

What You Need To Know To Profit From Crowdfunding

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Brace yourself—crowdfunding is coming. For small investors it will be either a great “level-the-playing-field” opportunity to get in on the ground floor of promising startups or a federally sanctioned invitation to fraud on a scale not seen since the boiler-room days. Or both.

Equity crowdfunding will allow entrepreneurs to sell unregistered shares directly to all sorts of investors via the Internet. It’s part of the bipartisan Jumpstart Our Business Startups (JOBS) Act that President Obama signed in April. The Securities & Exchange Commission is supposed to finalize the rules that will implement the act early next year.

Without going through an expensive and onerous SEC registration, companies will be able to sell up to \$1 million of stock per year to an unlimited number of investors. Individuals who earn less than \$100,000 a year can invest up to \$2,000 per company per year; wealthier folks can invest 10% of their income up to \$100,000.

If a company is trying to raise \$100,000 or less, the executive officer must certify the veracity of financial statements and provide prior-year income tax returns. Those raising between \$100,000 and \$500,000 must take the additional step of having an independent certified public accountant review financials. Offerings of more than a half-million dollars will require audited financial statements.

Even before the passage of the JOBS Act, crowdfunding was growing fast. In 2011 an estimated 452 crowdfunding platforms worldwide (but mostly in Europe and North



America) raised nearly \$1.5 billion, according to a May report from Crowdsourcing.org. That study estimates volume will hit \$2.8 billion in 2012.

But growth could be exponential once the SEC issues the new rules. That's because U.S. crowdfunding sites like Angel List have been (under pre-JOBS law) able to sell stock only to "accredited" investors—those with a net worth of more than \$1 million or an annual income of \$200,000 or more (\$300,000 for a couple).

For all the buzz about Kickstarter—it has raised more than \$230 million for 23,000 "projects" since 2009—it does not sell equity. (It isn't interested in equity projects, its founder said recently.) Instead, the public makes donations and gets some sort of premium reward. So Kickstarter projects tend to be small, artsy or fun. Example: Mystery Brewing Co. in Chapel Hill, N.C. raised \$44,259 in 2010 from 243 backers. In exchange for donations of \$5 to \$5,000, backers got logoed bottle openers, T-shirts, framed posters, home-brew recipes and tulip-shaped beer glasses.

The JOBS Act opens true equity crowdfunding up to the masses. "The target audience is likely to be unsophisticated," says Stephen Goodman, an attorney with Pryor Cashman LLP in New York. "We already know the SEC has been extremely skeptical of this [crowdfunding] process."

Skeptical or not, the SEC must go along with the new law. So while crowdfunding won't eliminate all red tape for startups, there should be a lot less of it.

Brokers and portals hoping to jump into crowdfunding will have to register with the SEC and other regulators. Cyberunderwriters must provide disclosures on investment risk and do background checks on company officers, directors and shareholders who hold more than 20% stakes in the companies.

Small-time frauds claiming to sell pre-IPO shares of companies like Facebook have already surfaced, according to the SEC. Kickstarter itself recently canceled a solicitation from a company called Little Monster Productions for a game called Mythic: The Story of Gods and Men. It turned out, according to members of the Reddit online community, that the company had purloined some images from another game site. It had pledges for \$4,739 toward an \$80,000 goal before Kickstarter shut down the funding drive.

Little Monster never received the money, and social media can claim credit for outing the villain. So perhaps, in the best case, millions of eyes vetting startups will ultimately prove more effective at rooting out fraud and bad actors than a poorly financed and thinly staffed regulatory agency like the SEC.

Meanwhile, evaluate crowdfunding opportunities more diligently than you would normal publicly traded equities. Be ready to play Sherlock Holmes as well as Warren Buffett. Here's a checklist:

Financial statements. Ask for corporate tax returns; all companies must provide at least this much. An experienced accountant can review them and tell you if anything looks fishy. Although companies asking for less than \$500,000 don't have to provide audited financial statements, request them anyway. Some of the more disclosure-friendly officers may even provide personal tax returns. Never hurts to ask.

Licenses and registrations. If it's a legitimate business, it should have licenses from city, county and state agencies. If it provides a regulated service, such as selling insurance or securities, state regulators should have a record of the licensure. Secretaries of state or state corporation departments should have information on business registrations. Read the filing, even if it's stale. If you spot something questionable in this basic information, a company could be lying on other details.

Litigation. Has the company ever been sued? You can always ask the company directly, but may not get an answer—or at least a complete one. Search online at the free site Justia.com for federal lawsuits as well as bankruptcy filings. Be sure to search the company's current and past names and its affiliated corporate names, as well as the names of its principals. (You can retrieve court filings at Pacer.gov for 10 cents a page.) You can also use the legal information services Westlaw and Lexis, which are available at law libraries and some college libraries. If a company or principal was sued, were there judgments or settlements? A consistent pattern of arbitrations, complaints and litigation can tell you a lot. Bankruptcies, corporate or personal, should also cause concern.

Employment and educational history. While employment background is a little tricky due to privacy concerns, you can contact any college a principal lists to see if he or she attended and graduated. (Not all provide this info.) Did he actually earn a Harvard M.B.A. or just attend a summer seminar? Employment searches are easiest if they involve high-profile executives. Search company websites. Check LinkedIn and Facebook for executives' profiles, then verify the information independently. Focus on the management team, and look for criminal arrests, trials or convictions. Have they hired family members? Have they relocated frequently? If references are provided, call them; make sure they aren't just friends, family and neighbors but have some business connection to the company.

Required disclosures. The company or funding portal must disclose how much it's hoping to raise, the terms of the sale, how the securities are being valued and how future transactions may affect minority owners. The precise rules on all this have yet to be written, but you should know what your shareholder rights are and if your stake will be diluted by future offerings. It's also essential to know who the company's competition is and how it compares. Perhaps most important, look at the details of how the money will be spent. Beware of insider dealings.

After all that, do some old-fashioned tire-kicking. Call up the company and ask questions or visit one of its facilities. If company officials exhibit "caginess," says Sara Hanks, a securities attorney and chief executive of CrowdCheck Inc., that may be a signal to move on.

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