Why Venture Capital Will Not Be Crowded Out By Crowdfunding

Ryan Kantor

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 credit’s been tight, and no matter how good ideas are, if an entrepreneur can’t get a loan from a bank or backing from investors, it’s very difficult 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.

Keywords: crowdfunding, venture capitalist (VC), financing, entrepreneur, startup business, capital

1. Introduction

As the recovery period from one of the worst recessions in our history continues, life for the fledgling and, often times, experienced entrepreneur, has been tough. Indeed, President Obama has remarked that ‘[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 almost impossible to get their businesses off the ground’ [sic]. In response to this ever-present need for business funding, and in an attempt to stimulate the economy and job growth, Obama signed the

---

2 Ibid.
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. More specifically, Title 2I of the Act, which is still awaiting commentary from the proposed rules recently promulgated and is likely to go into effect in early 2014⁴, 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 for 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’), 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 capitalist, Fred Wilson, boldly suggested that venture capital (‘VC’) could be swept away altogether by a flood of crowdfunding money unleashed by the JOBS Act. His reasoning is 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 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

---

⁶ John S. (Jack) Wroldsen, ‘The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists’ Dilution of the Crowd’, 15 Vand. J. Ent. & Tech. L. 583 (2013) (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.’)
estimate in other pundits’ views\(^{10}\), will dwarf the amount that venture capitalists put into the
system, which will minimize their role as aggregators of cash, leading to less utility and an
overall decrease in their value\(^{11}\). 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 flowing into closed-in funds and other ways
of funding, which are outperforming VCs.\(^{12}\) In any event, one cannot deny the premise: the
genesis of crowdfunding as an option for an entrepreneur looking to raise capital will have an
effect on the VC industry. However, the converse is true as well, in that traditional means of
financing, specifically VC funding, will have an effect on crowdfunding. Beyond impact that
crowdfunding and traditional VC funding will have on one another are many other risks,
cautions, and perils for companies looking to crowdfunding as means of financing and for
investors looking to invest through crowdfunding portals.

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

Part 2 of this article briefly highlights the different methods startup ventures 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 examines the
corollary of the high failure rate of startups with an emphasis on the VC’s expectations and
strategy. Part 2 concludes by citing reasons as to why the demand for financing from startup
companies is not being met.

Part 3 inspects and scrutinizes the JOBS Act with a specific focus on Title 2I: Public
Securities Crowd Investing. It spells out how non-accredited investors will be able to
participate in investing in startups, including the investment amount limitations and required


\(^{12}\) Cale Guthrie Weissman, ‘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’.
company disclosures investors are privy to. Lastly, an in-depth analysis is 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 class of non-accredited, ordinary individuals), the focus is on fraud concerns and horizontal risks associated with not having appropriate VC protections. Shifting to the lens and perspective of the company, the focus is on the negative consequences of crowdfunding; namely deterring future funding from VCs.

Part 4 of this article concludes by reaffirming the notion that crowdfunding and VCs can, and will, coexist. I 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.

2. Startup Financing

It is estimated that around two million new businesses are formed each year, of which about 550,000 are considered ‘startups’. To understand the different financing rounds, or funding stages, a startup company proceeds through, it is best to think of a new venture on a timeline. At the beginning is conception of the idea of the business and the creation of the business model. The company then moves forward along the timeline as the idea gains credibility and forward momentum. Throughout this process, the company, ideally, is hitting the necessary milestones previously put in place by investors like VCs and, to a lesser degree, ‘angels’ (who are high net worth, accredited investors seeking high returns through private placements in startup companies), resulting in the receipt of funds via the different rounds of funding discussed briefly 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 until the company ‘exists,’ which generally means either an IPO or an acquisition.15

Traditionally, nascent companies are initially funded from credit cards and savings (‘bootstrapping’), and then from friends and family.16 In a best-case scenario, this usually raised up to about $250,000; then the startup is then forced to look elsewhere for funding.17 Angels are usually sought out at this point. Angels are typically looking to invest a set amount ranging from as low as $10,000 to as much as $1,000,000.18 In addition, angels are normally seeking high growth-potential companies and often focus solely on particular industries with which they are familiar.19 Assuming the company is in the vast minority and is actually fortunate enough to receive angel funding,20 once that amount has been exhausted, the startup turns to a VC firm for funding. Although this funding process may sound rather simple, obtaining the necessary funding at the different stages of development can actually be so difficult that the ultimate demise of many businesses is lack of funding.21

2.1 Lack of Funding and the Funding Gap

It is well known that small business often face an uphill battle when attempting to raise money through traditional funding sources such as bank loans, angel investors, and VC firms.22 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 in post-

15 Ibid. See also Brian Broughman & Jesse M. Fried, ‘Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups’, 98 Cornell L. Rev. 1319, 1321 (2013) for discussion of other ‘exit’ options such as dissolution and then liquidation of the company.
17 Ibid.
recessionary times due to the tightened underwriting standards imposed by banks.\textsuperscript{23} 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.\textsuperscript{24} Moreover, a joint report by PWC and National Venture Capital Association (NVCA) shows that from 2009 to the present, VCs have invested the least amount of money in early stage deals and have also invested the smallest amount of early stage deals by volume compared to the other stages of development.\textsuperscript{25} Some details from the joint report shed some light and provide a more context. In 2012 VCs invested in 3,826 deals, 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%).\textsuperscript{26} As can be seen, just over a decade ago, the chance of obtaining VC funding was more promising and even 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 noted that for every 30-40 investment proposals that slide across the desk at a VC firm, only one will receive investment.\textsuperscript{27} So, the question is: if startups have a dire need for funding at an early stage of development in order to get their businesses off the ground, why are VCs failing to meet this demand?

### 2.2 Venture Capital Funding

VCs are 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 factors. First, VCs primarily seek to invest greater sums – on average

\textsuperscript{23} Ibid.; 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.

\textsuperscript{24} Ibid.; See also Bradford, 100, n 64, (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)).

\textsuperscript{25} ‘PricewaterhouseCoopers/National Venture Capital Association.’ MoneyTree™ Report, Data: Thomson Reuters Total U.S. Investments by Year Q1 1995 - Q3 2013.19 Nov 2013. https://www.pwcmoneytree.com/MTPublic/ns/moneytree/filesource/displays/notice-B.html; see Mashburn,, '[d]ata also show that angel investors, the traditional source of capital for startup companies, are investing in companies closer to commercialization than in the past'.

\textsuperscript{26} Ibid.


\textsuperscript{28} Mashburn, n 24.
between $2 million and $10 million – than startups are pursuing.29 Second, VCs have a preference for investing in somewhat less risky companies – those that have already endured through the initial startup phase with proven track records and clearer exit prospects.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.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’.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.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 2011.34 Normally, VC funds, despite getting hundreds or even thousands of investment proposals each year, invest in about 10-12 total.35 The general partner, or VC firm, is responsible for sourcing, evaluating, and ultimately negotiating the investments that are made into the startup, or portfolio, companies.36 Therefore, the ability of investment funds to invest is constrained by the ability, expertise, and experience of their managers.

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.37 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

---

29 Ibid.
30 Ibid.
33 Ibid.
35 Sahlman, n 30; see also McKaskill, n 26.
36 Ibid.
37 2013 WL 574518 (ASPATORE), 1 (ADJUSTING TO INVESTMENT TRENDS IN A NEW VENTURE CAPITAL MARKET)
fund is therefore resource-constrained in the human capital sense (i.e., at full capacity), which is one major reason that VCs fail to meet the demand for financing of startup companies.

Another key reason that VCs don’t 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 home runs if they want to give their limited partners a reasonable yield on their investment. 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. As a result, many startups outside of those industries of interest often time go unfunded, because just being profitable isn’t enough. For example, even though a 10% return would be a great return for a retail investor investing in common investment

[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,’ n 31

[41 Shikhar Ghosh, http://hbswk.hbs.edu/item/6591.html ‘Very few companies achieve their initial projections. Failure is the norm’.

[42 Gage, n 20.


[44 Ibid.


products, 10% is not a good return for a portfolio company.\(^{47}\) In sum, the selectivity and the stringent investment criteria VCs call for, limits the universe of startup companies as candidates for VC funding. Thus, the ability for VCs to meet the demand for financing startup companies have is further limited.

Besides the inability of VCs to properly evaluate and monitor numerous portfolio companies due the lack of human capital, and the need for VCs to invest in specific kinds of business models that have the ability to be home runs 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 failure to meet the high demand for financing by startups each year.\(^{48}\) As mentioned above, 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 an 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 California’s Silicon Valley.\(^{52}\) The result of this VC investment concentration is that many startups located in less prevalent VC areas go unfunded.\(^{53}\)

For these reasons, \textit{inter alia}, many startups are short-lived and end up being nothing more than a business idea or concept that never materializes. In short, the 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 in which a new class of investors has since been born to help alleviate the lack of funding problem startups in the past have faced.

3. \textit{Crowdfunding}

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


\(^{49}\) \textit{Ibid.}

\(^{50}\) \textit{Ibid.}

\(^{51}\) \textit{Ibid.}

\(^{52}\) \textit{Ibid.}

\(^{53}\) MyCapital, n 44.
Crowdfunding, in fact, originated in the United States as a ‘donational’ model in which people provided money to fund different projects without expecting to receive an ownership interest or profit in return. 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 five different types or uses of crowdfunding that can be categorized by distinguishing what the investor is promised in return for their contributions: 1) the donation model; 2) the reward model; 3) the pre-purchase model; 4) the lending model (peer-to-peer lending); and 5) the equity model. The first four types have been legally used in the past; however, the fifth type, the equity model, has only recently been enabled by Title III. The equity model differs from the other types because the contributor of funds expects to receive a share of the profits or return of the business they are funding, causing the transaction, categorizing it as a sale of securities and thus subject to Federal Securities Laws. 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.

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 it to sell securities without registering or completing the complete disclosure requirements ordinarily mandated for public offerings. 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.

Under the Crowdfund Act, a company will be able to raise up to $1 million over a twelve-month period. Crowdfunding websites display business plans/funding requests on their site and anyone can view them and decide whether to invest or not. Individual investors

---

54 Bradford, n 20 (noting that the leading crowdfunding site today, Kiva, did not open for business until 2005).
56 Bradford, n 20 (such as Kickstarter or IndieGoGo),
57 Ibid.
58 Ibid; see also Alan R. Palmiter, n 54.
59 Zachary J. Griffin, ‘Crowdfunding: Fleecing the American Masses’, n 27.
60 Benjamin P. Siegel, n 4.
61 Ibid; see also Mr. Merkley (for himself, Mr. Bennet, Mr. Brown of Massachusetts, and Ms. Landrieu), In The Senate Of The United States. S. 2190 (112th): Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012, 112th Congress, 2011–2013, Text as of Mar 13, 2012 (Introduced).
62 Griffin, n 27.
will be limited to contributing: 1) 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 2) 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 must take place through a ‘broker’ or ‘funding portal’ and must comply with certain disclosure requirements.64 This intermediary (broker or funding portal) is responsible for making disclosures ‘related to risks and other investor education materials’ in which the SEC determines is appropriate.65 The Crowdfund 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 more than $500,000 within the 12-month period, acquiescing to a broad-based background check to be conducted by the intermediary, and other provisions intended to preclude fraud and protect investors in the process.66

Crowdfunding could very well mark a ‘revolution in how the general public allocate[s] capital’, or, at a minimum, democratizes the process of deciding how, and whose ideas are financed. In fact, the impetus for passing the 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.’67 Copious examples of non-equity based, large, successfully rowdfunded projects exist, such as the ‘Pebble’ project in which over $10 million was raised in just thirty-six days to fund a highly customizable wristwatch that works in unison with a smartphone.68 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 signed into law by lawmakers, then what could possibly be wrong with crowdfunding?

3.1 Problems With Crowdfunding

To achieve the goal of increasing a small businesses’ access to capital, the Crowdfund Act decreases the number of regulatory hoops that parties must jump through in order to

---

63 Ibid; see also Wroldsen, n 6 (the cap on individual investors applies to the aggregate amount invested via crowdfunding in any twelve-month period, not to each investment).
64 Ibid.
65 Ibid.
66 Siegel, n 4.
67 Wroldsen, n 6.
68 Ibid.
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 2) 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 much of the general public is largely financially illiterate. The financial illiterate, or unsophisticated, investor will have a much more difficult time understanding the risks associated with crowdfund investing. Moreover, the issuer disclosures are usually distributed to investors in a very dense form containing financial verbiage that is unfamiliar and unintelligible for to an unsophisticated investor. To paraphrase what two law professors point out, disclosures that are seen today are often too long and complex. W, and when an ordinary investor is inundated with them such disclosures, 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 facilitates 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 are familiar with the concept of cybercrime (fraud conducted over the Internet), yet many people may not

---

69 Siegel, n 4.
70 Ibid.
71 Ibid.
73 Ibid.; see also Palminter, n 54.
74 Ibid.
75 Ibid.
76 Press Release, ‘IOSCO Publishes Paper on Cyber-Crime, Systemic Risk and Global Securities Markets’, Wall Street Journal, 16 Jul 2013. (This article highlights the urgent need to consider cyber threats to securities markets as a potential systemic risk due to the rapidly evolving nature in terms of actors, motives, complexity, and frequency).
realize that considerable amounts of securities fraud conducted over the Internet occurred in the not-too-distant past.\(^78\) In 1992, in a manner quite similar 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 Regulation D to allow a non-reporting company to generally solicit and advertise their offering of securities.\(^79\) Soon thereafter, numerous cases of security fraud were identified.\(^80\) Specifically, the ‘pump and dump’ scheme occurred in which an unscrupulous promoter would purchase a low-priced, thinly capitalized, and relatively unknown and uncovered by analysts stock, known as a ‘microcap’ stock; endorse and stimulate buying activity around the stock, using the internet to reach the public; and then 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.\(^81\) The promotional materials were frequently comprised of misrepresentations of the microcap stock leading to the price crashing after the promoter dumped his/her position, leaving the investors with practically nothing.\(^82\) The whole scheme was, in essence, made possible due to the SEC’s decision to eliminate the restriction on general solicitation and advertising.\(^83\) 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 that fraudulent activities are ubiquitously entwined with the Internet.

The last of the three dominant reasons as to why crowdfunding may lead to more fraud revolves around the disincentive investors might 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.\(^84\) 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

\(^78\) Griffin, n 27.
\(^79\) Ibid; see also Revision of Rule 504 of Regulation D, The ‘Seed Capital’ Exemption, Securities Act Release No. 7644 (Feb. 25, 1999).
\(^80\) Ibid.
\(^82\) Ibid.
\(^83\) Ibid.
\(^84\) Siegel, n 4; see also Palmiter, n 54.
crowdfunded venture is between $10,000 and $100,000, and often investors will have contributed even less (around $2,000), and 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 is capped at $1 million for a crowdfunding exemption. The economic impracticality of this situation is true from an attorney’s perspective as well. Typically, an attorney litigating this matter would be working on a contingent fee basis (normally 20-30% of the award), which, again, would not be a worthwhile undertaking. 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.

3.2 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 may still not realize the expected above-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 VCs. Without

---

85 Palmiter, n 54.
86 Siegel, n 4; see also Diamond Kaplan & Rothstein, ‘Crowdfunding May Increase the Likelihood of Fraud’, FindLaw (Nov. 1, 2012).
87 Ibid; see also Siegel, n 4.
88 Wroldsen, n 6; see also Bradford, n 20.
89 Ibid.
adequate VC protections, an early-stage crowdfunding investment in a successful startup company can result in significantly lower financial returns.90

The concept of horizontal risks was depicted in the film The Social Network when Eduardo Saverin’s ownership stake is diluted from his original 30 percent down to less than 1 percent when Facebook obtained VC financing.91 Other existing ownership interests, such as Mark Zuckerberg’s, were, at most, minimally diluted.92 Saverin’s failure to negotiate the essential investor protections led to this vast dilution. Similar 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.93 Professor Bradford explains the dilemma by pointing out that most crowdfunding investors do not have the know-how and cleverness to understand the necessity of having control rights or protective covenants. 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 crowdfunding investor and the remote, impersonal nature of crowdfunding preclude any meaningful negotiation’.94 The overarching concept of the VC being in a position of power, seeking control of the startup, and diluting prior investors is not novel nor is it exclusive to crowdfunding investors.95 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.96 In substance, these are all VC ‘tools’ that can potentially take advantage of early-stage investors like crowdfunding investors by reducing the value of their shares by enormous amounts.97

Due to the potential problems associated with fraud and the horizontal risk due to absence of investor protections, crowdfunding investors should proceed with caution. As painful as it would be for a crowdfunding investor to surrender a capital investment to a mismanaged, failed, or fraudulent startup company, it would be even more unfortunate for a crowdfunding

---

90 Ibid.
91 Ibid.
92 Ibid.
93 Ibid.
94 Ibid.
96 Ibid.
97 Ibid.
investor to invest in a startup that becomes a huge success and then fail to earn an adequate return, while the VC profits immensely.98

Companies seeking investments from crowdfund investors should also be leery. Using crowdfunding can lead to myopia in the sense that later investors like VCs will be deterred from investing in future rounds of financing for a few different reasons.99

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).100 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 exposure to.101

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.102 It goes something like this: the riskiest companies will be the ones who seek crowdfunding, because their family, friends and business associates denied them.103 In other words, crowdfunding may be seen as a last resort, or a sign that the particular venture seeking funding is even riskier than a typical startup. It has been argued that herein lies 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’.104

4. Conclusion

In the past, VCs were seen as great investors and job creators. Recent reports, however, have criticizes VCs for providing less-than-expected returns while being much too dominant and

---

98 Ibid.
100 Ibid; see also Mashburn, n 22.
101 Mashburn, n 22.
102 Stocker, n 99.
103 Joyce M. Rosenberg, ‘Crowdfunding may be more bust than windfall’, New York (AP), 24 Apr 2013.
104 Ibid.
harsh in the terms they demand.\textsuperscript{105} Investing in VCs is beyond the scope of this paper. Rather, VCs as investors, despite their harsh terms, are value-added partners. VCs provide substantial amounts of funding, invest in multiple rounds of a company’s growth, participate in active management of the company, and provide introductions that can help lead to more business or funding down the road.\textsuperscript{106} Crowdfunding will not replace VCs, contrary to what Fred Wilson has predicted.

Large institutional investors like VCs turn down 99\% of the business plans submitted to them, which attests 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 better candidate for crowdfunding than VCs, whereas a capital-intensive, high-growth company would be a better fit for VCs, but would not be a very good fit for crowdfunding due to the $1M limitation on funding over a 12-month period.\textsuperscript{107} Apart from focusing on dissimilar companies, crowdfunding also helps fill the gaps for 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.\textsuperscript{108} The argument is that the online portals, or crowdfunding websites, are accessible by VCs too, so they have the opportunity to analyze companies they might have missed initially.\textsuperscript{109} 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.\textsuperscript{110} 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?

Crowdfunding has the potential to be a huge, positive source of startup capital in the near future. However, those looking to become crowdfunding investors, and those looking to obtain investment via the crowdfunding investors, must both act with prudence. Many aspiring

\textsuperscript{105} Diane Mulcahy, Bill Weeks, and Harold S. Bradley, ‘We Have Met The Enemy...And He Is Us’, Ewing Marion Kauffman Foundation, <http://www.kauffman.org/~media/kauffman_org/research%20reports%20and%20covers/2012/05/we%20have%20met%20the%20enemy%20and%20he%20is%20us(1).pdf>.

\textsuperscript{106} McKaskill, n 27.

\textsuperscript{107} Andrew Stephenson, ‘Crowdfunding can supplement your offering to accredited investors’, CrowdCheck Blog, 05 Nov 2013, <http://crowdcheck.com/blog/crowdfunding-can-supplement-your-offering-accredited-investors>.


\textsuperscript{109} Ibid.

\textsuperscript{110} Ibid.
investors and investees are hopeful and confident, yet gloom and misery are right around the corner if the involved parties do not exercise due diligence and discipline.

The SEC will undoubtedly be an intricate part in curbing fraud in the crowdfunding realm.\textsuperscript{111} 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 them to perform certain tasks and disclose certain information.\textsuperscript{112} If the SEC were to implement too many rules, that were too difficult to obey, then it would have completely defeated the purpose of Title II of the JOBS Act since companies would find it too time-consuming and expensive to utilize. Other options may 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.\textsuperscript{113} Taking into consideration the above, it seems that the SEC has done a worthy job on paper, yet 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 disciplined and have turned down companies deemed not worthy of investment.\textsuperscript{114} The more reputable and trustworthy these third-party intermediaries are, the less likely fraud will occur.\textsuperscript{115} 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 or feedback.\textsuperscript{116} This will help avoid fraud, though it 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.\textsuperscript{117} 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

\textsuperscript{111} Palmiter, n 54.
\textsuperscript{112} Ibid.
\textsuperscript{113} Siegel, n 4.
\textsuperscript{114} Rosenberg, n 103 (on how Crowdfunder and CircleUp have been turning down many companies).
\textsuperscript{115} Ajay Agrawal, Christian Catalini, and Avi Goldfarb, ‘Some Simple Economics of Crowdfunding’ (June 2013), NBER Working Paper No. w19133 (on mitigating the problems of Adverse Selection and Moral Hazard).
\textsuperscript{116} Ibid.
\textsuperscript{117} Wroldsen, n 6.
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 in subsequent rounds of financing. Share-based dilution occurs when the company issues additional shares of common stock, which causes the convertible preferred stock held by crowdfund investors much less valuable.

Fortunately, there are anti-dilution protections available and commonly negotiated, 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. The table could appear on the website alongside the investor education materials that third-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. Investors and investees contemplating involvement, however, should proceed carefully. Beyond the more obvious risk of fraud are more obscure 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.

118 Ibid.
119 Ibid.
120 Ibid.
121 Ibid.
122 Ibid.