

Crowdfunding

The Internet has become an inexpensive and easy way for individuals and businesses to raise money for their activities. Congress recently passed the JOBS Act, which directs the Securities and Exchange Commission (SEC) to create rules exempting crowdfunding from the securities registration laws. Once implemented, these rules will remove restrictions on start-up companies seeking investors over the Internet. Investors should be on the lookout for unscrupulous issuers and intermediaries who may attempt to engage in crowdfunding before the rules are written or misuse crowdfunding to steal from investors through false and misleading representations.

Crowdfunding is an online money-raising strategy that began as a way for the public to donate small amounts of money, often through social networking websites, to help artists, musicians, filmmakers and other creative people finance their projects. The concept has recently been promoted as a way of assisting small businesses and start-ups looking for investment capital to help get their business ventures off the ground.

Traditionally, investment opportunities are offered by professionals, such as broker-dealer firms and investment advisers, who must recommend investments that are based on their clients' investment objectives and levels of sophistication. Through crowdfunding, individuals are able to invest in entrepreneurial start-ups through an intermediary, such as a broker-dealer or a "funding portal." By law, "funding portals" are not allowed to provide investment advice.

Funding Portal

A funding portal is a website, also called a "platform," that advertises the investment opportunities and facilitates the payment from the investor to the issuer. Some portals advertise a variety of investment opportunities on one website, allowing the investor to select one or more projects in which to invest.

How Crowdfunding Works

Joe's small business sells goat cheese made from his special pygmy goats. To keep his business afloat or to help it grow, Joe can turn to the Internet to seek online donations from the public who contribute small amounts of money and expect nothing in return. Joe usually sends a sample of his cheese as a thank-you for the donation; large donors might even get a cheese named in their honor.

New legislation has directed the SEC to write rules that will change how Joe can raise money online. Once the rules are written, Joe will be able to use the Internet to raise up to \$1 million each year by selling investments in his company to thousands of investors. Because Joe will be issuing shares in his company in exchange for investment capital, his supporters are no longer donors; they become investors and will expect a financial return for their investment.

Why Investors Must be Extremely Cautious About Crowdfunding Investments

- Crowdfunding investments cannot be offered legally until the SEC adopts rules to permit them. Beware of offerings that seek investments immediately.
- All investments have risk, but small business investments have even greater risk than normal. About 50 percent of all small businesses fail within the first five years.
- Issuers using funding portals to raise money may be inexperienced. Their track records may be unproven, unsubstantiated, or outright fraudulent.
- The information about the investment is limited to what is provided through the funding portal. Investors may need to rely on their own research to determine the issuer's track record.

- Because state regulators are not allowed to review crowdfunding issuers or their offerings, full and complete disclosure may not be available to investors.
- Investors may have limited legal ability to take action against the issuer should the investment not perform as represented. Due to limited regulatory oversight over these offerings, investors may be left on their own to pursue costly private lawsuits when things go wrong.
- Crowdfunding investments are mostly illiquid and investors must be prepared to hold their investments indefinitely. It also may be difficult or impossible to resell these securities due to the lack of a secondary market.
- Funding portals must be registered with the SEC, belong to a self-regulating organization (SRO), and comply with other rules the SEC may issue.
- Crowdfunding portals claiming an accreditation or “seal of approval” from a standards program or board may not be legitimate.

The Bottom Line

It pays to be skeptical of investment opportunities you learn about through the Internet. When you see an offering on the Internet — whether it is on a funding portal, in an online newsletter, on a message board or in a chat room — you should be cautious until you have done your homework and proven that it isn’t a scam. If you have any questions about crowdfunding offerings, contact the Department of Licensing and Regulatory Affairs (LARA), Corporations, Securities and Commercial Licensing Bureau at 517-241-6345 or visit www.michigan.gov/lara.