A Piece of the Action

BY CHARLES GERENA

Crowdfunding — financing a project with lots of small donations — dates back centuries. Part of the money for the Statue of Liberty's pedestal came from more than 100,000 donors who responded to a newspaper campaign. Today, the global reach of the Internet has taken crowdfunding to a new level, generating more than $16 billion in 2014 and an estimated $34 billion in 2015 to finance countless gadgets, creative works, and even the making of a bowl of potato salad.

Now this practice has entered the world of corporate finance. Under Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012 and rules issued by the Securities and Exchange Commission (SEC) that go into effect in May 2016, entrepreneurs can pursue "equity crowdfunding." Will this new source of startup money help spur innovation and generate lots of new jobs as lawmakers intended?

Title III enables a company to raise capital from any investor without registering with the SEC, which can be cost prohibitive. Still, the process is governed by a relatively extensive set of filing and disclosure requirements in order to limit the risks for so-called "unaccredited" investors, who do not meet the SEC's income and wealth requirements to participate in large-scale transactions.

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For example, there are limits on how much equity can be sold by a company over a 12-month period ($1 million) and how much equity can be purchased by an individual (for those whose annual income or net worth is less than $100,000, the greater of $2,000 or 5 percent of income or wealth; 10 percent of income or wealth for everyone else). Also, issuers must disclose their finances and file an annual report with the SEC, while intermediaries that facilitate crowdfunding transactions have to follow their own set of requirements.

The desire to protect unaccredited investors is why it has taken four years to implement Title III, according to Christian Catalini, an assistant professor of technological innovation, entrepreneurship, and strategic management at the Massachusetts Institute of Technology. In contrast, Title II of the JOBS Act has allowed companies to solicit money from accredited investors without registering since 2013.

Another difference between Title II and the new Title III is that the former allows for the use of a syndicate model to facilitate equity crowdfunding. In this model, accredited investors entrust their money with a lead investor, typically an experienced venture capitalist or "angel" financier who sorts through potential deals and brings the best ones to the group in exchange for a share of the upside.

Such curation of potential deals helps to address a problem that arises with equity crowdfunding. "When you're going online and trying to invest in startups, the key issue is asymmetric information," says Catalini. "It's very hard to evaluate some of the companies — it's not like an entrepreneur comes with a rating." But small investors have little incentive to perform the costly due diligence on a potential deal that a venture capitalist would do. "It's not worth your time."

Because Title III doesn't permit syndication, and in view of the accounting requirements and limitations on the amount of capital that can be raised, Catalini doesn't foresee equity crowdfunding under Title III becoming a major source of capital for the next Facebook — a high-growth, tech startup with the potential to create a large number of jobs in the future. Rather, he sees equity crowdfunding being used by small businesses like restaurants or real estate developers.

Many small businesses may not reap the benefits of equity crowdfunding, however. Some observers believe that it could follow the evolutionary path of crowdfunding in general, a path that has taken the financing approach from the province of dreamers into the boardrooms of corporate America.

When crowdfunding first emerged on the Internet in the 2000s, any person who needed money to realize an idea could appeal directly to those who believe in the same idea and value non-pecuniary benefits, such as early access to a product or unique rewards for their donations. Musicians have produced CDs without a record label and authors have released books without a publisher.

Today, larger, more established companies have turned to crowdfunding as a way to gauge consumer demand, obtain feedback, or generate publicity for a new product. Crowdfunding isn't just for the "little guy" anymore.

Indeed, many of the most successful crowdfunded projects are associated with celebrities or others who are widely known and have built a fan base. In Catalini's view, crowdfunding could transform equity markets "into a market for reputation."

In short, those who expect the JOBS Act to have a far-reaching impact may have to adjust their expectations. Research has shown that only a small fraction of entrepreneurial, innovative projects account for the majority of funds raised through crowdfunding. **EF**