Equity Crowdfunding for Investors

A Guide to Risks, Returns, Regulations, Funding Portals, Due Diligence, and Deal Terms

By David M. Freedman and Matthew R. Nutting

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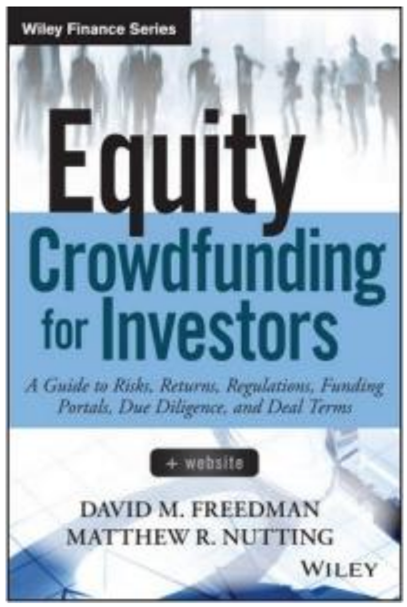

Chapter Summaries

Foreword by Charles Sidman, MBA, PhD

Sidman is an angel investor and managing partner of ECS Capital Partners LLC (Bar Harbor, Maine); founding member of Angel Capital Assn; and past president of Crowdfunding Professional Assn.

Preface: The New Angel Investors

In 1977 Mike Markkula became the first angel investor in Apple Computer. His $80,000 stake in Apple grew into about $200 million when the company went public three years later. Few opportunities can generate personal wealth as profoundly as being a founder or early investor in a startup that achieves that sort of grand success. Before 2012, however, angel investing was strictly limited to wealthy and extremely well connected people. Thanks to Title III of the JOBS Act of 2012, tens of millions of average investors will, for the first time in several decades, have an opportunity to invest in growing startups and early-stage companies via equity crowdfunding portals. This book covers not only Title III crowdfunding, but Regulation D offering platforms and intrastate securities exemptions (in at least 18 states) as well.

Chapter 1: The Foundations of Online Crowdfunding

Internet crowdfunding gained traction around 2003, starting with rewards-based platforms like ArtistShare, Kickstarter, and Indiegogo. They were followed by donation-based platforms like GoFundMe. Securities (debt- and equity-based) offering platforms launched around 2011 in the United States. Equity offering platforms were still open to accredited investors only, however. The JOBS (Jumpstart Our Business Startups) Act of 2012 legalized a new form of equity crowdfunding for all investors regardless of income or net worth. This chapter clarifies the differences between the various kinds of crowdfunding and provides lessons for investors about risk, reward, fraud prevention, and the wisdom of the crowd.

Chapter 2: Equity Offering Platforms (under Regulation D)

Starting in 2011 in the United States, startups and early-stage companies began offering securities to accredited investors through Web-based offering platforms, under Rule 506 of Regulation D. Issuers could raise an unlimited amount of equity capital via Reg D platforms. Title II of the JOBS Act of 2012 lifted the ban on general solicitation for offerings made under new Rule 506(c). We profile two pioneers in Reg D offering platforms: MicroVentures (focusing on tech startups) and CircleUp (focusing on early-stage consumer products and retail companies).

Chapter 3: Equity Crowdfunding (for All Investors, under Title III of the JOBS Act)

Title III of the JOBS Act of 2012 created a legal framework for equity crowdfunding, whereby all investors (not just wealthy “accredited” investors) can buy securities issued by startups and early-stage companies. The regulations limit the amount of money investors can invest in equity crowdfunding offerings each year, based on their income and/or net worth.

Chapter 4: Intrastate Equity Crowdfunding

Non-accredited Investors May Invest in Startups Located in Their Own State

At least a dozen states got a jumpstart on equity crowdfunding, using the “intrastate exemption” to initiate regulatory frameworks for in-state equity crowdfunding. Georgia was the first U.S. state in which an equity crowdfunding portal successfully funded a startup with participation of non-accredited investors.

Chapter 5: Deal Flow

What kinds of companies will offer equity shares on Title III crowdfunding portals? Will they really have high growth potential and be worth investing in? Will there be a big enough supply of offerings to meet the demand of tens of millions of new angel investors? In this chapter we forecast what kinds of companies—in terms of industry, development stage, growth potential, and other characteristics—will represent the most attractive Title III deals for all (including non-accredited) investors.

Chapter 6: Angel Investors

In depth we discuss the benefits, returns, costs, and risks of investing in startups and early-stage companies via equity crowdfunding. The possibility of earning spectacular return on investment (even if not very likely) is one attraction of angel investing. We discuss how the emergence of equity crowdfunding creates a new class of angel investors, with some of the same motives and benefits as traditional angels but some new ones, too—especially social benefits.

Chapter 7: Equity Crowdfunding Portals

How to Navigate the Websites That List Title III Offerings

This chapter offers a glimpse behind the scenes of equity crowdfunding portals—how they are regulated, the difference between “funding portals” and broker-dealer platforms, how they decide whether to approve or reject issuers’ applications, how investors communicate with each other, and using an investor dashboard.

Chapter 8: How to Invest, Part 1: Portfolio Strategy

A three- to five-year plan for building an equity crowdfunding portfolio

Investing in private securities, including Title III offerings, is one way to diversify your investment portfolio. This chapter helps you decide what percentage of your portfolio assets should be devoted to "non-correlated" alternative assets like Title III offerings; identify your primary motives for investing in startups and early-stage companies so you can narrow down the kinds of offerings that you consider; create an equity crowdfunding budget, pinpointing the amount of money that you can invest each year over three to five years; and build a diversified equity crowdfunding portfolio.

Chapter 9: How to Invest, Part 2: Identify Suitable Offerings

How narrow down your choice of Title III offerings, based on your selection criteria—the first of which is identifying your social, personal, and/or financial motivation for investing in startups and early-stage companies.

Chapter 10: Equity Crowdfunding Securities

Title III equity offerings are predominantly C corporation stock, limited liability company membership units, and convertible debt. This chapter covers the fundamentals of each of those securities (including both common and preferred stock), and their advantages and drawbacks for both issuers and investors.

Chapter 11: Deal Terms

We provide concise explanations of the terms of private securities deals, in four categories: economic terms (like price per share, minimum investment, fully diluted valuation, etc.); control terms (protective provisions, veto power, etc.); terms relating to liquidity events and future financing (liquidation preferences, anti-dilution provisions); and other terms (conversion rights, dividends, redemption rights, right of first refusal, etc.).

Chapter 12: How to Invest, Part 3: Due Diligence

How to research an issuer's management team, financial reports, revenue projections, business strategy, regulatory compliance, and other key indicators. You have the option of conducting due diligence independently, relying on a sophisticated "lead investor," hiring a professional adviser, and/or collaborating with members of the crowd through on-platform discussions and Q&A forums.

Chapter 13: How to Invest, Part 4: Funding and Post-funding

We talk about the on-platform investment transaction, your rights and obligations as a shareholder, and how to monitor and manage your equity crowdfunding portfolio.

Chapter 14: Liquidity and Secondary Markets

Equity crowdfunding securities are relatively illiquid, especially in the first 12 months that you hold the investment. Secondary markets will probably develop over the next few years to provide liquidity to Title III securities. We look back at how secondary markets developed for accredited investors in the past 10 years, and project how they might develop for all investors in the near future.

Epilogue: Trends and Innovations

What to expect in terms of legislative and regulatory revisions of Title III, technological innovations in funding portals, creative investment vehicles and corporate entities tailored for equity crowdfunding, and educational opportunities for new angel investors.

Appendix: Equity Crowdfunding Resources

About the Companion Website (www.wiley.com/go/equitycf)

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About the authors

David M. Freedman has worked as a financial and legal journalist since 1978 (freedman-chicago.com). He has served on the editorial staff of *The Value Examiner* (NACVA) since 2005. He is a frequent contributor to Accredited Investor Markets (aimkts.com), and participates as panelist and moderator in webinars presented by Financial Poise and West LegalEd.

Matthew R. Nutting is a corporate lawyer with the Fresno, CA, firm Coleman & Horowitt (ch-law.com). He advises on all facets of business law, including rewards-based and securities-based crowdfunding. He is a director of the National Crowdfunding Association and served as its national legal affairs director. He is also the cofounder of CrowdPassage.

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