SteelBridge

Insights

A management consulting view of private capital's evolution

Crowdfunding

Building a better Private Capital marketplace

Key Highlights:

- **Crowdfunding presents significant opportunities for investors and small companies, but those opportunities carry risks**
- **The SEC and FINRA, through the JOBS Act, now share responsibility for ensuring a fair and transparent crowdfunding marketplace**
- **With crowdfunding in play, Private Capital managers will be able to better capitalize on existing trends in early-stage investing**

"In the United States, small businesses play a crucial role in the economy and our capital markets. The SEC has been quite focused in recent years advancing a range of initiatives aimed at facilitating capital formation for small and emerging companies, including by updating and amending our existing rules for smaller offerings and by developing new rules for crowdfunding."[1]

Mary Jo White, SEC Chair

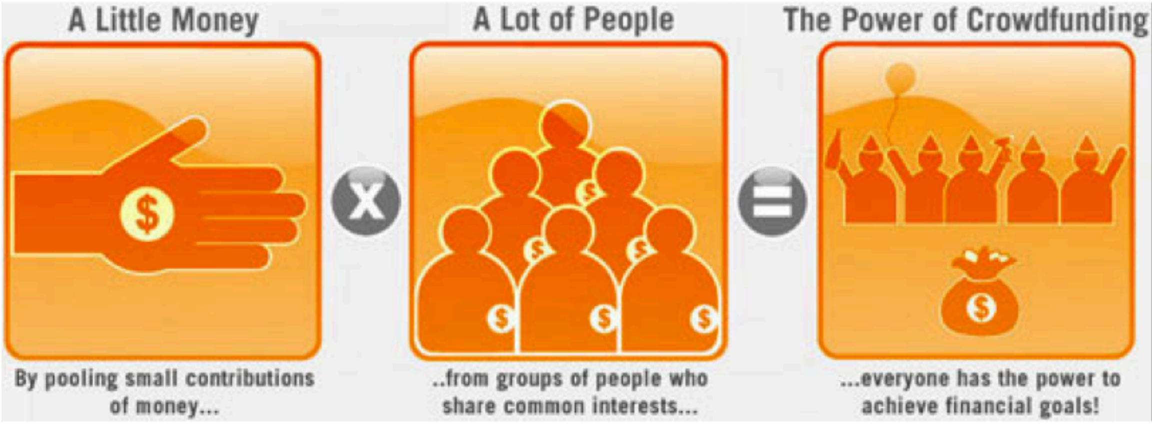
Introduction

With those remarks from the SEC chair, one of the most significant developments to take place within the investment industry is underway. Beginning May 16, 2016, companies may use crowdfunding to offer and sell securities to the investing public.[2] While the full impact of the rules remains to be seen, many anticipate that crowdfunding will prove to be a boon for small businesses, entrepreneurs, investors and, ultimately, the economy as a whole.

What is Crowdfunding?

The SEC defines crowdfunding (termed Regulation Crowdfunding) as: "an evolving method of raising capital that has been used outside of the securities arena to raise funds through the Internet for a variety of projects ranging from innovative product ideas to artistic endeavors like movies or music."[3] In more general terms, crowdfunding provides firms with the ability to raise money using small investments from a large base of investors.

This graphic from Testify Communications shows this concept quite clearly:



This development occurred with the implementation of the JOBS Act, which creates an **exemption** under the securities laws to allow purchase and sale of company securities through approved crowdfunding online web portals. A key function of crowdfunding is information sharing – presenting members of the crowd with an idea or business. Members then have the opportunity to exchange thoughts and evaluate the idea or business. The SEC states that "an 'online-only' requirement enables the public to access offering information and share information publicly in a way that will allow members of the crowd to decide whether or not to participate in the offering and fund the business or idea."[4]

A Brief Summary of the Rules

Upon signing the JOBS Act into law, President Obama stated: "For the first time, ordinary Americans will be able to go online and invest in the entrepreneurs that they believe in."[5] While that is the general premise of the rules, the reality is more nuanced. There are four significant obligations and restrictions placed on all parties involved.

1. Maximum Company Offering Amount

A company is only allowed to raise a maximum aggregate amount of $1 million through crowdfunding offerings in a 12-month period. The only exception to this rule is that the company does not need to include non-crowdfunding offerings in the $1 million calculation.

2. Investor Limits

Under the new rules, investors can invest up to certain maximum amounts based on their income and net worth. The general guidelines are[6]:

Investor income *or* net worth is less than $100,000

- Investment limit is the greater of $2,000 or 5% of income or net worth

Investor income *and* net worth is $100,000 or greater

- Investment limit is 10% of the lesser of income or net worth

NO purchases greater than $100,000 of securities in a 12-month period

3. Crowdfunding Platforms

The rules specify that all crowdfunding must occur through an SEC-registered intermediary – either a broker-dealer or a crowdfunding portal. The purpose of this requirement is to protect the investor. The SEC defines the crowdfunding intermediary platform as "an Internet website or other similar electronic medium through which a registered broker or a registered funding portal acts as an intermediary."[7] All crowdfunding platforms must be registered with the SEC and be a member of the Financial Industry Regulatory Authority (FINRA). The portal will be subject to regulatory oversight, including FINRA's surveillance and examinations, reporting requirements, and eligibility requirements.

Intermediaries have a duty to:

- Provide investors with educational materials and the appropriate literature to assess their potential investment;
- Take measures to reduce risk of fraud;
- Provide a forum to allow discussions on the platform; and
- Execute the offer and sale of the securities

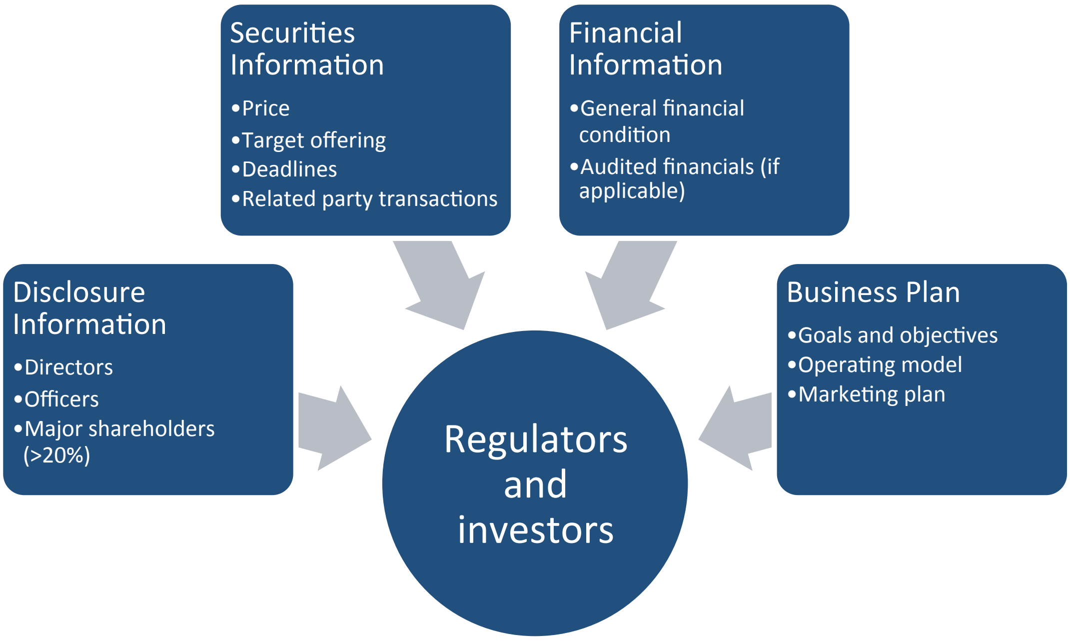
Further, intermediaries are prohibited from offering investment advice or making recommendations, soliciting, owning, or holding investor funds or securities. Reputable crowdfunding sites that investors may consider include: Kickstarter, Indiegogo, RocketHub, GoFundMe, and Razoo.

4. Company Eligibility and Other Requirements

The SEC has also implemented several eligibility requirements for companies to abide by when offering securities through a crowdfunding portal. Examples of eligibility requirements include:

- Non-U.S. companies and companies that are currently SEC reporting companies cannot participate;
- Securities purchased via crowdfunding may not be resold for a period of one year;
- Companies must comply with certain advertising restrictions;

Companies may only promote their offering through the SEC and their FINRA-licensed portal *after* they have filed their offering materials with the SEC and their FINRA-licensed portal. Further, they are required to share this information with investors via the intermediary through which they raise funds:



Crowdfunding Is Here To Stay

"With the intersection of the internet, social media and technological innovations, creating a crowdfunding transaction which put FINRA broker-dealers at a disadvantage – could be the beginning of a slippery slope which would threaten the FINRA monopoly – with even larger transactions – and disrupt the established financial community."[8]

Samuel Guzik

Creating the optimal regulatory environment

While not everyone agrees that crowdfunding is good for companies, investors, and the global economy, we believe it's a capital raising method that is here to stay. However, one frequent complaint of businesses is the high degree of regulatory burden imposed on companies by state and federal regulators. This situation is particularly true with smaller businesses given their limited resources. High regulatory burden requires capital to support compliance functions, which translates into less capital being available to incubate and grow the business. The SEC, in conjunction with states' agencies, is tasked with the challenge of delicately balancing the need for a less burdensome regulatory environment with the need to protect investors from fraud and maintain a fair and efficient market.

There remains uncertainty as to whether these rules have achieved that balance. Critics assert that the audited financial statement requirements are unduly burdensome. While the rule only applies to firms raising more than $500,000, it may be a cost concern for many companies. In addition, the complexity of filing requirements with the SEC is time-consuming and frustrating for many smaller companies.

Forecasting the impact of crowdfunding rules

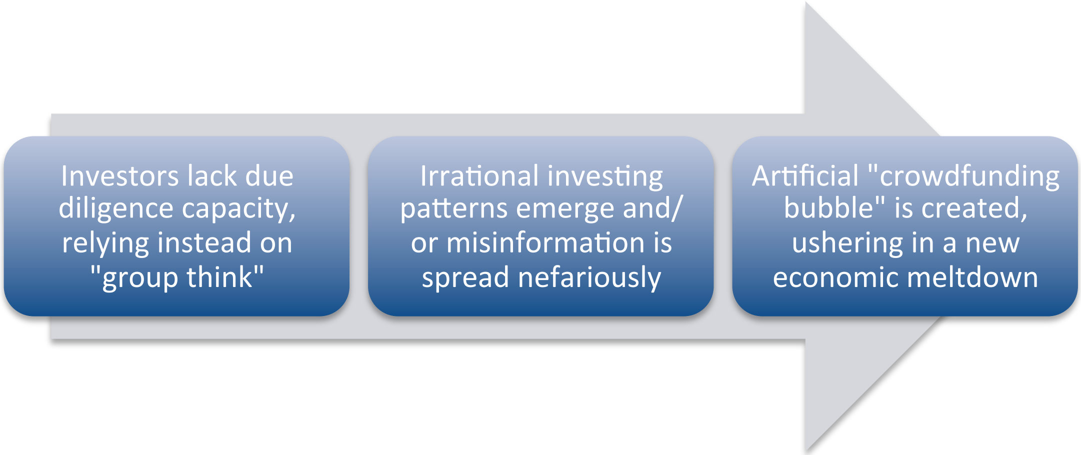
One of the JOBS Act's primary goals is to provide a new source of capital for entrepreneurs. A business cannot grow and expand without sufficient capital, and many budding entrepreneurs struggle raising that capital, particularly equity. This new avenue is designed to provide some relief for entrepreneurs as it allows them to raise capital faster and more easily. However, stakeholders should take certain precautions.

Startup investing brings high reward potential but at high risk.		
•Access to investments previously open only to accredited investors holds significant upside potential •Early-stage investing presents a unique opportunity for diversification	•Startups have a high fail rate, impacting investors who can't absorb losses •Speculative investments present vulnerability to fraud	•Investors and intermediaries should conduct proper, ongoing due diligence •Companies should take care to provide a clear plan and purpose in their disclosures and presentations

As a corollary to risk, these investments are highly illiquid, and there is currently no true secondary market available. Investors must take it upon themselves to find interested buyers. Moreover, there could be cancellation restrictions placed on these investments. So naturally that begs the question: what is the end game for these investors and companies? It is highly unlikely that many of these companies will go public.

Does a viable exit strategy exist? Will a secondary market emerge? All of these questions will be answered over time, but for now investors need to be aware that change in ownership is the only way they will see a return on their investment.

Finally, investors in crowdfunding are not professional investors. Their knowledge of due diligence requirements and their research and analytical skills will be limited. This will likely translate to an over reliance on "group think," potentially resulting in the progression below:



We all have seen, through recent economic bubbles (housing, dot-com, Japanese asset prices), how our economy has been impacted when irrational exuberance of groups of investors hits a critical stage. We are interested to see if this new method of raising capital will cause an artificial bubble that could cause havoc on global economies.

Though the prospect of leveraging technology is appealing and may disrupt a long existing platform, it is abundantly clear that the process can be fraught with risks and investors must be aware of those risks. Time will be the only metric that will truly tell us whether the SEC's protective rules are suitable for the investors, companies, and the global economy participating in crowdfunding.

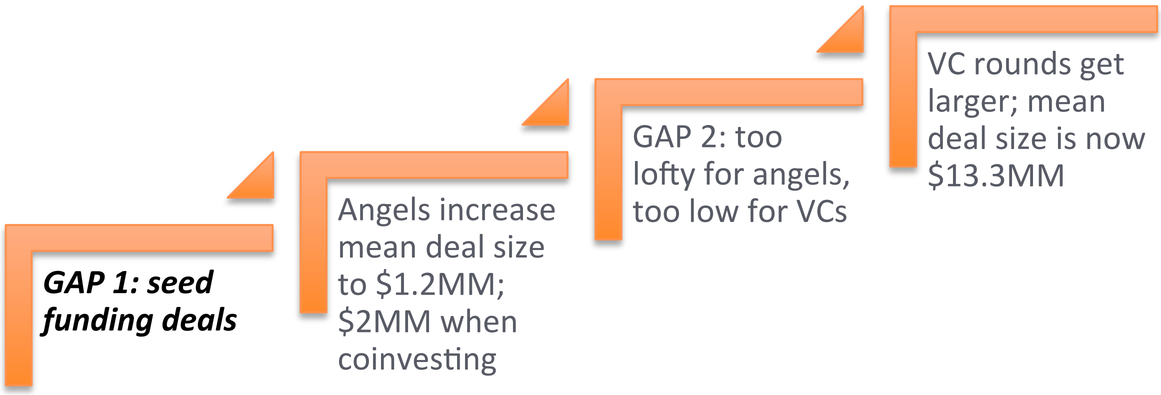
"It may fall to a new generation of disruptive innovators to usher in the era of crowd-based investment. If so, it will be another example of regulatory change that unleashes the power of technology to remake industry — or potentially in this case, to remake all of them."[9]

Why should Private Capital care?

Given their trillions of dollars in commitments, it would be easy for later-stage Private Capital firms to dismiss these smaller fundraising rounds as irrelevant. The likelihood of crowdfunding ever reaching the sheer magnitude of PE and Hedge investments is comparatively slim. But crowdfunding has the unique opportunity to impact the sourcing and quality of deals that ultimately cross fund managers' desks.

Early-stage investing – which we consider to be angel and venture capital – has long been following two trends. VC investments have steadily crept up in size over the past five years, half of which now go to expansion or late-stage companies. Simultaneously, the angel community has seen both increased deal size and co-investment activity – resulting in a sizable increase in mean angel rounds.

The effect of these trends is the creation of two gaps in the funding cycle for companies. One gap exists in the $3-7MM space where angels view deals as too large and VCs too small. The second is in smaller, seed investments – this is where crowdfunding enters the picture.



Sources: 2015 Halo Report, Angel Capital Association; 2015 Yearbook, National Venture Capital Association

Crowdfunding allows the domino effect that is already happening to continue *while* ensuring that small companies aren't left behind. By seeking seed investments through crowdfunding, new companies and concepts let angels look later in the business life cycle, beginning to close the gap between themselves and venture capital. VCs, with ever-larger deals in play, can act as "mini-PE firms" – sourcing fewer, larger, better-vetted deals. The companies they help to grow and expand invariably find themselves seeking private capital investment once they have outgrown their angel and VC support.

Conclusion

Small businesses and startups are our nation's engine for economic growth and job creation. Without access to capital, though, those small businesses will never see the light of day, and later-stage Private Capital will ultimately see fewer deals – and less *quality* deals – sourced. These new rules serve two purposes: they expand access to capital for small businesses, and they create a new investing opportunity for an investor class that was previously frozen out.

While it's too early to say whether these rules will be a disruptive and innovative model that significantly improves capital formation, it is a compelling development in the capital raising process for both companies and investors and is one that will certainly help fuel economic growth.

About SteelBridge

SteelBridge is a boutique advisory services firm with deep expertise in Private Capital. We have a passion for helping our clients identify and affect change to improve process and technology for more effective organizations and positive portfolio company outcomes. We help general partners, limited partners, third party administrators, software vendors, and portfolio companies. At SteelBridge, we hold ourselves to the highest standards by providing exemplary services for our clients.

To learn more call us at 646.737.7960 x1008, visit us at www.steelbridgeconsulting.com, or join us on our Facebook and LinkedIn pages for more information:

Let us show you why we are the leading boutique advisory services firm in the Private Capital space.

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[1] https://www.sec.gov/news/speech/financing-small-medium-enterprises-and-challenges-crowdfunding.html
[2] http://www.thinkadvisor.com/2016/05/16/secs-equity-crowdfunding-rules-finally-kick-in
[3] https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677#.Unf7rCSe5vC
[4] https://www.sec.gov/rules/proposed/2013/33-9470.pdf
[5] http://www.nytimes.com/2012/04/06/us/politics/obama-signs-bill-to-ease-investing-in-start-ups.html?version=meter+at+3&module=meter-Links&pgtype=article&contentId=&mediaId=&referrer=https%3A%2F%2Fwww.google.com%2F&priority=true&action=click&contentCollection=meter-links-click
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