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Weighing the Risks for the "Crowd" in Equity Crowdfunding

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Now that the long awaited and much anticipated federal crowdfunding rules under Title III of the JOBS Act have become effective, startup companies can raise seed capital from everyday, non-accredited retail investors through online equity crowdfunding platforms. Many of these investors are excited to have finally the opportunity to invest in high-growth, early-stage business ventures—opportunities that have, until now, been mostly restricted to high-net-worth individuals and institutional investors. Before investors decide to participate in federal crowdfunding offerings, however, it is essential they have a solid grasp of the risks of investing in early-stage startups and are aware of the protections in place for non-accredited investors.

Risks

There are substantial risks inherent in any purchase of securities. Even large, seemingly safe public companies spectacularly go bust from time to time, wiping out the value of their stockholders' shares and even many of their bondholders' debt securities. Stockholders are at the very bottom of the pecking order when it comes to claims on an insolvent company's remaining assets; they are the last to receive any return on their investment after all of the company's creditors have been paid.

In the case of public companies, stockholders may be able to cut their losses by selling at a steep discount on the open market if a company's bankruptcy appears imminent. However, investors in privately held companies, such as startups, do not have this luxury. The securities of private companies are generally, illiquid, and stockholders of a private company on the verge of going bust usually have no alternative but to hold onto their shares and hope for the best.

Lack of liquidity is merely one of the reasons that investing in the equity securities of an early-stage startup company is significantly riskier than purchasing public company stock. Startups also face a much higher risk of failure than public companies. There is an oft-recited statistic that nine out of ten startups fail within their first three years. As a result, experienced early-stage venture investors typically spread their bets over dozens of companies in the hopes that one will end up being successful enough to offset the total loss of most of their other investments and provide a decent overall return.

Sophisticated investors in startups typically negotiate special rights and protections to ensure they have some control and influence over their investments, despite being minority owners of the companies they fund. Conversely, non-accredited investors in early-stage startups who purchase their shares through equity crowdfunding offerings will likely lack many of the protections that more sophisticated investors would negotiate when writing larger checks.

Equity crowdfunding may also present a substantial risk of negative selection. Due to the substantial costs and regulatory burdens imposed by the federal crowdfunding regime, startups are highly incentivized to first exhaust more cost-effective traditional sources of early-stage capital (typically from high-net-worth angel investors and early-stage venture capital funds). As a result, many industry observers have raised concerns that, for the most part, only startups that are unable to raise funds from those traditional sources of capital would be likely candidates for federal crowdfunding offerings. That would leave the investors in those crowdfunding offerings with opportunities to invest primarily in companies that have been passed over by more sophisticated startup investors (who have already had their pick of the litter).

While these are the risks involved in investing in the equity securities of legitimate early-stage startups, there is also always the possible risk of outright fraud. The risk of fraud may be especially prevalent in the case of early-stage companies (which have little to no operating histories) that are selling stock to non-accredited, unsophisticated investors, most of whom will have no pre-existing relationship with these companies or their founders.

Protections

The federal framework for equity crowdfunding that Congress and the Securities and Exchange Commission (SEC) created is strong evidence that they were clearly concerned about the risks for non-accredited investors participating in crowdfunding offerings. Regulation Crowdfunding—the SEC's rules implementing the crowdfunding provisions of Title III of the JOBS Act—contains many provisions aimed at protecting non-accredited investors both from fraud and the risk of excessive losses.

For starters, the JOBS Act limited the total amount that investors can invest in crowdfunding offerings (across different companies) within any 12-month period. Individuals with either an annual income or net worth that is less than $100,000 can only invest up to the greater of $2,000 and 5% of annual income or net worth (whichever is less). Individuals with both an annual income and net worth of at least $100,000 can invest up to 10% of annual income or net worth (whichever is less). Regardless of how high an investor's income or net worth may be, individual investors are capped at $100,000 per 12-month period across all federal crowdfunding offerings. These investment limitations were designed to prevent crowdfunding investors (particularly non-accredited retail investors) from losing more than the federal government believes those investors can afford to lose.

When it comes to protecting investors, the SEC is also relying quite heavily on the online intermediaries through which companies are required to conduct their crowdfunding offerings. These intermediaries can be either SEC-registered broker-dealers (which have long been subject to a well-developed consumer protection regulatory regime) or a new category of intermediary specifically created for crowdfunding, known as "funding portals" (which are subject to a less stringent regulatory regime). Crowdfunding intermediaries are required by law to adopt policies to reduce the incidence of fraudulent offerings through their platforms. The anti-fraud measures include conducting background and securities enforcement regulatory checks on companies and certain related parties (like founders and directors) and denying access to an issuer or offering that the intermediary believes presents a potential risk of fraud.

Some crowdfunding platforms are also choosing to curate the offerings permitted on their sites—not merely to reduce fraud, but to differentiate themselves from other platforms that may have less exacting standards (and therefore potentially less attractive investment opportunities for investors). The intermediaries' incentive to curate offerings carefully may increase if part of their compensation for serving as an intermediary is in the form of stock of the companies raising funds through their platforms, as the SEC's final rules permit. That said, it is unclear how widespread this practice will become.

The intermediaries are further charged with policing compliance with the investors' investment limitations and are required to provide educational materials to each new investor who signs up to invest through their platform. In addition to the intermediary's educational materials about investing in startups and the federal crowdfunding process generally, the company issuing securities is required to provide substantial disclosures about those securities and the company's business (including detailed risk factors). These disclosures, however, are not reviewed or passed upon by the SEC, or any other regulator before the company sells its securities to crowdfunding investors and the level of detail in company disclosures has varied widely thus far. The disclosures are made available on the crowdfunding platform along with a communication channel for investors to ask questions of the company and discuss the merits of the investment among themselves. The "wisdom of the crowd" that investors may glean from these communications, it is hoped, will help them make better investment decisions than they might on their own.

To the extent that a company makes material misstatements or omissions to investors in connection with a federal crowdfunding offering, investors may sue the company (and potentially the intermediary hosting the offering) for rescission or damages. Due to the small size of these investments, the cost of bringing an action will likely far outweigh any recovery, which means crowdfunding investors may have trouble finding lawyers to take their cases. Even if the investors are able to clear this hurdle by bringing class actions, by the time investors file suit, the company may well have spent all of the funds and be judgment-proof. That would leave the intermediary as the only potential source of recovery, assuming the investors can successfully assert their claims against the intermediary (which remains to be seen).

Weighing the Risks

Non-accredited retail investors have been reading for years now about high-flying private startups (the so-called unicorns) and the early investors who made millions, or even billions, of dollars from funding them. Many non-accredited investors are understandably eager to get in on the action; they too want to play the startup lottery. However, some factors strongly suggest that investors proceed with caution into the federal crowdfunding marketplace. The first and foremost is that investing in early-stage companies is significantly riskier than other investments that have been available to most non-accredited investors. That risk is exacerbated by problems of negative selection, due to the high cost of capital raised through federal crowdfunding offerings compared to traditional alternatives.

If investors do decide to dabble in crowdfunding investments, they should seek to invest through reputable intermediaries who provide significant curation of the offerings made available through their platforms. These investors should also make sure to diversify appropriately. At the end of the day, the investment limits mean that investors will only be able to lose so much of their nest eggs through crowdfunding offerings. Investors who still want to speculate in startup securities should approach equity crowdfunding with their eyes wide open to the potential risks and be emotionally and financially prepared to suffer a total loss on their crowdfunding investments.

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