The Coming ‘Transformation’ in Private Capital Markets

By David M. Freedman

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The Jumpstart Our Business Startups Act of 2012 spawned several innovations in small-business financing. Mary Jo White, the SEC chair, said in January 2014 that thanks to the JOBS Act, “[W]e are at the start of what promises to be a period of transformative change in capital formation.”

Title II of the JOBS act lifted the ban on general solicitation for Regulation D offerings under the new Rule 506(c) [http://www.sec.gov/answers/rule506.htm], which went into effect in September 2013. In the two years after Rule 506(c) went into effect (Sept. 2013 to Sept. 2015), almost 10 percent of Regulation D offerings used the Rule 506(c) exemption, according to Offerboard. And roughly 100,000 accredited investors participated in private securities offerings for the first time during those two years—a 50 percent increase over the number of AIs who participated each year before 2013. Only accredited investors may participate in 506(c) deals.

Title IV of the JOBS Act expanded the moribund Regulation A exemption by increasing the maximum raise limit to $50 million from $5 million, preempting blue sky review for “Tier 2” offerings. Regulation A (and now so-called Regulation A+) has always allowed all investors, including non-accredited, to participate.

Reg A+, which went into effect in June 2015, is structured for growth- and later-stage companies that are not quite ready to file an IPO, so it’s not—as some in the media initially insisted—an opportunity for small investors to buy equity in seed- and early-stage companies.

Neither Title II nor Title IV offerings are required to be listed on Internet-based offering platforms, so it’s a stretch to call them crowdfunding—but many people do anyway.

True Crowdfunding

Title III is the part of the JOBS Act that does allow non-accredited investors to invest in seed- and early-stage companies. Title III offerings, unlike Titles II and IV, are required to use Internet-based intermediaries: funding portals and broker-dealer platforms that are registered with both the SEC and the Financial Industry Regulatory Authority [www.finra.org]. The portal/platform requirement is why Title III is called “true securities crowdfunding.”

Title III limits issuers to offerings totaling $1 million per year, maximum. Investors have annual investment limits based on their net worth and income—those limits range from $2,000 for the lowest-income investors to $100,000 for wealthy individuals. Funds and institutions may not invest in Title III deals.

The SEC issued final rules for Title III securities crowdfunding in October 2015 (see CrowdCheck’s summary of the rules [http://bit.ly/1XE8c44]), and Title III funding portals/platforms can launch in May 2016. There has been a lot of speculation in the financial industry and media

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as to whether Title III crowdfunding, as currently regulated, is viable and whether entrepreneurs will take advantage of it, given its costs and limitations.

Controversy

Title III was the most controversial part of the JOBS Act, because it opened the riskiest area of alternative investing to tens of millions of investors who, because they were not wealthy, were presumed to be less sophisticated—certainly they were less experienced. And because they are not wealthy, their capacity to endure a lost investment is presumably small. That's why, for example, the Senate knocked the raise limit down to $1 million after the House passed a "crowdfunding exemption" bill in 2011 that allowed raises up to $2 million.

A moderate optimist is Duncan Niederauer, CEO of NYSE Euronext (a merger of the New York Stock Exchange and Euronext NV). Niederauer predicted in 2012 that equity crowdfunding, if properly done, "will become the future of how most small businesses are going to be financed."

Several experts predicted that Title III crowdfunding would make the early-stage financial markets more "transparent," an annoying buzzword that in this case means that equity crowdfunding portals will let everyone observe private offerings, investor participation, and transaction terms that are otherwise cloaked in secrecy. Such transparency will help new private equity investors understand the process of early-stage capital formation.

If equity crowdfunding goes well for issuers and investors, a surging supply (of early-stage equity offerings) and demand (for alternative investment opportunities by newly enfranchised angel investors) will result in not only growth of private capital markets but also innovations that we can't anticipate yet. Innovation might include Web technology that better connects issuers to investors and facilitates transactions, simplified deal terms, and new business entities (like a *Subchapter CF corporation* or *crowdfund venture*?) structured specifically for equity crowdfunding transactions.

Supply-Side Pessimists

The pessimists weighed in, too. On the supply side, experts worried that the $1 million per year raise limit would confine crowdfunding issuers to the smallest, earliest-stage—therefore, probably the riskiest—companies.

Issuers that need to raise $500,000 to $1 million may believe that the cost of audited financial statements (only for issuers who have raised capital at least once via Title III, not for first-time issuers) is too burdensome, compared with Reg D—or, for that matter, a rewards-based crowdfunding campaign—where there are no raise limits, and where audited financials are not required at all.

Even for raises under $500,000, equity crowdfunding is not cheap. The SEC estimated that issuers seeking to raise up to $100,000 would spend roughly $13,000 to $18,000 to prepare and execute the offering (that doesn't include the fee paid to the portal), and issuers raising $100,000 to $500,000 would spend $25,000 to $55,000.[1] Joanna Schwartz, the CEO of EarlyShares, one of the pioneers in Reg D platforms, calculated the costs to be higher in some ranges. However, once again, issuers and their advisers are working on creative ways to try to keep the total cost under $10,000—for example, filing provisional patents (to avoid the higher costs of full patent

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[1] "Crowdfunding: Proposed Rules," SEC, October 23, 2013, pp. 358–359, http://www.sec.gov/rules/proposed/2013/33-9470.pdf.

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applications), forming new entities instead of using established entities (to simplify any audit requirements), and the like. In this new regulatory environment, it is not clear how effective such strategies might be in reducing the prefunding financial burden on issuers, but there are various professional groups seeking this outcome.

Certain kinds of issuers—high-tech startups that would probably need future rounds of angel and VC funding, for example—might avoid equity crowdfunding because of the specter that raising capital from thousands of small investors would complicate their capitalization tables (detailed spreadsheets that list investors and their equity holdings). Complex cap tables *might* scare venture capitalists away from later-stage raises.

Realistically, we may not know how the Title III requirements and costs will affect deal flow for a year or two or three. We do know that if the costs remain high for issuers, then those who will be most disadvantaged will be lower-income entrepreneurs in the underserved communities that need economic development and new jobs the most. For that reason, the SEC indicated that it may consider adding an under-$50,000 raise category with simpler, less costly requirements. That doesn't sound like a lot of capital, but it might be just what an inventor needs to apply for a patent, produce CAD drawings, build a prototype, and license the invention to a big company.

Demand-Side Pessimists

Pessimism thrived on the demand side, too. Some skeptics fear that unsophisticated investors will not understand what they were getting into and would tend to be lured by slick marketing tactics to misallocate capital to poorly managed startups that were bound to fail, not only losing their savings but also depriving more deserving companies of growth capital. Moreover, some financial gurus say that new money tends to be eager and therefore overpay for equity, which could lead to a bubble. To be sure, some of the folks who issued these warnings worked in investment brokerages and mergers and acquisitions advisory firms for which equity crowdfunding represented new competition. So their criticisms were self-serving, even if they may have been valid. We also want to point out, in response to their skepticism, that adding potentially tens of millions of investors broadens the capital pool beyond the formerly oligopolistic set of capital channels. Shattering that oligopoly with vast new sources of capital can benefit many worthy but overlooked startups and inventors.

Some in the securities industry worry that equity crowdfunding will become the "funding of last resort," used by companies that were rejected by traditional angel investors, venture capital firms, or Reg D offering platforms. We hasten to point out that angel groups, VCs, and Reg D platforms typically fund only a miniscule percentage of the applicants they review, and each year many thousands of worthy applicants trickle down through the capital channels unfunded. Many such "rejects" have gone on to be very successful, including Amazon.com. Perhaps street-level members of "the crowd" will prove to be wise in their collective judgment of enterprise potential and will fund the gems that VCs in their mahogany boardrooms have missed.

The most common fear expressed in connection with Title III, however, was fraud. Supporters of crowdfunding acknowledge that some fraud will occur, as it does everywhere, including the public securities markets. But they point to the low instance of fraud in rewards-based crowdfunding in the United States, and especially in equity-based crowdfunding in Australia (since 2006) and the United Kingdom (since 2012), where unsophisticated investors may similarly participate. It is important to note that Australia and the United Kingdom have different securities regulations than the United States, and every country defines *fraud* a bit differently, so

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it is not an apples-to-apples comparison. But in general, equity crowdfunding has proceeded in those countries fairly cleanly so far.

The Cautious Outlook

As a result of all these fears and uncertainties, after Title III funding portals launch in May, this new industry could be flat for a year or two. “Issuers are being advised by their lawyers to use extreme caution, because it’s still so new,” says Richard Swart, PhD, who leads a global crowdfunding research team at the University of California in Berkeley. “But after a year it will escalate very quickly.”

Some equity crowdfunding professionals and their advisers believe it will take much longer for activity to escalate, and it may take another act of Congress. Kim Wales, CEO of Wales Capital in New York City and an executive board member of the CrowdFund Intermediary Regulatory Advocates [www.cfira.org], predicts that Congress will pass “JOBS Act 2.0” which will, among other revisions, increase the maximum amount that can be raised via crowdfunding from $1 million to possibly $5 million, which will attract more established companies (thus, less risky offerings) as well as more “smart money.” If that happens, Wales says, “there will be a pivot point in the marketplace in five years, with major changes in the private equity financing system. Venture capital and private equity will evolve along with the maturing crowdfunding industry.” But, she adds, “Everyone is cautious now.”

Here is my outlook. We are a nation of pioneers, experimenting and sometimes failing, always recovering, and quite often succeeding spectacularly. Equity crowdfunding is a new, big idea, a wild frontier. No amount of legislation or regulation can guarantee that it will succeed or that there will not be fraud, or that some unsophisticated (and sophisticated) investors will not be wiped out.

There will be many crowdfunding investors who commit to an offering mainly because they have an emotional attraction—an affinity—to a product or brand or team of founders and want to support them, in the same way that you might buy a jacket with a team logo on it. These affinity investors might not even glance at the company’s financial statements. They, along with the crowd that they invest with and have discussions with on their social networks, may turn out to be the company’s most passionate brand advocates. If they earn a strong return on their investment, it will be a pleasant surprise. If the investment turns out to be a loss, oh well, maybe one of the other startups they invested in will be a home run. At the very least, they are members of the vanguard of “new” angel investors, participating in an experiment in democracy. This is *much* more fun and rewarding than dropping a bundle at the casino.

Donation, rewards, and debt crowdfunding have already become integral parts of our financial system, despite some disappointments and losses on both sides of the table. Donors, contributors, funders, and lenders of moderate income and net worth have realized benefits both tangible and intangible on crowdfunding platforms, and, in the case of debt crowdfunding, significant financial benefits. Equity crowdfunding will also become, maybe in a year or maybe in five years, just as integral to our financial system as its predecessors.

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Financial Poise webinars for investors. Freedman is a coauthor of *Equity Crowdfunding for Investors: A Guide to Risks, Returns, Regulations, Funding Portals, Due Diligence, and Deal Terms* (Wiley & Sons, 2015). See details: www.ec4i.com.

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