KIM: Beware of new “Crowdfunding” investment opportunities

Mickey Kim
March 26, 2016

Entities or individuals using crowdfunding typically seek small contributions from a large number of people. Sites like Kickstarter are popular for raising capital to support a wide range of ideas, projects and ventures.

Start-ups and small companies need capital to launch and grow their businesses. Investors want to get in on the ground floor and reap huge, venture capital-type returns by finding the “next Facebook.”

Due to securities laws, crowdfunding has historically *not* involved the offer of a share in any financial returns or profits the fundraiser expects to generate from the business activity financed by the campaign. Come May 16, 2016, companies seeking capital and speculators looking for the proverbial pot of gold will have a new way to meet when rules created by the SEC’s “Regulation Crowdfunding” take effect.

Instead of getting a t-shirt for supporting someone’s project, you’ll have the opportunity for a “piece of the action.” However, aside from the fact these wagers are inherently highly risky, you can be sure scoundrels will also be “fishing.” It will be difficult to separate those offering a “businessman’s risk” investment from outright crooks looking to rip you off, so your fraud antenna needs to be at its ***highest setting***.

The Jumpstart Our Business Startups Act (“JOBS Act”) became law in April 2012, when the U.S. economy was still in a post-financial crisis funk. The purpose of this bipartisan legislation was to make it easier and cheaper for small companies to raise capital for growth. I wrote a column on how Twitter had used accommodations offered by the JOBS Act during its IPO process (IBJ--September 28, 2013).

The JOBS Act also contained crowdfunding provisions meant to help provide start-ups and small businesses with a cheaper and easier way to raise capital by making low dollar offerings of securities, to be purchased in low dollar investments by the “crowd.” The SEC was charged with making the rules. The fact Regulation Crowdfunding will have taken four years to implement indicates the complexity and risks involved.

Under Regulation Crowdfunding, in any 12-month period, companies can raise a maximum of $1 million and individuals are limited to total crowdfunding purchases of $2,000-$100,000 (depending on income/net worth). Transactions must be conducted through an intermediary that either is registered as a broker-dealer or “funding portal” (i.e. companies may ***not*** sell securities directly to investors).

The SEC issued “Crowdfunding for Investors” on February 16, 2016 https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html, which warned of a number of risk factors, including:

- **Speculative**. Investors should be able to afford and be prepared to lose their entire investment.
- **Illiquidity**. Unlike companies listed on a stock exchange, investors generally cannot resell their investment for the first year and may need to hold for an indefinite period.
- **Cancellation restrictions**. Once you make a purchase commitment for a crowdfunding offering, you are committed (within a certain period).
- **Valuation and capitalization**. It is difficult to value private companies. You risk overpaying and the issuer may have other securities with rights superior to yours.
- **Limited disclosure**. The issuer must disclose information about its business plan, the offering and anticipated use of the proceeds. However, continuing disclosure may be sporadic and limited.
- **Possibility of fraud**. Where money, greed, naiveté and the Internet intersect, fraud is sure to be close.

Let the buyer beware!
