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Joining the Crowd

Investing profitably in equity crowdfunding

Crowdfunding is a word you've heard a lot since the passage of the JOBS Act in 2012. But what is crowdfunding, and, more importantly, how you can use it to invest profitably?

What Is Crowdfunding?

Crowdfunding is the name given to a new type of investing in which companies raise money by soliciting funds from a large number of individuals, often expecting only small amounts from each. While there are many types of crowdfunding (e.g., equity, debt, donation and reward), we will focus here on equity crowdfunding.

As its name implies, equity crowdfunding involves sales of equity securities in non-public companies, typically through the Internet or social media. This type of crowdfunding was generally not achievable under U.S. securities laws until the passage of the JOBS Act in 2012. Even after passage, equity crowdfunding remained unavailable pending implementation by the Securities and Exchange Commission (SEC).

The SEC has not met the statutory deadlines stated in the JOBS Act, however, and it has currently implemented only one of its "crowdfunding" provisions - Rule 506(c) of Regulation D. This rule allows companies to raise an unlimited amount of money through general solicitation and advertising (including through the Internet and social media), provided that sales are made only to verified "accredited investors," who are individuals with a net worth (excluding primary residence) of $1 million or income of at least $200,000 ($300,000 with spouse) in each of the last two years.

The SEC has proposed, but not yet adopted, other rules for crowdfunding. These rules, when adopted, will permit companies to raise up to $1 million from an unlimited number of investors regardless of whether they are accredited (although net worth and income will affect how much each investor can invest). Further regulations permitting companies to raise up to $50 million from such investors have not yet been proposed.

Why Is Crowdfunding Important?

The size of the crowdfunding market alone make it an investment option that cannot be ignored. Market research firm Massalution estimates that crowdfunding will be used to raise more than $5 billion in capital in 2013, an 81% increase over 2012. When the JOBS Act is fully implemented, this figure should rise significantly.

From an investing perspective, companies seeking crowdfunding are generally thinly capitalized, early stage companies. As a result, they can offer many of the benefits associated with small cap stocks

– particularly the potential for explosive growth not present with more established companies. These companies are also not widely covered by analysts and often have little public information available. They may therefore be underpriced relative to their true potential, enabling savvy investors to profit from personal knowledge not built into the offer price.

Of course, these same factors can cause the securities to be exceedingly risky. Most importantly, due to the lack of public information, the risk of investor fraud by companies misrepresenting their prospects seems particularly high. As with any early stage company, the risks of company failure also cannot be ignored. Companies seeking crowdfunding are usually start-ups, a high percentage of which fail. Crowdfunded companies may be at particular risk as they may do so after failing to attract traditional VC financing, which may indicate an underlying problem with their business model. So, beware!

How Can You Invest in Crowdfunding?

So if you still think that the companies that use crowdfunding might be for you, how can you get in on the action? Investing in equity crowdfunding is generally accomplished through the Internet. The following are four popular websites currently available to accredited investors:

- AngelList (*angel.co*)
- MicroVentures (*microventures.com*)
- CircleUp (*circleup.com*)
- Wefunder (*wefunder.com*)

Ultimately, whatever your take is on crowdfunding, it is undeniably a revolutionary development and one that will experience increasing future growth. Equity crowdfunding should be reserved for the riskiest tier of your diversified portfolio and you should consult with your investment advisor and personal attorney before investing any significant funds.

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