

Crowdfunding:

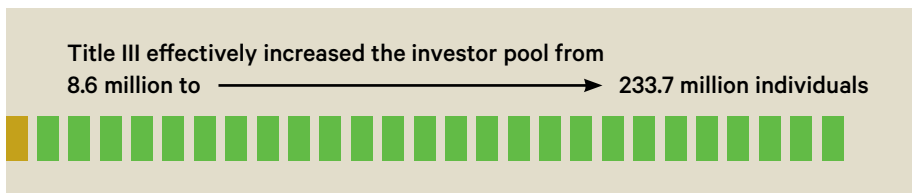
The Future of
Equity Investing



OVERVIEW

What would you call someone who invests in an opportunity with a 90 percent chance of failing? Reckless? Crazy? Savior? It depends on your perspective, but to those receiving the funds, these investors are called “angels.” They earn this name because of their somewhat “miraculous” contributions or, stated in practical terms, they invest before the feasibility of the product or service has been fully established. These “angel investors” support various equity crowdfunding projects, taking bets on everything from start-up businesses to seemingly off-the-wall products. Of the roughly 8.6 million accredited investors available to support such ventures, only three percent put up funds for **equity crowdfunding** projects. However, recent SEC rulings will likely increase the number of “angels” that are out there.

As of October 30, 2015, the SEC passed Title III of the Jumpstart Our Business Startup (JOBS) Act, opening equity crowdfunding opportunities beyond accredited investors to include those in a lower income bracket. With the inclusion of these non-accredited investors, Title III effectively increased the investor pool from 8.6 million to 233.7 million individuals—many of whom will be diving into the high risk, high rewards world of equity crowdfunding for the first time (Silchenko, 2015).



In this whitepaper, we will cover the risks and explore best practices to help investors protect and potentially grow their assets with equity crowdfunding.

Title III

Need to Know Elements

- Startups and small businesses may now raise up to \$1 million per year
- Non-accredited investors may invest up to \$2,000 or five percent of their annual income
- Accredited investors (those making more than \$100,000 per year or have a net worth more than \$1 million) may invest up to 10 percent of their annual income
- Offerings must be made via broker-dealer or “portal intermediary” (such as an online crowdfunding platform)
- Significant disclosures are required to help provide transparency
- All investors must hold investments for at least 12 months from the time of purchase

The entirety of the SEC’s Title III ruling may be found [here](#).

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Part I:

CROWDFUNDING AND ITS RISE IN POPULARITY

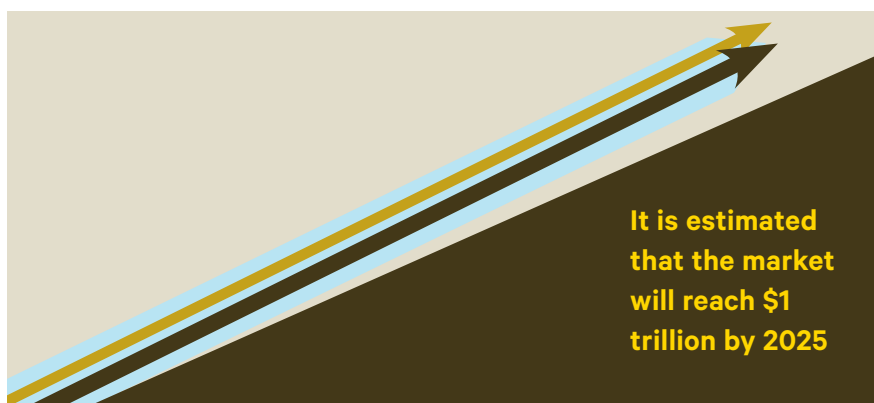
AS ITS NAME IMPLIES, CROWDFUNDING IS THE PRACTICE of raising capital for a project or venture by soliciting contributions from a vast number of people, i.e. a “crowd.” The practice has risen in popularity as online platforms have made finding and funding opportunities relatively quick and easy.

According to the crowdfunding website **Fundable**, the first instance of crowdfunding was in 1997 when a British rock band funded its tour via online donations from fans. Yet it was not until 2009 that crowdfunding became mainstream. Between 2009 and 2011, crowdfunding dollars jumped from \$530 million to \$1.5 billion (The History of Crowdfunding, n.d.).

As the numbers show, this online, project-based funding model is extremely popular. However, it is especially beloved by start-ups and charities because it is more informal and tends to move faster than soliciting big investors.

There are now hundreds of crowdfunding sites, but a handful remain the most popular. Among these are **Kickstarter**, **Indiegogo**, **Crowdfunder**, and **RocketHub** (Silchenko, 2015). These sites support all types of crowdfunding while others, such as restaurant funding platform **Foodstart**, focus on niche areas.

Due to this increase in crowdfunding sites and surge in consumer demand, crowdfunding contributions continue to rise. In 2012, President Barack Obama signed the JOBS Act, relieving previous solicitation restrictions on small businesses and regulating online equity crowdfunding. The equity crowdfunding industry grew by 81 percent that year and continues to grow (MacLellan, 2013). It is estimated that the market will reach \$1 trillion by 2025 (Crowdfunding: a Major Threat to the Global Wealth Management Industry, 2015).



This whitepaper specifically discusses equity crowdfunding, but there are numerous forms of crowdfunding, including:

- **Rewards-based:** funds a variety of projects such as movies, scientific research, and inventions by providing incentives like free services, exclusive experiences, or “limited edition” products to donors.
- **Debt-based:** funds individuals’ debt by providing interest on unsecured loans.
- **Litigation:** funds legal disputes globally by giving funders a stake in potential settlements.
- **Charity:** funds anything without return (other than good feelings) to donors.
- **Equity:** funds start-ups by providing shares in company profits to donors.

Part II:

TITLE III OF THE JOBS ACT AND ITS IMPACT ON EQUITY CROWDFUNDING

EQUITY CROWDFUNDING ALLOWS INDIVIDUALS TO STAKE A CLAIM in the project's success. It provides the funder a share in the company, grants decision-making capabilities, and offers financial benefits should the company succeed. The risks of investment are high, and the reward potential is great.

Historically, this type of investing has been limited to the relatively wealthy—those making more than \$100,000 per year, or with a net worth of more than \$1 million. With the passing of Title III, however, the field of potential investors is much larger. Now non-accredited investors—those making less than \$100,000 per year or with a net worth of less than \$1 million—may participate in equity crowdfunding. This change expanded the pool of potential investors to over 25 times its original size, increasing from 8.6 million to 233.7 million individuals.

Title III is the latest in trends to broaden investment beyond the affluent. While open investing harkens to the American dream—“be anything you want to be”—it can be risky for all parties involved. Novice investors run the risk of being swindled by fraudulent or less than principled fund seekers. Project owners working with unseasoned investors risk losing funding. And crowdfunding platforms, which work with both parties, are exposed to financial and legal risks should either fail to deliver on their promises. Each stakeholder needs to step carefully in the changing world of equity crowdfunding.

Accredited vs Non-Accredited Investors

ACCREDITED: Investors who make more than \$100,000 per year or have a net worth more than \$1 million

NON-ACCREDITED: Investors who make less than \$100,000 per year or have a net worth less than \$1 million



90 percent of
startups fail within
the first three years



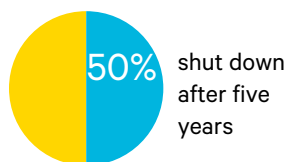
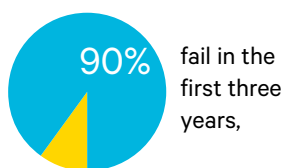
Part III:

EQUITY CROWDFUNDING RISKS

ALTHOUGH THE DOORS OPENED BY TITLE III have increased the popularity of equity crowdfunding, the likelihood for project success remains the same. Statistically speaking, 90 percent of startups do not succeed. In fact many call it quits within an average of three years (Patel, 2015). Investors that don't do due diligence, or invest more than they can afford to lose, have the potential to end up with a huge financial hit.

Risks associated with equity crowdfunding investment include, but are not limited to:

- **Fraud:** An obvious risk, fraud is what investors must strive to avoid. Some project owners may turn to crowdfunding in lieu of other financial options because it requires less information and chances of rejection are low. This lack of oversight makes it easy for illegitimate projects to pass as valid investments.
- **Inexperienced project owners:** While new investors run the risk of investing beyond their means, project owners may not understand how to stretch their short influx of funds over their long-term expenses. Lacking in expertise, first timers have higher potential to mismanage funds.
- **Intellectual property theft:** Most crowdfunding platforms do not provide intellectual property protection. A project owner must gain his or her own patent or other protections prior to seeking funds via crowdfunding. If not, they risk theft of ideas, which could result in immediate, targeted competition and increased risk of failure.
- **Illiquid investment:** Generally, investments made via crowdsourcing are illiquid and have no secondary market. Title III calls for investors to hold their investment for a minimum of 12 months, but it is unlikely gains will be made in this timeframe.



Coupled with these risks are the harsh statistics. As mentioned, 90 percent of startups fail in the first three years, and 50 percent shut down after five years (TDIC Gives Investors the Do's and Don'ts About Crowdfunding, 2015). And when an equity crowdfunding venture fails, money invested is lost.

Part IV:

PROTECTING YOUR ASSETS

DESPITE THE HIGH RISKS ASSOCIATED, MANY STILL INVEST IN EQUITY

crowdfunding projects. Successful investors manage to protect their assets, often reaping high rewards. However, there are a number of potential pitfalls investors, especially first time investors, must strive to avoid.

Some best practices to avoid these pitfalls include:

1. Invest only what you can lose

When you invest in equity crowdfunding, you are taking a bet on the venture's success. As with all bets, only put what you can afford to lose on the table. It is recommended to invest less than a tenth of your portfolio in such high risk/high reward scenarios.

2. Research the market

Before you dive in, get to know the market. Look for warning signs such as a recent flood of startups. This may simply indicate validation of demand, but an excessive increase in competition translates to a higher chance of failure.

3 Watch for red flags

Be wary about falling prey to scams. When a project catches your eye, check other crowdfunding sites to see if it pops up. It is considered bad practice to seek funds on multiple platforms.

4. Look beyond the project page

It is important to remember that the information provided on a project's page is usually the bare minimum. To really know your investment, you will need to do your own research. Investigate the owners. Anyone who is serious about online funding will have an online presence, and items like their social media profiles will help verify their identity. Search for past projects. Is this the first project they've posted? If not, what is their success record? How does their past experience fit with the project's goals?

5. Identify business savvy

When looking for projects to fund, single out those that publish a contingency plan, additional funding streams, and other critical business information. These details show that the owners have business experience and make it more likely their venture will succeed.

6. Find a partner

Try not to go in to investing alone. Look for a partner to provide a second opinion and increase your due diligence. Although it is best to partner with a professional advisor, anyone with experience in small business or entrepreneurship can also prove helpful.

In the end, make sure you invest in something you are passionate about. You are investing your time as well as your money, both of which are important assets to protect.

Scam Prevention

Resources

Scammers are out there, and so are those trying to prevent such crowdfunding fraud. A number of sites exist to report fraudulent crowdfunding activity, such as Kickscammed and Facebook's GoFraudMe page. Check out these sites if you are suspicious about a campaign.

Doing Your Research— Quick Questions to Ask Before Investing

- Does the business have experience in the field?
- Are the managers experienced in running a business?
- Does the business have a prototype?
- Is there an endorsement from a prominent organization or individual?
- Are there funds already promised?

Part V:

CROWDFUNDING INSURANCE: A NEW POTENTIAL MARKET

DUE TO THE HIGH RISK INVOLVED, INSURANCE FOR CROWDFUNDING is inevitable. However, crowdfunding insurance is in its infancy. The SEC is taking note. Preliminary rules require crowdfunding platforms to purchase what is known as a fidelity bond of at least \$100,000. This form of insurance protects online crowdfunding platforms from illegal or dishonest acts performed by their employees. Investors, however, are not required to purchase any form of protection (What is Crowdfunding?, n.d.).

The fidelity bond required by the SEC protects the crowdfunding platform from the acts of individual employees, but does not cover claims against the platform as a whole. This leaves both the platform and those hosting projects unprotected should a data breach or technical failure occur. Ideally, all parties involved (platform, investors, project managers) need some form of protection. This is where the budding insurance market is beginning to develop.

Insurance for those seeking funding should focus on protecting intellectual property. Like any entrepreneurial activity, these individuals should also invest in liability insurance to protect against litigation.

Insurance for crowdfunding platforms should cover the platform and be offered to investors. Crowdfunding platforms should consider Director and Officer (D & O) insurance to protect the owners and operators from claims made against the platform via the various projects seeking funding (Roderick, 2015).

Insurance for investors should mirror D & O insurance and protect investors from claims made against project owners and managers. Some insurance agencies are beginning to provide this type of coverage. Agencies are modifying current policies, such as those covering portfolio investments, to fit equity crowdfunding investment (Roderick, 2015).

Some work is currently being done to adapt D&O policies for crowdfunding, and there are developments in policies and bonds as well (What is Crowdfunding?, n.d.).

Though there is nothing concretely available in crowdfunding insurance at the moment, Title III opened the floodgates to millions of new potential investors who will likely need coverage. As the need becomes more apparent, this burgeoning market has a lot of room to grow.

Platforms Testing

Crowdfunding Insurance

A few crowdfunding platforms have begun to offer insurance to investors. Among these are Indiegogo, which provides non-refundable investor insurance. The policy states if the project does not deliver within a certain amount of time, the funder's investment is returned, minus the cost of the insurance purchase.

French white label service provider Particeep joined forces with insurance group AXA Creditor to offer insurance covering investors. Similar to Indiegogo's coverage, this policy promises up to 100 percent repayment. Additionally, in case of death or disability of the project owner, the remaining capital is paid back to investors.

Conclusion:

IS CROWDFUNDING WORTH THE RISK?

WITH SO MANY RISKS ASSOCIATED, WHY INVEST IN EQUITY CROWDFUNDING?

When it comes down to investing, the motto is “the right amount for the right reasons.” Smart investing means putting up only what you are willing to lose, and asking yourself why you want to invest in this specific project. The best reasons for investment are:

- You know and trust individuals with whom you’re investing
- You would use the product or services yourself
- You are passionate about the product/services
- You see potential for growth

Notice that “making money” is not listed as a major motivator. Most investors realize the risks involved in equity crowdfunding make significant profit unlikely.

If you decide to invest in an equity crowdfunding project, get connected with experienced advisors and/or consultants to keep you on track and warn of pitfalls. Finally, be realistic: know you may never get your investment back, or that it may be years before you see return. Equity crowdfunding proves to be an exciting, break-through investing opportunity so, get moving! And watch your step.



RESOURCES

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