PART I

The Business of Crowdfunding

CHAPTER 1

Crowdfunding: A Historical Perspective

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Crowdfunding, simply put, is pooling the financial resources of many individuals to convert an idea into a project or business. Instead of relying on a few large donors, it requires many small ones. This chapter steps back in time to understand what happened to this form of financing, why it's "new all over again," and why it's emerging as one of the hottest topics in global business financing. It reviews the risks that led to changes in U.S. financial laws in the early twentieth century and how these laws had the unintended consequence of shutting off capital markets to many startups and small businesses. It discusses how advances in the Internet and technology have allowed us to safely go back to where we started. Today's crowdfunding enables anyone to use the Internet to gauge the value of people's ideas and use online reputations and their own judgment and experience to make their own decisions about which ideas have the best chance for success.

Crowdfunding Isn't New

Crowdfunding is a new way to do something old. It uses the Internet to facilitate capital formation in much the same way that communities financed transactions as far back as 3000 B.C. Prior to the advent of banks and other financial institutions, wealthy families and rulers provided loans to individuals in communities to finance everything from businesses to infrastructure. Financial instruments not unlike simple loan documents used today were created as promissory notes. Interest rates were determined based on how well individuals knew each other and how much capital was needed. Risk was a function of relationship and ability to execute. Default came with a heavy toll.

While difficult to relate the experiences of 5,000 years ago to today, life in the United States in the late nineteenth and early twentieth centuries offer some examples of American institutions and icons that emerged from the crowd. In the 1930s, before the Great Depression, banks existed primarily to finance infrastructure and the activities of governments. This was ushered in by the Industrial Revolution that led to a change in farming techniques. In order to adapt, farmers were forced to take loans for equipment. Other businesses faced similar technology shifts and access to capital was the same challenge.

Building and loan associations were one of the answers to how to provide capital to businesses and individuals. Groups of people deposited their savings into an association. When the association gained enough money, it financed activities for its members, mainly through mortgages. This system helped many working-class people buy homes. Unlike banks, these associations made their investments based primarily on the interests of their members instead of on the promise of the greatest returns and security. Associations, however, tended to serve small groups or communities and didn't offer many of the services that banks did.

In 1876, crowdfunding was used to finance one of the United States' most iconic monuments, the Statue of Liberty. The citizens of France paid for the statue, and the citizens of the United States paid for the pedestal. Citizens in both countries held meetings, theater performances, art auctions, prizefights, and rallies to raise money. Frédéric Auguste Bartholdi, the Statue of Liberty's architect, offered a miniature version of the statue with the name of the buyer engraved on it in exchange for a donation—a "perk" when compared to today's crowdfunding.

Despite being $250,000 short, newspaper publisher Joseph Pulitzer used *The World*, a New York City daily newspaper, to mount a fund drive, promising to print the name of each donor. Pulitzer's plan worked and millions of people around the country began donating whatever they could including a kindergarten class in Iowa that sent $1.35.

Why? Because these people believed in the project and wanted to give back; they wanted to be a part of history and be a part of something bigger than themselves. These are the same reasons people give to crowdfunding today. Times might have changed but core beliefs have not.

Why Crowdfunding Disappeared

In the early 1900s, the main role of investing in startups and small businesses fell into the hands of wealthy families like the Morgans, the Vanderbilts, and the Rockefellers. Starting in 1911, the process of raising capital from the public was enforced by each state under so-called blue sky laws. With these laws, states regulated the offering and sale of stocks to protect the public from fraud. The specific provisions of these laws varied among states, but they all required the registration of all securities offerings and sales, as well as the registration of every stockbroker and brokerage firm. Providing a structure was a benefit; lacking an infrastructure to monitor, police, and hold people accountable opened the doorway to fraud.

In 1915, the Investment Bankers Association told its members that they could ignore blue sky laws by making securities offerings across state lines through the mail. Allowing solicitation via a mechanism as opaque at the mail opened up the floodgates to fraud. Because the markets weren't regulated at the federal level, shady stockbrokers started to issue stocks in dubious, fictitious, or worthless companies and sell them to people in other states, using the mail as their means of communication.

This ushered in a period replete with snake oil salesmen and grifters moving from one opportunity to the next and debunking Americans out of their savings. During the 1920s leading up to the Great Depression, which began in 1929, the marketplace was full of exuberance. Stock prices kept going up, reinforced by shady brokers. Tempted by promises of riches and easy credit, many investors started to borrow money to buy essentially worthless stocks. Greed drove them to neglect the risks and believe unreliable information about the securities in which they invested.

During the 1920s approximately 20 million large and small shareholders set out to make their fortunes in the stock market. Of the $50 billion in new securities offered during this period, approximately half became worthless as a result of the stock market crash in October 1929.

When the stock market crashed, public confidence in the markets collapsed. Investors large and small, as well as the banks that had loaned to them, lost great sums of money in the ensuing Great Depression. For the economy to recover, the public's faith in the capital markets needed to be restored, so Congress held hearings to identify the problems and search for solutions.

Congress passed the Securities Act of 1933. This law and the Securities Exchange Act of 1934—which created the U.S. Securities and Exchange Commission (SEC)—were designed to increase public trust in the capital markets by requiring uniform disclosure of information about public securities and establishing rules for honest dealings. The main purposes of these laws can be reduced to two common-sense notions:

1. Companies publicly offering securities for investment must tell the public the truth about their businesses, the securities they're selling, and the risks involved in investing.
2. People who sell and trade securities—brokers, dealers, and exchanges—must treat investors fairly and honestly, putting investors' interests first.

Congress established the SEC to enforce the newly passed securities laws, to promote stability in the markets, and, most important, to protect investors. The Securities Exchange Act of 1934 requires that issuing companies register distributions of securities, such as stocks, with the SEC prior to interstate sales of these securities. This way, investors have access to basic financial information about issuing companies and risks involved in investing in the securities in question.

The SEC was founded in an era that was ripe for reform. The 1933 and 1934 laws set the way in which the capital markets would function for the next 50 years. Having a mechanism where information was centrally stored and accessed by the public was required; today, this is facilitated by the Internet.

Regulation D, Sarbanes-Oxley, and Regulatory Reform

From 1933 to 1982, the way business was conducted in the U.S. capital markets stayed relatively unchanged. In 1982, the SEC adopted Regulation D, which established three exemptions from the registration requirements under the Securities Act of 1933. An exemption enables some companies, in certain situations, to issue securities without the requirement to register them with the SEC provided they follow all the rules. Included within Regulation D's definitions was the notion of an accredited investor. The SEC adopted two definitions of an accredited investor, one based on net worth and the other based on income:

1. *Net worth criteria*. Under the net worth definition, an accredited investor is someone who, at the time when he purchases a security, has a net worth of $1 million or more, not including the value of his primary residence. (Note that net worth could be the individual's net worth alone or that of himself and his spouse.)

2. *Income criteria*. Under the income-based definition, an accredited investor is someone with individual income above $200,000 during the two most recent years or with joint income (with a spouse) above $300,000 in each of the two most recent years. This person also should expect to achieve a similar income in the current year.

Prior to the 2012 Jumpstart Our Business Startups (JOBS) Act, a company issuing stock to investors had to restrict the number of unaccredited investors it included in a securities offering. If you were starting a small business raising less than $5 million in securities in 2010 and wanted equity investors, you could have only 35 unaccredited investors. (You could have an unlimited number of accredited investors.) This structure allowed your closest supporters, such as friends and family, to become equity owners in your business while preventing you from reaching larger numbers of your network to ask them if they would like to invest in a business that might carry significant risk. This was one of the measures that attempted to address the pumping-and-dumping schemes leading up to the Great Depression.

Unfortunately, the side effect of this regulation was that small investors found themselves largely shut out of some of the most lucrative, albeit risky, investments such as technology startups. As a result, small businesses and startups found themselves fairly restricted when trying to raise funds. Plus, the underlying implication of the definition is that small investors are, by virtue of their smallness, less educated, sophisticated, or knowledgeable about risk than larger investors—a notion that is flawed when considering scandals such as the one involving Bernie Madoff.

The 1990s and early 2000s saw the rise of a whole new level of financial engineering. That was the creation of financial structures and instruments that allowed corporations greater flexibility (and much greater risk) in their investments. Most of the time, the "flexibility" was really code for "leverage," or the practice of betting on the direction of a stock's or other financial instrument's movement. The larger the bet on the direction, the larger the risk if the stock moved in the opposite direction. When corporate bets worked as planned, companies showed significant gains. However, when these bets soured, the results could be disastrous. Two examples follow.

Enron was an energy, commodities, and services company based in Houston, Texas. Between 1995 and 2000, it was called one of America's most innovative companies. It filed for bankruptcy in December 2001, and several of its top corporate officers were later convicted of financial crimes. These executives were hiding huge losses in offshore accounts that were not reported in Enron's financial statements, and their financial "engineering" ultimately caused the company to collapse. Thousands of employees lost their jobs, and millions of Enron shareholders lost billions of dollars. At the time, it was the largest corporate failure in U.S. history, and it was all due to a handful of executives playing fast and loose with company money to enrich themselves.

In July 2002, just seven months after Enron's demise, WorldCom also declared bankruptcy after using fraudulent accounting and aggressive finance practices to hide losses and inflate revenues. Again, the company's collapse led to thousands of lost jobs and the elimination of billions of dollars of stockholder value.

With back-to-back, multi-billion-dollar business failures that were based on accounting and finance fraud, the federal government was pressed to enact significantly enhanced financial regulations. As a result, the Sarbanes-Oxley Act of 2002 (commonly referred to as SOX) was the largest overhaul of federal securities laws since the 1930s. It covered a wide range of corporate governance, accounting, industry analyst relations, and financial reporting issues.

Although well intentioned, SOX had enormous unintended negative consequences for businesses in the public capital markets. These negative consequences were most profound for small businesses that were interested in going public to raise capital. Because SOX treated all companies (regardless of size, industry, geography, or market) exactly the same, all companies faced a similar burden related to regulatory costs. This setup may seem reasonable at first blush, but imagine a mom-and-pop store trying to achieve the same reporting and accounting standards followed by a Fortune 500 company. It can't be done.

Effectively, SOX ensured that if your business was worth less than $100 million, it made zero financial sense to go public because in order to execute an initial public offering (IPO), you'd spend millions of dollars on accounting and administration, and your annual compliance fees would be well over $1 million. SOX effectively closed the IPO market for all but the largest corporations and dramatically reduced small businesses' access to capital. Startups and small businesses were restricted to seeking funding from an elite group of wealthy venture capital investors who for the past decade have determined who among America's businesses were worthy of funding. This, of course, left out the other 27.5 million businesses that needed access to capital as well, the majority of which are not high-tech startups but local mom-and-pop businesses that are profitable, yet still find it difficult to gain access to capital.

The Modern Era

With the rise of the Internet and e-commerce, the foundational tools were in place for nonprofits to begin raising money online as well as offline. As individuals gained experience and trust in completing transactions online, it enabled them to save time, save money, and extend their reach into more geographies, sectors, and interests across the globe.

In 2005, an organization named Kiva was founded to use the Internet to source microloans from people in the United States to entrepreneurs in the developing world. Individuals in the United States were able to visit the Kiva web site and directly interact with individuals in the developing world and participate in loans as small as $100 to $1,000 that would enable those entrepreneurs to purchase a cow, a motorbike, an oven—some means by which they could build a business to lift their families out of poverty. Lenders in the United States knew the names of the people they were lending to, as well as their circumstances, and received a photo and a way to monitor their progress, via the Kiva web site, as they built their business and repaid the loan. This allowed people who wanted to feel directly connected to other people they were helping to satisfy that deeper human need of being part of something larger than you are on your own.

Then, in 2008, the United States and every other country were hit with the global financial crisis, causing substantial financial damage to individuals and businesses. Among the many negative outcomes of this crisis, the loss of investment capital in small and medium-sized business was deep and profound. Raising capital or being accepted for a bank loan always was a challenge, but in the wake of the financial crisis, it became virtually impossible. Banks were generally not even lending to profitable, successful businesses. Most of the time, the business needed to have the amount of the loan (or greater) in assets before the bank would consider lending to the business. In other words, banks were only lending money to people who did not need it. Unfortunately, due to the SEC regulations written in 1933 and 1934, there were very few avenues for businesses to gain access to capital.

Shortly after the modern financial crisis began, in 2009, the web site Kickstarter was begun by Perry Chen out of a desire to help musicians and artists raise money for their projects. Perry had a band, so he understood what it was like to need money to tour or record music and that if these artists and musicians were able to tap into their fan base and supporters to each pitch in small amounts of money, they could help artists to reach their goal, and they could provide something back (a perk or thank you gift) for their contribution. This usually took the form of the output of the artists such as a CD, a DVD of the film being produced, a T-shirt, and so on. This was the rise of the "micro-patron of the arts."

The third technology element that led to the rapid adoption of crowdfunding was the rise of the social Web, otherwise known as "Web 2.0." Web 1.0 was consuming information and completing transactions. With Friendster, MySpace, and later LinkedIn, Facebook, Twitter, and Instagram, the Web became a place to not only consume information and complete transactions, but also a place to share interests, communicate with friends, and build relationships with people that you may not have initially known in person, but with whom you could create a relationship online.

The rise of the social Web was crucial to the success of perks-based crowdfunding. It enabled people to not only make their donations, but also amplify the power of those donations by making it very easy to spread the word to friends and family via social networks about a project they believed in and encourage their networks to participate as well. This not only increased the success of campaigns, but it also increased the scale and utilization rates of perks-based crowdfunding platforms like Kickstarter.

In August 2010, a group of successful entrepreneurs were talking about how frustrating it was for small—sometimes even profitable—businesses in the United States and around the world to access capital. To them, it seemed crazy that people could give away money on web sites like Kickstarter to artists and musicians and lend money to entrepreneurs in the developing world on web sites like Kiva, but it was illegal to use the Internet to raise investment capital for entrepreneurs and business owners in the United States. It didn't make sense that the securities laws had not advanced to the Internet Age and the same tools such as the Web and social media, which were a daily part of our lives, could not be used to raise money from their communities. It didn't make sense that the Regulation D exemptions excluded crowdfund investing online because this would require raising money with public solicitation from unaccredited investors. Investors were asking themselves the same question, "Why can't I invest in businesses in my community or entrepreneurs I believe in?"

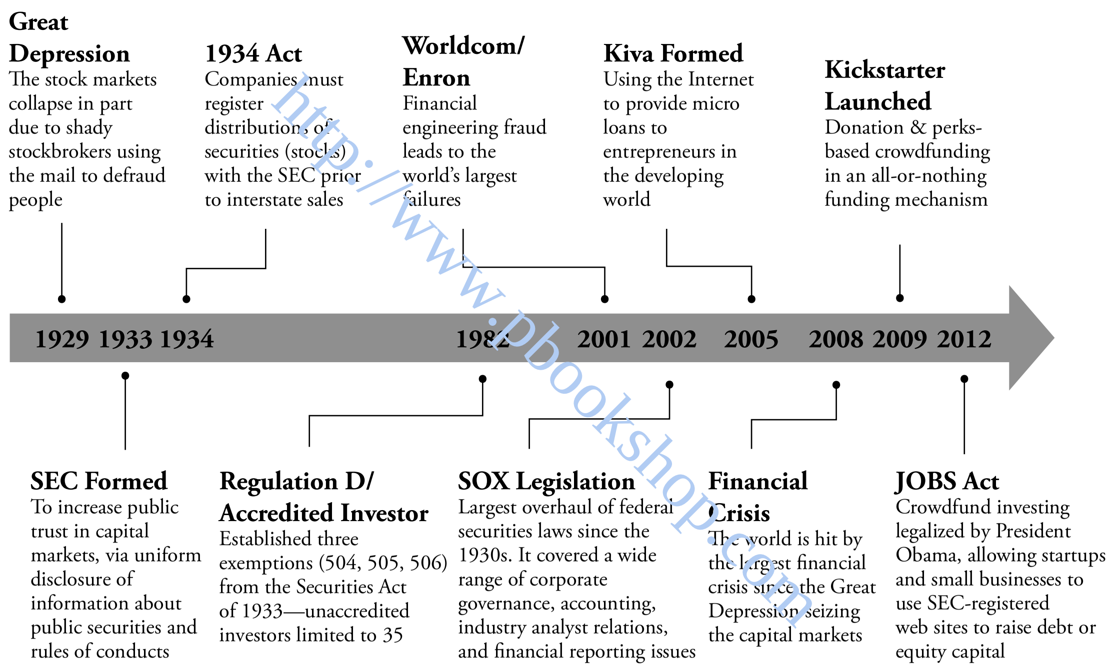
This marked the creation of Web 3.0 where the social Web meets capital formation. This was also the creation of the term crowdfund investing so as to make a clear distinction between perks-based crowdfunding and securities-based crowdfunding. That was the jumping off point for the team of entrepreneurs to create the Startup Exemption Framework that would form the basis of the crowdfunding legislation in the 2012 JOBS Act. Sitting at a dining room table with the Regulation D language, they created the framework that would enable entrepreneurs and small businesses to raise up to $1 million per year from an unlimited number of investors.

From there, this group of entrepreneurs talked with securities attorneys who told them not to waste their time—the laws had not changed in 77 years and there was nothing they could do about it. But they pushed forward anyway and met with the Small Business Division of the SEC, who said, "We don't make those kinds of changes, you'll need an Act of Congress." Instead of quitting or just complaining about the problem, they took an entrepreneurial approach and took their solution, the Startup Exemption Framework, to Capitol Hill to advocate for its passage. By putting a stake in the ground, they were able to engage the White House and both Democrats and Republicans in the House of Representatives and Senate in debate and discussion on how to create legislation to pass crowdfunding to help address the critical needs facing the United States at that time—increasing jobs, innovation, and entrepreneurship. With good timing, teamwork from many people, and amazing amount of luck, this legislation was able to pass both houses of Congress with wide, bipartisan majorities, and on April 5, 2012, 460 days after they began walking the halls of Congress, these entrepreneurs (including the authors of this chapter), attended the Rose Garden ceremony at the White House to watch President Obama sign the JOBS Act. Their work was embodied in the third part of the JOBS Act, otherwise known as "Title III."

Obviously, in creating a new asset class and a new industry that would be regulated by the SEC, a trade association needed to be formed. So this same group of entrepreneurs cofounded the Crowdfunding Regulatory Intermediary Advocates so that the industry could engage with the SEC and the Financial Industry Regulatory Authority (FINRA, the organization responsible for securities regulation in the United States), with a unified voice and so that crowdfunding platforms could work together to create an orderly market for crowdfund investing. They also formed the Crowdfunding Professional Association to provide networking, education, and collaboration among startups, small businesses, and investors.

The SEC took the first step to regulating crowdfunding during the summer of 2012, when it released the final rules relating to Title II of the JOBS Act. Title II of the JOBS Act required the SEC to lift the ban on general solicitation to accredited investors. The final rules allow entrepreneurs to use public means like the Internet or even an aerial banner to solicit investments in their businesses provided that they prove the investor is accredited. Prior to this, the burden of proof was on the investor, and self-certification of one's accreditation was all that was needed. Now the burden has shifted to the issuer. While some opponents say that that the forced disclosure will deter

FIGURE 1.1 A Timeline Leading to Crowdfund Investing: Regulation that Didn't Scale Down. . .



investments, proponents see third-party providers like accountants certifying forms for investors in order to keep personal information confidential.

The final rules also included a class of individuals otherwise known as "bad actors" from partaking in these offerings. The intent is to reduce fraud in the marketplace. All offerings must be submitted 15 days before they go public with the SEC. The specifics regarding these latest changes are covered later in this book.

The elimination of the ban on general solicitation went into effect at the end of September 2013. It is yet to be determined the impact this will have on both investments and investors.

As of the writing of this book, the SEC has not yet released draft rules for comment related to Title III, Crowdfunding, and so the history is still unfinished. The crowdfund investing industry has been actively engaged with both the SEC and FINRA to provide comment and perspective as those bodies contemplate rules for the crowdfunding legislation.

In the meantime, the world has not waited on U.S. regulation. The United Kingdom has equity- and debt-based crowdfunding platforms in operation, and Italy has passed crowdfund investing legislation and has final rules that restrict the types of issuers to technology-related companies and require a lead angel investor. While seen as a first mover, Italy has also been critiqued for leaving behind those most in need of capital: mom-and-pop businesses. Many other countries are also looking at how they will institute crowdfund investing for the benefit of their citizens. Also, development organizations including the World Bank are actively working on models for crowdfunding that will fit in the developing world. Are there ways for developing countries to leapfrog the developed world in this new asset class? An often-cited example of this from the past would be the way in which cell phones came to China and connected vast numbers of people who never had telephone service via landline before.

Another issue that development organizations are attempting to solve is "the last mile problem" for delivering resources and capital to businesses and entrepreneurs. In many countries around the world, leaders of governments face the same challenge. That is, how to use funds that have been earmarked for entrepreneurship, innovation, or jobs and deliver funding to the "right entrepreneurs" that will be successful. While there is no way to do that with anything approaching 100 percent accuracy, the question becomes whether these organizations can leverage crowdfund investing and/or crowdfunding to create "signals" from the crowd that an entrepreneur is worthy of greater investment. The World Bank and national governments are exploring how this might take shape. One example of a government that is already moving forward is in the United Kingdom, where the government has created a £20 million (US$30 million) fund to coinvest with debt-based crowdfunding site Funding Circle.

Could this provide another opportunity for a new technology or business process to fix inefficiencies in a market? And if it does, what is the opportunity to create an entire ecosystem for crowdfunding? At the beginning of the social Web, there were only the social networks themselves. Once Facebook opened its application programming interfaces to developers and encouraged companies to create applications that could be used with Facebook, a massive ecosystem was created that has formed thousands of companies that has yielded hundreds of exits for entrepreneurs that created value in the ecosystem. It is our belief that we are already seeing the birth of the Web 3.0 ecosystem and we are excited to watch it grow.

One could say that the history of crowdfunding is measured in hundreds, if not thousands, of years. Crowdfund investing, however, has a very brief history and interesting prospects for success with potential risks that the industry and governments must work together to address. It creates new challenges for entrepreneurs, business owners, investors, and regulators. Those challenges also create business opportunity for savvy entrepreneurs, who can bring new technology solutions to address these market opportunities both here in the United States and globally. This is the birth of a new asset class, and we believe that if the industry can get it right, it will unlock significant opportunity for innovation, entrepreneurship, and economic growth.