offers a tremendous opportunity to democratize access to capital for small businesses. Management teams, however, should be deliberate in their assessment of the responsibilities, obligations, and expectations that come along with raising capital from investors. Businesses that are high growth with limited excess cash flow may have to explore equity fundraises. If the business is highly cash generative, issuing debt or a revenue-share arrangement may be a better option, especially since both have a lower cost of capital than equity.

CHAPTER 8

Communicating with Your Investors or “Backers”

Joy Schoffler

Leverage PR

As has been discussed elsewhere in this book, Title II of the Jumpstart Our Business Startups (JOBS) Act has passed, yet Title III—which gives ordinary, nonaccredited investors the ability to invest in private offerings (i.e., equity crowdfunding)—is still in the works. Predictions about when those regulations will go into effect abound, but it could be a while. It took nearly a year from the time the Title II rules were released to the time they were implemented, and in the case of Title II, all the Securities and Exchange Commission (SEC) was doing was lifting a previously imposed ban on general solicitation.

General solicitation and the rules governing a company’s ability to advertise a fundraising transaction can be confusing. To shed some light on this subject I reached out to Doug Ellenoff, who is a partner at the law firm of Ellenoff, Grossman and Schole, and Sara Hanks, chief executive of CrowdCheck.

Doug is a veteran securities attorney and due to his expertise within the emerging crowdfunding industry, he regularly attends meetings with the SEC and Financial Industry Regulatory Authority (FINRA) in order to discuss the proposed rules and implementation issues. He is a board observer to the Crowdfunding Intermediary Regulatory Advocates (CFIRA) and additionally, he represents many portals in the crowdfunding industry.

Doug advises issuers and their advisers to be diligent when facilitating a general solicitation under the SEC's new Rule 506(c), paying particular attention to the "bad actor" provisions of the rule and to the investor verification process.

In order to participate in a 506(c) offering, issuers must ensure that no one involved in the offering has a history of questionable securities conduct, or what's referred to as being a "bad actor." Being considered a bad actor is much broader than just being convicted of a crime or subject to regulatory discipline, so entrepreneurs are encouraged to consult their lawyers to find out if they are ineligible to conduct a general solicitation under Rule 506(c). According to Doug, the other focus of securities regulators will be whether the participating investors have been properly and thoroughly verified by the entrepreneurs as accredited. Title II specifically requires that entrepreneurs take reasonable steps to verify whether investors are accredited under the rules. Keep in mind that the standards may change and entrepreneurs are well advised to stay updated. Failure to take approved reasonable steps can result in the financing's being invalidated and the exempt status of the offering subject to being challenged.

In addition to being chief executive of CrowdCheck, a firm managing the due diligence process within the crowdfunding community, Sara formally served as the chief of the Office of International Corporate Finance at the SEC, where she led the team drafting the regulations that put into place a new generation of rules governing the capital-raising process. Through her position as an observer on the CFIRA board she has been working directly with the SEC on implementation issues.

Sara believes it's critical that issuers follow the "three W's" when communicating with investors.

- *When* can you say something to current or prospective investors? The rules for communications are different when a company is about to make an offer of securities or is about to release important information.
- *What* can you say? Securities fraud is a complex area of law. You might think you are making an optimistic assessment of something about your product or business. The SEC might think you are making an untrue statement of a material fact. The difference between the two amounts to what might be considered fraud. Get professional advice with respect to the content of your company's communications. Make sure to back up what you say.
- *Where* can you disseminate communications? The rules from the SEC determine where companies will be able to communicate with their investors. Some methods of communication (e.g., social media) may be tightly constrained. There may be rules requiring disclosure to be made in some forums and prohibiting it in others. Know those rules.

Under the old regulations, issuers had to have a preexisting and substantial relationship with their investors in order to be exempt from registration of their securities. Rule 506(c) offerings allow all issuers, from startups to private investment funds and their intermediaries, to generally solicit as long as all of the investors in the offering are accredited. While this means that you can use social media, advertising, webinars, and public relations (PR) to market your deal, good marketing practices still apply. And although there has been some buzz in the entrepreneurial media that general solicitation will be a panacea to the startup community’s capital needs, common sense needs to rule here. Someone you do not know is very unlikely to invest with you based on a tweet that you sent out. In the new world of investor relations, it will be important to focus on targeted marketing and PR to let people know that your company is seeking investment. An example of this would be to mention a fundraising while speaking at a conference in front of your target audience or in a media interview. And if you are going to solicit, you must ensure that you and all your staff are critical about your written communication. Even a harmless business development tweet to a high-value target client from your marketing department could cause you to lose your exempt status for purposes of conducting a private placement.

The Issuer’s Dilemma

By the time many issuers get to the point where they start to raise capital, they frequently need the money pretty badly. This need for capital often causes them to be overly optimistic. Broker-dealer Craig Goos of 99 Funding relates issuers to “Tigger” in the children’s book *Winnie the Pooh*. He told me, “They are upbeat about their business and they tend to exaggerate the positives and gloss over the negatives.” Instead, when you are conducting a securities offering, you need to be an “Eeyore” and explain to investors all the ways that the investor could lose their money—in writing!

One more reason to be conservative is the SEC provision that addresses making untrue statements of material fact or omitting to state a material fact. In plain English, this means you are responsible for all of the statements made by you, your officers, directors, financial and accounting staff, or anyone else selling your securities. This is not just for information they know, it is for information they should have reasonably known as well. So make sure that you do not have an eager “Tigger” on your team opening you up to liability. At the end of the day, you are responsible for everything your team does. The amount of money you may raise in your offering could be nothing when compared to the amount you spend on legal fees.

Having personally spent a good deal of time involved in the capital-raising process, it's safe to say that investors respect and value an issuer that clearly articulates the risks of an investment. Nothing will turn off an investor quicker than someone who brushes over the risks of an offering. It is a telltale sign that an investor will be put at risk. Those ignorant of risks up front are often oblivious to them in daily operations as well. The good news is that the JOBS Act mandates that Title III crowdfund investors be educated about the risks and be tested to ensure that they understand the risks involved before they invest. Title III crowdfunding portals are presently developing technologies that will automate this process for the issuer. They include videos that explain investment risk for investors to watch prior to investing as well as tests to be taken after watching the videos.

The Value of Building Your Crowd

The most important item on any prospective fundraiser's list is to start building relationships with new people that could potentially fund them some day. To be clear about it, do not start talking to prospective investors now about a future offering—instead, start building relationships. Let them see how knowledgeable you are in your industry, and let them get to know the strength of your character—a close relationship will get you funded quicker than anything else.

Many people take the “if you build it, they will come” approach to their crowdfunding campaigns. However, as evidenced by June 2012 Kickstarter data, 54 percent of all campaigns fail to meet their minimum funding requirement. The number one reason why is that they fail to build and engage their crowd before the launch of a campaign. In rewards-based crowdfunding, people want to see that a crowdfunder has a strong network of supporters, no matter how much they are contributing. If people's closest friends and family do not believe in them, there is little hope others will. This is even more true in equity-based funding, where investors will be judging both market and execution risk. By showing an investor that your prospective customer base is willing to invest in you, you are going a long way in providing the social proof needed to convince investors that your idea is viable.

There have been a number important studies conducted about the importance of social ties in crowdfunding. Researchers at the University of Arizona and the University of Maryland examined 56,584 loan requests from the lending-based crowdfunding site Prosper.com¹ and found that if a borrower

1. M. Lin, N. R. Prabhala, and S. Viswanathan, “Judging Borrowers by the Company They Keep: Friendship Networks and Information Asymmetry in Online Peer-to-Peer Lending,” 2011.

had one or more friends who were among their lenders, then the likelihood of securing their full loan amount more than doubled. Interestingly, they found that for 95 percent of all the loan requests that included friends and family, only 4.4 percent of the total amount raised was provided by friends. In a related study at the University of Nebraska, it was discovered that social capital was even more critical if the borrower had poor credit. Having friends invest not only increased the likelihood of getting funded but also resulted in better terms.²

Wharton Business School professor Ethan Mollick conducted a similar study on Kickstarter, finding a direct correlation between the number of Facebook friends and the probability of getting funded.³ If a person had 10 friends linked on Facebook, the probability of getting funded was 9 percent; if they had 100 friends, it jumped to 20 percent; if they had 1,000 friends, it jumped to 40 percent. While the number of friends linked to a person's Facebook account may not be equivalent to their actual friends, it does serve as a proxy for the extent of a project owner's network. The moral of the story here is that connections matter—people want to see who else is contributing to your campaign. This will become even more important when equity-based crowdfunding is legalized. Investors will be combing through your network to see if friends and family believe in you enough to invest and if old coworkers and bosses think you have what it takes. Like it or not, this will be used to judge your moral character and work ethic—so you better get comfortable with going to your network, as this is the biggest indicator of success.

Issuers who do not already have a strong network of supporters, customers, or potential investors will be disappointed quickly. On donation- and rewards-based crowdfunding sites, successful campaigns typically raise the initial 25 percent from friends and family. The data are clear—you need to prepare in order to be successful. This means building a solid digital presence and a high-quality network that is engaged and responsive to your requests. The core of this is communicating with your crowd before an offering.

2. M. E. Greiner and H. Wang, *The Role of Social Capital in People-to-People Lending Marketplaces*. *Thirtieth International Conference on Information Systems (ICIS)* (Phoenix, AZ: AIS Electronic Library, 2009).

3. E. Mollick, “The Dynamics of Crowdfunding: Determinants of Success and Failure.” In Working Papers Series, 2012. Philadelphia, PA: The Wharton School of the University of Pennsylvania, July 11, 2012.

Building Your Digital Presence

If you are an issuer thinking about launching a crowdfunding campaign, you need to take a long, hard look into your digital mirror and see what the world is saying about you. One of the first steps people will take in their due diligence process when you reach out to them for investment is searching for you online. So before you even think of launching a campaign, look on Google or Bing and see what comes up. Do your search results speak to your expertise in your industry? Are you used as a source by high-profile publications and industry blogs? Do you have a web site that is relevant to your campaign? Is your messaging clear? Does your brand portray who you are? Would you invest your hard-earned money in your company if it were not yours? Why would you? If your answer was less than positive, take the time to fix it before you start your outreach, as the first step to success is ensuring that you look the part.

When you researched yourself, did you look like an expert? Did you feel good about the quality and quantity of third-party mentions about your company and people?

Positive publicity is one of the most powerful tools available to you in the capital-raising process. It not only provides validation and credibility but also improves search engine optimization by providing high-quality, high-traffic backlinks to your web site.

A word of warning: If you have been involved in any way, shape, or form with anything fraudulent, and search results make reference to this—even if you were not found guilty—please do not crowdfund. Social media has an illuminating effect. If you have any questionable history, it will be revealed. Not only will it be out there for the world to see, but chances are good the media could even pick it up.

Connecting with Influencers

While the ban on general solicitation has been lifted and those doing a Regulation 506(c) offering can now legally communicate that their company is raising capital, very few if any people you don't really know well will respond to direct outreach. Besides being tacky, pitching a company to a stranger will often fall on deaf ears. A better approach is to connect and engage with influencers before a raise. Seeds rarely take root in a field that has not been tilled.

Once you have your digital presence set and ready to impress, it's time to start looking for influencers—people in your industry with pull or social clout—to connect with. Connecting with people in your industry is important, as they will understand what you are up to and will likely have an interest

in it—making them more likely to invest. Trying to educate someone on not only your business but also your industry is a daunting task; stick with people who get it and save yourself the work.

If you have ever been in sales, you know that it is much easier to close a deal if you start at the top and let them direct you down. Looking for top people in your industry and providing them with something of value is a great way to increase the quality of your network. It helps to not only build your business but to also have a great presence when it comes time to launch your campaign. Just think about how good it will look if you have built a great network with the top industry players and they are discussing news with you over Twitter or in a LinkedIn group.

There are a number of ways to offer value to influencers that will get their attention. Make an introduction to a potential customer for them. If you have a media interview coming up, reach out to them and see if they would also like to be interviewed (provided, of course, that the journalist is okay with it). Share and favorite their content on social channels—you may have to do this one a few times before it will get you traction. Comment on their op-eds. Write op-eds for publications or industry blogs with a lot of traffic and ask them for an interview.

If you are not sure who you should connect with, look on Klout.com or search for LinkedIn groups in your industry. As second- and third-degree social connections will also be able to invest once Title III equity crowdfunding is legalized, it is also valuable to start combing through your second- and third-degree connections for people in your industry or surrounding industries and getting to know them better. To find these people look under the contacts section of your LinkedIn account.

Setting keyword alerts on time-saving social media management tools like Hootsuite is also a great way to find influencers on Twitter. We recommend building a list of the influencers in Twitter that you want to connect with and importing it into Hootsuite, then retweeting or sharing their content once a week. You can also do this with journalists who you would like to cover you. This is a great way to not only connect with people who could invest when the regulations are released but to also get press coverage and find customers, distributors, employees, and other key stakeholders who could help you grow your business.

Building Your Target List

Any good communicator will tell you that determining who your audience is is the most important part of the marketing and communications process.

The same is true when reaching out to potential backers and investors. Before you start your outreach to the influencers or friends and family, you need to first make sure that you have a big enough crowd. The first step is compiling a list of all your contacts. I recommend using a customer relationship management (CRM) system, but an Excel spreadsheet will do if that is all you have. Download all of your contacts from LinkedIn, and comb through Twitter and Facebook for connections that you think might be willing to fund you. Once you have your list, segment them into A, B, and C investors.

- *A investors* are the ones who are most likely to invest. Examples of these A investors include past bosses you are close with, mentors, wealthy family and friends, leaders of associations or organizations you are active in, and others who understand your industry or have a deep belief in your ability to execute. You would also want to include people who are well connected and would want to help you build this list.
- *B investors* are the ones that might invest if they saw a lot of traction on your campaign or would need to get to know you better and do some due diligence on you before making a commitment. These people include industry influencers, investors who are active in your industry and professional acquaintances.
- *C investors* are those people who would likely not invest in you unless your campaign was a major success or unless you were able to generate a good deal of buzz that made them take notice. Examples of these people are social media connections and other acquaintances.

Once you have your list segmented, you will want to put potential dollar amounts next to each name on your A and B list. Be conservative with the amounts you list here, as you will not want to launch your campaign until you are at least three times over your funding goal. Once you have your list in place, you will want to start the process of engaging prospective backers. You will want to spend 80 percent of your time on the top 20 percent of the people most likely to invest.

Reconnecting with Prospective Investors and Backers

Once Title III goes into effect, many cash-hungry startups will likely jump at the chance to pitch their family and friends on their business. While it may seem like common sense, you should never ask people to invest if you have not seen or spoken with them for a long time. Just like with influencers you

want to connect with people in your network first, before directing them to a portal to view your offering once the rules are finally implemented. You need to reach out and start doing helpful and nice things for them now.

Could you imagine if an old coworker with whom you had not spoken for years reached out to you with a mass e-mail directing you toward his crowdfunding deal room? I am sure your receptiveness would be much higher if a few months beforehand he had reconnected and had introduced you to a prospective customer.

There is an old adage in the funding world: *if you want advice, ask for money; if you want money, ask for advice*. When first pursuing your top 20 percent, reach out to them and ask them for advice about your campaign messaging, strategy, or overall business plan. Then ask them if they saw an offering like this would they invest—why or why not? Having their input will not only help you improve but also lead to their being engaged in what you are doing. This is also a way to engage them to find out what they have been up to in their business or personal lives. If you ask the right questions, this will give you a good bit of insight into their ability and willingness to invest. You will also want to ask for introductions to others in the industry who might be willing to invest in an idea like yours—adding them to your list.

Social Media Matters

Since you are reading a book on social finance, it's safe to say that you may already have a fairly good understanding of the value of social media. That being said, many people have gotten burnt out on it. Over the years, social media has been touted as a magic elixir by many in the marketing world to solve all of a company's woes. Begin looking at social media in another way, a way not to market but to reach, communicate, and engage with busy people in a succinct manner. I have used it to reach out to best-selling authors, CEOs of major companies, top-tier reporters, and many other influential and busy people. The results my company has obtained include booking many high-level customers met through social channels, landing hundreds of stories, and even helping a client get acquired through an influencer that we connected them with on Twitter. The point is that social media works—if you work it!

Take It Offline

While your online presence is critical, nothing beats good, old-fashioned face time. If you are thinking about crowdfunding in the future, you need to be building your network offline as well. If you don't have a strong network to

build from, you need to be doing everything you can to get in front of new people. Some of the advice I offer my clients follows:

- Join associations for your industry—try to get on a committee or volunteer to beef up your bio and meet people.
- Speak at (or attend) trade shows and industry events—attending events is a great way to make new connections, but being a speaker opens doors and qualifies you in front of stakeholders in ways that you could not believe. Speaking engagements also look great in bios.
- Go to community business networking events—while your key targets will be industry-focused events, business networking groups are a great way to connect with other business owners that could be potential investors.
- Join powerhouse organizations like the Entrepreneurs Organization and FoundersCard that have large networks of accredited investors in their memberships who have been successful fundraisers themselves.

The Benefit of the Process

If you take the time to build and prepare your network, the benefits will be much larger than getting someone to invest in your business. In fact, you may find yourself having such a bump in sales that you don't even need as much capital as you once thought!

Chris Camillo, an angel investor and author of *Laughing at Wall Street*, looks for businesses that have a crowd of financial backers across a diversity of backgrounds that don't only invest but also are strategic business partners that can help the organization grow.

"Businesses have an opportunity to leverage their crowd for more than just their financial contribution," says Camillo. "Take time to research your investor base and network for presence of specialized knowledge or network contacts that could help accelerate your company's mission." This means not just taking any money that comes your way. There is a major difference between smart money and cash. Every prospective investor should be looked at as a partner in the growth of your company. If done correctly and looked at strategically, by the end of your campaign preparation you should have a network not only ready to invest but also ready to make introductions to partners and customers that will help your business grow. The added bonus is that these people will also be much happier and often easier investors to deal with, as they will feel in control of their investment.

By now, many of you may be shaking your heads—those of you who have raised a good deal of capital will be shaking your head in agreement and

those of you who have never raised any in disbelief. I am now telling you to find not only money but also investors to work for you. Raising capital is a difficult process. However, if you prepare and have a business that is not over-valued and has been dressed for the show—it is not as difficult as previously thought—investors want to put their money to work.

Investor Relations: Are You Ready to Walk Down the Aisle?

Taking on an investor is like entering into a marriage; it is a long-term commitment that requires you to be 100 percent accountable to that person. Many view closing an investor similarly to landing the perfect mate—once you get them, life will be perfect and all the hard work will be over. But just like a marriage certificate, don't sign on the dotted line no matter how badly you want their capital unless you are ready and willing to do all it takes to keep them happy. You are taking a person's hard-earned money—this is one of the most serious things you will ever do in your life. You have to be ready and willing to give them regular updates, answer their questions, and have the hard conversations no matter how uncomfortable it is. What's even worse is that you could have hundreds or even thousands of investors to report to. For standard Regulation D and Title II raises utilizing general solicitation, there has been an increase in the private holder cap from 500 to 2,000 investors. For Title III offerings there is no limit to the number of investors.

Anyone who has raised capital can attest that this many investors can easily turn your capital-raising dreams into an investor relations nightmare if you do not execute some extensive crowd control through a comprehensive investor relations program.

Pick Your Crowd Carefully

While the JOBS Act and crowdfunding allow you to increase the overall quantity of investors allowed in your offering, it is important to evaluate who you are walking down the aisle with. As issuers that utilize Title III crowdfunding will typically be smaller businesses, the CEO will usually already be wearing many hats. When picking which investors to allow into your offering and the minimum investment amount to consider, it is critical to keep in mind the costs that will be associated with each investor. Make sure you include the cost of extra time spent communicating throughout the life of the investment! Also, do you remember the tip about smart money? You should want smart money in your deal just as much as you want a smart spouse!

Another important factor to keep in mind is smaller investors are often much more work. What may be considered a small \$2,000 investment by some could be a month's wages to another. It is important to really think this through when you set your minimum investment limits, and screen potential investors. At the end of the day, you choose who will invest in your company. If people are fearful or it takes a ton of work to convince them to invest with you, really make sure to consider whether you should be taking their money and, if so, how much. At the end of the day, your life is going to be much easier and your business much more successful if you pick your investors carefully. Most important, you will have better sleep at night during the tough times if you know people are comfortable with the amount of capital they have entrusted you with.

The same components of crowdfunding that make it so appealing also give it the potential to ruin not only the businesses of naïve issuers but also their lives. Social finance is just that. You connect with friends and family—in other words, your entire support system. Anyone who has been part of or witnessed the train wreck that is a failed startup knows the worst part of it all is the relationships that are affected if the issuer had taken large amounts of friends and family money. While the JOBS Act does set conservative limits based on income for how much an investor can invest, no one wants to be the person at Thanksgiving that has lost money for your family—even if it's just \$100.

For that reason, it is critical to put your Kool-Aid down and perform a very honest assessment of your business before you pitch investors.

Good Investor Relations Starts with the Pitch

If you overstate your probability of success, use language that is overly optimistic, or sell people on potential that does not materialize, you could be in violation of securities laws. Additionally, and even more devastating in some cases, is the loss of support and love that optimistic issuers may face from friends and family who believed in them and now see them as a dishonest person. If that isn't bad enough, add the potential for failure to go viral on social media, with hundreds or even thousands discussing the failure of your company on a Facebook page! Could you imagine?

While many people would be understanding of your failure, few can respect someone who they feel has lied. It is for that reason above all else that people looking into crowdfunding (or raising capital in general) need to be conservative in their pitches and clearly state the risk factors up front. While there will be many more safeguards for investors built into the laws than there

are currently, at the end of the day it is still important to be conservative in assumptions—especially financial assumptions. The best professional capital raisers will always tell you that the easiest way to raise a second round is to be successful in meeting your milestones in the first round.

Some issuers drink so much of their own Kool-Aid that they truly believe they are going to be millionaires and that they are doing people a favor by allowing them to invest in their offering. If this is you, put your Kool-Aid down before you even think about doing a raise. Sure, you may have a good idea, but there are a lot of them out there. What matters is the execution of the idea and the team behind you. If you are not looking at the risks, you will often fail, so start your investor relations off on the right foot and be conservative in your assumptions. Educate prospective investors on not only the benefits of the offering but also the risks.

Consistent Communication Is Key

Post-raise, communication needs to be done at regularly scheduled intervals, with quarterly updates at a minimum.

While you will want to communicate on a regular basis, the goal is high-level communication. No need to get into the day-to-day operations. Issuers should provide updates on successes, current operations, future goals, and ways that investors can help.

While communication can be succinct and a little less formal at times, it can never be skipped. If you have a major product release deadline or a deal that you said would occur by a certain date and you know that date has been moved, send a short e-mail to investors letting them know there have been some delays. This will save you hours answering phone calls and e-mails.

Communication is most important when it is the hardest. No one wants to tell their investors that they lost a major account, didn't meet a major deadline, or had a major setback. But these are the most critical things to report to investors, especially crowd investors. Information gets out, and the last thing you want to happen is for a major issue with your business to be uncovered on your LinkedIn company page. If there is a problem, you need to control the messaging and you need to tell investors. Not only will it help your investors stay happy in the long run, but it will also keep you out of potential legal issues and securities violations. Saying nothing is the worst thing that you can do.

Simply put, good communication is good for business. Have you ever heard the old adage that a thousand fans make a successful business? One of the things crowdfunding does is that it brings your fans together to help grow your

business. Communicating what is occurring within your business on a regular basis also allows you to engage your investors—showing them how they can help increase the value of their investment. Make sure your investors know not only what you have been up to in the previous quarter but also your tentative plan for the coming quarters. This will show them opportunities where they can help. If you have a consumer product or service, send them social media messages to post. Do you need connections into different industries? Are you looking to hire or have other needs? Let your smart money investors know in your updates. Who knows what kind of doors they will open for you?

A word of warning: Offer but don't push. While you want to offer opportunities for investors to get involved with your business, don't be forceful. Also, be sure not to broadcast anything that could be confidential or proprietary in nature. It is always best to consult your attorney if you are not sure. Think of investors as an unpaid resource that you can run things by to see if they can help. Not only will this save you time and money, but it will also lead to a more engaged investor base.

Communicate Like a Pro

There are reasons companies with large investor bases hire an outside investor relations firm to execute their communication strategy. First and foremost, there are legal requirements that every company needs to be aware of in investor communications, as discussed earlier. The other reason is, if done poorly or unprofessionally, bad investor communication can lead to a lot of additional phone calls and e-mails that already busy CEOs will have to respond to. When communicating with investors, it is critical that your communications are professional and well written. I would strongly urge any crowd issuer to invest in a low-cost investor relations service. I suggest this because you will need to do certain things at certain times to be compliant, and it will standardize the communication process helping people feel more comfortable.

Crowdfunding is new, and for many, new is often scary. Investment professionals who have worked in the industry for a while understand that at its core, the overall fundraising process is not likely to be all that different with crowdfunding. You are essentially moving the marketing process online. It is aimed at adding standardization and transparency while lowering the overall cost of raising capital.

While crowdfunding is starting to go mainstream, many people still do not understand it. Many people think it can be used only for raising capital to develop new tech products or fund movies—they haven't gotten around to understanding that what's happening is the development of a new asset class.

As it is so new and there is such a great deal of misinformation being provided in the marketplace, initial crowd investors, especially unsophisticated ones, are likely to already be skittish about their investment. If you're raising capital online, it is up to you to make sure to communicate regularly and professionally—not only because it is the right thing to do but because it will save you a lot of time and hassle at the end of the day.

The Changing World of Investor Relations

Crowdfunding is changing the world of investor relations in big ways. While private companies often give regular updates, investor relations is typically viewed as a task carried out by public companies with large numbers of shareholders. While there are a number of high-quality tools and agencies that perform these services, they often have high price tags associated with them that many small issuers cannot afford. The need for scalable investor relations tools in the marketplace is leading to a number of innovative solutions being created.

Using a good system to execute investor relations is going to be important in crowdfunded offerings that may include a large number of unsophisticated investors who have never invested in a private offering and are used to getting monthly investment statements from their broker. Looking and feeling professional will be one of the keys to decreasing your overall investor relations work in the long run.

If we did not provide you with enough reasons to ensure that you have a good investor relations program in place, here's another—it's the law! Crowdfund issuers will have regulatory-mandated communications with their investors.

While there are wonderful technologies being developed and large advances being made daily in this space, the simple fact is that none of the tools matter unless you have a crowd in place that is engaged and ready to invest in you. Once you have that crowd, make sure you treat them right and remain open and transparent—a supportive crowd can turn into an angry mob if you don't keep your lines of communication open.

Crowd Communications Checklist

If you are like most people, your head might be spinning from the large volume of information here. To keep things simple, here is a useful checklist you can use during your campaign.

Before a crowdfunding campaign or Rule 506(c) offering you should:

- Scrub your social profiles, ensuring they are free from errors and exaggeration.
- Make sure all aspects of your brand and your company are represented as you would like them to be.
- Build your digital presence through high-quality press mentions, speaking engagements, and other thought leadership activities.
- Build your list of A, B, and C investors/backers.
- Reconnect with potential A and B investors/backers, doing something for them, asking for advice, or connecting about a different topic that is focused on their interests.
- Have at least 30 percent of the investment committed before launch.
- Train all of your staff on communications policy and expectations, clearly stating the consequences if they violate that policy.
- Create a written communication and marketing outline every month, and have your attorney and your communications team review your strategy.
- Have your attorney or an outside compliance service review your pitch video and crowdfunding deal-room content to ensure compliance.

During a campaign, you should:

- Have a compliance service or legal adviser review any questionable communications material.
- Have several media interviews lined up to have a good deal of fresh content to send to potential backers that shows you are a leader in your industry.
- Connect with all A and B backers, letting them know you have launched a campaign and are requesting their help. C backers should be contacted once you have 30 percent of the funds raised so they see an active campaign.
- Communicate one-on-one if possible, even if it's a template e-mail that you are using for all of the communication.
- Provide regular updates thanking backers/investors and asking them to get others involved and share their investment.
- Accept investment only from investors you are comfortable being "married" to.
- Ensure that you are following all regulations with regard to accredited investor status and the requirements outlined in other chapters of this book.

After a campaign, you should:

- Thank all backers/investors.
- Ensure that you have a good investor relations plan in place for continued communication efforts.
- Ensure that you turn your investors and backers into brand ambassadors working on behalf of your company, by letting them know how they can help make their investment more profitable.

Equity-based crowdfunding will be an exciting and rewarding way to increase access to capital for businesses and investment firms, but the rules must be followed carefully to ensure compliance and investor protection. There are a number of resources available to help you get educated and prepare for equity crowdfunding. Following is a list of some of the better ones to help you stay informed:

- *Dealflow.com* produces newsletters, conferences, and other services that address issues related to raising capital online and crowdfunding. To learn more go to www.dealflow.com.
- *Crowdfunding Professional Association* is a professional association for those in the crowdfunding business. They provide content, education, and conferences. Visit www.cfpa.org.
- *Crowdfunding Intermediary Regulatory Advocates* is an advocacy organization for the crowdfunding industry. They provide content and regulatory updates, as well as relevant news and data. Visit www.cfira.org.
- *CrowdSourcing.org* is an analytical and consulting agency. It is also a web site for crowdfunding content and education. Visit www.CrowdSourcing.org.
- *Crowdfunding Insider* is a news site for the crowdfunding industry. It provides news and resources. Visit www.crowdfundinginsider.com.
- *CrowdfundBeat* is an online source of news, information, and resources for crowdfunding. Visit www.crowdfundbeat.com.
- *Bankless Times* is focused on content and news for the alternative finance market, including peer-to-peer lending and crowdfunding. Visit www.bankless.com.

CHAPTER 9

Alternatives to Crowdfunding

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This chapter addresses both legal and business aspects of raising capital by means other than crowdfunding. To be sure, there are many alternatives. The method a business uses to raise capital and the type of capital raised will be a function of the situation the business and its owners are in, the amount of capital to be raised and, to some degree, what prospective investors find most comfortable. Some preliminary issues that any new business should consider are briefly discussed as well.

Basic Types of Finance

Business investment falls into two basic categories: equity and debt. Equity owners, as a class, control the business and are entitled their share of the company profits, but are typically only paid if there are profits. Holders of debt typically receive a specified return whether or not the firm is profitable. Thus, issuing debt can increase the risk of business failure.

Debt

Debt is incurred when a business receives funds (the principal sum) from a lender in exchange for the obligation to repay those funds with interest within

a specified time (the term) on a specified schedule (the payment schedule). The debt may or may not be “secured” or “collateralized” by property that may be sold by the lender to satisfy the debt if it is not repaid in accordance with its terms. Accountants and banks consider certain leases to be debt even though they are not legally debts but contractual obligations. Some debt obligations are considered to be securities and others are not. Depending on its nature and context, a debt can be called a loan, a line of credit, a note, a revolving credit balance, trade credit, a bond, or a debenture. Generally, bonds and debentures are business debt obligations purchased by investors and are often underwritten by investment banks. The other forms of debt finance, except trade credit, are typically, but not always, provided by financial institutions, especially banks and credit unions. Trade credit is a loan extended by a vendor to a customer when immediate payment is not made for goods or services delivered.

Equity

Equity is an ownership interest that entitles the owner to a share of the profits of the business and usually, but not always, some measure of control over the business. Table 9.1 shows the basic types of equity interest but there are an almost unlimited number of variations on these themes. For example,

TABLE 9.1 Basic Types of Equity Interests

Type of Legal Entity	Type of Equity Interest	Type of Equity Owner	Legal Documents to Form Entity
Corporation	Stock (shares)	Stockholder (shareholder)	Articles of incorporation/bylaws
Partnership	Partnership interest (sometimes called percentage interests or units)	Partner	Partnership agreement (a certificate of limited partnership is necessary for limited partnerships)
Limited liability company (LLC)	Limited liability company interest (sometimes called percentage interests or units)	Member	Articles of organization/operating agreement
Business trust	Beneficial interest (sometimes called percentage interests or units)	Beneficiary	Articles of trust/trust agreement

different types of interests have different rights (1) to profits, (2) to tax attributes of the company, (3) to vote (or may have no voting rights), (4) to distributions upon dissolution of the company, and (5) against dilution.

Common Stock

Common stock represents a share of ownership of the corporation. Usually, each share is entitled to a single vote and a pro rata share of dividends declared by the board of directors. Occasionally, there will be more than one class of common stock. Most often, the difference between the different classes of stock is the number of votes per share.

Preferred Stock

Preferred stock is “preferred” in the sense that it has the right to receive dividends in accordance with its terms before common stockholders receive dividends. Similarly, upon liquidation of the company, preferred shareholders receive a return of their capital before common stockholders do. Generally, preferred stock dividends are fixed and will not increase if the company is highly profitable. If dividends are skipped, cumulative preferred stock requires that the skipped dividends be paid before any dividends are paid to common stockholders.

Partnership and Limited Liability Company Interests

Partnership and limited liability company (LLC) interests generally entitle the owner to a percentage of the company’s profits and a say in the management of the company. However, this is entirely determined by the partnership agreement or the LLC operating agreement. Some partners may have a very disproportionate share of the profits or the share may change over time or depend on certain triggering events. Similarly, the degree of control and voting rights is also entirely a function of these agreements. In addition, the tax attributes of the company are often not evenly shared. Limited partners in limited partnerships have either no or an extremely limited say in the management of the company.

Convertible Securities

Convertible securities are a hybrid type of interest. They typically (but not always) take one of two forms: (1) convertible debt or (2) convertible

preferred stock. Convertible debt (usually a note, a bond, or a debenture) may be converted by the holder into a specified number of shares (or other type of equity interest, e.g., LLC units). When this occurs, some or all of the debt is extinguished in exchange for the equity interest. Some preferred shares are convertible into other forms of equity, usually common stock. These types of securities provide their owners with a more secure investment since the convertible security typically has preference to common stockholders or similar interests in liquidation and are entitled, if debt, to be paid interest even if the company is not profitable or, if a preferred interest, dividends (or distributions) at a specified rate in preference to common stockholders (or other equity holders). The typical downside of owning these securities is that the investment does not usually entitle the holder to as large a share of the profits per dollar invested if the company does well.

Options and Warrants

Options and warrants entitle, but do not require, the owner to purchase a particular equity security (e.g., common stock) for a specified period at a specified price (usually called the strike price). Warrants or options are often provided to investors as “kickers” or “sweeteners” to make an investment more attractive. Incentive stock options, if they comply with the applicable tax rules, can be a tax-preferred way to compensate employees. Options and warrants can substantially dilute existing shareholders’ share of the profits, particularly if the strike price is set substantially below what those investors paid for their shares.

Choice of Entity

There are many considerations that should be taken into account when deciding which type of business entity to form. Among them are tax considerations, limited liability, capital structure, management structure, investor preferences, and so on.

All of the entities discussed earlier provide limited liability except for partnerships. Limited liability means that the owners (assuming the legal requirements have been adhered to) will not be held liable for the debts or other liabilities of the business. Partnerships are not afforded limited liability. However, limited partners in a limited partnership are generally provided limited liability if they do not get involved in the management of the business (although some states allow greater limited partner involvement in the

business management). Most well-advised limited partnerships have a general partner that is a corporation or an LLC and thus all investors, including management-investors, are effectively accorded limited liability.¹ In modern practice, the LLC has largely supplanted limited partnerships.

Tax considerations are important. Partnerships, LLCs, and business trusts are generally pass-through entities that do not pay tax at the entity level. Instead, the owners pay tax on their share of the profits (or deduct losses) on their individual tax returns. Corporations may elect to be S corporations that are also pass-through entities. But S corporations are subject to significant limitations. For example, they may not have more than one class of stock, more than 100 shareholders, or nonresident alien shareholders. In the absence of an S election, a corporation is a “C corporation.” A C corporation pays corporate-level income tax, and dividends paid to shareholders are then also taxed on the individual owners’ tax returns. Dividends paid to shareholders are not tax deductible.

Partnership and LLC capital structures are almost infinitely flexible. They are limited only by the terms of the partnership or operating agreements. C corporations have tremendous flexibility. S corporations are limited to one class of stock.

The management of corporations is typically by officers appointed by a board of directors (as is usually required by state law). LLCs and partnerships may have almost any management arrangement.

Overview of Securities Laws

The legal definition of a security is very broad. It includes almost anything sold to an investor with the object of providing a return other than tangible goods, such as commodities or collectibles, or real estate. Securities include any equity interest and most interest-bearing debts. Both the federal and state governments heavily regulate securities.

Federal

The primary federal agency regulating securities is the Securities and Exchange Commission (SEC). The primary federal law of concern to smaller firms is

1. Most states also have limited liability partnerships, which generally are similar to LLCs but typically do not allow professionals to escape malpractice liability.

the Securities Act of 1933.² The latest significant amendment to this act was the 2012 Jumpstart Our Business Startups (JOBS) Act.³ The general principals underlying federal securities law are disclosure and fraud prevention. Unless an exemption applies, securities must be registered with the SEC before they are sold. The registration process is expensive and time consuming and, assuming it's a first sale of securities, is known as "going public."

Blue Sky Laws

State securities laws are usually called "blue sky laws." Every state's law is different. Many require not only disclosure and registration but also a form of substantive review by state regulators on the merits of the offering (known as qualification). These laws will often be triggered by offering a security in the state, whether or not a sale of the security is actually consummated.

Preemption

Both state and federal securities laws apply. However, when federal laws govern instead of state laws (i.e., the state rules are deemed to not apply), the state laws are said to be preempted. Obviously, not having to deal with 50 different sets of state laws is a huge simplification for businesses.

Private Placements and Regulation D

For small firms, the most important exemption from the securities registration requirement is section 4(a)(2) of the Securities Act of 1933. It exempts "transactions by an issuer not involving any public offering." It is this "private placement" exemption that allows a few people to get together to start a local bar without having to register the stock in their company with the SEC. But the exemption is broader than that. In general, as long as you offer securities to people with whom you have a substantial preexisting relationship, this exemption will apply. Within reason, this exemption will also apply to sales to mutual friends or business acquaintances. In contrast, placing an advertisement in a newspaper seeking investors would constitute a public offering and is generally illegal without filing a registration statement with the SEC. As discussed later, the JOBS Act changes this for certain offerings. The exact

2. 15 USC §77a *et seq.*

3. Public Law 112–106, April 5, 2012.

parameters of this exemption are not well enough defined to provide comfort to issuers that they are exempt from registration requirement in certain situations.

Regulation D⁴ is a safe harbor from the securities registration requirement created in 1982. If an issuer complies with the Regulation D rules, its transaction will be exempt. The Regulation D rules are somewhat complex but not overly burdensome. There are three basic types of Regulation D offerings (corresponding to Rule 504, Rule 505, and Rule 506), but Rule 506 is by far the most important in practice. In all Regulation D offerings, a Form D⁵ must be filed with the SEC within 15 days of the first sale of securities in the offering.⁶ The SEC is considering amending Regulation D to require that Form D be filed prior to the offering in the issuer engages in general solicitation.

General solicitation or general advertising was entirely prohibited under Regulation D. The JOBS Act changed this for Rule 506 offerings, however. As discussed later, unless making a Rule 506 offering that complies with new rules issued by the SEC to comply with the JOBS Act, any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio is prohibited. Thus, talking to reporters about the offering is prohibited since they may publish a publicly accessible article. Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising is also prohibited.

Securities sold to investors via the Regulation D safe harbor are “restricted securities” and must be designated as such. The issuer is under an obligation to determine that the investor is purchasing them for investment purposes and not for resale. The investor may not resell them except if the company goes public or in another private transaction in accordance with SEC rules.

A key concept in Regulation D offerings is the idea of an “accredited investor.” Generally, an accredited investor is (1) a bank or other financial institution; (2) various investment funds; (3) any director, executive officer, or general partner of the issuer; (4) an individual with a residence exclusive net worth of \$1 million or greater; or (5) an individual who had an income in excess of \$200,000 in each of the two most recent years, or joint income with the person’s spouse in excess of \$300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.

4. 17 CFR §230.500 to 17 CFR §230.508 is Regulation D.

5. See www.sec.gov/about/forms/formd.pdf.

6. The SEC has proposed a rule that would require filing a Form D in advance of the offering, however.

Rule 506 without General Solicitation

The two most important things about Rule 506 are that the amount that can be raised is unlimited and that state registration and review requirements are preempted. The latter provision can save the issuer a tremendous amount of legal expense and time. State “notice” filings can still be required, however.

The rule provides that the issuer can sell to an unlimited number of accredited investors and up to 35 nonaccredited investors. However, having nonaccredited investors triggers greater disclosure requirements, and the non-accredited investor must have “such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.”⁷ Thus, in practice, most Rule 506 offerings are usually limited to accredited investors.

Rule 506 with General Solicitation

Title II of the JOBS Act provides that the prohibition against general solicitation or general advertising contained in Rule 502(c) will no longer apply in Rule 506 offerings provided that all purchasers of the securities are accredited investors. The issuer is obligated to take “reasonable steps” to verify that investors are accredited investors. The SEC was obligated under the law to issue new regulations by July 2012. On July 24, 2013 (a year late), the SEC issued the required rule.⁸

The verification requirements ultimately adopted by the SEC for offerings engaging in general solicitation are somewhat burdensome on issuers.⁹

7. This requirement is applicable only to Rule 506 and is a reason to consider other Regulation D offerings in certain circumstances.

8. See *Federal Register*, Vol. 78, No. 142, Wednesday, July 24, 2013, p. 44771: 17 CFR §230.506(c)(2)(ii).

9. For a discussion of the policy issues surrounding this rule see, David R. Burton, October 5, 2012, comment letter regarding “Eliminating the Prohibition against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings” at www.sec.gov/comments/s7-07-12/s70712-118.pdf; or Testimony of Jeffrey J. Van Winkle on behalf of the National Small Business Association regarding “JOBS Act Implementation” before a Joint Hearing of the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the Committee on Oversight and Government Reform and the Subcommittee on Capital Markets and Government Sponsored Enterprises of the Committee on Financial Services, September 13, 2012. Available at www.nsba.biz/wp-content/uploads/2012/09/NSBA-Testimony-on-JOBS-Act-implementation-Joint-Hearing-091312-Final.pdf.

Thus, issuers may want to abstain from general solicitation and use the “old” Rule 506 and not worry about the verification requirements. However, the ability to legally place an advertisement in the *Wall Street Journal* saying “business seeking accredited investors to invest in innovative technology” may prove revolutionary, dramatically improving small firms’ access to capital and reducing their capital costs.

The new rule provides a “nonexclusive” list of three ways to satisfy the requirement to take reasonable steps to verify the status of an investor as an accredited investor. They are:

1. With respect to income, reviewing copies of tax forms that report the income of the purchaser and obtaining a written representation that the purchaser will likely continue to earn the necessary income in the current year.
2. With respect to net worth, obtaining bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments or appraisal reports issued by independent third parties to verify assets and to verify liabilities, a consumer report from at least one of the nationwide consumer reporting agencies combined with obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed.
3. Receiving a written confirmation from a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant that they have taken reasonable steps to verify the purchaser’s accredited status.

At the same time, the SEC adopted a second new rule limiting the ability of “bad actors” to engage in Regulation D Rule 506 private placements. In general, the final disqualification rule covers criminal convictions or final regulatory orders finding fraud or other significant securities law violations by:

- The issuer.
- Directors and certain officers, general partners, and managing members of the issuer.
- Twenty percent beneficial owners of the issuer.
- Promoters.
- Persons compensated for soliciting investors as well as the general partners, directors, officers, and managing members of any compensated solicitor.

Regulation D Crowdfunding

A number of companies offer, in effect, crowdfunding for accredited investors. In late March 2013, the SEC issued No Action letters to FundersClub and AngelList.¹⁰ Thus, it is now clear that this form of crowdfunding is lawful even without implementation of Title III of the JOBS Act. In both letters, the SEC noted that neither firm received transaction-based compensation (which the SEC appears to believe is the key to triggering broker-dealer registration requirements).¹¹

Regulation A/A+

Regulation A¹² is based on the small issue exemption contained in section 3(b) the Securities Act of 1933.¹³ It is not often used. It was used by only one issuer in 2011, the most recent year for which data is available.¹⁴ The two very important advantages to using Regulation A are that the securities may be offered and sold publicly and that they are not restricted securities. They may therefore be much more easily resold by investors.¹⁵ This added liquidity increases their value and attractiveness to investors. The reason that Regulation A is not used very much is that, compared to Regulation D, the regulatory burden is significantly greater. This added burden is partially a function of preparing the offering statement for submission to the SEC and partially a function of the reporting requirements. However, compared to doing a full-blown registration and becoming a reporting company (i.e., becoming a public company), the burden is not so great.

10. See SEC No Action letter to W. Hardy Callcott regarding FundersClub dated March 26, 2013, and SEC No Action letter to Robert H. Rosenblum regarding AngelList.

11. See the discussion of finders below. See also letter of David R. Burton to SEC dated August 6, 2013. Available at www.nsba.biz/wp-content/uploads/2013/08/NSBA-Letter-to-SEC-re-Business-Brokers-and-Finders-080613-Final1.pdf.

12. 17 CFR §230.251 to 17 CFR §230.263 is Regulation A.

13. 15 USC 77c.

14. "Securities Regulation: Factors That May Affect Trends in Regulation A Offerings," United States Government Accountability Office, July 2012, available at <http://www.gao.gov/assets/600/592113.pdf>.

15. However, the true scope of this provision is not yet known. The JOBS Act provides that Regulation A securities will be treated as covered securities (and therefore exempt from most Blue Sky regulation) if "offered or sold on a national securities exchange or offered or sold to a qualified purchaser, as defined by the Commission," 15 U.S.C. 77r(b)(4). Rules implementing this have not been promulgated.

Title IV of the JOBS Act increases the maximum offering under Regulation A from \$5 million to \$50 million. This is sometimes called “Regulation A+.” This increase in offering size may spark renewed interest in Regulation A.

Initial Public Offerings

A public company is a company that has filed a registration statement with the SEC that has been approved. It therefore may offer its securities to any investor and be traded on a stock exchange.¹⁶ Being “public” triggers a whole host of reporting and other obligations. An initial public offering (IPO) is the first public sale of securities by a company. IPOs are only for well-advised firms that have substantial financial resources. There are large advantages to being public. Public securities are not restricted (i.e., they may be sold to anyone). They may be traded on stock exchanges, and as a result of this broader market, investor attention, and greater liquidity, the securities usually achieve a higher price. There are, particularly after Sarbanes-Oxley and Dodd-Frank, major disadvantages to being public as well. The compliance costs are extremely high and the legal constraints, scrutiny, and demands on public company management are substantial.

Types of IPOs

An underwritten IPO is an IPO in which an investment bank or group of investment banks (often called a syndicate) sells the company's securities to the public in exchange for a fee. Most IPOs are of this type. A direct IPO, direct offering, or direct to public IPO is when the company sells stock directly to the public without engaging an investment bank. Direct IPOs are relatively rare because of the legal complexities and regulatory risk, the costs and delay involved in finding an adequate number of investors and the risk that the effort will prove unsuccessful. They can, however, save the issuer a substantial underwriting fee. Crowdfunding may make direct IPOs practical in many more cases.

16. An alternative to a stock exchange or Nasdaq, is the so-called “over-the-counter” market (usually on the OTCBB [www.otcbb.com/] or the pink sheets [www.otcm Markets.com/home]).

Small Business Administration Loans

The Small Business Administration (SBA) offers many types of loans to small firms. The three most common are discussed in this section.¹⁷ All of these loans are subject to various eligibility requirements and restrictions. The SBA does not make the loans directly but instead guarantees the loans.

SBA 7(a) Loans

The most common type of SBA loans is a 7(a) loan. A 7(a) loan can be used for working capital; to purchase furniture, fixtures, machinery, or equipment; or to purchase or renovate a building, among other purposes. The largest loan possible is \$5 million. You must work with a bank or other lender that makes SBA loans.¹⁸

SBA 504 Loans

A 504 loan can be used for the purchase of land, including existing buildings, for building improvements and for the construction of new facilities or modernizing, renovating or converting existing facilities. These loans must meet one of a long list of policy objectives (e.g., job creation, export promotion, rural economic development). The largest loan possible is \$4 million. You must work with one of 270 certified development companies to receive these loans.¹⁹

SBA Microloans

SBA has a microloan program providing loans of up to \$50,000. Microloans can be used for working capital, inventory or supplies, furniture or fixtures, or machinery or equipment. Microloans are available through certain nonprofit, community-based organizations designated by the SBA. A list of providers is available from the SBA.²⁰

Other Sources of Capital

There are many other sources of capital for businesses. Depending on the context, these may prove to be the most appropriate.

17. For more detailed information, go to www.SBA.gov.

18. See www.sba.gov/category/lender-navigation/search-sba-lenders?select=proximity.

19. See www.sba.gov/content/cdc504-loan-program-find-cdc.

20. See www.sba.gov/sites/default/files/Microloan%20Intermediary%20Listing%2020121031.pdf.

Trade Credit

When a business buys goods or services from another business it can often negotiate deferred payment by paying on account. This is called trade credit. The terms are usually net 30, meaning no interest is charged if the invoice is paid within 30 days. Prompt payment discounts (often 2 percent) are offered for quick payment (e.g., within 10 days), and sometimes firms will negotiate a payment period of more than 30 days after delivery. At times, vendors will extend the term considerably, especially for capital equipment. For firms with good credit, trade credit can be a very important means of improving cash flow and obtaining a substantial amount of low-cost working capital.

Traditional Banks

Traditional banks (both money center banks and community banks) are a source of loans, lines of credit, and letters of credit (discussed later). A loan is typically for a fixed term with a defined payment schedule. A line of credit allows the business to borrow as needed and repay as it desires. Both are typically secured by collateral (including real estate, inventories, accounts receivable, and other property). The loan or credit line may contain other covenants regarding the financial condition of the borrowing business.

Credit Unions

Credit unions are an alternative to banks for loans and lines of credit. Some business owners find them to be easier to deal with. Federal law currently limits how much credit unions may lend to businesses. Some credit unions may be unable to lend to businesses due to these limits.

Peer-to-Peer Lending

Peer-to-peer (P2P) lending is a form of crowdfunding where lenders and borrowers bypass traditional financial institutions. Borrowers seek loans and lenders provide loans through web sites (also known as portals or platforms). Typically, lenders will provide a specified amount of money that is then lent in small increments to many borrowers. This provides risk diversification. Borrowers effectively borrow from many lenders but make only one payment through the medium of the web site. The P2P site handles the paperwork and

both collects and disburses the money. The two most prominent companies in the United States doing P2P lending are Prosper and Lending Club.²¹

Because of SEC enforcement actions, these lending platforms are not available to businesses. The SEC adopted the position that each business borrowing via the P2P platforms would have to file a registration statement (i.e., go public).²² This, of course, is prohibitively expensive. Title III of the JOBS Act should change that. In the meantime, however, individual business owners may find it advantageous to borrow using these platforms.

On Deck Capital

On Deck Capital²³ is a company that provides business loans for a variety of purposes. Instead of monthly payments, however, On Deck receives payments via small daily withdraws of a specified amount from the business's bank account. Some borrowers find it easier to manage very small daily payments than a larger monthly payment.

Factoring

Factoring is when a business sells its accounts receivable at a discount. The buyer buys the right to receive the payment from the selling company's debtors. Assuming the factoring is nonrecourse factoring, the buyer of the receivables assumes the risk that the debtor will not pay. If the factoring is recourse, then the selling business guarantees the payment and must make up for any nonpayment.

Leasing

Leasing equipment is a common way to finance purchases of machinery, equipment, and vehicles. Depending on the terms, a lease may be the financial equivalent of a loan. This is the case when the lessee can purchase the equipment for a nominal sum at the end of the lease. These so-called

21. See www.Prospers.com and www.lendingclub.com.

22. See Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8a of the Securities Act Of 1933 against Prosper Marketplace, Inc., Release No. 8984, November 24, 2008. There is also a consent decree for Lending Club. Both Prosper's and Lending Club's 10-Ks from the relevant period go into detail. See also "Person-to-Person Lending: New Regulatory Challenges Could Emerge as the Industry Grows," Government Accountability Office, July 7, 2011.

23. See www.ondeckcapital.com.

financing leases will probably be treated as debt by your accountant and by banks.²⁴

Letters of Credit

Letters of credit are particularly common in international trade but may be used in a wide variety of contexts. A letter of credit is issued by a financial institutional, usually a bank. It is “opened” by the firm that will pay upon the happening of a specified event, usually the presentation of specified documents evidencing the occurrence of that event. Upon the presentation of specified documents to the bank, the bank will pay. Letters of credit may be revocable or irrevocable and may be transferable or nontransferable.

For example, a buyer in country X might open a letter of credit specifying that when a bill of lading is presented to the bank showing specified goods were shipped along with a certificate of insurance showing the shipment is insured, then the bank will pay \$Y to the seller in country Z. Alternatively, a letter of credit could be issued that would pay upon the certification by some independent party that a contract had been satisfactorily completed.

Owner Financing

When acquiring an existing business, the buyer should seriously consider asking the seller to provide owner financing. This can be paired with financing from more convention lenders. Banks will almost always require the owner financing to be subordinate to the bank loan. The terms of owner financing are entirely negotiable. Sellers providing financing should be sure that they are provided some degree of security. Likewise, buyers need to be sure that the covenants in the loan are not so restrictive or onerous that they will impede the new owner’s ability to run the business or survive moderate financial reverses.

A Note Regarding Finders and Business Brokers

A finder (or “private placement broker”) is a person that helps you raise money from investors, usually in exchange for a fee specified as a percentage of the money raised. A finder can be a business colleague down the street that you

24. Statement of Financial Accounting Standards No. 13, “Accounting for Leases,” May 1980.

informally offer a percentage of money raised in exchange for introductions to investors that actually invest. A finder can be someone in the business of helping you find investors. Or a finder can be someone who helps companies to find investors as a sideline to another ancillary business. Finders remain commonplace, but they are very much under a regulatory cloud.

In 2000, the SEC yanked all of the guidance saying finders were often okay, and various SEC officials gave a series of speeches saying they would pursue finders as unregistered broker-dealers. It is, of course, very expensive to register as a broker-dealer. The SEC specifically attacked those finders that take a fee only if they succeed in helping the business raise money because those are “transaction-based fees.” These finders are, of course, the finders that most businesses preferred to deal with. They don’t get paid unless they actually help the business raise money.

The SEC view of who is and is not a broker-dealer is ridiculously broad. If you took their verbiage literally, just about everyone involved in your company (including your lawyer, accountant, any consultants, and probably your bookkeeper) would be required to register as a broker-dealer. The case law does not support a reading of the securities laws’ broker-dealer registration requirement that is as expansive as the SEC would prefer. However, you really don’t want to become entangled in securities litigation with the SEC or disgruntled investors over finders. The one thing that is very clear is that the state of the law is very unclear. The SEC is the reason.²⁵

Nevertheless, the fact that the SEC has targeted finders in principle, if not all that much in practice, makes people nervous. Most important, it makes sophisticated investors nervous—the kind of investors that may provide your company with the mezzanine financing necessary to grow and potentially go public. In fact, companies that have used success fee-based finders may find it difficult to go public in the current environment because the underwriters will not want to be involved with a company that used “unregistered broker-dealers” to raise capital.

There has been a serious effort to get the SEC to act to clarify these rules and establish a reasonable regulatory environment that does not shut finders

25. For a discussion of the issues involving business brokers and finders, see letter of David R. Burton to SEC dated August 6, 2013. Available at www.nsba.biz/wp-content/uploads/2013/08/NSBA-Letter-to-SEC-re-Business-Brokers-and-Finders-080613-Final1.pdf. For a very detailed discussion, see the American Bar Association, “Report and Recommendations of the Task Force on Private Placement Broker-Dealers,” June 20, 2005. See also, e.g., John Polanin, Jr., “The ‘Finder’s’ Exception from Federal Broker-Dealer Registration,” 40 *Cath. U.L. Rev.* 787, 1991.

down. These efforts have been largely ignored by the SEC, although there is now some hope that the SEC may be willing to clarify this area of the law over the next year or two. Some states (e.g., Texas) have adopted statutes regulating finders without requiring them to register as broker-dealers. That, of course, does not solve the federal problem.

The bottom line is this: Using finders may help you find capital that you desperately need or very much want. But using finders may make it very difficult for you to raise money from more sophisticated investors because of the legal risk that using them entails. And if you have aspirations of going public, using finders may make that very difficult.

You may encounter business brokers when you are buying a business, either as a free-standing business or to merge into your existing business. Buying a business can involve its securities. If a business broker receives transaction-based compensation, which they usually do, using a business broker raises similar issues as using a finder.²⁶

26. See, however, the Country Business No Action letter dated November 8, 2006.

PART III

Understanding the Framework of Rules and Regulations

CHAPTER 10

The Legal Aspects of Crowdfunding and U.S. Law

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Like all financings (and other forms of business transactions, for that matter), crowdfunding has a legal context that constrains and otherwise shapes behavior. The legal aspects of crowdfunding can be quite complex, especially when crowdfunding is used to offer and sell financial instruments that are considered securities under U.S. federal or state law. All forms of crowdfunding, however, involve interactions with various laws—both statutory (enacted by legislatures) and decisional (adopted by judges). This chapter outlines the key areas of U.S. law that engage with crowdfunding in the for-profit context. (Funding not-for-profit businesses and projects engages a wholly different set of laws and regulations, as mentioned briefly below.) The topics addressed at length in this chapter are among the most important, fundamental issues involving crowdfunding and U.S. law. The chapter concludes, however, with a brief mention of other significant U.S. laws that interrelate or may interrelate with crowdfunding. For purposes of this chapter, state law does not generally include the law of U.S. territories and possessions, even those that have their own bodies of law governed under the U.S. federal system. Those needing guidance on the laws in those jurisdictions should seek separate guidance.

Crowdfunding, as a method for soliciting financial backing for businesses and projects from a broad base of potential funders through the Internet, typically employs or is attentive to the laws associated with finance: federal and state (blue sky) securities regulation, the state laws governing business associations, and state contract law. These laws together address the types of financing that may be available for a particular venture and the appropriate documentation for that specific type of financing. An entity or individual must be legally authorized to engage in a specific type of crowdfunding. This involves determining whether the entity or individual can make and keep the promises he, she, or it desires to make to funders and whether the specific type of financing is authorized for use under the circumstances. Crowdfunding is merely one type of financing that may be used under these laws.

It is important, then, to understand a bit about each of these three important areas of finance law as they relate to crowdfunding. Accordingly, the three principal parts of this chapter describe securities regulation, business associations law, and contract law and relate each to crowdfunding. Securities regulation is the most important and detailed area covered, given its many, significant interactions with crowdfunding.

Crowdfunding and Securities Regulation

The nature of securities regulation dictates its effects on financing transactions and those who participate in them. Securities regulation promotes a few key policy objectives using three principal regulatory tools. Understanding these policy objectives and tools enables lawyers to assess the actual and prospective application of securities laws and rules to crowdfunded offerings.

The Nature of Securities Regulation

Securities regulation helps ensure that ventures can raise investment capital to support their operations. Laws and rules at the federal and state levels that protect both investors in those ventures and the integrity of the markets in which the financial commitments of those investors are sought and made support this goal of promoting capital formation. At the federal level, the U.S. Congress has used its constitutional power to regulate interstate commerce to charge the Securities and Exchange Commission (SEC), an independent agency consisting of a five-person commission supported by staff members organized into five divisions, with the difficult role of ensuring that investors are protected and securities markets remain honest, open, and healthy.

State securities administrators, who voluntarily associate across the continent in the North American Securities Administrators Association (NASAA), serve the same role with respect to transactions involving certain investors and markets, including some not regulated by the SEC.

Enforcement of antifraud provisions through litigation makes more headlines, but the principal method that the SEC and state securities commissions use to protect investors in securities markets is mandatory disclosure: the required revelation of specific, designated information and of all additional important facts needed to make that specific, designated information not misleading. Mandatory disclosure is consistent with the semistrong version of the efficient capital markets hypothesis, an economic theory holding that publicly available information is embedded in the market value of actively traded securities. Mandatory disclosures are triggered by various kinds of transactions and events, including (for public companies) the registration of a class of securities, the solicitation of proxies, the making of a tender or exchange offer, the engagement in a going-private transaction, and the completion of regular financial reporting periods. Statements (including registration statements and proxy statements) and reports (including annual and quarterly reports) that are filed with the SEC (and, in some cases, state securities administrators) include the required information. The documents filed with the SEC, publicly available through the SEC's web site, are designed to give investors the information they need to make ownership (buy, sell, loan, exchange, gift, pledge, etc.) and, if and when applicable, voting decisions. In addition, they standardize the informational foundation of securities markets.

Securities regulation at the federal and state levels also protects investors in and markets for securities through the enforcement of antifraud and other related liability provisions. These provisions prohibit misstatements and misleading omissions of material fact in public communications, especially when they manipulate the market price of securities or deceive investors. Liability may be enforced in proceedings (civil or criminal) brought by public officials or through litigation brought by private parties (typically disgruntled investors). The SEC and state securities commissions have authority to bring public civil enforcement proceedings, and the U.S. attorney's office and state prosecutors are authorized to bring criminal proceedings.

Sometimes—and this part of securities regulation is a growth industry—securities regulation provides specific substantive rules that govern, for example, the terms of transactions involving securities, the way in which various financing activities are conducted, and the entities and individuals who (1) issue, hold, or transact in securities or (2) are intermediaries in connection with securities transactions. This regulatory tool is a more central one; it

essentially defines the conduct of people and entities, telling them what to do, how to do it, and who can or cannot participate in doing it. In other words, substantive regulation may have the effect of proscribing or limiting certain types of transactions; guiding or determining the process through which a desired transaction may be accomplished; or encouraging, allowing, or prohibiting the participation of various individuals or entities in the transaction.

Each of these regulatory tools is used in a different way to keep investors and markets safe and, in doing so, contribute to the integrity of markets for capital. Currently, securities regulation is national, not international. Given that market transactions now cross borders on a regular basis (including in crowdfunding), the need for international coordination of processes and enforcement efforts has become more and more important. This topic is addressed in another chapter of this book.

Crowdfunding and Crowdfund Investing

The entities and individuals using crowdfunding to finance their businesses or projects may receive funding under various terms and conditions. Some ventures may solicit donations, some may solicit no-interest loans, some may promise rewards in the form of products or services or other nonpecuniary premiums, some may promise a share in the venture's profits or revenues as interest on a loan or as a form of current return on an investment interest of another kind. Crowdfunding can be used to do all of these things, but securities regulation applies only to certain financing models. Because the rules of securities regulation are complex and because a violation of them can have serious consequences for the ventures seeking funding, their principals, and those who assist them in their crowdfunding efforts, it is important to understand which types of crowdfunding constitute "investment crowdfunding" or "crowdfund investing" (also sometimes called "securities crowdfunding")—crowdfunded offerings of securities.

Types of Crowdfunding

As detailed in other chapters of this book, crowdfunding models have been labeled and characterized in various ways. However, one commonly accepted taxonomy separates crowdfunding into donation, reward, and investment crowdfunding. Crowdfunded financings in which a venture solicits contributions in the form of donations (gifts) are often referred to as donation crowdfunding. Reward crowdfunding typically describes crowdfunded financings in which funders are offered a product or service or nonpecuniary

premium of some kind in return for providing funding. Crowdfunded offerings in which funders are offered pecuniary gain in the form of interest on debt, profit sharing (including in the form of dividends), or revenue sharing typically are described as investment crowdfunding, crowdfund investing, or securities crowdfunding. The debt, equity, and other instruments that embody these financial rights generally are known as securities. Crowdfund investing involves a crowdfunded offering of securities.

Crowdfunded Securities

Both federal and state securities laws define the concept of a security. Under these definitions, notes and other evidence of indebtedness issued to fund the operations of business associations typically are securities. Similarly, stock in a typical for-profit corporation, membership interests in a limited liability company, and limited partnership interests usually are securities. Finally, under federal law principles, “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party,”¹ known as an investment contract, commonly is classified as a security. Some state securities laws also use this definition of an investment contract (known as the *Howey* test); but others use other, similar definitions. In many cases, state law definitions of an investment contract, as construed by state courts, are easier to satisfy than the federal *Howey* test. Accordingly, it may be easier for certain funding interests to be classified as securities under state laws than under federal law.

When interests in businesses or projects are securities and are offered and sold through crowdfunding, securities laws and rules apply to the offering unless those laws or rules provide for pertinent exemptions. Exemptions ordinarily exist only where the application of securities regulation is not necessary to serve securities regulation’s core underlying investor and market protection policy objectives. Before the president signed the Jumpstart Our Business Startups (JOBS) Act² into law in the spring of 2012, few (if any) exemptions were available for the activities conducted in an archetypal crowdfunded offering of securities. Even after that time, the delay in issuing and finalizing required enabling regulations to effectuate investment crowdfunding under Title III of the JOBS Act—known as the Capital Raising Online While

1. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946).

2. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 315 (2012) (codified in scattered sections of 15 U.S.C.).

Deterring Fraud and Unethical Non-Disclosure Act (or the CROWDFUND Act, for short)—prevented most businesses and projects from engaging in investment crowdfunding. As a result, few crowdfunded securities offerings had been legally conducted when work on this chapter was completed.

Securities Regulation Implications

Securities regulation applies to crowdfunding in a number of ways. For example, the offer and sale of securities in a crowdfunded offering is a regulated activity. In addition, in promoting crowdfund investing, crowdfunding web sites may be subject to regulation in a number of ways. Finally, investment crowdfunding's capacity to generate significant numbers of equity security holders creates the possibility that a crowdfunded offering may require an entity to register a class of securities and become a "public company." Public companies have significant transactional and periodic reporting requirements that effectuate the SEC's mandatory disclosure regime. In each of these contexts, misstatements of, and omissions to state, material fact may generate claims of securities fraud.

Registration of the Offer and Sale of Securities

Under the Securities Act of 1933, as amended (1933 Act),³ an offer or sale of securities must be registered absent an available exemption. The registration process involves drafting and filing a registration statement—the key mandatory disclosure document in connection with the securities offering—with the SEC. The process is complex and rigorous and therefore expensive. Detailed information about the issuer's operations, management, financial condition, results of operations, and the terms of the offering must be disclosed in the registration statement. Issuers of securities filing registration statements must obtain audited financial statements, which require a thorough review of management's bookkeeping and accounting.

Attention to detail is required in preparing the registration statement because the issuer is strictly liable for any misstatements of material fact and for any misleading omissions to state material fact in the registration statement at the time the registration statement becomes effective. Other offering participants also may be liable for these misstatements and omissions if they cannot satisfy due diligence defenses available under applicable law. Moreover, those who recklessly or willfully manipulate the market for

3. 15 U.S.C. §77a et seq. (2006). Available at www.sec.gov/about/laws/sa33.pdf.

securities or deceive investors in connection with the offer or sale of a security, including by misstating a material fact or by omitting to state a material fact also subject themselves to potential liability.

The onerous and costly nature of the mandatory disclosure requirements in the registration statement and the threat of liability for misstatements and omissions have the potential to discourage legitimate issuers from engaging in desired public offerings of securities. Unless an available exemption can be found, those issuers of securities either use other financing methods or forego financing their businesses or projects altogether. The standard, pre-JOBS Act exemptions did not fit investment crowdfunding well. They either require an essentially private offering (made to investors who had information or access to information and the perceived ability to understand that information) or prohibited general solicitations and advertising (restricting offers to those who had preexisting connections with the issuer). Ventures desiring to raise funds through investment crowdfunding before full implementation of the CROWDFUND Act typically found compliance with the registration requirements too expensive and time consuming and were unable to avail themselves of any applicable exemptions from registration. Accordingly, the strictures of federal securities regulation forced these ventures to raise capital through other forms of financing, including donation and reward crowdfunding, traditional private placements of securities, and bank loans.

State securities laws have a parallel system of registration in connection with securities offerings. Despite significant progress made by the NASAA and others in standardizing approaches to state registrations of securities offerings, the registration requirements and reviews are not uniform from state to state. In certain cases, federal law preempts state securities regulation, obviating the need for a state law analysis. But in other cases, transaction planners must separately engage an assessment of applicable state securities laws. Specialized (and sometimes local) legal counsel is needed for this analysis, since the securities laws and rules in each state are different.

Depending on the type of offering, some states require that offerings undergo “merit review,” which is a type of substantive regulation that involves assessing the quality and fairness of an offering. Merit reviews can be conducted at many different levels of intensity. (Although the SEC does review registration statements, it does not provide a merit review of those filings.) A coordinated review of equity registrations, in which multiple states agree to use the same, expedited review process, is available for some offerings in certain states. State securities laws also include exemptions from registration for certain offerings, some but not all of which are coordinated with federal exemptions. Very few of these state-based exemptions are friendly to

crowdfund investing (although recent exemptions adopted in Georgia and Kansas attempt to be friendlier to Internet investment solicitations by in-state businesses of in-state residents). The overall effects of state securities regulation on investment crowdfunding prior to full implementation of the CROWDFUND Act have been similar to those created by federal securities regulation—forcing law-abiding promoters of businesses and projects to seek funds through other financing methods or not at all.

Legal Status of Crowdfunding Intermediaries

Federal and state securities laws also regulate those other than issuers and investors who participate in the offer or sale of securities. Again, the key policy objectives underlying this part of securities regulation are the encouragement of capital formation through investor protection and the maintenance of honest, fair capital markets. These policy underpinnings are supported by various different kinds of regulatory provisions, depending on the activities conducted by the intermediary. The emphasis in this area of securities regulation is less on mandatory disclosure and fraud prevention (although those rules still exist and are important) and more on substantive regulation. Intermediaries handling financial assets may have to comply with certain capital requirements, for example. Similarly, securities intermediaries may be required to keep certain types of records. And intermediaries that have a financial interest in the outcome of a transaction may be endowed with fiduciary duties of loyalty designed to curtail self-interest. The SEC may directly control and monitor the activities of intermediaries such as stock exchanges and brokers that have systemic roles integrated into the very fabric of securities regulation.

In a typical crowdfunding transaction, the key intermediary is the operator of the web site through which the crowdfunding is conducted. Initially, operators of these web sites solicit businesses and projects to raise funds through campaigns hosted on their sites. The activities of these crowdfunding web sites were not conducted under the auspices of any specialized legal regime. However, the common law of agency and other laws of general application applied to crowdfunding web site operations. Crowdfunding web sites promoting businesses and projects that engage in investment crowdfunding, however, are potentially subject to federal and state securities regulation, absent an applicable exemption.

Under federal and state securities laws as they existed prior to full implementation of the CROWDFUND Act, the regulatory status of investment crowdfunding web sites was unclear. Different operators of crowdfunding

web sites performed distinctive functions for those seeking funding, among them vetting potential businesses and projects for inclusion on the site; promoting the selected businesses and projects to potential funders; advising the potential funders and principal promoters of the businesses and projects about soliciting and making financial commitments; providing a forum for facilitating the funding process; and administering and facilitating the ongoing relationship between the funders and the principals behind the business or project. These roles are similar to those played by more established intermediaries in various types of securities transactions: public offering underwriters, debt indenture trustees, brokers, investment advisers, and even stock exchanges. Each of these traditional intermediaries is separately regulated in specific, different ways under time-honored aspects of securities regulation. The activities typically conducted by crowdfunding web sites blur these lines. If crowdfunding web sites participate in investment crowdfunding, which area of regulation would and should apply to them? This became a mystery for the CROWDFUND Act to solve in relaxing restrictions on crowdfund investing.

Registration as a Public Company

The Securities Exchange Act of 1934, as amended (1934 Act),⁴ imposes registration obligations and significant, ongoing mandatory disclosure requirements (including annual and quarterly reporting and the dissemination of information in connection with voting, tender and exchange offers, and going-private transactions) on securities issuers that either (1) desire to have a class of their securities listed on and traded over a national securities exchange or (2) meet specified asset and equity holder thresholds. The 1934 Act also imposes reporting obligations on the management and, in some cases, key equity holders of these issuers. Colloquially, we refer to securities issuers required to register a class of securities under the 1934 Act and meet these mandatory disclosure obligations as “public companies.” In the years preceding enactment of the JOBS Act, media reports highlighted the risk that a business entity meeting the asset threshold (greater than \$10 million in total assets) with a significant equity investor base and commitments to issue shares under, for example, employee benefit plans, could inadvertently trigger public company status by crossing the equity shareholder threshold provided in the 1934 Act (that threshold was 500 persons). The highly publicized

4. 15 U.S.C. §78a et seq. (2006). Available at www.sec.gov/about/laws/sea34.pdf.

example of this type of venture is Facebook, Inc., which before its initial public offering in 2012 had concerns in this regard.⁵

The equity-holder threshold, like other elements of securities regulation, is intended to encourage capital investment by protecting investors and promoting the integrity of securities markets. The threshold seeks to achieve its aims by requiring that business entities with the potential for a large and active secondary private trading market in their shares comply with the same mandatory disclosure rules with which entities with exchange-traded securities must comply. In other words, the 500-person rule was designed to ensure that investors acquiring securities in large, impersonal trading markets—whether public or private—have access to all or substantially all of the same information in making an investment decision.

In its most classical form, crowdfunding involves seeking and securing financial backing in incremental amounts from a large number of funders. The possibility of a 1933 Act registration exemption for investment crowdfunding raised concerns among a number of legal commentators that a more significant number of securities issuers would be required to register their stock under, and comply with the periodic and transactional reporting requirements of, the 1934 Act. The weight of this ongoing form of regulation, both in terms of the human and financial resources it requires in drafting and filing the required statements and reports, was enough to stop many potential investment crowdfunding proponents in their tracks.

The JOBS Act and Its Consequences

The U.S. Congress determined to step into the void and address roadblocks to crowdfund investing. As described in other chapters of this book, the JOBS Act, through the CROWDFUND Act (embedded as Title III of the JOBS Act—an act within an act), exempts certain investment crowdfunding from the registration requirements of the 1933 Act and calls for the SEC to promulgate rules to effectuate its CROWDFUND Act provisions. Congress also began to clarify the roles and obligations of two types of crowdfunding intermediaries with different operating and regulatory attributes. The SEC is charged with finishing that task. Finally, in a separate part of the JOBS Act that coordinates with the CROWDFUND Act, Congress addressed the potential issues and costs created by crowdfunding under the

5. See, e.g., Steven M. Davidoff, “Facebook and the 500-Person Threshold.” *New York Times*, January 3, 2011. Available at http://dealbook.nytimes.com/2011/01/03/facebook-and-the-500-person-threshold/?_r=0.

500-person rule defining public-company status. Essentially, the JOBS Act provides for and facilitates the general solicitation of securities investors from, and the general advertising of securities offerings to, the broad-based public “crowd” on prescribed terms and under specified conditions.

Specifically, the CROWDFUND Act provides an exemption from 1933 Act registration for offers and sales of not more than \$1 million of securities in a 12-month period, as long as no more than a specified aggregate amount of securities is sold to any individual investor under the exemption *by all issuers* in a 12-month period (based on the annual income or net worth of the investor, but not to exceed \$100,000 in any case). Offerings under the exemption must be made through one of two regulated intermediaries—either a registered broker (as defined in and preexisting under the 1934 Act) or a funding portal (a new form of registered intermediary created under the CROWDFUND Act). The activities of issuers and intermediaries are further described in more detailed provisions of the CROWDFUND Act.

The rules for issuers (which must be organized under U.S. state or federal law and may not be public companies or regulated investment companies) under the CROWDFUND Act are both wide ranging and unfinished. For example, in its efforts to protect investors and maintain market integrity, the CROWDFUND Act requires issuers to make certain mandatory disclosures to the SEC and investors about itself, its capital structure, and the offering (which must include, for issuers offering more than \$500,000 in securities under the exemption in a 12-month period, audited financial statements), limit direct and indirect advertising and promotional activities, and provide to the SEC and investors an annual report on results of operations and financial statements. The CROWDFUND Act also creates new misstatements and omissions liability exposure for issuers, their principal executive officers, their principal financial officers, their controllers or principal accounting officers, and members of their managing bodies (e.g., directors, in the corporate context). These individual provisions, as well as the whole of the law, are qualified by reference to enabling SEC rules, however, making the provisions incomplete and potentially, in some cases, illusory.

Crowdfunding intermediaries, both brokers and funding portals, also are regulated under the CROWDFUND Act. All crowdfunding intermediaries must be registered with the SEC and the Financial Industry Regulatory Authority (FINRA). They also are responsible for making certain disclosures, engaging in investor protection (educational and fraud reduction) activities, providing a watchdog function with respect to the issuers’ use of offering proceeds and the investors’ compliance with the investment limitations, and ensuring the privacy of investor information. In addition, crowdfunding

intermediaries are prohibited from compensating “promoters, finders, or lead generators for providing . . . the personal identifying information of any potential investor,” and their management may not have any financial interest in any issuer using their services. Funding portals are subject to further restrictions. Specifically, a funding portal cannot “offer investment advice or recommendations; . . . solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; . . . compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; . . . [or] hold, manage, possess, or otherwise handle investor funds or securities.” Again, the SEC is responsible for further tailoring and adding to these rules applicable to crowdfunding intermediaries.

The JOBS Act also facilitates investment crowdfunding by making it a lot harder for securities issuers to trigger the registration and related reporting requirements under the 1934 Act. While the \$10 million total asset threshold remains the same, the 500-person rule was amended in Title V of the JOBS Act. Now, an issuer having total assets exceeding \$10 million is required to register under the 1934 Act if it has a class of equity securities held of record by 2,000 persons, as long as no more than 500 persons are not accredited investors (a term that includes perceived high-net-worth individuals, financial institutions, and entities as well as the issuer’s directors, executive officers, or partners, as applicable). Securities offered and sold in crowdfunded offerings exempt under the CROWDFUND Act are not counted at all for purposes of this threshold. The protections provided by the former 500-person rule were deemed nonessential in the context of CROWDFUND Act offerings because of the other statutory safeguards (i.e., mandatory disclosure, liability, and substantive regulatory provisions—including the mandatory involvement of registered brokers or funding portals) provided for these offerings.

What role does state securities regulation end up playing in crowdfund investing after the JOBS Act? The CROWDFUND Act expressly provides that certain state administrative and enforcement powers (such as notice filings) are preserved, but it also expressly prohibits states from separately requiring registration or qualification of offerings qualifying for the CROWDFUND Act exemption and from regulating funding portals in a manner inconsistent with the federal regulatory scheme. Accordingly, for most purposes, the CROWDFUND Act preempts state regulation of crowdfund investing.

States have, however, begun to address crowdfunding on their own. A few states have either passed legislation or regulations enabling crowd-based intrastate offerings of securities or are entertaining legislative or regulatory exemptions designed to permit these kinds of offerings within

their borders.⁶ Ultimately, these initiatives do not fulfill the broader mission of crowdfunding proponents: to reach out to a relatively large and fluid crowd—one that surely crosses state borders. However, financing local small businesses and projects may well be the most realistic, near-term, practical application of crowdfunding in any case.

Crowdfunding Interests in Business Associations

A business may be conducted and a project may be developed and completed by an individual acting alone or through contractual relationships with third parties that supply goods and services to the individual for that purpose. The law labels this way of doing business a sole proprietorship. The laws governing sole proprietorships are the laws governing the activities of individuals and businesses more generally. There is no specialized statute governing the rights and responsibilities of a sole proprietor.

In the alternative, business ventures may conduct their operations through a statutory business entity—a legally recognized business form created by legislative action. In most cases, state law ordains these forms of business association. The most common forms of business entity include partnerships, limited liability partnerships, limited partnerships, limited liability companies, and corporations. In general, the state law rules governing these forms of entity determine the rights and responsibilities of the participants in the venture. They also define the types and nature of investment interests that may be offered or sold.

All business owners face important decisions about whether to conduct their operations through a form of business entity or as a sole proprietor. The principals behind a venture that desires to raise funds through crowdfunding optimally should factor that desired method of financing into their decision making on whether to form a business entity through which they can operate their business. This part of the chapter focuses on these ventures. Although all

6. See, e.g., Ga. Comp. R. & Regs. R. 590-4-2-.08 (2012); Kan. Admin. Regs. § 81-5-21 (2013). See also Patrick Clark, “Kansas and Georgia Beat the SEC on Crowdfunding Rules. Now Others Are Trying,” *Bloomberg Businessweek*, June 20, 2013. Available at www.businessweek.com/articles/2013-06-20/kansas-and-georgia-beat-the-sec-on-crowdfunding-rules-dot-now-others-are-trying; David Drake, “One State Is Leading in Investment Crowdfunding: Guess Which One,” *Forbes*, May 2, 2013. Available at www.forbes.com/sites/groupthink/2013/05/02/one-state-is-leading-in-investment-crowdfunding-guess-which-one/; Kevin Lawton, “State Crowdfunding & State Banks Will Moot the JOBS Act,” *VentureBeat*, June 21, 2013. Available at <http://venturebeat.com/2013/06/21/state-crowdfunding-state-banks-will-moot-the-jobs-act/>.

business entities can borrow funds and issue short-term and long-term profit-sharing interests, each form of business entity offers different options for these and other securities that may be issued for capital-raising. This part of the chapter briefly describes the nature of business associations law, compares and contrasts the basic forms of business entity, and highlights a few ways in which choice of entity may be significant in the crowdfunding context.

The Nature of Business Associations Law

Business associations law provides venturers with a standardized set of rules designed to effectuate their reasonable expectations in forming and operating a business. Different venturers may have different anticipated roles. Some may desire to be owners—equity holders—venturers with both financial and governance (voting, consent, or other management) rights. Others may desire to be managers, and among those managers, some may want to manage the day-to-day business operations, and others may only want a say in more fundamental, higher-order business matters.

Business associations law exists to facilitate the formation of business entities. Since the law provides the standardized rules that govern the roles and relationships of the venturers, the venturers do not have to incur costs to formulate and negotiate these rules on their own. In many cases, the rules represent what venturers typically would devise and adopt in the absence of entity law statutes. Where the off-the-rack entity law rules do not work well for specific venturers, venturers can, in most cases, modify those default rules to better suit their needs. These modifications, however, require affirmative action on the part of the venturers and generate transaction costs.

Principal Forms of Business Entity

Business lawyers routinely advise business founders and promoters about the appropriate legal business forms for their ventures. To do this, they often rely on one or more of five key attributes of business entities that help distinguish among them: the costs of forming and maintaining business associations (which, while not significant in absolute dollar terms, can make a difference for new businesses); owner and manager liability to those outside the firm for the firm's obligations; overall governance structure (the roles, rights, and responsibilities of participant venturers); the type of permitted equity and other investment interests; and federal income tax status (firm and owners). State law governs all of these attributes except the last, which is governed by federal tax law. Table 10.1 summarizes these five attributes for each

TABLE 10.1 Comparative Attributes of Business Entities

	Partnership	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	Corporation
Costs of Organization & Maintenance	Drafting and negotiating partnership agreement	Filing expenses and fees (initial and annual); drafting and negotiating partnership agreement	Filing expenses and fees (initial and annual); drafting and negotiating partnership agreement	Filing expenses and fees (initial and annual); drafting and negotiating operating agreement	Filing expenses and fees (initial and annual); drafting and negotiating bylaws and shareholder agreement(s)
Governance Structure	Partners are both owners and managers	Partners are both owners and managers	General partners are both owners and managers; limited partners are owners with limited management rights and responsibilities	In member-managed LLCs, members are both owners and managers; in manager-managed LLCs, members are owners and managers manage	Shareholders are owners; officers are day-to-day managers; at the highest level, the corporation is managed by or under the direction of a board of directors
Owner/Manager Liability to Third Parties	Partners are jointly and severally personally liable for the obligations of the partnership	Partners generally have no liability for partnership obligations	General partners are jointly and severally personally liable for the obligations of the LP; limited partners generally have no liability for LP obligations	Absent veil-piercing, members and, as applicable, nonmember managers generally have no liability for LLC obligations	Absent veil-piercing, shareholders, officers, and directors generally have no liability for corporate obligations

(Continued)

TABLE 10.1 (Continued)

	Partnership	Limited Liability Partnership (LLP)	Limited Partnership (LP)	Limited Liability Company (LLC)	Corporation
Equity Interest	Partnership interest, share, or unit	Partnership interest, share, or unit	General partnership interest, share, or unit; limited partnership interest, share, or unit	Membership interest, share, or unit; multiple classes (voting, nonvoting; common, preferred) typically permitted	Stock; multiple classes (voting, nonvoting; common, preferred) typically permitted
Federal Income Taxation	Partnership is not taxed (pass-through entity); partners pay taxes on partnership income, whether or not distributed to them; can be modified by "checking the box"	LLP is not taxed (pass-through entity); partners pay taxes on LLP income, whether or not distributed to them; can be modified by "checking the box"	LP is not taxed (pass-through entity); partners pay taxes on LP income, whether or not distributed to them; can be modified by "checking the box"	LLC is not taxed (pass-through entity); members pay taxes on LLC income, whether or not distributed to them; can be modified by "checking the box"	<i>For C corporations:</i> corporation pays taxes on its income; shareholders pay taxes on income distributed to them <i>For S corporations:</i> corporation is not taxed (pass-through entity); shareholders pay taxes on corporate income, whether or not distributed to them; can be modified by notice to the Internal Revenue Service after shareholder vote

of the principal forms of for-profit business association. These summaries are general and nonspecific, created without reference to any single or selected laws. Rather, they are intended to illustrate basic similarities and differences among the different entity forms.

These entity characteristics are the most central, but not the only, factors useful in distinguishing among possible legal structures for a business.

A more detailed summary of key information about each principal form of for-profit business entity follows. The summaries provided, like those in Table 10.1, are generic in nature, highlighting common elements of the various forms among the different state statutes. Accordingly, these summaries and those in the chart should not be relied upon in making choice-of-entity decisions for a particular business. In advising clients about their choice of entity, lawyers would, of course, rely on the actual applicable statutes in the state in which the entity is to be formed.

Remember also that the summaries provided in this part of the chapter are summaries of the default rules in state entity law statutes (i.e., rules that apply in the absence of a contrary agreement of the parties). As noted earlier, most of these rules can be—and in many cases are—varied by agreements between the venturers in the individual businesses. In key cases, these abilities to vary the rules are noted in the summaries provided.

Partnerships

A partnership (often referred to in common parlance as a general partnership) exists when two or more individuals or entities associate to conduct a business for profit. No filings or filing fees (what lawyers call “formalities”) are required to form a partnership. Accordingly, venturers may not know that they have created a partnership.

A written partnership agreement typically is not required. The association of partners in a partnership may be governed by an oral agreement. The drafting and negotiation of a written partnership agreement adds cost to the formation of the partnership. Because the terms and provision of the partnership agreement have both entity and tax law consequences, legal counsel typically is sought in the purposeful formation of a partnership. This also adds to formation expenses.

In most states, an agreement between or among venturers to share profits creates a presumption that the venturers are partners. As a result, if a sole proprietor offers an investor a share of profits from a product or service, the law may view that investor as a partner. Although the presumption of partnership is rebuttable by evidence to the contrary, the sole proprietor or investor may

be required to incur significant expenses to successfully rebut the presumption in court as needed or desired.

The co-owners of a partnership are partners. Each partner owns and manages the business of the partnership and is an agent of the partnership for the purpose of conducting its business. Issues in the ordinary course of business of the partnership typically may be determined by a majority of the partners; extraordinary matters generally require unanimous consent. Partners are obligated to act in good faith and in a manner consistent with fair dealing. They owe fiduciary duties of care and loyalty to the partnership and their fellow partners.

Under partnership law, partners in a partnership are together (jointly) and individually (severally) personally liable for the debts and other obligations of the partnership. This is perhaps what partnerships are most well known for among those who think about choice-of-entity issues. It is also what they are most often avoided for, since business owners and operators rarely desire to take on obligations they did not create for themselves. What this means is that each partner in a partnership is obligated to pay or otherwise satisfy, himself, herself, or itself, individually, up to and including all of the obligations of the business, whether generated through contracts or resulting from harms caused by the business to individuals, other businesses, or property (known in the law generally as torts, unless the activity is criminal). For example, these obligations may include damages awarded by a court in a legal action for the partnership's breach of a contract or the commission of a tort by another partner in the ordinary course of the partnership's business.

Partnership law provides that partners must contribute their *pro rata* share of any partnership obligation covered by a fellow partner, and partnership agreements may reallocate liabilities among the partners. But these legal and contractual provisions merely adjust obligations among the partners themselves. Unless otherwise agreed in a valid, binding, and enforceable contract, a third party still has the right to satisfy his, her, or its entire claim against any one partner. That partner then must seek contribution from another partner or partners under law or the partnership agreement.

The bundle of financial and management rights in a partnership typically is referred to as a partnership interest, share, or unit. By default, each partner is entitled to an equal share of partnership profits and is charged with a share of the partnership's losses equal to the partner's share of profits, and each partner has coequal management rights in the partnership. This equality exists regardless of the input of each partner to the partnership. In other words, under these default rules, partners who contribute more money or more time and effort do not get more of the profits or a larger say in management. That

is why these default rights often are altered in a partnership agreement signed by all partners.

Partnership interests, units, or shares typically are viewed under securities law as investment contracts. Under the *Howey* test, for example, they generally are presumed not to be securities because the profit-sharing interest is not generated from the efforts of others (since partners are managers of the partnership). Remember that the *Howey* test determines whether financial instruments other than, for example, debt and stock—labeled under the law as investment contracts—are securities. An investment contract, under this judge-made test, is “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party.” However, the presumption that partnership interests are not securities may be rebutted by evidence of the actual rights and responsibilities of partners as dictated by the partnership agreement and actual partnership activities.

Partnerships are not taxed on their income under federal income tax laws; they are referred to as “pass-through entities.” Instead, their owners—the partners—are taxed on the partnership’s income. Partners incur this tax obligation regardless of whether any of the partnership’s profits have been distributed to them, and partners are not entitled to receive salaries or other distributions from the partnership. As a result, partnership agreements often provide for distributions to cover federal income tax and other routine partner liabilities. Federal tax law requires the partnership to report its income and the partners to report their individual allocable shares of that income so that the taxation requirements can be enforced. Partnerships may change their default status under federal income tax rules by filing a form with the U.S. Internal Revenue Service in which the partnership elects to be taxed as a corporation.

Under federal income tax rules, a partnership electing to be taxed as a corporation is taxed on its income, and partners are taxed only on the income actually distributed to them. Accordingly, if the partnership’s income is distributed to partners, there are two separate income taxes paid on those same dollars: one at the entity (partnership) level and one at the owner (partner) level. As a result, this form of income taxation commonly is referred to (usually pejoratively) as “double taxation.”

Limited Liability Partnerships

The exact same law that governs partnerships governs limited liability partnerships (LLPs). The overall governance structure, equity interests, and federal

income taxation rules are the same. The big difference? Partners in an LLP, unlike partners in a partnership not organized as an LLP, are not liable for some or all of the obligations of the partnership. Note that partners continue to be liable for the contracts they sign that are not contracts of the partnership and any torts they commit (harms created by them to individuals, entities, or property), although the partnership also may be liable for some of these obligations. In other words, by forming an LLP, partners do not get out of their own personal liability. They merely do not take on liability for some or all of the obligations of the partnership. Lawyers call this form of liability for owners and managers “limited liability,” since it limits the liability of a venturer—owner or manager—primarily or exclusively to funds already invested in the firm and liability for the acts the venturer commits.

Organizing as an LLP requires compliance with formalities: a filing (often called a statement of qualification) with, and the payment of an attendant fee to, the secretary of state of the state in which the venturers want to organize their LLP. Annual maintenance filings and fees also are required. Although these filings are relatively simple, the preparation costs and filing fees add cost to the organizational process that is not present in organizing a venture using the partnership form. (The cost of drafting and negotiating a written partnership agreement is common, however, to both partnerships and LLPs.) These formation and maintenance fees may exceed the fees charged for other forms of entity in certain states.

Finally, in some jurisdictions, LLPs are restricted from making distributions to partners unless certain financial tests are met. The purpose of this type of rule is to ensure that a small equity cushion is available for creditors that desire to bring actions against the LLP. This idea comes from corporate law where a similar rule often exists. The rule may operate to prevent the LLP from making distributions to partners to cover, for example, their federal income tax obligations.

Limited Partnerships

Limited partnerships (LPs) are organized under a different statutory framework than partnerships and LLPs. In many states, however, limited partnership law cross-references or incorporates partnership law for key concepts. Formalities—a filing (typically called a certificate of limited partnership) with, and the payment of an associated fee to, the secretary of state in the state of organization—are required to organize an LP. Annual maintenance filings and fees also are required to maintain an LP. This, and the expense of creating the required filings, adds cost to the formation and maintenance

of an LP as it does for LLPs. Without these formalities, an LP typically is (from a legal point of view) a partnership, since it involves the association of two or more individuals or entities in a for-profit business. This may mean that the purported limited partners in a defectively formed LP are treated as partners in a partnership for liability and tax purposes.

An LP has two different types, or levels, of partnership. There are general partners and limited partners. The same individual or entity may be both a general partner and a limited partner, but there must be at least two individuals or entities that are partners.

General partners in an LP are typically subject to the same management and liability rules as partners in a partnership. They manage the LP coequally, are agents of the LP for the purpose of conducting its business, and have general, joint and several, personal liability for the obligations of the partnership (unless the LP is organized—where permitted—as a limited liability limited partnership, a rarely used form of entity in which the general partners enjoy limited liability like partners in an LLP). They generally have approval rights, obligations of good faith and fair dealing, fiduciary duties of care and loyalty, and rights to contribution substantially similar to those of partners in a partnership not organized as an LP.

Limited partners in an LP have few management rights by default. They are not agents of the LP, and their consent generally is required only to make certain basic changes in the structure and operation of the LP. For example, they may have the right to participate in making decisions about changing the business purpose of the LP, converting it into another form of entity, or dissolving it (that is, providing for its windup and termination). Historically, limited partners have not had fiduciary duties to the partnership or their fellow partners, but modern statutes and case law have varied the rule, allowing for limited partners to have fiduciary duties. All partners in an LP usually are charged with obligations of good faith and fair dealing.

Limited partners also have limited liability for the obligations of the LP. This means that they generally are not liable for obligations of the LP, although they remain liable for obligations created by their own actions taken in the ordinary course of the LP's business. (The LP also may be liable for some of these actions.) Under older versions of limited partnership law still in operation in many states, limited partners are jointly and severally liable for obligations of an LP when they participate in control of the LP.

Partners in an LP own general or limited partnership interests, shares, or units as determined by their role in the LP. The financial and management rights and obligations included in these ownership interests are typically defined in a written partnership agreement; otherwise, they may be

determined by reference to the equality principles established under partnership law. In most cases, however, the partnership agreement tailors these rights and obligations.

Like interests, shares, or units in a partnership, general partnership interests, shares, or units in an LP are presumed not to be securities under the *Howey* test because of the comprehensive management rights of the general partners in the LP. However, limited partnership interests, shares, or units are presumed to be securities because limited partners have, as a general rule, only limited management rights. Accordingly, their profits are deemed to result solely or primarily from the efforts of others. Both presumptions—against and for security status—are rebuttable by a showing that the presumption is unwarranted based on the actual facts relating to the operation of the LP's business.

LPs and their owners have the same default tax status and reporting responsibilities that partnerships and LLPs have under federal income tax law. LPs themselves are not taxed on their income; general and limited partners are taxed on that income, whether or not it is distributed to them. Like partnerships, LPs can opt out of partnership taxation and choose to be taxed as corporations by filing an election with the U.S. Internal Revenue Service.

Limited Liability Companies

Limited liability companies (LLCs) are formed in a manner much like that in which LPs are formed. Venturers must comply with formalities—the filing of articles of organization (or similarly labeled documents) and the payment of related filing fees—to form an LLC. Maintaining LLC status also requires compliance with annual filing and fee requirements. The formation of an LLC typically involves the drafting and negotiation of an operating agreement that includes the financial, management, and tax-related rules applicable to the different participants. Legal counsel generally is retained for these purposes to ensure that the LLC effectuates the expectations of the venturers. The fees and expenses of these activities can be relatively high.

A key reason why formation and maintenance costs in an LLC can be higher than those in other forms of entity is the flexibility in LLC structure. Under most state statutes, LLCs can be organized in one of two forms: as a member-managed LLC or as a manager-managed LLC. The governance rules for each form are different, but both forms have members as their owners.

A member-managed LLC may consist of only one member. Other than that, the LLC is structured and governed like a partnership. Each member of a member-managed LLC both owns and manages the business of the LLC

and is an agent of the LLC for the purpose of conducting the LLC's business. Members of an LLC may be either individuals or entities. Management decisions in the ordinary course of business of a member-managed LLC typically may be approved by a majority of the members, and actions outside the ordinary course of business necessitate unanimous consent. Members of a member-managed LLC have obligations of good faith and fair dealing and owe fiduciary duties of care and loyalty to the LLC and their fellow members.

Manager-managed LLCs typically can be structured and governed like a limited partnership or like a corporation. The managers in the manager-managed form may be individuals or entities and, as the name suggests, manage the LLC and are agents of the LLC for the purpose of conducting its business. Members in a manager-managed LLC, like limited partners in an LP, may be either individuals or entities, are not agents of the LLC, and have limited management rights. There may be multiple levels of managers in a manager-managed LLC, with some managers having day-to-day management responsibilities and others (often acting as a board of managers) having an overarching management role. Under some older LLC laws, the articles of organization could provide that the LLC was managed by a board of governors through a chief manager and other officers. Few of these statutes are still in effect.

The managers of the manager-managed LLC typically owe fiduciary duties of care and loyalty to the LLC and its members and must act in a manner consistent with good faith and fair dealing. Members in a manager-managed LLC do not owe fiduciary duties to the LLC or their fellow members or have express obligations of good faith and fair dealing, unless they undertake managerial activities in the LLC. They may, however, be held to implied contractual duties of good faith and fair dealing under the operating agreement.

Members and, as applicable, managers enjoy limited liability. Neither members nor managers are personally liable to third parties for the obligations of an LLC merely by being members or managers in the LLC (although, as always, they remain liable for their own wrongful actions). This is true regardless of the level of management control afforded to and exercised by any member or manager.

However, courts may pierce this veil of limited liability and impose personal liability on LLC members (and even managers) under certain limited circumstances. These circumstances typically involve situations in which a member exercises an extreme level of control, uses that control to direct the LLC to engage in wrongful conduct that harms another individual or entity. There are many variants of this common law veil-piercing rule (known as, for example, alter-ego and instrumentality doctrines), each of which originated

under corporate law. Accordingly, the application of veil-piercing doctrine in the LLC context is not always clear.

The financial and management rights and obligations represented by membership interests, shares, or units in an LLC are much like those inherent in partnership interests in most jurisdictions. Members share coequally in profits and, as noted above, the management of a member-managed LLC unless the operating agreement otherwise provides. Under LLC law and practice, however, LLCs are given more latitude in providing for different levels of membership interest than partnerships typically are afforded.

Under many LLC statutes, LLCs are expressly permitted to create different classes of membership interests, shares, or units with distinct financial and management rights and responsibilities. The idea of creating different classes of ownership interests, shares, or units is derived from corporate law, which long has authorized the creation of multiple classes of common and preferred stock. Some states expressly allow LLCs to offer and sell financial rights only—uncoupled from any ongoing financial obligations to the LLC or any LLC governance rights or responsibilities. As a result, LLCs offer venturers flexibility in both overall governance structure and capital structure.

Membership interests, shares, or units are treated as investment contracts for securities law purposes. Under the federal law rule in *Howey*, membership interests, shares, or units in a member-managed LLC, like partnership interests, shares, or units in a partnership, are presumed not to be securities. Membership interests, shares, or units in a manager-managed LLC, like limited partnership interests in an LP, are presumed to be securities. In each case, these presumptions are rebuttable.

Like other unincorporated entities, an LLC is taxed as a partnership under federal income tax law unless it elects to be taxed as a corporation by notifying the U.S. Internal Revenue Service. The LLC is not a separate taxpayer for these purposes; it is a pass-through entity. Instead, the LLC's members pay taxes on the LLC's income.

Corporations

Corporations are the oldest form of statutory entity. (Legislatures enacted partnership statutes long after courts started recognizing partnerships.) Corporations are formed when a chartering document (labeled in various ways by different states as articles of incorporation, a certificate of incorporation, and a charter, among other things) is filed with the secretary of state of the state in which venturers desire to organize the corporation and the required filing fee is paid. Annual reports and fees also are required.

Internal governance and other related rules of the corporation not established in the corporate charter document are set forth in bylaws (sometimes referred to by another name, such as a code of regulations) and in shareholder agreements. Bylaws are authorized and required by statute; every corporation must have them and every corporate statute provides for them. The form and contents of shareholder agreements, contracts between or among the corporation's owners, may be expressly authorized or restricted by statute and must be construed in accordance with these statutes and any related judge-made law.

Corporations are managed by or under the direction of a board of directors, a management body that typically decides matters by a majority vote of the directors (historically individuals, not entities, but many statutes now allow entities to be board members). The board of directors delegates the day-to-day management authority of the corporation to officers, who are the agents of the corporation for the purpose of conducting its business. Some state statutes require that corporations have at least two named officers—a president and a secretary (or the equivalent). More modern statutes omit this requirement. The board of directors also typically elects or appoints the officers of the corporation.

The owners of a corporation are called shareholders—or stockholders, in some statutes. Some legislatures use the terms interchangeably. Shareholders are passive owners in the corporate form. They have few management rights, and those rights all are expressly provided for in the statute. They generally include the right to elect the directors and approve certain basic changes in the corporation: amending the corporate bylaws; voting for the directors of the corporation; and, after board approval, amending the corporate charter, approving a merger or sale of significant corporate assets, or dissolving the corporation. Corporate charters may, in some circumstances, vary the shareholders' management rights (for example, by changing quorum and voting requirements), but typically only within limited ranges.

Both directors and officers owe fiduciary duties of care and loyalty to the corporation. These duties have been construed to include or be supported by an obligation of oversight and good faith. Directors also owe a duty of candor or disclosure to the corporation or its shareholders in certain circumstances that may be part of or supplemental to their fiduciary duties. The law in this area is complex and has been evolving.

Delaware corporate law is a key source of corporate law principles, and the Delaware courts have been leaders in interpreting corporate law as it relates to the fiduciary duties of directors. Many legal commentators assert that, under Delaware corporate law, director fiduciary duties serve—or optimally should

serve—solely or primarily to maximize the corporation’s value to shareholders. Some contend that the purpose of a corporation is to maximize shareholder value. Others argue that shareholder wealth maximization is one (even if often the determinative one) of a number of different objectives of director and corporate action. The recent rise of corporate social enterprise entities (e.g., benefit corporations and flexible purpose corporations) responds to the perceived need for a form of corporate entity that exists to promote social and environmental, as well as shareholder wealth, objectives.

It is clear that shareholders, in the ordinary course, do not owe fiduciary duties to the corporation or their fellow shareholders. In some (limited) circumstances, majority shareholders may owe fiduciary duties of care and loyalty to minority shareholders. Also, courts in many jurisdictions (notably, Massachusetts) have held that shareholders in closely held corporations—corporations with small numbers of shareholders, who typically also serve as directors or officers of the corporation and often are related by family or friendships ties—have fiduciary duties to each other.

Directors, officers, and shareholders of a corporation all have limited liability for corporate obligations. As noted in the context of LLCs, however, courts may “pierce the corporate veil” or find a breach of fiduciary duty and hold shareholders, directors, or officers liable for corporate conduct. Courts often have trouble finding that the requisite extreme level of control or willful or reckless conduct exists in veil piercing cases, however.

The ownership interests of shareholders in a corporation are shares of stock. Stock represents a shareholder’s distribution (including as dividends and upon liquidation) and voting rights. Shareholders are not entitled to distributions as a matter of right; the board of directors must approve them. By default, each share of stock affords the holder one vote, and shareholder decisions generally are made by shareholders having a majority of the shares present and voting at a meeting at which the required quorum (a majority of the outstanding shares of common stock) is present.

Stock typically is divided into two principal classes: common stock and preferred stock. The rights and obligations of holders of common stock are almost exclusively a matter of statutory law. The rights of preferred stock are much more contractual. Preferred stock typically provides the holder a preference (in timing or amount or both) in the payment of dividends or on liquidation. Because holders of preferred stock get these distribution preferences, they often do not have voting rights (other than voting rights required by law, typically for decisions that adversely affect the preferred shareholders).

Corporate law also provides that each of the two principal classes of stock (common and preferred) can be subdivided into multiple series. The board of

directors and, when a charter amendment is required to create the series, the shareholders entitled to vote, must approve the designation of a new series of stock. Each series of stock has its own terms and conditions consistent with the terms and conditions of the overall class of stock under which the series is designated. This high degree of control over the corporation's capital structure allows corporate boards of directors, officers, and shareholders significant flexibility in financing the operations of the corporation.

Unless the context otherwise requires (and it rarely does), stock is a security under federal and state securities laws. Accordingly, the offer and sale of shares of stock requires registration under federal and state law, absent an exemption. Most public companies (issuers of securities trading on a stock exchange or issuers meeting the total asset and shareholder thresholds established under the 1934 Act) are corporations; and most of those are Delaware corporations.

Under U.S. federal income tax law, corporations are taxed on their income. Corporations taxed in this manner are referred to as "C corporations" or "C corps." Federal income tax law also provides that shareholders are taxed on the income, including salary and the dollar amount of any distributions (dividends and liquidation), received by them from the corporation. This creates the possibility of double taxation.

A corporation that qualifies (based on, for instance, its place of incorporation and the nature and number of shareholders it has) can request to be treated like a partnership for federal income tax purposes. Corporations taxed in this manner are referred to as "S corporations" or "S corps." S corporations are not taxed at the federal level on their income; they are pass-through entities for federal income tax purposes. Shareholders are taxed on the S corporation's income, whether or not that income is distributed to them. Unlike unincorporated business associations, a corporation's election to become an S corporation cannot be accomplished merely by checking a box on a form. The U.S. Internal Revenue Service reviews the election, filed on Form 2553, and notifies the corporation whether its election is accepted or not accepted.

Crowdfunding and Business Associations

The possibility of crowdfunding and other financing options should be taken into account in determining a choice of entity for a venture. Familiarity with the basics of the law of business associations helps promoters of businesses and projects that may want to use crowdfunding as a financing tool to assess how to organize their firms, from a legal point of view, to best accomplish their business objectives and their short-term and long-term financing goals.

Principals that desire to use crowdfunding may or may not have taken formal action to organize their venture as a statutory form of entity at the time they seek funding from the crowd. If no filing has been made with the office of the secretary of state in any state to form an LLP, LP, LLC, corporation, or other statutory entity, the venture through which a business is conducted or a project is developed generally is legally recognized as either a sole proprietorship or a partnership.

Both sole proprietorships and partnerships are easy and inexpensive to form, making them attractive to small business owners (including those desiring to use crowdfunding) at first blush. However, these forms of entity may not be desirable for the principals as they begin business operations and make promises to funders buying crowdfunded interests in their business or project. Among other things, the owner-operator structure of sole proprietorships and partnerships, where all owners also are managers, and the fact that sole proprietors and partners have unlimited personal liability for the firm's obligations, often make them undesirable. In this regard, it is significant to note that, by offering an investor a share of the profits generated by a business or project (as is done in investment crowdfunding), that investor may acquire the legal status of a partner and, as a result, be vested with the financial and management rights and personal liability of a partner—a status that the promoter(s) of a business or project or investors may find undesirable. Said another way, most crowdfunders, like small business owners more generally, are concerned about offering management rights to third-party funders not known by them; investors may be similarly concerned with this and with the prospect of personal liability for the obligations generated by the business or project. Also, although the income of a partnership is taxed at the federal level only once for both sole proprietorships and partnerships, that tax is paid by each partner individually, based on that partner's allocable share of the partnership's income, regardless of whether the partnership has distributed any of its profits to that partner. Businesses or projects that are in the start-up phase often need to reinvest profits and may not have sufficient cash to distribute to partners to cover income tax payments.

For these reasons, venturers are well advised to consider affirmatively organizing a statutory form of business association to conduct business or develop a project that may be funded by the crowd. Most new businesses are formed either as LLCs or as corporations, both of which are more expensive to form and maintain than a sole proprietorship or partnership and offer limited liability to venturers. Although LLPs and LPs also offer limited liability, venturers generally prefer the governance structures of LLCs and corporations. LLCs are the newest and most popular form of unincorporated

business association, although both LLCs and corporations offer significant benefits. LLCs offer structural flexibility, but LLC law is less well developed than corporate law and LLCs historically have been less accepted, as a general rule, in venture capital and “going public” circles. They also offer default pass-through taxation for federal income tax purposes, which may or may not be desirable to the principals. Corporations, however, offer less structural flexibility, although corporate law is well developed, and the corporate form is widely accepted by investors. Shareholders are taxed only on corporate income distributed to them; the corporation pays taxes on its own income.

Crowdfunders can offer profit-sharing interests in LLCs and corporations without involving investors in the management of the firm. This can be done in a variety of ways, including by offering investors nonequity interests—profit-sharing interests not recognized as ownership interests. This flexibility, taken alone, is a large benefit to using LLCs and corporations as legal entities for crowdfunding.

Contracts in Crowdfunding

Business transactions involve contracts—express and implied, written and unwritten—and crowdfunding comprises a variety of different business transactions. Of course, in all buy-sell arrangements, there may be contracts between the buyer(s) and seller(s), as principals, memorializing the transactional terms and conditions under which one party is offering value for something possessed by the other. Financing, as a specialized form of buy-sell arrangement, involves the transfer of value by a funder in return for an interest in a business or project.

In financing transactions involving intermediaries (including crowdfunding), there typically are contracts involving each intermediary. Crowdfunding intermediaries, construed broadly, may include not only crowdfunding web sites, but also any other promoters of the crowdfunded offering. Separate contracts may exist for each of these arrangements. For example, principals of a business or promoters of a project may contract with a crowdfunding web site to host a crowdfunded offering or contract with one or more marketing agents (videographers, writers, etc.) to help promote the business or product in the offering. Prospective funders may contract with the crowdfunding web site to contribute funds to a business or project or may contract with financial or diligence experts, among others, to help vet potential businesses or projects they may desire to fund. Each contract establishes the intermediary’s transactional role and duties and the amount and form of his, her, or its compensation, among other things.

Ultimately, then, all forms of crowdfunding are built on contracts. Contracts are legally recognized forms of agreement between two or more individuals or entities, typically referred to as “parties.” The basic rules of contract law are, therefore, important to the legal context of crowdfunding.

The Nature of Contract Law

Parties are incentivized to enter into contracts because they can rely on courts and others to uphold them against challenges to their validity, hold the parties to the benefit of their bargain, and enforce that bargain. The law governing the establishment, interpretation, and applied force of a contract determines whether the contract is valid, binding on the parties, and enforceable against them. A review of the basics of contract law, learned by most law students in their first year of law school, demonstrates that most aspects of crowdfunding contracts are straightforward.

Contract law is principally state common law, made through state judicial opinions rather than in legislatures. Most of the fundamental facets of the law differ only slightly, if at all, from state to state. This part of the chapter summarizes core aspects of contract law that may be important in the context of crowdfunding contracts. The text notes where there are variances in the law from state to state or where the law is unsettled for other reasons.

Elements of a Contract

A party desiring to enforce a contract in court must prove that one exists. This is trickier than it sounds. Judges and lawyers do not always agree on the central elements of a valid contract. Moreover, because judges in each state determine the matters required to be proven in that state, there is bound to be variety from state to state. The following items, however, appear on many commonly available lists of contract elements:

- *Offer*—a promise of action or forbearance on the part of one individual or entity.
- *Acceptance*—unambiguous assent to an offer made by another.
- *Consideration*—the lawful surrender of something of value.
- *Mutuality*—a meeting of the minds—evidence of agreement on the substance of the agreement between or among the parties.
- *Capacity to contract*—the state of being legally competent to contract.
- *Intent to contract*—the objective to create a legally enforceable agreement, which may be/often is presumed in business contracts.
- *Lawful subject matter*—terms and provisions that do not violate law.

The first three elements are absolutely essential. A claimant proving these elements of a contract establishes a *prima facie* case (effectively, a presumption) that a contract exists. Without any one of these elements, a court may find that the asserted contract is invalid.

Defenses to Contract Formation

Those who desire to challenge the existence of a valid contract may rebut proof of any of the elements of a contract. Depending on the circumstances, the contract may be void or voidable. Some rebuttals are straightforward—for example, proof that there was, in fact, no offer or acceptance or a failure of consideration, proof that the parties did not intend to create a legally binding agreement (e.g., where the parties sign an agreement to agree—a letter of intent or other contract providing for the execution of a later agreement on specified terms or subject to specified conditions), or proof that the subject matter of the contract is unlawful. Others are less obvious.

For example, a mistake on the part of both parties to an asserted contract about a fact vital to the agreement tends to rebut the element of mutuality and render an asserted contract void. Fraud in the inducement (misstatements that prompt a party to enter into a contract) also refutes mutuality. Similarly, when one party signs an agreement under duress or as a result of undue influence or agrees to terms that are unconscionable, mutuality may be rebutted. Also, if a party to an avowed contract is mentally ill, a minor, or otherwise legally incompetent or incapacitated at the time the asserted contract is entered into, the contract may be voided.

Binding Nature of a Contract

A valid contract may not bind all parties under all circumstances. For example, a valid contract may exist as to one or more parties on either side of an agreement, but may be void as to one of them because of incapacity. Also, a party may assert that performance of the contract is not required because the very purpose of the contract is frustrated or because of impossibility—a radical change in conditions or events that renders the party unable to perform under the contract. In addition, the fraudulent misrepresentation of a material term of the contract to a party may excuse that party from performance.

Enforceability of a Contract

A void or voidable contract is not enforceable against the parties, and a court will not enforce an agreement against a party who is not bound. A court also

may refuse to enforce an otherwise valid and binding contract, however. This often occurs when formalities are required for a specific type of contract, and there is noncompliance with those formalities. For instance, the statute of frauds in a jurisdiction may require that certain contracts be in writing to be enforceable. Moreover, a party that excuses another party's performance under a valid and binding contract will be estopped from enforcing the contract against that party as to the excused performance. Also, a court may decline to enforce a valid and binding contract that violates public policy.

Contract Law Issues in Crowdfunding

Although we do not yet have much experience with crowdfunding contracts, in most cases, they will raise issues no different from those associated with contract formation, performance, and enforcement in other areas of business. In particular, contracts between those desiring funding and their agents (including intermediaries that they may retain, such as crowdfunding web sites) are likely to be somewhat run-of-the-mill, unless the parties contract to do something that is illegal such as investment crowdfunding outside the parameters of federal or state securities law. Claims and controversies relating to these kinds of contracts should look much like the traditional contracts cases.

Agreements between those desiring funding or crowdfunding web sites, on the one hand, and funders, on the other, may raise more novel contract law claims and concerns. These agreements are, in most cases, standardized and conveyed wholly over the Internet, without personal negotiations or other interactions among the parties. In general, these forms of agreement may be classified as either click-wrap or browse-wrap contracts. A click-wrap agreement is characterized by terms and provisions conveyed through a web site to which a party may agree by clicking a button that indicates assent. A browse-wrap agreement consists of terms and provisions conveyed on a web site that allegedly bind users of the web site merely by browsing its contents or making use of some of the web site's tools or services.

The use of these types of agreements in crowdfunding may raise a number of basic contract law issues. For instance, a crowdfunding web site or crowd-funded business (or the principals behind a crowd-funded project) desiring to enforce a click-wrap or browse-wrap agreement as a valid contract may be challenged by a funder on the grounds that there was never any acceptance of the offer made through the crowdfunding web site or that there was a lack of mutuality or intent to contract. As a general matter, these arguments should have more force in claims involving browse-wrap agreements than those involving click-wrap agreements, since the funders have the ability to read

the terms and conditions and affirmatively indicate a decision to agree in the case of a click-wrap agreement. Yet, a browse-wrap agreement with a funder still may be valid, binding, and enforceable if the funder has clear, up-front notice of the agreement and proceeds with use of the web site on that basis.

The use of the Internet in crowdfunding also creates other opportunities for contract law challenges to Internet-based agreements. The faceless nature of the Internet may encourage the participation of minors and others lacking the legal capacity to contract and may make it hard to locate parties for enforcement purposes and extract damages or other remedies in the event of a breach of contract. Funders desiring to avoid click-wrap or browse-wrap agreements also may be more prone to raise claims of unconscionability or undue influence. Even if these claims are ultimately unsuccessful, the need for crowdfunding web sites or crowdfunded business or projects to defend against these claims increases the cost of crowdfunding and may discourage some potential market entrants.

Other Potential Legal Issues

Other basic legal issues worthy of consideration in connection with crowdfunding abound. Some are specific to particular types of businesses and projects. Others are common to all or most business ventures. A few are mentioned briefly here.

Tax laws other than federal income tax laws (such as state income tax laws, franchise or excise tax laws, sales tax laws, and property tax laws) also impose costs on businesses and projects. Businesses should determine the nature and timing of these payments and budget for them as a matter of course. Venturers considering crowdfunding should take these costs into account in determining what they can offer to funders.

Intellectual property laws—the laws governing patents, trademarks, copyrights, and trade secrets—can be very important to crowdfunding. This topic is covered in detail in another chapter of this book. Suffice it to say that even a simple logo used in marketing a crowdfunded offering can create heartache and legal expenses if intellectual property laws are not taken into account in planning a venture.

Crowdfunders also should be mindful of bankruptcy and reorganization law. Many small business firms fail, and structuring a business in a manner that provides options in the event of failure is generally a good investment of resources. In particular, ventures financing businesses or projects through crowdfunding will want to determine how their promises to funders may be

renegotiated in a voluntary, nonbankruptcy reorganization and how they may be treated in a bankruptcy.

Businesses always should pay attention to federal and state antitrust law as well. Antitrust laws protect businesses from anticompetitive behaviors like price fixing and market splitting. Although there is nothing about crowdfunding that makes it a particular risk under antitrust laws, both crowdfunding intermediaries and crowdfunded businesses should take care in constructing their business models to avoid problems under these laws.

Conclusion

The legal basics relating to crowdfunding are broad and varied and apply to both those seeking financing through crowdfunding and the intermediaries with whom they work to obtain that funding. The basic laws and regulations that impact crowdfunding are those that govern businesses more generally. Three key areas for focus are securities regulation, business associations law, and contract law. But other areas of law such as taxation, intellectual property, bankruptcy and reorganization, and antitrust, also are worthy of attention.

A number of legal matters addressed in this chapter are noteworthy, but two key issues are worth reviewing here. By offering investors a profit-sharing interest in a business or project in a crowdfunded offering, crowdfunders may be offering a security (invoking federal and state securities laws) and, absent the organization of a different legally recognized form of entity, may be making those investors partners in their business. Also, without the proper notice, browse-wrap contracts may not be valid contracts and, therefore, may not bind crowdfunding web site users or be enforceable against them.

Finally, and this may go without saying, although all business participants should be familiar with basic legal principals in constructing and operating a business, legal counsel is necessary to the establishment of a strong foundation for a business venture. In particular, in crowdfunding—a new type of business with multiple business models—both ventures seeking financing through crowdfunding and businesses seeking to sell crowdfunding services should retain lawyers to help them navigate untested waters. An experienced business lawyer can help crowdfunding-related businesses assess the application of various laws to their particular venture and establish crowdfunding models with strong legal foundations. In other words, legal counsel should be considered an essential investment rather than a discretionary transaction cost for firms planning to engage in, as well as those already engaged in, crowdfunding.

CHAPTER 11

Crowdfunding Laws Based on Global Jurisdiction

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While the United States has often been at the forefront of financial innovation, the strictures of its regulatory system—and, in particular, its “black-line,” rules-based approach to securities law—have at times allowed other jurisdictions a head start. Nowhere has this been more the case than in crowdfunding. Over the past few years, beginning before the JOBS Act was even on the legislative agenda, crowdfunding platforms have begun to emerge and thrive across Europe.

The fact that European crowdfunding platforms have been able to launch and grow can be ascribed largely to the difference in the way that financial regulation works in non-U.S. jurisdictions. Every country has its own securities laws, but a common feature across Europe (notwithstanding the lack of formal harmonization at European Union level) is a more principles-based approach than exists in the United States. Many of the regulations were written in the past decade or two, as opposed to the 1930s, and they were constructed with a view to being adaptable to new technologies and new forms of finance. This has meant that, even in the absence of crowdfunding-specific legislation, entrepreneurs in the United Kingdom, the Netherlands, and elsewhere have found ways to create legal, effective crowdfunding platforms using existing laws.

This chapter gives an overview of how crowdfunding, specifically investment crowdfunding, has been working outside of the United States. It is a big topic, and there are variations across every country in which a platform has been launched, but in the interest of brevity we focus on the broad generalities and commonalities that have defined European crowdfunding to date. For the avoidance of doubt, when we talk about “crowdfunding” we mean the equity-based version; donation-based, rewards-based, and debt-based crowdfunding models fall under different regulatory regimes (or none at all) and have developed pursuant to their own unique patterns, and therefore they are not the subject of this chapter.

The Emergence of Equity Investing in Europe

The need for groups of individuals to be able to invest in the equity of private ventures (which, at its core, is what crowdfunding means) is centuries old. Young, innovative ventures inherently lack the repayment capacities to service debt repayments. This, combined with the substantial uncertainties that are involved in such businesses, means that risk-sharing instruments like equity are their natural form of finance. And the more the risk can be spread across multiple people, each of whom bears only an amount he or she can afford to lose, the more that equity finance becomes an efficient and effective means to fund innovative entrepreneurs.

While the offering of risk-sharing stakes in certain types of ventures dates to ancient times, the forerunner of modern equity investing emerged in late medieval times in the form of shipping finance. In England, Holland, and other seafaring powers, there was a need to fund what were inherently all-or-nothing ventures: the ship generally either returned safely or it sank. From that need grew a variety of structures that would allow investors to put up capital not for a fixed return but instead on the basis of shared revenue and ownership.

These were, however, single ship voyages, and until the mid-16th century there remained no means by which to invest in an ongoing undertaking. That changed in 1553 with the chartering of the Company of Merchant Adventurers to New Lands, an English company with 250 shareholders (the term *Merchant Adventurer* meaning a merchant who ventures his capital, hence the origin of today’s investors in new, high-risk businesses—venture capitalists). Russia followed suit two years later with the formation of the Muscovy Company to conduct ongoing trade between Moscow and London, and the Dutch chartered their East India Company in 1602 (the English one having been formed in 1600).

What was critical about the formation of these companies was not simply that they provided a structure through which to invest in a going concern, but that in many cases they provided limited liability to those individuals who made the investments. In a partnership, each partner takes personal liability for the debts of the firm, and this works because each partner is actively involved in the business and (at least in theory) can control the extent to which debts are incurred. In order to let people who aren't involved in management—the “crowds”—invest in an ongoing business, the investors need to know that if the company takes on irresponsible debts, they will not have to cover them out of their own pockets. The innovation of these early companies was to limit investors' liabilities to the amount of their investment, that is, once the investors had subscribed for shares, they could not be forced to contribute any further capital. The mechanism for the crowds to fund a venture was thus born.

In the three centuries after this critical innovation, company formation—and widespread equity investing with it—grew slowly. Companies could generally be formed only by royal charter or legislative act, meaning that most ventures operated as partnerships or other types of unincorporated association. This meant unlimited liability for investors, and so most businesses were funded by their operators (and by debt) rather than by the crowds.

That changed with enactment in the United Kingdom of the Joint Stock Companies Act 1844, which was the first law in the world to permit general-purpose companies with limited liability to be formed on an entirely private basis. The floodgates soon opened, and by the second half of the nineteenth century, the other major European nations had legislation allowing for limited liability companies to be formed without government action. Many of the colonies of the European powers would follow suit in coming years, as would the United States (the first general incorporation law being enacted in New Jersey in 1896).

Where Investing Emerges, Regulation Follows

As it became increasingly straightforward to structure private ventures as limited companies, so the number of investment opportunities for the crowds began to proliferate. It was soon apparent that there needed to be a system of regulation around how those opportunities could be made available, as well as what companies needed to do once investors had joined.

Britain enacted some of the earliest securities regulations in Europe, with the Companies Act 1867 setting forth the rule that if a prospectus was

issued it had to disclose any contracts that would influence whether or not an applicant would take up shares, as well as corporate transactions to which directors were parties. Germany was also an early adopter here: a new stock corporation law introduced in 1884 included many preinvestment provisions, especially affecting initial public offerings (IPOs); among the rules was a requirement that the company file independently audited balance sheets and profit-and-loss statements for the two years preceding the offering. The German Exchange Act of 1896 tightened the regulation further and took over principles that emerged through the Companies Act in Britain: every company applying for listing would have to issue a prospectus with specified content including the use of the capital to be raised, recent financial performance, and dividends paid over the previous five years.

Just as incorporation laws came to the United States a few decades after they permeated Europe, so securities regulation only began to take hold in the United States in the early decades of the twentieth century. Initially, much of it was similar to what existed in Europe. The Kansas Act, and the statutes that were inspired by it, introduced the system of “merit review,” establishing a test that (1) any company wishing to offer securities must be an organization whose plan of business or contracts didn’t include any provisions that were “unfair, unjust, inequitable or oppressive,” and (2) that the investment would “promise a fair return.” Contemporaneously, the New York Stock Exchange’s Committee on Stock List began obtaining IPO disclosure agreements from most firms in the early 1910s.

Following the economic shocks of the late 1920s and early 1930s, however, a significant divergence between the American and European systems occurred. As an immediate response to the stock market crash and the Great Depression that followed, the United States began to implement a much more comprehensive system of securities regulation than existed in Europe. Although the Securities Act of 1933 was inspired in part by Britain’s Companies Act 1929, it created (together with the Securities Exchange Act of 1934) a new and much bolder approach to controlling the offering and trading of securities than existed anywhere else in the world. That system remains the foundation of American securities regulation today.

In Europe, by contrast, there was no such reaction to the economic crisis. Widespread investing among ordinary citizens was less common in European nations than it was in the United States by this point, creating less pressure to adopt protections beyond those already in place. Moreover, as the 1930s wore on, more pressing pan-European issues emerged, putting investment reforms lower on the legislative agenda. So over the next 70 years, individual European countries continued to amend and improve their regulatory

systems, but little in the way of significant overhauls took place. Into the 1990s, securities laws in many European countries looked not entirely dissimilar to what they had been a century before (albeit with ever-evolving regulatory bodies and nuances to the applicable legislation).

The modern systems of securities regulation emerged in Europe as the twentieth century drew to a close. Germany's Securities Trading Act and its Second Financial Market Promotion Act, both of which came into force in the mid-1990s, set the basis for modern securities regulation in Germany. France adopted the Financial Activity Modernization Act in 1996 (followed by the Financial Security Act in 2003), and Britain's modern system emerged from the Financial Services and Markets Act in 2000. In 2005, the EU as a supranational body made its first move into securities regulation, enacting the Prospectus Directive, with the Markets in Financial Instruments Directive (MiFID) following two years later; although both were significant pieces of legislation, they were largely embedded into the national systems that had been created in the preceding decade rather than representing an overhaul in and of themselves.

Although each of the regulatory systems that have been adopted in Europe differs from each other significantly, they tend to have two things in common. One is that they are largely principles based, and they operate more through collaboration between the regulator and regulated firms rather than through adversarial enforcement. The second is that they tend to be structured in a way that is more accommodating of innovative models: the way in which securities are issued, sold, and traded has changed—and broadened—dramatically since the 1930s, and most of the major European regulatory systems reflect that in varying ways.

Crowdfunding Is Born in Europe

It is into this long history of equity investing that crowdfunding has entered. But it is a very modern combination of commercial drivers and regulatory structures that led Europe to be crowdfunding's global birthplace.

Even in the absence of the regulatory context, Europe was a natural region for the emergence of crowdfunding. It has all of the infrastructure—education, access to technology, stable governments, relatively free markets—for entrepreneurship to thrive. And while culturally it has not traditionally embraced startups in the way that the United States has, that is rapidly changing as the old economic model—driven largely by state organizations and large corporations—is proving unsustainable and a new approach is being

sought. It is therefore no surprise that the entrepreneurial ecosystem has started to boom across Europe over the past five years, with major hotspots like London and Berlin complemented by pockets of startup activity from Dublin to Athens.

At the same time, capital—especially seed capital—has not been nearly as available to startups in Europe as it has been in the United States. Venture capital has tended to look much more like private equity—lower risk, lower return—than those merchant adventurers of Elizabethan times, meaning that seed and even early-stage funds are a relatively new innovation in Europe. Meanwhile, angel investing remains fairly nascent in much of Europe, and even in Britain—where it is quite active—many angels focus on small, operating businesses rather than new ventures.

Finally, wealth tends to be less concentrated in the hands of the very rich in Europe than in the United States. There are far fewer individuals in Europe than in the United States who have sufficient capital to act as venture capitalists or angel investors; but the European middle classes represent a significant level of financial resource, and while each individual may not have the money to make large-scale equity investments, in aggregate the middle classes have tremendous capacity to fund new businesses. The key to tapping into that capacity is allowing each person to invest relatively small amounts—which is exactly what crowdfunding does.

The combination of strong (and quickly growing) levels of entrepreneurial activity, a shortage of seed capital, and the dispersion of wealth creates a set of market conditions to which crowdfunding is an ideal contributor.

Given the commercial imperative for crowdfunding in Europe, it has been good fortune that the evolution of European regulatory systems occurred as it did. In the United States, where the rigid offering rules of the Securities Act of 1933, along with the broker-dealer rules of the Securities Exchange Act of 1934, there has been no scope to fit the crowdfunding model into existing legislation. By contrast, the structure of European regulation has opened the door to a range of crowdfunding models.

The most important regulatory contributor to crowdfunding has been the public offering rules. Under the EU Prospectus Directive, offerings of €5 million or more must be made pursuant to an approved prospectus—which is the equivalent of the registration requirement under Section 5 of the Securities Act of 1933. Individual EU member states are then permitted to impose their own prospectus requirements for offerings below €5 million, but they may not require a prospectus for offerings below €100,000. In other words, throughout all of Europe, offerings of less than €100,000 may be conducted without a prospectus; and in countries that have chosen not to adopt

additional rules—including the United Kingdom—no prospectus is required for offerings below €5 million.

This prospectus requirement, or lack thereof, is critical to crowdfunding. Formal prospectuses require very detailed and comprehensive disclosures, and it often involves hundreds of thousands (if not millions) of dollars in legal and accounting fees to put those disclosures together. For a startup, these costs are almost always untenable, meaning that publishing a prospectus is not an option; being able to raise money without one is therefore essential for crowdfunding to be viable.

The lack of a prospectus requirement does not mean that there is no scrutiny of a company's disclosures. In addition to the general antifraud rules, some countries have specific requirements surrounding "financial promotions," which include any disclosures that are targeted at encouraging people to make an investment. These requirements tend to be a prime example of the principles-based approach to regulation in that they don't specify form or content but simply require that the disclosures be fair, clear, and not misleading. In some cases, the requirement is that a regulated financial services firm sign off on the disclosures—which provides a bit of a burden on companies, but usually a far less onerous one than preparing a full prospectus.

Beyond the public offering rules, the other key aspect of the European regulatory structure relates to the regulation of the platforms themselves. Whereas the United States has specific, narrow categories of financial intermediary—most notably broker-dealers—the European systems tend to use a broader concept of an "authorized firm." Financial services firms of almost any type go through roughly the same processes to become authorized by the relevant regulator, and once authorized, the firm tends to have a fairly broad scope in which to conduct its activities. Each firm is given a slightly different range of permissions, and certain activities such as deposit taking are highly restricted, but, generally speaking, this system creates far more flexibility than the American approach.

That flexibility proves important in new areas of finance like crowdfunding. There was no clear category of regulated firm into which a crowdfunding platform would fall; instead, platforms have been able to seek general permission and then create a tailored list of permissions specifically applicable to them. This has meant that there has been no need to create a new type of regulated firm—as the U.S. "funding portal" concept aims to do—and instead has allowed for supervision and regulation within the existing concept.

The other aspect of platform regulation that has been important has been the range of available exemptions from regulation. A number of crowdfunding platforms throughout Europe operate (or originally operated) on

an unregulated basis. In some cases the justification for their doing so was tenuous at best: relying on “loophole” exemptions that were intended for very different types of transactions, some platforms have made a wager that the authorities would enforce only the letter, and not the spirit, of the law. But in other cases, platforms have sought and received express confirmation from the regulator that their activities did not require authorization, usually because the individual country’s law viewed the activities more as introductions than as formal financial services.

Together, the public offering rules and the approach to platform regulation have thus far created a system in Europe that has permitted crowdfunding to flourish. The rules are far from perfect, and many countries (as well as the EU itself) are now looking at adopting tailored regulation to focus specifically on crowdfunding. For the time being, though, increasing numbers of industrious entrepreneurs are succeeding in setting up platforms and getting new businesses funded.

European Platforms in Practice

Within this commercial and regulatory framework, a number of models have emerged in different European countries. Virtually every country—and every platform within every country—does things slightly differently, and a comprehensive description of every model is outside the scope of this chapter. Instead, we look at a few of the models in order to give a flavor of how crowdfunding is working in Europe.

United Kingdom

The first British equity crowdfunding platform to launch was Crowdcube, in February 2011. At the time of its launch, Crowdcube was not authorized by the Financial Services Authority (FSA), Britain’s financial regulator (which has since been split into the Prudential Regulation Authority and the Financial Conduct Authority). Instead, it purported to rely on what is known as the “intragroup offering” exemption. The exemption, which was designed for internal restructurings, says that if a group company issues shares solely to shareholders of another member of the same group, the transaction falls outside securities regulation. Crowdcube designed a model whereby all investors became nominal shareholders of a Crowdcube group company, while the startup seeking capital temporarily handed over slightly more than 50 percent of its share capital to Crowdcube, thereby itself becoming a group

company. The share issuance took place, and the shares of the startup held by Crowdcube were handed back to their original owners, thereby making the startup independent again.

Shortly after launch, Crowdcube decided to seek FSA authorization, which it received in February 2013. It now operates a direct model whereby it simply intermediates a direct share issuance from the startup to investors. Crowdcube does not approve startup's listings for financial promotions purposes, meaning that under U.K. law it may let people invest only if they self-certify as "sophisticated investors" or "high-net-worth individuals"—roughly the equivalent of accredited investors in the United States.

In May 2012, Seedrs (of which one of the authors of this chapter is cofounder and CEO) received FSA authorization, making it the first equity crowdfunding anywhere in the world to obtain express regulatory approval. It launched in July 2012, operating a different model to Crowdcube's. Instead of acting as a pure intermediary, Seedrs takes a number of active steps in each transaction, including (1) approving each listing as a financial promotion; (2) conducting legal due diligence on each startup, and executing a subscription agreement with it, before completing an investment; and (3) holding and managing the shares of each startup as nominee for each investor. The latter of these means that the startup need only face Seedrs for purposes of votes, consents, and other legal matters, thereby avoiding the need to track down dozens or hundreds of individual shareholders. And because Seedrs approves financial promotions, it may permit a wider group of investors to participate than Crowdcube can, but it still requires investors to complete a quiz demonstrating they understand the risks involved.

In recent months, a plethora of further platforms have emerged or announced their intention to launch, including CrowdBnk, FundtheGap, BanktotheFuture, and a number of others. In March 2013, these platforms—along with some from the debt and rewards side of crowdfunding—came together to form the U.K. Crowdfunding Association in order to present a united industry perspective on the growing space. In October 2013, the FCA (as successor to the FSA) proposed a set of rules tailored specifically to crowdfunding. The proposals were generally well-received by members of the U.K. Crowdfunding Association and are expected to become law by April 2014.

The Netherlands

The leading equity crowdfunding platform in the Netherlands is Symbid. It operates what one may call a "crowdfunded pledge fund" structure, whereby

intermediate entities called “cooperatives” hold the shares of the underlying startups, and membership units in the cooperatives are offered to investors. The cooperative structure is relatively familiar to Dutch investors—some major banks in the Netherlands are organized as cooperatives—and their use involves far fewer formalities than normal Dutch companies would. In addition, like Seedrs’ nominee structure, cooperatives allow the shares of the underlying company to be managed by an intermediary. Before launching, Symbid sought and received confirmation from the Dutch regulatory authorities that authorization would not be required for this structure.

Another platform, Seeds.nl, was established by the Dutch bank ABN AMRO and uses a contractual revenue sharing right in lieu of direct equity. This means that an investor actually becomes a creditor of the company instead of a shareholder; however, unlike straight debt, returns are based on performance rather than being a fixed sum.

France

In France, WiSEED has established a dual model, with both direct equity intermediation (similar to Crowdcube) as well as a system to place units in an intermediate holding entity, called a “WiCAP,” that can sell these repackaged units to the public (similar to Seedrs or Symbid). Notwithstanding WiSEED’s successful operation of both of these models, the Autorité des Marchés Financiers (AMF), France’s securities regulator, has so far expressed a good deal of discomfort with crowdfunding and has indicated in private an intention to be more restrictive in the market than have other European regulators.

Germany

Germany is one of the few countries that separately regulate the content of financial promotions, including for offerings that fall outside the Prospectus Directive, by creating prospectus-like requirements in its Civil Code. Nonetheless, some equity crowdfunding platforms are operating, and a common model is the sale of silent partnership units from a silent partnership between the investors and the investee company (the active partner). This model is used by Innovestment and previously also by Companisto (which now uses subordinated debt). Silent partnerships are a secret relationship between the partners, in the sense that it is unknown to third parties, as the active party still conducts business in his name alone and does not mention in its daily business undertakings the fact that profits will be shared. Silent

partnerships have a beneficial tax treatment in Germany, as the payments are treated as loan payments and are therefore tax deductible as a business expense of the active partner.

Italy

While Italy has not seen as much crowdfunding activity as some of its European neighbors, it is the one European country that has enacted a crowdfunding-specific law. A recently passed piece of legislation regulates the country-specific promotions below €5 million for companies that can obtain the label of an “innovative startup.” Although the regulation creates some requirements for those to-be-crowdfunded innovative startups (e.g., a need to source a more traditional financier to underwrite at least 5 percent, and pursuing very strict research-and-development-related activities), platform operators also need to meet a number of restrictive requirements. Banks and adequately authorized investment firms may act as a platform manager, but subject to a number of authorization requirements, ad hoc authorizations for other types of managers are also possible. Such platform operators then have to meet a number of informational requirements, and they also need to undertake checks on the level of the innovative startups as well as the investors. For instance, they need to provide investors with a set of mandatory information regarding risks that are associated with investing in young firms (e.g., loss of capital, illiquidity, rarity of dividends, dilution, need for diversification), the right of withdrawal (the existence of such right is a requirement from the regulation, as long as the campaign is not completed), and so on. Retail investors are limited to investing 500 euro per project or 1,000 per year (which may be exceeded, but then the crowdfunding platform faces a traditional regulatory regime instead of the lighter regime from the crowdfunding regulation), and they must demonstrate that they understand the nature of the activity of the portal, the nature and specificity of the financial instruments issued by innovative startups and the relative risk of each offer. This approach bears certain similarities to the JOBS Act but also draws closely on some of the measures implemented by platforms elsewhere in Europe.

Looking Ahead

These and other platforms have found ways to use Europe’s existing regulations to make crowdfunding work in their respective countries, and in doing so they have put Europe at the vanguard of the global crowdfunding ecosystem.

But the status quo is not necessarily sufficient: the preceding examples demonstrate some of the hoops that platforms have jumped through (and, more important, the limitations they have imposed) in order to develop structures that work under their national laws; and the absence of any cross-border crowdfunding platforms shows that the lack of EU-level rules remains a major obstacle. Looking forward to the next few years, there are two sets of developments that will undoubtedly come under discussion and, if implemented properly, could help accelerate the growth of European crowdfunding.

The first, very simply, is a set of national laws that are tailored specifically to crowdfunding. Italy, as discussed, has already led the way here, and a number of other countries are thinking about putting forward similar legislation. If done properly, these laws can be particularly helpful in allowing platforms to move away from peculiar structures (like the Dutch cooperatives and German silent partnerships) and facilitate investments in ordinary limited companies. This, in turn, would create greater certainty and simplicity in the system, encouraging more platforms to launch and more startups and investors to use them. But new legislation is not without risk: badly written laws can be worse than no laws at all, and if the new measures are too restrictive or fail to be fit for purpose, the effect could be to stifle, rather than nourish, the growth of crowdfunding.

As valuable as well-drafted national laws would be, the bigger prize comes in the form of EU-wide coordination. Were platforms able to operate across European borders, they would have available to them a larger market—in terms of population, capital, and potentially even startups—than the entirety of the United States.

This sort of coordination could be realized in one of two ways. The most straightforward would be through a mutual recognition regime. No crowdfunding-specific rules would be adopted at the EU level, but instead each EU member state would be required to permit a crowdfunding platform to operate within its borders so long as the platform was properly regulated and supervised in its home member state. This sort of mutual recognition regime is common in European law and indeed forms the backbone of much of the regulation of the internal market. The advantage to this approach is that it avoids the need for a lengthy policy-making process at Brussels level—something that could take years and may not result in the most sensible outcome. But while mutual recognition would free up member states to devise their own rules (and to do so as quickly as they like), that opens the door to a potential “race to the bottom,” with member states competing for the most lax set of rules.

The alternative would be EU legislation that sets out the core rules—or at least a set of minimum standards—for crowdfunding platforms. If the rules were well written, this approach would have the potential to provide a clear, clean, and unified approach that allows platforms to operate on a cross-border basis while ensuring that every player in the market was subject to a sufficiently robust regulation regime. The problem, though, comes in both the detail and the timing: finding a set of substantive rules that satisfied different member states with very different existing regulatory frameworks will be a challenge and could easily result in compromises that make the situation worse for everyone; and even if a good result could be achieved, it would almost certainly take a number of years to get there. These concerns around detail and timing are not without precedent: in many ways the JOBS Act process and delays serve as a useful precedent for what would be in store for any attempt at comprehensive EU crowdfunding legislation.

CHAPTER 12

Living with the New Reg D and Its Impact on Pitch Events and Demo Days

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With the passage of the Jumpstart Our Business Startups (JOBS) Act, the regulation governing most private securities offerings is undergoing a dramatic makeover. Congress tasked the Securities and Exchange Commission (SEC) with developing new rules allowing companies to generally solicit funds, subject to restrictions as determined by the SEC. In July 2013, the SEC issued final rules on this topic and also proposed additional rules that are not yet final. Managers of incubators, accelerators, angel groups, and others involved in startup capital raising have expressed great concern about how the revised regulations will affect them, particularly with respect to their public-facing events.

Whether presenting at a demo day event, angel group meetings, or business plan competitions constitutes general solicitation is a question that has caused great concern among many angel groups, incubators, and other event organizers around the country. This chapter is designed to provide practical tips to event organizers on how to structure their demo day, pitch event, or angel group meeting event in light of new federal rules and the current regulatory landscape.

Starting September 23, 2013, the final rules published by the SEC in July 2013 went into effect and companies began using general solicitation (or advertising) in connection with their securities offerings under the new Rule 506(c) of Regulation D of the Securities Act of 1933, adopted under Title II of the JOBS Act. However, companies that choose to take advantage of general solicitation under the new rules will have to take steps they did not need to take in the past, including additional verification of accredited investor status. If the proposed rules go into effect—which, as of the writing of this chapter, they have not—there are further steps that would be imposed on companies choosing to generally solicit, including making advance filings of a Form D, filing with the SEC the materials used in the general solicitation and including specific language (referred to as “legends”) in written solicitation materials.

There has been concern about whether the implementation of the new final rules will have serious negative consequences for angel investing. Most notably, some worry that existing events such as demo days, business plan competitions, and pitches to angel groups could be swept into the category of general solicitation requiring compliance with the Rule 506(c) restrictions. However, companies can still raise funds in the same way as they have in the past by complying with Rule 506 of Regulation D (with the former Rule 506 now revised to Rule 506(b)) that always prohibited making general solicitations. Participation in angel group “pitch” events typically was not viewed as general solicitation in part because companies and guests were curated such that attendees were accredited investors with some preexisting relationship between themselves and the angel organization.

However, as a result of the SEC’s implementation of Title II of the JOBS Act and its new rules that allow general solicitation under Rule 506(c) (provided the other requirements of Rule 506(c) are met), general solicitation is allowed and significant attention is being paid to what that means. Additionally, the proposed rules would require companies using general solicitation to provide the SEC with their solicitation materials, something that many private companies and their investors do not want due to confidentiality concerns as well as concerns about inadvertent noncompliance.

With the new rules, there will be special challenges for demo days or other pitch events if presenting companies are simultaneously engaged in fundraising activities. Some of the presenting companies may choose to generally solicit using the new Rule 506(c), while others may actively avoid general solicitation and rely on the old approach using Rule 506(b).

Event organizers are left with the dilemma of navigating these new rules and sorting out if they need to change things as a result. Many are receiving conflicting advice about what the rules mean for them and are concerned

about how they should structure their events. Questions such groups are asking include:

- What is general solicitation?
- What are the new rules?
- Can I ignore the new rules and do what I've always done?
- Is my event a demo day or a pitch event?
- If my event is a demo day, how can I structure my invitation and event to avoid general solicitation?
- If my event is a pitch event, can some companies use general solicitation under Rule 506(c) while others avoid it and rely on Rule 506(b) at the same event?

Key Securities Law Concepts

As background, federal law requires all sales of securities to either be registered with the SEC or qualify for an exemption from registration. Publicly traded stocks such as Apple or Google are registered with the SEC. Most startup financing transactions have been done relying on Rule 506 under Regulation D for their securities exemption. Historically, under Rule 506, startups could raise an unlimited amount of money from certain high-net-worth investors so long as the company did not engage in general solicitation as defined in Rule 502(c) of Regulation D.

What Is General Solicitation?

Rule 502(c) of Regulation D provides that “neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

1. Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio.
2. Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

In general, this means that there will need to be a substantial preexisting relationship with those to whom an issuing company makes an offer of securities under Rule 506 (now Rule 506(b)).

What Is an Accredited Investor?

Under Rule 501(a) of Regulation D, an accredited investor is a person who meets certain qualifications and therefore is deemed able to protect themselves in making investment decisions without certain additional protections under the securities laws such as those obtained through the SEC registration process and the public disclosure of information about the company that is made through the process of becoming an SEC reporting company. There are several ways to qualify as an accredited investor, with the most common being (1) an individual with at least \$200,000 (or \$300,000 jointly with a spouse) in annual income over the past two years or at least \$1 million in net worth (excluding the value of a principal residence) or (2) an entity in which all of the equity owners are accredited investors or the entity has at least \$5 million in net assets.

The JOBS Act

The JOBS Act was passed on April 5, 2012, based on significant public support and demand on our president and Congress to help create jobs. The JOBS Act consisted of the following parts:

Title I: IPO On-Ramp

Title II: Lifts the Ban on General Solicitation

Title III: Crowdfunding

Title IV: Reg A+ Offerings

Title V: Shareholder Limit

In relevant part, Title II of the JOBS Act directed the SEC to promulgate rules to lift the ban on general solicitation in effect under Rule 506, as discussed above. Title V of the JOBS Act raised the limit on the number of shareholders a company may have before it triggers public reporting requirements from 500 to 2,000 accredited investors. The combination of these two changes could result in private companies utilizing new methods of marketing securities to investors other than a traditional securities offering registered with the SEC such as an initial public offering.

Rule 506(b): The “Old Way” Preserved

In implementing these rules, the SEC chose to preserve the past Rule 506 approach in the form of Rule 506(b) so as not to disrupt the way offerings

have traditionally been done. If a company is not using general solicitation, they can continue to conduct offerings as they have done in the past in terms of verification of accredited investor status¹ and, presumably, continue to use self-certification of accredited investor status (i.e., investors can continue with the check-the-box forms or sign representations indicating they are accredited investors). That said, there is some concern that we will see heightened regulatory scrutiny on the issue of accredited status even for companies conducting Rule 506(b) offerings that are not using general solicitation. This is in part due to the concern that many companies may generally solicit through some action taken in the process of the offering (perhaps not even realizing it until after the fact) and find themselves unable to rely on Rule 506(b). As a result they may try to fit within Rule 506(c) and need to meet the higher verification standards. As noted above, while the “old way” of conducting a Rule 506(b) offering was maintained, the new focus on accredited investor status has caused concern that the regulatory landscape could be changing even for those companies not using general solicitation for their offerings.

In addition, as discussed below, the SEC also has proposed further rules regarding Rule 506(c) offerings, including advance Form D filing requirements and general solicitation disclosure and documentation filing requirements that have not been finalized. We expect that practices may need to evolve as the SEC issues new final rules or additional commentary and its views become clearer.

Rule 506(c): The “New Way”

Under the new Rule 506(c), companies can generally solicit (or advertise) their securities offerings so long as all of the investors who actually purchase securities in the offering are accredited. This means that companies will be able to talk about their offerings in public seminars, send out e-mail blasts, push offering information out on social media web sites, and run ads on

1. The JOBS Act did effect one important change that applies to all Rule 506 offerings, including those relying on Rule 506(b): the “bad actor” rules set forth in new Rule 506(d). In order to rely on Rule 506, the new rules require that neither the company nor any “covered person” have committed certain securities-related violations. Note that “covered persons” includes officers, directors, general partners, managing members, 20 percent shareholders, investment managers, promoters, and compensated solicitors, and companies will likely desire to obtain questionnaires from such covered persons. A sample of such a questionnaire is available at www.TheVentureAlley.com at www.theventurealley.com/vc-and-pe-funds/new-sec-rules-disqualifying-bad-actors-in-private-fundraising/.

television, radio, and the Internet. Companies will generally be free to talk about their offering to whomever they want.

Using this rule, however, comes with certain additional compliance requirements. Companies that generally solicit under Rule 506(c) may only *sell* securities to accredited investors in the offering. Additionally, companies will have to take additional steps to verify that all purchasers actually are accredited. In its release issuing the new rules, the SEC explicitly said that it did not believe self-certification by the purchaser checking a box was as adequate (absent other information) to verify the accredited status for purposes of Rule 506(c).

The new Rule 506(c) includes several nonexclusive methods that will be deemed to satisfy the verification requirements (provided that the issuer does not have knowledge that the purchaser is nonaccredited). The “safe harbors” (and they are safe harbors, not mandatory methods) the SEC has provided for verification of accredited investor status include:

1. Income verification by checking federal tax forms, including W-2s and tax returns, and a statement by the investor that he or she expects enough income in the current year to remain accredited.
2. Net worth verification by checking a recent credit report (within the past three months) and bank or investment account statements, together with a written representation from the purchaser that he or she has disclosed all liabilities necessary to make a determination of net worth.
3. Certification of accredited investor status by a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant who has verified the purchaser’s accredited investor status.

The SEC also included a form of “grandfather” provision in the new Rule 506(c), which provides that for existing investors who were accredited investors in a Rule 506(b) offering prior to September 23, 2013, a self-certification of accreditation status by such investor at the time of sale in a new offering by the same issuer under Rule 506(c) will be deemed to satisfy the verification requirement in Rule 506(c), although the company may not rely on this exemption if it has actual knowledge that the investor is not accredited.

Structuring Your Event

We refer to a “demo day” event as one in which companies present their new products or services. A good example of this is New York Tech Meetup, where

it's all about the product and they frown upon any discussion of business models and discourage presenting companies from mentioning their financing or capital raising.

By contrast, a "pitch event" is organized for the purpose of helping presenting companies raise capital. Now, with the new Rule 506(c), pitching companies will need to decide if they are going to generally solicit funds under the new rule, or use the approach allowed under the old Rule 506(b).

These two types of events can be structured differently to address the different legal implications of demonstrating a new product versus trying to raise funds. Also, within the pitch events, there will be companies wanting to fundraise without general solicitation and those who decide to publicly try to raise funds. The differences among the types of presentations is where event organizers can help by paying attention to the general solicitation regulations and structuring events to provide appropriate environments.

Demo Days

For true demo days, where the presenting companies are not actively fundraising and the purpose is to demonstrate a company's products or services (rather than recruit investors), organizers can publicize the event freely and all may attend. The organizers should not mention fundraising in any promotional materials. Each company should be given specific instructions to avoid mentioning their fundraising efforts and to avoid presenting their business plans, financial projections, growth rates, and other topics typically covered in a fundraising context.

If you are not doing a "demo day" as described here, your event probably falls into the "pitch event" category. For these events, it is important to ask each of your presenting companies whether they are going to be relying on Rule 506(b) (without general solicitation) or Rule 506(c) (with general solicitation). You should also consider getting written confirmation from each presenting company on this point, and encourage them to speak to experienced legal counsel about it, as many companies at an early stage may not be actively consulting counsel on securities regulations in advance of commencing pitch activities. Included at the end of this chapter as Exhibit A is a form of confirmation that can be sent to each company in advance. For pitch events, questions about this should be included in your application process. For accelerators, companies will need to decide which route they intend to go prior to pitch day.

Company Application Process

- Ask each company to confirm that they are familiar with the rules and restrictions regarding soliciting funds. You do not want to be giving them legal advice, but you can suggest they read up on the topic and consult experienced legal counsel.
- Ask whether they will be relying on Rule 506(b) or Rule 506(c), or whether they plan to use any general solicitation of any sort in their fundraising process (now or later).
- Ask each company if they have offered securities in the past six months and whether general solicitation was used for that offering.

506(c)-Only Events — General Solicitation Expected

- If the companies you plan to include intend to generally solicit (and therefore you expect they will be relying on Rule 506(c)), you can freely invite members of the public (both accredited and nonaccredited investors).
- As discussed earlier, since companies using Rule 506(c) will be able to sell only to accredited investors who have verified their accreditation status, potential buyers may be surprised when asked to do so. You may want to explain that for any planned purchases by the attendees, they should expect to be asked for verification, which may include significant financial detail or certification from one of their financial or business advisers.
- Have each company confirm that it is aware of the consequences of generally soliciting.
- If the proposed rules described below go into effect, ask each generally soliciting company to confirm it is making the appropriate regulatory filings and has included appropriate disclaimers and legends on the company's presenting materials. See Exhibit A at the end of this chapter.
- An *open* pitch event is one in which members of the public in general can attend, the event is promoted publicly and often requires payment of a registration fee. From a legal perspective, this is similar to a “demo day” discussed earlier.
- A *closed* pitch event is typically open only to accredited investors with a preexisting relationship to the event organizers, such as a meeting of an angel investor group.

Closed Pitch Events

For a closed pitch event, managing the invitation and event promotion process is the key concern. Organizers should take extra care to ensure that the

event is not a “meeting whose attendees have been invited by any general solicitation or general advertising.” In practice, this means:

- Send invitations only to people who are part of your existing network and are known to be accredited investors.
- Obtain a completed accredited investor questionnaire or certification on file for each person receiving an invitation. It is likely that most individuals will not be comfortable sharing the level of data with individual startups or event organizers that would be needed to meet one of the safe harbor verification standards for accredited investor status, so many expect that broker and CPA certifications will become the norm (since they have the investors’ financial data already). There are also likely to emerge third-party services consisting of broker-dealers, lawyers, online platforms, or others that will specialize in verifying accredited investor status for a fee. Getting out in front of the issue should help streamline future events.
- At registration for the event, organizers should confirm that they have a completed accredited investor questionnaire or certification on file prior to admitting the attendee.
- Do not include the event posting on public event listings or otherwise send out invitations to any public forum (i.e., do not list the event on Startup Digest, Gary’s Guide, Twitter, Facebook, LinkedIn, etc.).
- Do not invite or admit press. All attendees and presenting companies should be informed to not disclose information about fundraising publicly (i.e., companies should not appear in TechCrunch noting that they are “raising \$1 million”).

If the event meets these criteria, companies should be able to talk openly about their company, including specifics about securities offerings, without their participation becoming a general solicitation.

Events for Companies Relying Solely on Rule 506(b) and Not Using General Solicitation

These events should be carefully structured to avoid any discussion by companies of their fundraising activities and plans. This means that during the presentation portion of the event:

- The company should not mention anything about their fundraising plans, and the following should not be included in a pitch deck or verbal pitch:
 - Any mention that the company is fundraising.

- Discussion of financial projections or results.
- Terms of offering (i.e., convertible note, series A, valuation, etc.).
- Event organizers should make clear that such material is not allowed and consider reviewing any written presentation material in advance to ensure compliance.
- Carefully moderate any open Q&A. Any questions touching on fundraising issues should be handled by the company saying “we are not here to discuss fundraising at this time, but I would be happy to speak to accredited investors offline.”

All conversations about financing should happen privately in one-on-one conversations with known accredited investors (and not through publicized opportunities to meet with investors or companies seeking funds) or in a separately-held closed event conforming with the procedures previously outlined for closed pitch events. This could include holding a separate dinner or networking portion with a prequalified group of accredited investors. If potential investors approach a company, the company can explain that it is selling only to accredited investors and screen an investor at that time.

Events for Companies Relying on Rule 506(c) and Using General Solicitation

If all of the presenting companies at an event turn out to be using 506(c) with general solicitation (or you screen them in this way), then you will not need to worry about general solicitation and can freely invite members of the public (both accredited and nonaccredited) and the companies will be allowed to pitch, talk about their securities offering, and talk about the specifics of their financial model. Companies could even direct investors to invest in real time during the event through an online platform. However, all of the accredited status verification issues discussed earlier must be addressed because companies may sell only to accredited investors in a Rule 506(c) offering and must meet the accredited status verification standard.

As the event producer, you should ask each company to confirm that it is familiar with the requirements of Rule 506(c), has consulted experienced legal counsel about participation in the event or similar events, and if the proposed rules discussed below are adopted, has included appropriate disclaimers and legends on the company’s presenting materials and has made (or is making) appropriate and timely regulatory filings. See Exhibit A for sample language.

Proposed SEC Rules

As of this writing, the SEC has proposed additional regulatory requirements for companies using general solicitation under Rule 506(c), including:

- Make an advance Form D filing 15 days before any general solicitation. This means that the company needs to make a filing at least 15 days before the event. If this requirement comes into effect, event organizers should request that a copy of this filing be delivered 15 days prior to the event.
- Attach prescribed legends to the pitch deck or any other written material (this would include any recording of the pitch).
- File any written materials with the SEC on or prior to the date of the event (this generally means that the pitch deck would need to be prefiled with the SEC).

As of the writing of this chapter, these proposed rules are currently in a comment period and not final. They might never be enacted or could change substantially before they are. Event organizers should be in contact with each company and ask them to consult with counsel before any event to confirm compliance with the latest rules and regulations.

Events with Both 506(b) and 506(c) Companies

These events create special challenges to event organizers. One option is that you can run the entire event as if all companies were 506(b) companies and follow the instructions above. Alternatively, you could segregate the 506(b) and 506(c) companies via separate rooms or separate times (e.g., morning is 506(b) only and afternoon is 506(c)). In that case:

- The 506(b) room would only admit investors with a substantial preexisting relationship with the event group and with a completed accredited investor questionnaire on file, preferably received at least 30 days before the event.
- Any public advertisements for the event would not mention the 506(b) time, room, or companies.
- The 506(b) invitation should be done in accordance with the preceding instructions.
- The 506(c) room and companies may be broadcast publicly and should follow the relevant instructions.

Event Series—506(c) Event Followed by 506(b)

From an event organizer's perspective, a practical solution to this problem may be to hold two separate events, with the 506(c) event used to establish a preexisting relationship with accredited investors, who can then be invited to a subsequent 506(b) event.

Event 1—506(c) companies only. Hold the first pitch event solely with 506(c) companies allowing for broad promotion. As part of the registration process for the 506(c) event, each accredited investor should complete an accredited investor questionnaire. During the event, the organizers should work to establish a relationship with each accredited investor in attendance.

Event 2—506(b) companies only. A second event could be held later, preferably at least 30 days after the first event. The organizers will then be able to invite all of the accredited investors with which they established a preexisting relationship in the previous 506(c) event. Companies that are relying on 506(b) could participate in this second event if it were run as previously described in the section regarding 506(b) offerings.

Note that any company that participates in a 506(c) event—or that generally solicits in any other manner—will be required to comply with the rules of 506(c) even if it later participates in a closed accredited investor-only 506(b) event. In other words, there is no going back to relying on Rule 506(b) once a company has participated in an event that was structured as a Rule 506(c) event with the public invited.

For any event, it is a good practice to make it clear that the organization in no way endorses, and has not verified the accuracy of, any of the statements made by the presenting companies. Exhibit B, found at the end of this chapter, is a sample disclaimer, which can be included in event materials and/or read at the beginning of an event.

It remains to be seen how all of the final rules will shake out, but it is clear that companies and the groups that manage events where companies and potential investors interact are going to have to be well prepared and vigilant about keeping current with the new rules and the possible enactment of additional proposed rules.

EXHIBIT A Sample Request for Acknowledgment for Presenting Companies

(Each company applying to present should confirm that the following statement is true and check the appropriate boxes below by completing this and returning it to event organizers in advance.)

By signing below and/or forwarding this e-mail from my e-mail account, I acknowledge and confirm that [**Company Name**] ("Company") and its officers, directors and executive management (including the Company's presenter(s) attending your event) are aware of the rules regarding general solicitation and the Company has been encouraged by you [**Angel Organization/Event Organizer Name**] to consult with experienced legal counsel about applicable securities regulations in advance of participating in your event.

I am the Company's [**Presenter's Title**] and I have consulted with experienced legal counsel about the implications of Rules 506(b) and 506(c).

1. For our current securities offering, the Company plans to rely on the following securities law exemption (check one):

_____ Rule 506(b) and will *not* be conducting any general solicitation or advertising;

OR

_____ Rule 506(c) and will be conducting general solicitation or advertising

OR

_____ Other exemption (please specify here: _____).

2. The Company _____ has / _____ has not (check one) offered securities (debt or stock) in the previous 6 months.

If the Company *has* offered securities in the past 6 months, general solicitation

_____ was used / _____ was not used / _____ not applicable (check one).

On behalf of the Company, I confirm we have made, and will continue to make, the appropriate regulatory filings and have included appropriate disclaimers and legends on our presenting materials.

Signature: _____

Title: _____

Date: _____

EXHIBIT B Sample Disclaimer

The information presented here is the sole responsibility of the presenting company. **[Event Organizer]** has not taken any steps to verify the adequacy, accuracy or completeness of any information, materials or statements presented here. Neither **[Event Organizer]** nor any of its officers, directors, stakeholders, agents, and employees makes any warranty, express or implied, of any kind whatsoever related to the adequacy, accuracy, or completeness of any information presented here.

Each presenting company and investor is responsible for ensuring his/her/its compliance with applicable securities laws.

[Event Organizer] does not give investment advice, endorsement, analysis or recommendations with respect to any securities and is not a broker, venture fund, or an investment adviser.

Afterword

If popular websites like Kickstarter and Indiegogo got the crowdfunding party started, it is equity crowdfunding that's going to keep the party going. And it's already off to a fast start: Deloitte expects all forms of crowdfunding to reach \$3 billion globally in 2013 and grow at a compound annual growth rate of 100 percent over the short term.¹ Equity crowdfunding, still in its infancy, is expected to grow even faster, with a compound annual growth rate of 114 percent, according to Massolution,² a crowdfunding research firm.

Crowdfunding may still be in its infancy, but it's making its way quickly to the mainstream both in the U.S. and globally. New platforms are emerging every week to pair crowds and their funds with worthy projects. North America leads all regions in crowdfunding volumes, growing an estimated 105 percent to \$1.6 billion by the end of 2012.³ Crowdfunding, in all its splendor, threatens to disrupt traditional funding models, as companies and individuals are becoming more receptive to these alternative channels for raising capital.

Crowdfunding had a breakout year in 2013. Lending Club, a peer-to-peer lending platform, surpassed \$2.5 billion worth of loans underwritten by the crowd. Companies raising money via donation/rewards-based platforms were repeatedly featured in the news with story after story of successful crowdfunding campaigns of over \$1 million. It appears that everything can be crowdfunded: from mortgages to medical school educations to innovative scientific discoveries.

In fact, 2013 marked a milestone year in the crowdfunding industry as the stage was set for the newest and, perhaps, largest form of crowdfunding:

1. Let's get together: Crowdfunding portals bring in the bucks. <http://www2.deloitte.com/content/www/global/en/pages/technology-media-and-telecommunications/articles/tmt-technology-predictions-2013-crowd-funding-portals.html>

2. 2013 Crowdfunding Report. <http://research.crowdsourcing.org/2013cf-crowdfunding-industry-report>

3. Ibid.

equity crowdfunding. With equity crowdfunding, investors can pony up as little as \$1,000 each, which, when pooled together, is used to buy an equity stake in a company. This model can be used to fund and develop businesses like a local gelato stand. But the real sexy application the industry and investors are betting on is startup investing.

If equity crowdfunding is truly the next frontier, it will require a change to the way companies are presently allowed to solicit investments. In September 2013, the first leg of the JOBS Act kicked into action as equity crowdfunding platforms were essentially given a blessing by the SEC. By opening up general solicitation of new deals to the public, investors will begin to see opportunities showing up in their Twitter streams, Facebook feeds, and elsewhere online. Shortly after the rules on general solicitation went into effect, the SEC also proposed its long-awaited rules for equity crowdfunding. It looks as though equity crowdfunding is on the cusp of breaking out.

Equity crowdfunding builds off the excitement already being generated in donation/rewards-based crowdfunding. And while the public and media await further liberalization of regulation to open up private equity investing to the masses, the surprising thing is that as of this writing, equity crowdfunding in its current form—that is, restricted to accredited investors—has already succeeded. Firms like AngelList, FundersClub, and our firm, OurCrowd, have already invested tens of millions of dollars from the crowd in the first generation of equity crowdfunded startups.

And it makes sense. Wealthy investors, tiring of an undulating stock market, years of low interest rates, and seeing tech IPOs net early investors billions of dollars of profits, are looking for a home for their money. According to April's Northern Trust survey of high-net-worth investors, 30 percent are more inclined to consider alternative investments than they were five years ago. Royal Bank of Canada estimates that globally, high-net-worth investors account for \$45 trillion of investable capital—5 million U.S. households alone account for about \$10 trillion, according to Carlyle, a leading private-equity firm.

As adoption of crowdfunding increases, additional scrutiny will be placed on the platforms that enable crowdfunding to take place. Already, the market is starting to take off in different directions. With this in mind, we pose a few questions to consider.

Question number one is this: What's the funding platform's role post-funding? Part of this conversation has to do with defining the role of the evolving equity crowdfunding platform. Is it just an electronic enabler of transactions? Or does equity crowdfunding, in some sense, replace a traditional funding source, like venture capital? If it's the latter, the platform

should replace other typical functions, for example, due diligence, that the investment intermediary typically performs.

This parallels discussions around platforms in general and is similar to the difference between Apple's mobile strategy and Google's open-source Android platform strategy. Apple's iOS has been a walled garden, sacrificing the quantity of apps available on its platform but ensuring the quality of those that are made available. Google, on the other hand, takes a broader approach, making it easy for pretty much any app to be available for distribution on Android.

Similarly, equity crowdfunding has also seen a bifurcation. Firms like *Angellist* are following the Android playbook, opening up their platforms to almost every startup that's raising money. Contrast this with more selective crowdfunding websites that utilize platform dynamics, such as user ratings, meta data and other checks and balances, to help create a hierarchy of quality within its offerings. The other approach, which follows the Apple model, are crowdfunding platforms that see themselves performing a similar role as a traditional investor in risky, early-stage companies. Successful angel investors work hard to mitigate risk via due diligence and by helping to actively manage portfolio companies with ancillary assistance in hiring, business development, and future funding rounds.

A follow-up question is this: Is due diligence the responsibility of the investor or the platform? Regardless of the different approaches crowdfunding platforms have taken, no one disagrees that picking winning investments in startups is tricky. While the payoffs can be huge if you get it right, the odds are against the investor. The average early stage investment doesn't end well—the majority of startup companies never celebrate their fifth birthday. To improve the odds, an investor must perform due diligence. Investors should use a system to screen out the poorer investment candidates by analyzing criteria such as the potential market, the team, and the startup's go-to-market plans.

Given the heightened risk environment, it's imperative that due diligence be performed on potential investments. Some platforms leave the diligence to the investor while others provide sophisticated screening in their role as a professional curator of deals. This is a crucial decision as to the nature of the platform and impacts its future plans for size, scale, and brand. Screening deals requires experience and takes a lot of time and manpower to be done right, limiting the number of potential candidates a platform could make available to the crowd. Conversely, for a less discriminating platform, it's caveat emptor for the investor. Going forward, education will play a key role to the success that investors—and therefore, the industry—enjoys.

So after an investment is made, it's logical to ask: What's next? One way an investor (or platform) can help boost a startup's chance to produce positive

ROI is by supporting a company after it receives investment. That's what good venture capitalists and other private equity investors do after they make an investment. They spring into action, orchestrating a supportive ecosystem for their portfolio companies. Early-stage investors lend their experience to help companies cross the startup chasm by advising on key hires, introducing potential business partners, and most importantly, helping prepare for future funding rounds that will sustain a company through maturity.

Key future questions remain: Can equity crowdfunding platforms afford to provide this level of support to all the companies their investors invest in? Can they afford not to?

If equity crowdfunding is changing how companies raise money, it may also be the future for how people invest their money. Investors have been educated to think that anything outside traditional stock market investing is too risky. The 2007 to 2008 financial period showed that buy-and-hold investing and passive indexing—money management strategies that were recommended *because* they were safe—could also on average lose more than 50 percent over a 12-month period. If equity crowdfunding lives up to its potential, it's conceivable that investors manage at least part of their 401(k)s and IRAs by logging into a crowdfunding platform and allocating their capital.

Of course, for this to work, it will require a lot of investor education. Just as investors have learned what characterizes a good blue-chip stock, investors using equity crowdfunding will learn how to size up private companies. Investment quality ratings will arise, like S&P does for credit markets and stocks, and this will provide third-party coverage of startups to help investors with their decision making. As more people become familiar with the asset class and the startup ecosystem, investor education will arise to fill in the knowledge gaps and help investors manage risk better.

From our experience running the OurCrowd platform, it's become clear to us that startup investing requires a pretty robust system to sift through potential opportunities. It all begins with the founders and the team running the show. "A startup's management team is its lifeblood . . . no amount of awesome ideas will ever overcome a fundamentally flawed management team," said Carlos Espinal, partner at European micro-seed investment fund, Seedcamp, as he described management's importance as a success metric.⁴

It's therefore important for investors to have the tools to identify good managers. Startup investing has been active long enough that investors are getting the opportunity to invest in teams that have multiple successful exits

4. <http://thedrawingboard.me/2011/09/12/how-does-an-investor-evaluate-a-startups-team/>

under their belts. Past performance doesn't necessarily guarantee future success but having already successfully ridden the startup roller coaster helps. A founding figure of venture capital, George Doriot, was fond of saying that it is always better to back an A-team with a B-plan than a B-team with an A-plan.⁵

As entrepreneurs use social media to market themselves and their companies, investors get a ringside seat into their activities. By analyzing all of this big data being produced by social networks, investors can get a better idea of what constitutes entrepreneurial winning traits. In a recent paper,⁶ researchers showed that the more entrepreneurs are embedded in their own tribe, the more successful their business endeavors.

One approach investors use to mitigate the risk of investing in early stage companies is to identify companies that have already achieved a certain level of success. We call this "traction" and it can express itself in a number of forms. An early-stage company that has found customers to spend real money on a product is inherently different than a company that's still working on its big idea or just embarking on building a product. To a certain extent, traction validates businesses (though it doesn't ensure their future success). Having early-stage partnerships or distribution partners validates a company's initial (and potential) value in the market.

It may take a village to raise a child but it takes an even larger community to build a startup. Getting a company off the ground and getting it to the stage of being able to sell it for a nice profit requires the support of advisers, customers, partners, and investors. Crowdfunding is going to be an extremely interesting experiment in not only tapping the capital of smart people around the world, but also leveraging their collective intellect, business connections, and experience in building and running companies. The more talent a company surrounds itself with, the more it improves its chances that it will return money to its investors. With this in mind, following are a few more thoughts regarding the search for good deals.

Buying low and selling high works as an ethos for all types of investing. It's especially true for equity crowdfunding as investors are coming in at a very early stage with the intention of selling out only much later. There aren't really any liquid markets (yet) to "trade" a small private investment, so equity crowdfunders

5. Ibid.

6. Nann, Stefan, Jonas S. Krauss, Michael Schober, Peter A. Gloor, Kai Fischbach, and Hauke Fuhres, *The Power of Alumni Networks: Success of Startup Companies Correlates with Online Social Network Structure of Its Founders* (January 11, 2010). MIT Sloan Research Paper No. 4766-10.

are going to hold on to their investments for the long term. Determining what constitutes a good valuation is an art as much as a science. Expect valuations for good deals to go up as more investors clamor to get access, while valuations of poorer deals will flounder as so many new deals come online.

Peter Lynch, the famed Fidelity mutual fund manager and one of the most successful stock market investors in history, liked to say that investors should invest in a company that any monkey could run . . . because one day the monkeys will run it. We like investing in startups that are easy to understand, easy to discuss with other potential investors, and easy to identify their profitability levers. Warren Buffett invests only in companies he understands, and equity crowdfunders would do well to follow his sage advice.

Lastly, equity crowdfunding investors should pay special attention to startups addressing large markets. Not only should the market be big (we're talking about markets that have already matured), but it should be a growing market. This also helps ensure that there doesn't need to be a whole lot of market education to make an investment work—if the market is growing, participants already “get it” and are spending money addressing it.

Put together an investment checklist and make sure you stick to your principles of sound investing—equity crowdfunding demands no less. Investing in startups via equity crowdfunding requires patience, diligence, diversification, and sound risk management. Experienced investors understand this and are using today's tools to build diversified portfolios to help diversify away execution risk. Equity crowdfunding may still be in its infancy, but visionary investors are already placing their chips on the expected winners. The future for equity crowdfunding seems to be very bright, indeed.

Jon Medved & Zack Miller, OurCrowd

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