Why Venture Capital Will Not Be Crowded Out By Crowdfunding

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ABSTRACT

As the recovery period from one of the worst recessions in our history continues on, life for the fledgling and even, often times, experienced entrepreneur has been tough. Indeed, President Obama remarked “[c]redit’s been tight, and no matter how good their ideas are, if an entrepreneur can’t get a loan from a bank or backing from investors, it’s always impossible to get their businesses off the ground.” In response to this ever-present need for business funding, and in an attempt to stimulate the economy and job growth, Obama signed the Jumpstart Our Business Startups Act (“JOBS Act”) into law on April 5, 2012. The Act, among other things, increases a business’s access to capital by enabling them to sell securities to both accredited and non-accredited investors without registering or completing the full disclosure requirements typically required for public offerings.

The overarching purposes of this paper will be to: 1) explain and analyze the relationship and overall dynamic that will exist between crowdfunding and VCs; 2) elucidate why investors should avoid or, at the very least, be wary of investing money through the crowdfunding medium; and 3) expound reasons as to why crowdfunding as a means of financing should be used as a last resort for a budding entrepreneur.
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I. INTRODUCTION

As the recovery period from one of the worst recessions in our history continues on, life for the fledgling and even, often times, experienced entrepreneur has been tough.\(^1\) Indeed, President Obama remarked “[c]redit’s been tight, and no matter how good their ideas are, if an entrepreneur can’t get a loan from a bank or backing from investors, it’s always impossible to get their businesses off the ground.”\(^2\) In response to this ever-present need for business funding, and in an attempt to stimulate the economy and job growth, Obama signed the Jumpstart Our Business Startups Act (“JOBS Act”) into law on April 5, 2012.\(^3\) The Act, among other things, increases a business’s access to capital by enabling them to sell securities to both accredited and non-accredited investors without registering or completing the full disclosure requirements typically required for public offerings.\(^4\) More specifically, Title III of the Act, which is still awaiting commentary from the proposed rules recently promulgated and is likely to go into effect in early 2014,\(^5\) presents the option for an issuer, the company, to use the Internet to access capital (“funding”) from public investors (the “crowd”) at much lower costs than in a registered offering and with fewer regulatory burdens than in an exempt unregistered offering. This concept, which has been termed crowdfunding, in the broadest sense, refers to the practice of using the Internet to raise capital by way of small investment from a large number of investors.\(^6\) Allowing non-accredited investors to invest in private, startup companies will not only be completely undermining 80 years of securities doctrine, dating all the way back to the Securities Act of 1933 (“Securities Act”),\(^7\) but it will also be totally changing the investment landscape with regard to the financing of startup companies.

In fact, the landscape may change so drastically that one of the most prominent venture capitalists, Fred Wilson, boldly suggested that venture capital (“VC”) could be swept away altogether by a flood of crowdfunding money unleashed by the JOBS Act.\(^8\) His reasoning looked something like this: if each family, or individual, invests 1% of their assets in crowdfunding, it will equate to around $300 billion, which is approximately 10 times greater than the $30 billion annual average of VC funds infused

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\(^2\) Id.
\(^6\) Wroldsen, John S. (Jack) (2013) «The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists’ Dilution of the Crowd», Vand. J. Ent. & Tech. L., 15, p. 583 (crowdfunding is “the practice of many (i.e. crowds of) people investing small amounts of money over the Internet in early-stage businesses in exchange for equity interests that are not registered with the Securities and Exchange Commission.”)
in the market over the past couple of years. The logic follows that since the $300 billion in crowdfunding, which has been said to be a conservative measure in other pundits' views, will dwarf the amount that venture capitalists put into the system, then their role as aggregators of cash will be minimized, leading to less utility and an overall decrease in their value. It should be noted that Wilson also possessed this pessimistic outlook towards the VC industry for additional reasons beyond just the deluge of crowdfunding money being invested: namely, too much money going into closed-in funds and other ways of funding are outperforming VCs. In any event though, one cannot deny the premise: the genesis of crowdfunding as an option to an entrepreneur looking to raise capital will have an effect on the VC industry. The converse however is true, as well, in that traditional means of financing, specifically VC funding, will have an effect on crowdfunding. Beyond just the mere impact that crowdfunding and traditional VC funding will have on one another, many other risks, cautions, and perils lie for both companies looking to crowdfunding as means of financing and investors looking to invest through crowdfunding portals.

The overarching purposes of this paper will be, in the first place, to explain and analyze the relationship and overall dynamic that will exist between crowdfunding and VCs; secondly, to elucidate why investors should avoid or, at the very least, be wary of investing money through the crowdfunding medium; and lastly to expound reasons as to why crowdfunding as a means of financing should be used as a last resort for a budding entrepreneur.

**Part II** of this paper will briefly highlight the different methods startups have used to obtain capital prior to the enactment of the JOBS Act and the appurtenant crowdfunding provision. VC funding will be the main focus in this Part. The relationship between the inability to access capital and the failure rate of a startup will be analyzed. This Part will examine the corollary of the high failure rate of startups with an emphasis on the VC’s expectations and strategy. Finally, this Part will conclude by citing reasons as to why the demand for financing from startup companies is not being met.

**Part III** of this paper will inspect and scrutinize the JOBS Act with a specific focus on Title III: Public Securities Crowd Investing. This Part will spell out how non-accredited investors will be able to participate in investing in startups, including the investment amount limitations and required company disclosures investors are privy to. Lastly, an in-depth analysis will be conducted and viewed disparately from both the investor’s perspective and the company’s perspective highlighting potential problems, issues, and complications that may arise through the use of, or participation in, crowdfunding. From the lens and perspective of the investors (i.e. the new investing

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11 Novellino, supra note 9

12 Weissman, Cale Guthrie. "Fred Wilson: Venture capital as we know it will cease to exist." Pando Daily. 17 Jun 2013. <http://pandodaily.com/2013/06/17/fred-wilson-venture-capital-as-we-know-it-will-cease-to-exist/>. (“I believe that the venture capital business as we know it will not exist in 25 years.”)
class of non-accredited, ordinary individuals), the focus will be on fraud concerns and horizontal risks associated with not having appropriate VC protections. Shifting to the lens and perspective of the company, the focus will be on the negative consequences of resorting to crowdfunding; namely deterring future funding from VCs.

**Part IV** of this paper will conclude by reaffirming the notion that crowdfunding and VCs can, and will, coexist. I will then propose some feasible, practical solutions that properly balance the JOBS Act’s goal of increasing access to capital for startups, on the one hand, and the SEC’s endless objective of protecting investors, especially the non-accredited, from fraud, malfeasance, and other unintended consequences, on the other hand.

## II. STARTUP FINANCING

### A. Overview

It is estimated that around two million new businesses are formed each year, of which around 550,000+ are considered “startups”.13 To understand the different financing rounds, or funding stages, a startup company proceeds through, it is best to think of the new venture on a timeline. On the far left is when the idea of the business was conceived and the business model was created. The company then moves from left to right as the idea gains credibility and forward momentum.14 Throughout this process, the company, ideally, is hitting the necessary milestones previously put in place by investors like VCs and, to a lesser degree, angel investors, resulting in the subsequent receiving of funds via the different rounds of funding discussed in brevity below. These funding rounds are known in the startup world jargon as the seed round, series A round, series B round, series C round and so on and so forth until the company “exits,” which generally means either an IPO or an acquisition.15

Traditionally, nascent companies are initially funded from credit cards and savings (“bootstrapping”), and then reach out to friends and family.16 In a best-case scenario, this usually covers up to about $250,000, and then the startup is forced to look elsewhere for funding.17 Angels, who are high net worth, accredited investors seeking high returns through private placements in startup companies, are usually sought out at this point. Angels are typically looking to invest a set amount ranging from as low as

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15 Id. See also Broughman, Brian and Fried, Jesse M. (2013) "Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups«, *Cornell L. Rev.*, 98, pp. 1319, 1321 for discussion of other “exit” options such as dissolution and then liquidation of the company


17 Id.
$10,000 to as high as $1,000,000. In addition, angels are normally seeking high growth potential companies and often focus solely on particular industries in which they are familiar with. Assuming the company is in the vast minority and is actually fortunate enough to receive angel funding, once that amount has been exhausted, the startup turns to the VC firm for funding. Although this funding process may sound rather simple, in practice, obtaining the necessary funding at the different stages of development can actually be so difficult that many businesses ultimate demise is lack of funding.

1. Lack Of Funding And The Funding Gap

It is well known that small businesses often face an uphill battle when attempting to raise money through traditional funding sources, such as bank loans, angel investors, and VC firms. Following the 2007 financial crisis, conditions worsened. Startups seldom have adequate cash flow or collateral to qualify for bank loans in normal economic times, let alone post-recessionary times due to the tightened underwriting standards imposed by banks. As a matter of fact, estimates suggest that there is a $60 billion shortfall in the demand for early-stage private equity financing each year. Moreover, a joint report by PWC and National Venture Capital Association (NVCA) shows that from 2009 to date, VCs have invested the least amount of money in early stage deals and have also invested in the smallest amount of early stage deals by volume compared to the other stages of development. To shed some more light and provide a bit more context, in 2012 VCs invested in 3,826 deals total of which only 876 were early stage investments (22.8%), whereas in 2001 VCs invested in 4,590 deals total of which 1,321 were early stage investments (28.8%). As can be seen, just over a decade ago, the

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21 Gage, Deborah. «The Venture Capital Secret: 3 Out of 4 Start-Ups Fail». Wall Street Journal. 20 Sep 2012; see also commentary from Senior Lecturer of Business Administration at Harvard Business School, Shikhar Ghosh, http://hbswk.hbs.edu/item/6591.html
23 Id; See also Office of the Comptroller of the Currency, U.S. Dep't of the Treasury, 2012 Survey of Credit Underwriting Practices 7-8 (2012). As of May 2012, only 10.2% of small businesses that applied for bank loans received them.
24 Id; See also Bradford, supra note 64, at 100 (quoting William K. Sjostrom, Jr., Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings, 32 Fla. St. U. L. Rev. 1, 3 (2004))
26 Id.
chance of obtaining VC funding was more promising and likely, especially at an early stage of development. With that said, however, procuring VC investment has never been an easy feat. In fact, it has been said that for every 30-40 investment proposals that slide across the desk at a VC firm, only one will be invested in.\textsuperscript{27} So, the question becomes: if startups have a dire need for funding at an early stage of development in order to get their business off the ground, why are VCs failing to meet this demand?

2. \textit{Venture Capital Funding}

VCs are very selective and offer only limited assistance to startups, investing on average less than a quarter of their total investments in early-stage companies.\textsuperscript{28} This occurrence can be attributed to two main reasons. First, VCs mainly seek to invest greater sums – on average between $2 million and $10 million – than startups are pursuing.\textsuperscript{29} Second, VCs have a preference for investing in somewhat less risky companies – those having already endured through the initial startup phase with proven track records and clearer exit prospects.\textsuperscript{30} Before one can truly understand why VCs operate in the manner they do and, in the process, fail to meet the demand of startups seeking early-stage financing, a brief explanation of the VCs structure and strategy is necessary.

In layman’s terms, venture capital is a professionally managed pool of capital that is invested in equity-related securities of private ventures at different stages of their development.\textsuperscript{31} The VC firm—itself is typically the “general partner”. The outside investors contributing towards the pool of capital are typically institutional investors and high net worth individuals who are referred to as the “limited partners”.\textsuperscript{32} The prevailing form of organizational structure of the fund becomes a limited partnership in which the VC firm serves as the manager of the fund.\textsuperscript{33} In 2012, the median U.S. fund size was $150 million, which was a 12% increase from the median size of $134.5 in 2011.\textsuperscript{34} Normally, VC funds, despite getting hundreds or even thousands of investment proposals each year, invest in 10-12 or so total.\textsuperscript{35} The general partner, or VC firm, is responsible for sourcing, evaluating, and ultimately negotiating the investments that are made into the startup, portfolio, or companies.\textsuperscript{36} Therefore, the ability of investment funds to invest is constrained by the ability, expertise, and experience of their managers.

\begin{thebibliography}{99}
\bibitem{Mashburn} Mashburn, supra note 24
\bibitem{Id.} Id.
\bibitem{Id.} Id.
\bibitem{Id.} Id.
\bibitem{Sahlman} Sahlman, supra note 30; see also McKaskill, supra note 26
\bibitem{Id.} Id.
\end{thebibliography}
Resource-Constrained

The general partner is actively involved in the management and strategy of their portfolio companies. VCs with a $100 million fund simply cannot properly monitor and manage 100 investments of $1 million, even if they were all splendid opportunities. Performing due diligence on the investment opportunities is a time consuming task due to the uncertainty involved with their business model. In addition, much of their time and attention is spent on prior investments already made in the attempt to minimize the risk of failure. The VC fund is therefore resource-constrained in the human capital sense (i.e. at full capacity), which is one major reason why VCs fail to meet the demand for financing of startup companies.

Counter To VC Model

Another key reason why VCs do not meet the demands of startups seeking financing relates to their high risk of failure and the limited partners return on investment expectation. It is estimated by the NVCA that 40% of portfolio companies fail, 40% of portfolio companies return moderate amounts of capital, and only 20% or less produce high returns. In another study conducted by Shikhar Ghosh, Senior Lecturer at HBS, no matter how “failure” is defined, the statistics are still discouraging. Ghosh even states that the failure rate is much higher than the industry usually cites, with as many as three-quarters of venture-backed firms in the US not even returning investors’ capital. Consequently, VCs have to hit homeruns if they want to give their limited partners a reasonable yield on their investment. In sum, since the vast majority of portfolio companies do not provide adequate returns, the fund is dependent on at least one of the portfolio companies to “knock it out of the ballpark” with a 10x, 20x, or even 30x multiple of their investment so as to make up for the underachievers in the portfolio. For this reason, coupled with the pressure to deliver returns to limited partners in a timely manner, VCs target startups with the ability to grow really big rapidly. Growing big rapidly requires the ability to scale hastily and capture the market while delivering a high margin, which is only feasible for certain types of companies within particular industries such as technology, healthcare, energy, life sciences, etc.

37 2013 WL 574518 (ASPATORE), 1 (ADJUSTING TO INVESTMENT TRENDS IN A NEW VENTURE CAPITAL MARKET)
38 "Venture Capital Funds Raised $20.6 Billion During 2012." VC Industry Continues to Bifurcate Into Large and Small Funds. Thomson Reuters Corporation, 07 Jan 2013. (Only 182 funds in 2012 further evidencing the lack of human capital resources in venture capital)
40 "Frequently Asked Questions About Venture Capital,” supra note 31
41 Shikhar Ghosh, http://hbswk.hbs.edu/item/6591.html “Very few companies achieve their initial projections. Failure is the norm.”
42 Gage, Deborah, supra note 20
44 Id.
45 Hogg, Sam. " Why So Many VC Firms Invest in the Same Companies Read more: http://www.entrepreneur.com/article/227144
As a result, many startups outside of those industries of interest often go unfunded, because just being profitable is not enough. For example, even though a 10% return would be a great return for a retail investor investing in common investment products, 10% is not a very good return for a portfolio company.47 In sum, the selectivity and the stringent investment criteria VCs call for limit the universe of startup companies as candidates for VC funding. Thus, the ability for VCs to meet the demand for financing startup companies is further limited.

Geographic Limitations
Besides, the inability of VCs to properly evaluate and monitor numerous portfolio companies due to the lack of human-capital, and the need for VCs to invest in specific kinds of business models that have the ability to be “homeruns” in order to overcome the high likelihood of fellow portfolio company failures and thus meet the high yield return expectations of limited partners, simple logistics play a role in VCs failing to meet the high demand for financing by startups each year.48 As mentioned earlier, VCs tend to be actively involved in the portfolio companies meaning they have significant participation in and oversight of each portfolio company.49 Accordingly, VC investment is inherently local or, at most, regional activity.50 Indeed, data from 2010 and the first half of 2011 reveals that the top five regions for VC investment accounted for roughly 76% of total VC investment.51 More specifically, the data divulges that approximately 39% of total VC funding by region was invested in Silicon Valley.52 The result of this VC investment concentration is that many startups located elsewhere in less prevalent VC areas go unfunded.53

For these reasons, inter alia, many startups are short-lived and end up being nothing more than a business idea or concept that never truly materializes. In short, lack of funding, although not the sole cause or reason, often precipitates the high failure rate among startup companies. With this in mind, the JOBS Act was created, resulting in the birth of a new class of investors helpful to alleviate the lack of funding – a problem that startups have faced in the past.

III. CROWDFUNDING

A. Overview

The concept of crowdfunding, collecting small amounts from the general public in support of, or to complete a larger goal (e.g. politician collecting small donation amounts from general public to win election), is nothing new; however internet-based crowdfunding is relatively new.54 Crowdfunding, in fact, originated in the United States

49 Id.
50 Id.
51 Id.
52 Id.
53 MyCapital, supra note 44
54 C. Steven Bradford, supra note 20 (noting that the leading crowdfunding site today, Kiva, did not open for business until 2005).
as a “donational” model in which people provided money to fund different projects without expecting to receive an ownership interest or profit in return.\(^{55}\) So, if crowdfunding has been around for a number of years and has already been legally utilized by different people and companies, what exactly makes Title III meaningful?

There are different types or uses of crowdfunding that can be categorized by distinguishing what the investor is promised in return for their contributions: 1) donation model; 2) reward model; 3) pre-purchase model; 4) lending model (peer-to-peer lending)\(^{56}\); and 5) equity model.\(^{57}\) The first four types of crowdfunding are the types that have been legally put into practice in the past; however, the fifth type, the equity model, is what Title III will finally enable. The equity model differs from the other types, because in it the contributor of funds expects to receive a share of the profits or return of the business they are helping to fund, causing the transaction to be deemed a sale of securities and thus subject to Federal Securities Laws.\(^{58}\) Unless an exemption applies, a sale of securities needs to be registered with the SEC, which can be extremely burdensome and costly for an entrepreneur.\(^{59}\)

Title III of the JOBS Act, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012, termed the “CROWDFUND ACT,” increases a business’s access to capital by allowing them to sell securities without registering or completing the complete disclosure requirements ordinarily mandated for public offerings.\(^{60}\) The goal of the CROWDFUND ACT is to give businesses (typically smaller ones) greater access to capital by making securities offerings conducted over the Internet to the public at significantly reduced costs by avoiding many of the SEC registration requirements.

How Does It Work?

Under the CROWDFUND ACT, a company will be able to raise up to $1 million over a twelve-month period.\(^{61}\) Crowdfunding websites will display business plans/funding requests on their site and anyone will be able to view them and decide whether to invest or not.\(^{62}\) Individual investors will be limited to contributing: i) the greater of $2,000 or 5% of annual income or net worth if either annual income or net worth is less than $100,000; or ii) 10% of annual income or net worth, not to exceed $100,000, if either annual income or net worth is more than $100,000.\(^{63}\) The transaction is required to be done through a “broker” or “funding portal” that must comply with certain disclosure requirements.\(^{64}\) This intermediary (broker or funding portal) is responsible for making disclosures “related to risks and other investor

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\(^{56}\) C. Steven Bradford, supra note 20 (think Kickstarter or IndieGoGo)

\(^{57}\) Id.

\(^{58}\) Id; see also Alan R. Palmiter, supra note 54

\(^{59}\) Griffin, Zachary J. "CROWDFUNDING: FLEECING THE AMERICAN MASSES," supra note 27

\(^{60}\) Benjamin P. Siegel, supra note 4


\(^{62}\) Griffin, Zachary J. "CROWDFUNDING: FLEECING THE AMERICAN MASSES," supra note 27

\(^{63}\) Id; see also John S. (Jack) Wroldsen, supra note 6 (the cap on individual investors applies to the aggregate amount invested via crowdfunding in any twelve-month period, not to each investment.)

\(^{64}\) Id.
education materials” in which the SEC determines is appropriate. The CROWDFUNDING ACT also encompasses other rules and requirements such as the company: disclosing how the obtained funds will be used, being financially audited if it raises $500,000 within the 12-month period, acquiescing to a broad-based background check conducted by the intermediary, and others intended to preclude fraud and protect investors in the process.

Crowdfunding could very well mark a “revolution in how the general public allocate[s] capital,” or at a minimum democratize the process of deciding how, and whose ideas are financed. In fact, the impetus for passing Title III, or CROWDFUND ACT, was as one senator noted, “[the] enormous potential [of crowdfunding investment] to bring more Americans than ever into the exciting process of powering up startups and expanding small businesses.” Copious examples of non-equity based, large, successful crowdfunded projects exist such as the “Pebble” proposal in which over $10 million was raised in just thirty-six days to fund a highly customizable wristwatch that works in unison with a smart-phone.

So, if crowdfunding has the potential to provide startups with a completely new class of potential investors and thus capital, it has been successful in the past under the non-equity based types, or categories, and it has been publicly endorsed and even signed into law by our lawmakers, then what could possibly be wrong with crowdfunding?

**B. Problems With Crowdfunding**

**Investor Perspective**

1. **Fraud**

To achieve the goal of increasing a small businesses’ access to capital, the CROWDFUND ACT decreases the number of regulatory hoops parties must jump through in order to participate in an exempted crowdfunded offering (i.e. effectively making the process less stringent and easier to conduct). With less regulation under the crowdfunding exemption, there is a greater potential of increased fraud exposure for an investor. Indeed, one of the main reasons security regulations exist is to prevent fraudulent dealings by issuers. Critics have listed countless reasons as to why crowdfunding may open the door for fraud to permeate the market, and I will focus on three primary reasons below.

In the past, unregistered securities have been offered to accredited individuals because either: i) their wealth allows them to tolerate the risk of loss; or ii) their financial sophistication aids them in better comprehending the risks affiliated with such investments. The primary issue with offering securities to the general public is that most individuals are non-accredited, and therefore in need of the protections provided by state and federal securities laws. Various studies and tests have evidenced that the

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65 Id.
66 Benjamin P. Siegel, supra note 4
67 John S. (Jack) Wroldsen, supra note 6
68 Id.
69 Benjamin P. Siegel, supra note 4
70 Id.
71 Id.
general public is largely financial illiterate. The financial illiterate, or unsophisticated, investor will have a much more difficult time understanding the risks associated with crowd fund investing. Moreover, the issuer disclosures are usually distributed to investors in a very dense form containing financial verbiage that is unfamiliar and unintelligible for an unsophisticated investor. To paraphrase what two law professors point out, disclosures that are seen today are often too long and complex, and when an ordinary investor is inundated with them, they lack the necessary skills to identify and fully comprehend what the information means and how to use it effectively. Therefore, the combination of the average crowdfunding investor being naïve and being ill equipped will facilitate higher levels of fraud.

The second dominant reason that crowdfunding may lead to more investment fraud stems from the idea that the Internet and fraud go hand-in-hand. Most people have heard of and are familiar with the concept of cybercrime, or fraud conducted over the Internet; yet many people may not realize that considerable amounts of securities fraud conducted over the Internet occurred in the not too distant past. In 1992, in a very similar manner to the JOBS Act, and with the similar purpose to facilitate capital raising for small businesses, the SEC sought to reduce the burdens of registration under the Securities Act. In short, the SEC revised the rule 504 exemption under Reg. D to allow a non-reporting company to generally solicit and advertise their offering of securities. Soon thereafter, numerous cases of security fraud were brought forth. Specifically, the “pump” and “dump” scheme occurred in which an unscrupulous promoter would: 1) purchase a very low priced, thinly capitalized, and relatively unknown and uncovered by analysts stock, known as a “microcap” stock; 2) endorse and stimulate buying activity around the stock, using the internet to reach the public; and then 3) sell the stock at the artificially inflated price, which is only temporarily caused by the momentum built from using the Internet to garner interest from the public in the first place. The promotional materials frequently were comprised of misrepresentations of the microcap stock; leading to the price crashing down after the promoter dumped his/her position, leaving the investors with practically nothing. The whole scheme was, in essence, made possible due to the SEC’s decision to eliminate the...
restriction on general solicitation and advertising. Therefore, the lesson of the past in which the SEC relaxed regulations and allowed companies to use the Internet to raise capital, which is precisely what CROWDFUND ACT will permit, should serve as a reminder as to the fraudulent activities that are ubiquitously entwined with the Internet.

The last of the three dominant reasons, or explanations, as to why crowdfunding may lead to fraud becoming more prevalent revolves around the disincentive investors will have in bringing a cause of action forward. Due to the limits, or cap, on what an individual investor can invest in the aggregate over a twelve-month period (greater of $2,000 or 5% if annual income and net worth less than $100,000; up to 10%, not to exceed $100,000, if annual income or net worth greater than $100,000), it does not make economic sense for an investor to sue for damages. In other words, it is not practical for an investor to sue, even though a private right of action is enumerated in the CROWDFUND ACT. The most an investor will be able to contribute towards a crowdfunded venture is between $10,000 and $100,000, and often investors will have contributed even less (closer to the $2,000 floor), therefore it is unlikely investors will have sufficient damages to warrant bearing the great deal of costs associated with litigation (i.e. a private suit by an individual is cost-prohibitive). Moreover, a successful lawsuit could potentially not be recovered “since it is possible that those engaged as crowdfunding issuers are ‘uncollectible’.” Even a class action lawsuit may not be a viable alternative given the total offering amount for a crowdfund exemption being capped at $1 million. The economic impracticality of this situation is true from the attorney’s perspective as well. Typically, the attorney litigating this matter would be working on a contingent fee basis (normally 20-30% of the award), which, again, would not be worthwhile for the attorney to undertake. Therefore, after taking into consideration the small, limited investment amount and the attorney’s fees associated with litigating a fraud claim, it becomes unappealing and economically impractical to pursue a claim for both the investors and the attorney.

In conclusion, the problem of fraud is derived from the fact that the company (entrepreneur) has all of the power. As a well-regarded professor explains it, “[i]nvestors have little information about what is to come and little control over what the entrepreneur does. This presents the entrepreneurs with opportunities for self-dealing, excessive compensation, misuse of corporate opportunities, and dilution of investors’ interests…” This scenario lends itself to fraud, and thus investors need to be cautious in making their investments through the CROWDFUND ACT.

2. Horizontal Risks And The Absence of VC Protections

Assuming the investor via crowdfunding makes a sound investment into a successful startup company, and the company conducts itself in a legitimate, good-faith manner (i.e. fraud is not present), the investor still may not realize the expected above-

83 Id.
84 Benjamin P. Siegel, supra note 4; see also Alan R. Palmiter, supra note 54
85 Alan R. Palmiter, supra note 54
86 Benjamin P. Siegel, supra note 4; see also Diamond Kaplan & Rothstein, Crowdfunding May Increase the Likelihood of Fraud, FindLaw (Nov. 1, 2012)
87 Id; see also Benjamin P. Siegel, supra note 4
88 Author fails to discuss the result of charging by the hour. My assumption is that a complex lawsuit would be worthwhile for the attorney, however would be cost-prohibitive to investor(s).
89 John S. (Jack) Wroldsen, supra note 6; see also Professor Steven Bradford, supra note 20
average financial return (high risk-high return concept) due to the absence of investor protections against horizontal risk. The concept of horizontal risks considers the fact that promising investment opportunities in startups appeals to competing investors, who are often sophisticated VC’s. Without adequate VC protections, an early-stage crowdfunding investment in a successful startup company can result in significantly lower financial returns.

The concept of horizontal risks was depicted in *The Social Network* when Eduardo Saverin’s ownership stake is diluted from his original 30 percent all the way down to less than 1 percent when Facebook obtained VC financing. Other existing ownership interests such as Mark Zuckerberg’s were, at most, minimally diluted. Saverin’s failure to negotiate the essential investor protections led to this vast dilution. Similarly to Saverin’s situation, individual crowdfunding investors will not be in a position to negotiate the kinds of protections against horizontal risks that VCs demand. Professor Bradford further explains the dilemma by initially arguing that most crowdfunding investors will not have the know-how and cleverness to even understand the necessity of having control rights or protective covenants. Furthermore, even if the crowdfunding investor does understand the importance of seeking such protection, it is uncertain how they would negotiate for the protection, or whether it would be worth their effort. “The small amount invested by each crowdfund investor and the remote, impersonal nature of crowdfunding preclude any meaningful negotiation.”

The overarching concept of the VC being in a position of power, seeking control of the startup, and diluting prior investors in the process is not novel nor is it exclusive to crowdfund investors. In fact, the problem known generally as “minority shareholder oppression” has existed for years and is often referred to by different names such as squeeze-outs, freeze-outs, washouts, etc. In substance, these are all VC “tools” that can potentially take advantage of early-stage investors like crowdfund investors by reducing the value of their shares by enormous amounts.

Due to the potential problems associated with fraud and the horizontal risk due to absence of investor protections, crowdfund investors should proceed with caution. As painful as it would be for a crowdfund investor to surrender a capital investment to a mismanaged, failed, or fraudulent startup company, it would be even more unfortunate for a crowdfund investor to invest in a startup that becomes a huge success and not earn an adequate return while the VC profits immensely.

**Company Perspective**

Companies seeking investments from crowdfund investors should also be leery. Using crowdfunding can lead to myopia, or shortsightedness in the sense that later

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90 Id.
91 Id.
92 Id.
93 Id.
94 Id.
95 Id.
97 Id.
98 Id.
99 Id.
investors like VCs will be deterred from investing in future rounds of financing for a few different reasons.\textsuperscript{100}

Crowdfunding creates a capital structure that is unappealing to VCs. VCs have little interest in competing and associating with the masses of retail investors, because they do not want to deal with inconveniences that ensue from having numerous shareholders such as corporate actions that trigger voting requirements and approval.\textsuperscript{101} In other words, a large, diverse shareholder base leads to a logistical nightmare. In addition, deals with many small and unsophisticated shareholders can lead to an increased likelihood of lawsuits and liability for VCs down the road; a risk that VCs clearly do not want to be exposed to.\textsuperscript{102}

Beyond discouraging later investors, like VCs, from investing due to the large, diverse shareholder base being both burdensome and risky to deal with, merely using crowdfunding in the first place creates an unintended signaling problem.\textsuperscript{103} It goes something like this: the riskiest companies will be the ones seeking crowdfunding, because their family, friends and business associates denied them.\textsuperscript{104} In other words, crowdfunding may be seen as a last resort, or a sign that the particular venture seeking funding is even riskier than the typical startup. It has been argued that herein lays the overarching problem of crowdfunding: there is a dangerous mismatch occurring, because “the process introduces only the riskiest of startup ventures to the investors least able financially to absorb loss.”\textsuperscript{105}

**IV. CONCLUSION**

In the early days, VCs were seen as great investments and job creators. More recently, reports have come to light that criticize VCs as providing less than expected returns while being much too dominant and harsh in the terms they demand.\textsuperscript{106} Investing in VCs however is beyond the scope of this paper. Rather, VCs as an investor, despite their harsh terms, are value-add partners. VCs provide substantial amounts of funding, invest in multiple rounds of a company, participate in active management of the company, and make introductions that help lead to more business or funding down the road.\textsuperscript{107} Crowdfunding will therefore not replace VCs contrary to what Fred Wilson predicted.

Large institutional investors like VCs turn down 99% of the business plans submitted to them, which attests to the point that crowdfunding and traditional VC can, and will, coexist. VCs target particular kinds of companies, which leave companies outside of that specification in desperate need of funding from an alternative source like crowdfunding. For example, a mom-and-pop retailer that grows slowly would be a

\textsuperscript{100} Stocker, Michael W. Labaton Sucharow LLP "Startups, Raising Money By Crowdfunding May Scare Off Other Investors. Read more: http://www.businessinsider.com/too-much-crowdfunding-can-scare-off-investors-2012-8

\textsuperscript{101} Id; see also David Mashburn, supra note 22

\textsuperscript{102} David Mashburn, supra note 22

\textsuperscript{103} Stocker, Michael W, supra note 99

\textsuperscript{104} Rosenberg, Joyce M. "Crowdfunding may be more bust than windfall." New York (AP), 24 Apr 2013.

\textsuperscript{105} Id.

\textsuperscript{106} Diane Mulcahy, Bill Weeks, and Harold S. Bradley. "WE HAVE MET THE ENEMY... AND HE IS US" Ewing Marion KAUFFMAN Foundation

\textsuperscript{107} McKaskill, Dr. Tom, supra note 27
better candidate for crowdfunding than VCs whereas conversely capital-intensive, high-growth companies would be a better fit for VCs, and would not be a very good fit for crowdfunding due to the $1M limitation on funding over a 12-month period. Apart from focusing on unalike companies, crowdfunding can also help fill the gaps and fund worthy startups that were overlooked or ignored. With that said, some have predicted that crowdfunding and VCs may end up investing in the same kinds of companies. The argument is that the online portals, or crowdfunding websites, are accessible by VCs too, so they will have the opportunity to analyze companies they might have missed initially. Moreover, the online portals may even serve as validation; giving companies who have obtained funding from the crowd more credibility and allure in the eyes of VCs. In any event, traditional VCs and crowdfunding will coexist. And since they will be coexisting, what, if anything, can be done to protect the different parties involved?

Solutions
Crowdfunding has the potential to be a huge, positive source of startup capital in the very near future; however, those looking to become crowdfund investors and those looking to obtain investment via the crowdfund investors must both act with prudence. Many aspiring investors and investees are very hopeful and confident, yet gloom and misery are right around the corner if involved parties do not exercise proper due diligence and discipline.

The SEC will undoubtedly be an intricate part in curbing fraud in the crowdfunding realm. The SEC is tasked with creating rules and requiring certain disclosures and their task is far from easy due to the inherent conflict in allowing companies to access capital more easily and cheaply from investors while also protecting those same investors by requiring such companies to perform certain tasks and disclose certain information. If the SEC were to have made too many rules that were too difficult to abide by, then it would have completely defeated the purpose of Title III of the JOBS Act since companies would find it too time-consuming and expensive to even utilize it. Other suggestions seem to convolute and complicate the process such as creating a “semi-accredited” investor class to ensure investors are sophisticated enough to understand the risks and low probability of success in their investment. Taking into consideration the above, I believe that the SEC has done a worthy job on paper, yet I believe the true test lies in how the online portals conduct their operations.

Online portals must be diligent and thorough in their reviews, background checks, and due diligence performed on the businesses seeking to be listed on their website for crowdfunding purposes. Idea-stage companies, without any true direction or management experience, are simply too risky. Some of the websites have thus far been acting in line with this concept of being disciplined and turning down companies not

108 Stephenson, Andrew. "Crowdfunding can supplement your offering to accredited investors." CrowdCheck Blog. 05 Nov 2013
109 Shane, Scott. "Why Equity Crowdfunding Isn't a Threat to Venture Capital." Entrepreneur. 07 Oct 2013
110 Id.
111 Id.
112 Alan R. Palmiter, supra note 54
113 Id.
114 Benjamin P. Siegel, supra note 4
worthy of investment. The more reputable and trustworthy these 3rd-party intermediaries are, the less likely fraud will occur. Taking it one step further, online portals could implement a feedback rating system in which issuers build a reputation similar to sellers on eBay allowing for would-be investors to avoid issuers with negative reviews/feedback. This will help hinder and impede fraud, yet will not be a solution to the more subtle horizontal risks.

Without sufficient protections, crowdfund investors will be at risk of dilution from both price-based and share-based actions by VCs. At a high-level overview, price-based dilution occurs when shares are issued at subsequent round at a lower price per share than what the existing investors paid (a “down-round”). Without price-based anti-dilution protection, crowdfunders will see the value of their existing investment be reduced to a nominal value following subsequent rounds of financing. Share-based dilution occurs when the company issues additional shares of common stock, which makes the convertible preferred stock held by crowdfund investors much less valuable.

Fortunately, there are anti-dilution protections available and commonly negotiated for, in addition to other types of protections such as tag-along rights and preemptive rights. Including these contractual provisions as a default in contracts for crowdfund investors will go a long way in protecting them. If these provisions were included in standard contacts being negotiated with VCs, crowdfund investors would at least have the protections initially - whether they remained in the contract pursuant to the negotiation is another story. Standard contracts with this boilerplate language provide for a better starting point in the negotiation for the crowdfund investor, because at least then there is awareness of crucial issues involved such as anti-dilution. Along the same theme of investor awareness and enlightenment, another potential solution to horizontal risk would be an easy-to-read disclosure table. The table would graphically highlight what investor protections the particular investee/company was offering. Such table could appear on the website alongside the investor education materials that 3rd-party intermediaries are required to supply. To be clear, the standard investor-friendly contracts and the disclosure table are merely suggestions that could mitigate, not eliminate, horizontal risks for crowdfund investors.

In closing, crowdfunding will become a major financing source for startups; however, investors and investees contemplating involvement should proceed carefully. Beyond the more obvious risk of fraud, there are more obscured horizontal risks, which are also value destroyers to a crowdfund investor. An investee must be careful not to fall into the trap of immediately using crowdfunding, because it will, most likely, dissuade later-stage investors like VCs.

115 Rosenberg, Joyce M, supra note 103 (Crowdfunder and CircleUp have been turning down many companies)
116 Agrawa, Ajay (2013), “Some Simple Economics of Crowdfunding,” University of Toronto, Rotman School of Management. (Mitigating the problems of Adverse Selection and Moral Hazard)
117 Id.
118 John S. (Jack) Wroldsen, supra note 6
119 Id.
120 Id.
121 Id.
122 Id.
123 Id.