Crowdfunding:
New Rules, Global Growth

When homecare network CareGuide founder John Green sought funding for his venture, he had already lined up 10 investors. He could've continued pounding the pavement, but instead turned to crowdfunding platform AngelList, where he raised more than $1.5M from 50 investors.

"It democratizes things in a way," Green told *The Globe and Mail*. "People with smaller sums to invest have access to deals like this."

In the U.S., this type of crowdfunding—known as investment or equity crowdfunding—was previously limited to "accredited investors," high net worth individuals whose wealth is assumed to buffer the impact of financial risk. As of June 19, 2015 that's all expected to change. New rules hammered out by the Securities and Exchange Commission (SEC) allow ordinary U.S. citizens to take equity positions in companies raising funds on these platforms.

The rule change, Regulation A+, a clarification and amendment to the JOBS (Jump-Start Our Business Start-ups) Act of 2012, could be a game changer. For the first time in the U.S., equity crowdfunding is available nationally for non-accredited investors.

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Where crowdfunding platforms such as Kickstarter and Indiegogo are rewards-based, doling out items like first dibs on a smart watch you invested in or invitations to the premier of a movie you helped fund, sites like AngelList allow investors to own a piece of the company and potentially profit from its success.

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The JOBS Act is considered by many governments to be a model for equity crowdfunding regulations. If the SEC's new, open approach to crowdfunding proves viable, countries that are still developing regulations—China included—may well follow suit, opening the floodgates worldwide.

In the UK, where equity crowdfunding has been open to the general public for over three years, it's been funding everything from micro-breweries to wearable technology, growing to £84M last year. (See sidebar, UK: A Test Case)

In addition to industry leader AngelList, which is backed by top tier Silicon Valley venture capital firms and angel investors, dozens of similar sites are up and running in the U.S., ready to benefit from the new opportunities, among them Crowdfunder, SeedInvest, CircleUp and EarlyShares. Since the new rules were announced, a platform has already launched aimed at women-owned businesses, FundAthena.

EarlyShares is part of an emerging category of real estate crowdfunding, with potential to provide new funding sources for commercial developers. This trend is catching on worldwide.

For the average investor, the opportunity to participate in the growth of an emerging company through crowdfunding could be a big draw.

"The rewards can be tremendous—and they go beyond a terrific financial return," says Jeff Lynn, CEO of the UK's leading equity crowdfunding platform, Seedrs, speaking from his London office. "Investors get to back businesses they believe in, products or services that will make a positive difference in the world. Through crowdfunding, individuals can band together and participate in something bigger than themselves."

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Many banks recognize that crowdfunding is emerging as a viable alternative to more established fundraising methods. Partnering with or backing such platforms could give them ways to share in the excitement around this new type of financing.

CROWDFUNDING GROWS UP

Crowdfunding has been immensely popular since 2009, when Kickstarter first opened its doors. Since then, the New York, NY-based rewards-based crowdfunding site has helped raise more than $1.7B for 85,000 projects, many of which might never have seen the light

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of day, and helped launch a worldwide movement. However, the most that supporters can expect in return for their pledges is appreciation, acknowledgement, and a T-shirt or perhaps an early version of a product.

UK: A Test Case

When it comes to equity crowdfunding, the UK has had a three year lead on the rest of the world. The country's Financial Conduct Authority (FCA) approved the first such platform, Seedrs, in 2012, allowing anyone at any financial level to invest. There are now over 35 equity crowdfunding sites in the UK, including CrowdCube, Angels Den, Syndicate Room, Investingzone and many others.

In the two years following the FCA approval, the market skyrocketed 410% to £84M. Much of the money is coming from inexperienced investors: 62% had never backed a company before, says Nesta, an innovation charity that conducted an extensive survey of alternative finance in the UK.

The UK government has aggressively incentivized equity-based crowdfunding in order to grow Britain's small businesses. It allows deductions of up to 50% from annual income tax, no capital gains on any appreciation, and further deductions if a funded business fails.

In April 2014, the FCA tightened rules, requiring that the public invest only 10% of their investable assets. They also hammered out requirements that companies provide documentation that is "fair, clear and not misleading."

Nesta's report, published in 2014, found that in the short term, crowdfunded cash infusions were fueling SME growth across multiple industries. Nearly half of funded companies increased profits, three-quarters launched a new product or service, and 60% added employees. Fundraisers said that in addition to much-needed capital, crowdfunding gave them access to a wider network of business contacts.

Overall, the experiment has shown that the UK public has a large and growing appetite for this type of investing, and there is no shortage of companies seeking financing.

The case of headset maker Oculus VR highlights the limitations of the rewards model. Having raised $3.4M on Kickstarter in 2012, Oculus was later acquired by Facebook for $2B—angering many supporters, who were unable to share in the company's success, and had no say in the decision.

While crowdfunding's early adopters were typically musicians and filmmakers raising funds for artistic projects, it's now heavily focused on entrepreneurial ventures. Globally, the market for all types of crowdfunding is projected to top $34B by the end of 2015, with the lion's share going to small-and medium-sized enterprises (SMEs).

The growth curve is steep: between 2013 and 2014, the amount raised for entrepreneurial and other business ventures more than tripled, outstripping all the other categories. From the investor point of view, crowdfunding holds the potential for new sources of yield. Worldwide, equity crowdfunding grew 182% between 2013 and 2014 to $16.2B. The fastest growth was in Asia, driven mainly by China.

The Chinese appetite for equity crowdfunding is growing, with interest in everything from films to "smart hardware" such as smart TVs and smart WiFi routers. Last year, a total of $70.9M was raised on such platforms as JD (a spin-off of the e-commerce giant), Z.jd, and Zhongchou, according to iResearch.

Equity Crowdfunding Basics

Despite their underlying differences, equity crowdfunding platforms are typically structured in a way similar to their rewards-based counterparts: investors sign up and can browse company descriptions, watch videos, learn about the team and choose which to back.

Many offer the opportunity to ask questions directly of the company's CEO, just as a venture or angel investor does. Most platforms make these questions and answers available to participating investors, leading to lively conversations that provide significantly more information than startups usually share in public forums.

Companies that raise funds on these platforms choose the percentage of the company they're willing to sell as equity. Each platform determines the minimum that can be invested per company—sometimes as little as $10, depending on the type of investment.

In return, the company often pays dividends to these multiple shareholders, who can fully cash out when and if the company is either acquired or goes public.

Companies typically pay either a flat fee or percentage (or both) to the equity crowdfunding platform in exchange for multiple services, including handling much of the paperwork involved in selling private company shares. Some platforms also charge investors. Seedrs, for example, charges the companies and the investors 7.5% of the amounts raised or profits, respectively.

The fact that investors can spread their investments widely across multiple companies is part of the appeal of crowdfunding, and experts suggest making multiple small bets in this high risk/high return environment.

China's government has yet to fully hammer out equity crowdfunding regulations, and this has hamstrung its growth. For example, current regulations only allow 200 shareholders per company. Taiwan's government, meanwhile, plans to launch its own equity crowdfunding platform to support business growth.

UK AND EUROPE IN THE LEAD

In the UK and in several countries across Europe, equity crowdfunding is open to all types of investors. Since its founding in 2012, Seedrs has funded over 200 campaigns, and is growing 15% month over month.

"In the UK and continental Europe, where true [equity] crowdfunding already exists, Seedrs has shown the industry's potential," says Lynn. "Seedrs members are now investing at a rate of over $3M per month. Opportunities on Seedrs have varied from a publicly-listed winemaker to a popular mobile app to a peer-to-peer lending company."

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Seedrs has expanded to the U.S. by acquiring an existing platform, San Francisco, CA-based Junction Investments, as part of its push to bring U.S. investors into European deals. Seedrs American competitor AngelList, meanwhile, has recently expanded into the UK.

As the market matures, crowdfunding platforms are finding new ways to entice investors, such as building debt vehicles that pay interest. Crowdcube, another UK platform, has launched "mini-bonds." For an initial investment of £500 or more, investors receive 7% fixed rate interest per annum.

The bonds helped well-known British restaurateur Hugh Fearnley-Whittingstall raise £1M in *just three days* for his foodie venture, River Cottage.

"I am a huge advocate of crowdfunding and this new innovation from Crowdcube helps reduce the cost and complexity of raising finance and provides an effective way for more established brands, like River Cottage, to raise growth funding without the banks," Rob Love, River Cottage's managing director and co-founder, told startups.co.

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SILICON VALLEY AND CROWDFUNDING

In Silicon Valley, crowdfunding has emerged as a viable way to garner seed funding for new and untested products and services.

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Venture capital investors often view it as a way to gauge the potential market value of a startup. Often, startups will reference their success in a crowdfunding campaign as part of their pitch to VCs.

Based in San Francisco, AngelList embodies the Silicon Valley ethos by making crowdfunding democratic, and giving it the same cool factor in the startup world as angel investing. It’s even giving VCs a bit of a poke in the eye.

In 2013, AngelList introduced a syndicate model that allows smaller, accredited investors to join with leading angels in funding companies they are interested in. Even more attractive, all the investors receive up to 20% of the investment profits, known as the “carry,” just as VCs do. AngelList takes 5% for itself.

Led by Silicon Valley insiders Babak Nivi and Naval Ravikant, the company has attracted well-known angel investors such as Tim Ferris, author of The 4-Hour Workweek, and Gil Penchina, former eBay executive. Entrepreneurs and investors are lining up to participate. Over 500 companies raised $125M on AngelList in 2014, with the largest single investment, at $50M, going to Life360, a mobile application that keeps families connected.

THE CAMPAIGNS

16.4%
of submitted campaigns got approved

165
average number of investors per funded deal

42.6%
of approved campaigns successfully funded

27 days
average time for a deal to fund

Seedrs curates its campaigns to filter for the most interesting and engaging

AngelList recently gave its blessing to a separate fund set up by several of its leading angels, Maiden Lane, which has raised $25M to support syndicate investments of $200K on the site. Some think these types of vehicles could shake up the VC model that has dominated Silicon Valley for decades.

In the past, without the blessing of Sand Hill Road—the locale for the powerful VC firms of the Valley—startups had few choices.

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With a rising tide of startups seeking seed capital, there is a great deal of call for more investing at that early stage. These innovations provide angels and other investors greater deal flow—in other words, access to a larger number of potential startups to back.

Once non-accredited investors are added to the mix, it could tip the scales in favor of crowdfunding, which offers efficiency and transparency on a wider scale.

CAVEAT EMPTOR

Because equity crowdfunding is so new, it's difficult to determine how well these platforms will fare in the long term. According to the U.S. Small Business Administration, about half of all small businesses fail within the first five years of operation.

One major reason is lack of access to much-needed capital, a problem that crowdfunding can help fix. However, even full-speed-ahead crowdfunder Lynn cautions that, "in no case, should investors put in more money than they can afford to lose."

Inexperienced investors may also not understand the fine points of small business funding, particularly dilution. For example, the co-founder of Facebook, Eduardo Saverin, was famously cut out of its success when the company issued new shares.

The burgeoning industry has many complexities that remain to be fully ironed out.

This could be a widespread problem with equity crowdfunding, because many companies go on to raise further rounds of funding, and those who participate in the initial seed round may find their share value dwindling. In their role as investor representatives, some crowdfunding platforms, Seedrs included, have put protections such as anti-dilution clauses into place.

The burgeoning industry has many other complexities that remain to be fully ironed out. For example, with hundreds or even thousands of individuals holding shares of a company, managing their expectations is no easy task. As the industry grows, these challenges will need to be fully met.

CONCLUSION

Equity crowdfunding, while still in its infancy, is growing by leaps and bounds. It takes advantage of inefficiencies in the traditional financing models for startups and other SMEs. With many banks tightening their purse strings in the wake of the financial crisis, and access to investors such as angels and VCs proving difficult for many emerging businesses, crowdfunding has stepped into the breach.

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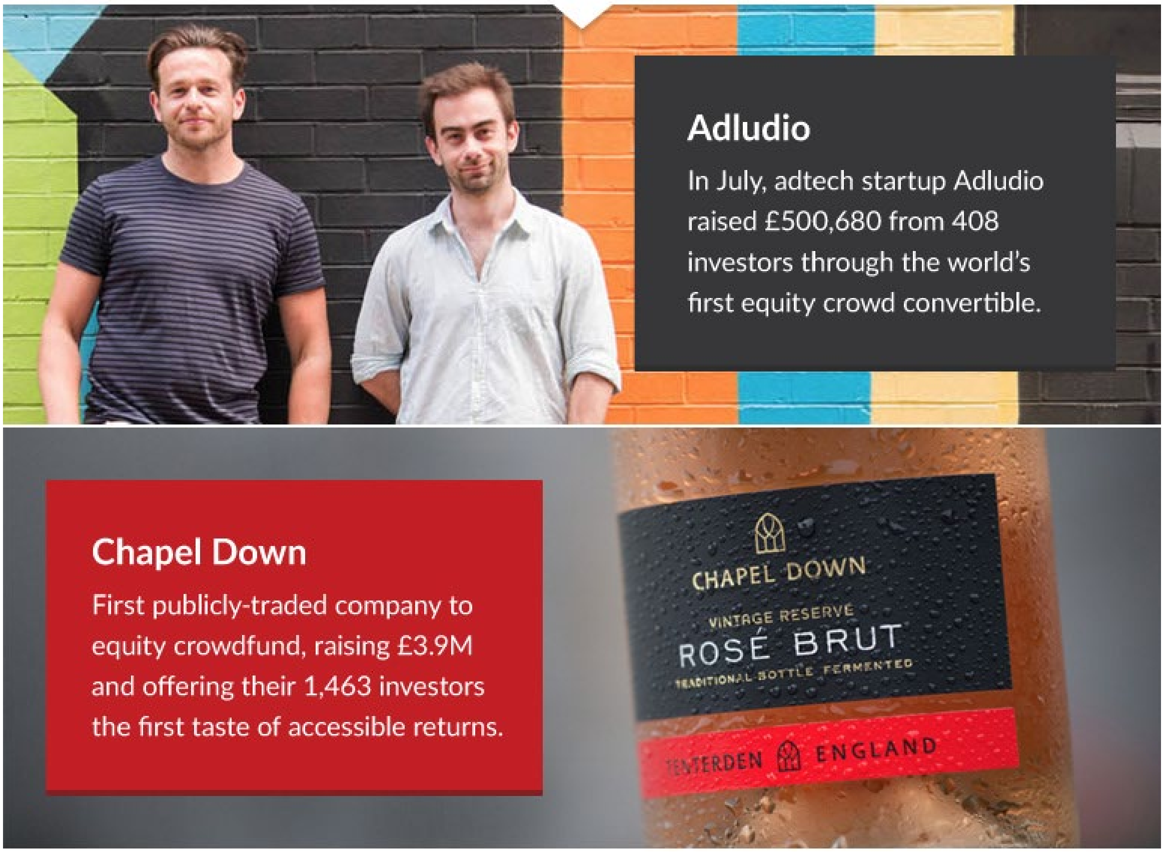
There are some limitations to the new rules: for campaigns that wish to raise \$20M–\$50M (Tier 2), non-accredited or retail investors can only invest 10% of their income or net worth. For campaigns up to \$20M (Tier 1) companies are subject to state blue sky laws, not the case for Tier 2. Either way, the companies have a lower burden of paperwork to file than if they were issuing an IPO. Many believe this nascent industry is on the verge of a major upsurge in light of the new regulations.

Equity crowdfunding potential: successful Seedrs campaigns



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