The Many Facets of Crowdfunding for Startups

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“Crowdfunding” is a generic, catchall term commonly used to refer to various methods that startups may use to raise funds in modest individual amounts from a large, dispersed group of strangers (the “crowd”) through an online platform. Many people are unaware, however, that there are at least five distinct types of crowdfunding in the U.S. that are available to startups in need of capital:

- Rewards crowdfunding
- Accredited crowdfunding
- Federal crowdfunding
- State crowdfunding
- “Mini” public offerings

Each type of crowdfunding is governed by different (and sometimes overlapping) regulatory regimes and has varying costs, benefits and drawbacks from a startup’s perspective. Before undertaking any type of crowdfunding offering, startup founders and their advisers should have a robust understanding of the merits and shortcomings of each type as a fundraising tool, especially when compared with more traditional fundraising options such as venture capital (VC) or angel financings.

Rewards Crowdfunding

When most people think of crowdfunding, rewards crowdfunding platforms, such as Kickstarter and Indiegogo, are often what spring to mind. These platforms allow startups to seek financing for new products or businesses by offering rewards (like branded merchandise) to anyone who provides contributions of a certain size. Unlike most other forms of crowdfunding, rewards crowdfunding participants do not receive ownership stakes in the companies they fund.

Startups bringing exciting consumer products to market, like the Pebble smartwatch or Coolest cooler, have had the greatest success with rewards crowdfunding. Pebble, for example, has raised over $30 million from nearly 150,000 people across its two campaigns on Kickstarter. These startups leveraged rewards crowdfunding platforms to pre-sell new products based solely on a concept, following which they could pay for the design and production of the product itself with proceeds from the pre-sale. Some startups, like Oculus VR, have even attracted traditional VC investment on favorable terms by first demonstrating high demand for a new product in a rewards crowdfunding campaign.

Startups should be aware, however, that failing to deliver on promises made to crowdfunders can land a company in hot water with consumer protection regulators. Startups encountering production problems may also alienate their early adopters if customers have to wait a long time to receive the product they funded.

Accredited Crowdfunding

Offerings through accredited crowdfunding platforms, such as AngelList and CircleUp, are largely the same as traditional equity offerings to angel investors conducted under Regulation D of the Securities Act, in which the investors become minority owners of the business. The key difference: instead of a startup's founders having to seek out individual angel investors to solicit their investments, the angels find startups through the online platforms.

As the name implies, participation in offerings made through these platforms is limited to wealthy " accredited investors" because they are theoretically more likely to be sophisticated investors that can fend for themselves in making investment decisions and to have sufficient resources to withstand substantial losses. As a result, the "crowd" in these offerings is a much smaller pool of prospective investors than in other forms of crowdfunding that allow almost anyone to participate. Additionally, since founders don't typically have much interaction with the individual investors who fund their startups through accredited crowdfunding platforms, they may not be able to leverage those investors' connections and experience as they often would with traditional angels.

Federal Crowdfunding

The long-awaited federal framework for equity crowdfunding to non-accredited investors allows startups to sell stock to the public through SEC-registered funding portals or broker-dealers. Regulation Crowdfunding (the SEC's rules implementing the crowdfunding provisions in Title III of the JOBS Act) goes into effect on May 16, just over four years after passage of the JOBS Act. The rules limit startups to raising $1 million through this type of crowdfunding every 12 months and place stringent limits on how much investors can invest in those offerings.

Many industry observers expect federal crowdfunding to be cost-prohibitive for most startups due to the investment limitations on investors and companies, restrictions on advertising the offerings, and burdensome disclosure requirements (which are similar to those of a smaller public company). Despite the fanfare associated with federal crowdfunding, startups that are able to attract traditional angel or VC investors-or that can raise seed capital through rewards crowdfunding or accredited crowdfunding-will likely choose any of those options over the more costly and cumbersome federal crowdfunding.

State Crowdfunding

Over half of the states in the U.S. have adopted their own form of equity crowdfunding regulations under state securities laws.
However, federal securities laws have made it difficult for many startups to take advantage of these opportunities.

Currently, many of these state crowdfunding options are only available to startups that can meet strict requirements regarding the in-state nature of the transaction, including advertising, offering and selling stock only to investors in the state where the company is incorporated and does business. In October 2015, the SEC proposed modernizing the federal safe harbor for intrastate offerings (Rule 147 under the Securities Act), which may eventually make certain state crowdfunding regimes particularly those that are more cost-effective than the federal version-a more attractive option for startups with predominantly local footprints.

"Mini" Public Offerings

The "mini" public offering under Regulation A is another form of crowdfunding, though many don't instinctively think of it as such. The SEC's overhaul of Regulation A (now often called Regulation “A+”), as required by Title IV of the JOBS Act, became effective in June 2015. The first startups to use these new provisions (such as Elio Motors) closed their offerings early in 2016.

Under Regulation “A+,” startups can raise up to $50 million from non-accredited investors, far more than they can under the federal crowdfunding regime. These financings are often thought of as “mini” public offerings because they require substantial disclosure reviewed by the SEC and share other commonalities with traditional IPOs. As with federal crowdfunding, Regulation “A+” limits the amount that non-accredited investors can invest, and startups often advertise and conduct the offerings through online platforms, such as StartEngine and SeedInvest.

Startups that have a large and enthusiastic public following, either from previous rewards crowdfunding efforts or due to the nature of their businesses, may find Regulation “A+” offerings a viable option. However, these “mini” public offerings are only feasible for startups able to raise significant amounts of capital to offset the considerable legal and accounting fees associated with conducting “mini” public offerings and the ongoing regulatory burdens. The regulatory burdens (and related fees) for “mini” public offerings are greater than with federal crowdfunding, but still significantly less onerous than the requirements for full-fledged public companies. Traditional VC investors, however, can provide similar amounts of capital with much greater flexibility at a fraction of the cost, making the traditional route still vastly preferable for startups that can find ways to access it.

What’s a Startup To Do?

While there’s been tremendous hype around crowdfunding, traditional angel and VC financings are still by far the best fundraising option for any startup that is able to attract those investors. Rewards crowdfunding can be a helpful tool to appeal to more traditional startup investors, but typically only for companies that have products or services that can excite the “crowd.” Accredited crowdfunding has many of the advantages of traditional venture financings, and also opens the clubby angel/VC world up to startups without connections in that community. Despite the excitement around non-accredited equity crowdfunding (both the federal and state versions, as well as “mini” public offerings), for most startups, it should likely be the financing tool of last resort.

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