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White Paper

An Introduction to Crowdfunding: The New Paradigm in Startup Capital Funding.

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Quick Tips:

- **Crowdfunding for investment purposes is not yet sanctioned by Congress**
- **Crowdfunding may offer a alternative means by which small investors can invest in new high-growth potential businesses**
- **Crowdfunding may require fewer restrictions by and less involvement with SEC regulators**

Something to consider:

The current U.S. Senate Crowdfunding Bill lowers the individual investing caps to between $500-$1000. What the Senate does not seem to understand, (or perhaps understands very well) is that crowdfunding for startups will never really work if it overburdens the process with onerous, expensive, and meaningless regulation and restricts individual investments to $500, $1000, or even $5,000.

From the author:

Crowdfunding in one form or another has been in existence for many years, yet it has been the rapid growth of the internet and social media that has brought the concept of Crowdfunding into the spotlight as a potential source of equity capital for startups. Crowdfunding (also referred to as Crowdsourcing or Crowd Financing), describes the process of using the internet and other developing technologies to collectively finance non-profit organizations, charities, musicians, artists, filmmakers, authors, etc. Until now, the common denominator for crowd-funding efforts has been the focus on raising capital from the public (referred to as the "crowd"), usually in small donations, to launch new ideas, finance charitable causes or to support new artists, without the expectation of a monetary gain on the part of the donors.

The internet has facilitated this phenomenon, and examples of crowdfunding websites that are designed for these purposes include Kickstarter, Indie Gogo, Rockethub, and others. This type of funding has worked well, as donors have made their "investments" in social causes or to support artists for the emotional pay-off that comes with seeing their cause or artist succeed. These types of investors often receive small rewards for their backing in the form of a book, or CD that is produced as a direct result of their contributions. Sometimes the payback is as little as a t-shirt, or the satisfaction that the "investor" has pushed the ball forward toward a better world.

A new paradigm in startup financing

Now, as the traditional sources of financing for for-profit startups have all but dried up, crowdfunding is being tested as a new category of alternative financing. Since the financial crisis of 2008, startup capital is no longer readily available from friends and family, who, in many cases, have suffered tremendous losses as a result of the financial crisis. In addition, angel investors and venture capitalists are now licking their own wounds. Owing to the near collapse in the global financial system, they are concentrating on managing their existing portfolio of investments rather than investing in new ones. Traditional bank financing for startups has never really been a viable source of capital and in the current economic environment startups can discount this possibility altogether.

Based on the non-profit model, the new idea behind crowdfunding is to provide startup capital for the for-profit enterprise where capital is simply not

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available through traditional means. The goal of crowdfund investing is to enable individuals to evaluate and self-select their own investments in startup enterprises via the purchase of private equity in new companies in relatively small amounts. The investment is made with the expectation of financial reward.

The legislative logjam

Crowdfund investing, as the term is used today, is made possible by powerful internet technologies that enable the fast and easy delivery of financial services around the world. Sounds great, right? Not so fast. Today there exists a maze of old, obsolete securities rules and regulations— most importantly the SEC Act of 1933—that currently prohibit the use of crowdfunding for equity financing without significant changes in U.S. Federal and State Securities laws. President Barak Obama has backed the Startup Exemption to existing securities regulations and has supported passage of H.R. 2930, the Entrepreneur Access to Capital Act that passed in the House of Representatives on 11/3/11. H.R. 2930 allows startups to raise between $1-$2m, and investors are limited to investing an amount equal to the lesser of $10,000 or 10% of their annual income. Under H.R. 2930, the startup issuer or crowdfunding intermediary, must take a number of steps to limit investor risk including, but not limited to, warning investors as to the speculative nature of the investment, the limitations on resale, and the requirement of investors to answer questions demonstrating their understanding of the risks. Add to this the requirement to provide notice to the SEC of the proposed offering, including certain prescribed information.

At this point, however, the bill is stuck in the Senate and the Senate versions of the bill differ dramatically from the version passed in the House. The Senate versions being proposed seem to defeat the essence of Crowdfunding for startups before the process is even given a chance. The current Senate Crowdfunding Bill lowers the individual investing caps from the lesser of $10,000 or 10% of income to between $500-$1000. What the Senate does not seem to understand, or, perhaps understands very well, is that crowdfunding for startups will never really work if it overly restricts individual investments in startups to $500, $1000, or even $5,000, and overburdens the crowdfunding process with onerous, expensive, and meaningless regulation.

Crowdfunding proponents need to understand just who their actual opponents are, and be prepared for an arduous fight in the Senate. One may wonder whether or not the powers that be in our global financial system, or the well-entrenched regulators that “protect” our collective interests are, in fact, opposing the adoption of Crowdfunding for obvious reasons—while at the same time paying lip-service to it.

Welcome to the Wild West

While we ultimately see an exciting future in Crowdfunding for investment purposes, we are also acutely aware that Crowdfunding (as an industry) is in its startup phase. Like the many disruptive technologies that came before it, the

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world of crowdfunding resembles the Wild West. To date it is characterized as pure chaos, though some would point out that it resembles the internet in its nascent stages of development. There is no doubt that most crowdfunder intermediaries are well intending and view crowdfunding as a mechanism by which they may jump-start new businesses and reinvigorate the economy. Proponents of crowdfunding believe that only through the elimination of unnecessary regulation that crowdfunding can become a significant engine for the capitalization of new and early stage businesses and add to job creation in a country where an epidemic of joblessness prevails.

Opponents of crowdfunding for investment purposes make their fear mongering arguments against lifting the current regulatory barriers based on the potential for fraud. At first blush, their arguments seem to make sense, but they weaken on further inspection. Though we have been lead to believe otherwise, it is quite possible that there is now more transparency and plain dealing in the crowdfunding investment process than through traditional investment channels. Dispensing with regulation altogether, however, would be imprudent. When and if legislation clears both Houses of Congress, crowdfunders and startup issuers will still have to file notices with the SEC and adhere to other requirements, but they would be exempt from many other SEC regulations.

Proceed at your own peril

As it stands now, crowdfunders and startups need to be aware that Federal and State Securities Regulations currently forbid crowdfunding for equity purposes and that violating these regulations could put them out of business. Regulations include:

- A prohibition against "general solicitation"- which means that a company may not offer or sell securities unless there is a substantive, pre-existing relationship between the company (or a person acting on its behalf) and the prospective investor.
- Regulation demands disclosure and state law compliance requirements if the investors are not "accredited investors"- which usually makes the offering of securities too costly and onerous for a startup.
- A requirement that any intermediaries, including crowdfunding websites, must be registered with the SEC and applicable state securities regulators as a broker-dealer and member of FINRA in order to charge any transaction based compensation in connection with the sale of securities. (Non-Public Stock is considered a security and many types of loans may be interpreted as securities as well.)
- A requirement that any company that has 500 or more shareholders and total assets exceeding ten-million dollars must register with the SEC and file periodic reports.

Your conduit for information, research and analysis

At StartupFactory, it is our intention to serve the interests of our startup clients during what is arguably one of the most challenging financial environments in history.

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Times like this offer a great opportunity to those innovators with revolutionary ideas, passion, and an unfailing desire to succeed. Our goal is to bring over two decades of proven experience to bear in assisting startups achieve their business objectives and ambitions. It is increasingly evident to us that the past decade of global financial upheaval will result in many changes to the financial systems we once knew.

We believe that crowdfunding has the potential to cause a profound change in the way investment transactions will be conducted between the masses, (the crowd), and the new business enterprise. What this portends for a redirection of global investment money to projects that are deemed to be "worthy" to the crowd is anybody's guess. In any event the potential impact of crowdfunding is deserving of some very serious consideration.

While government gatekeepers, "regulators", politicians, lobbyists, and other powerful forces may attempt to thwart the establishment of crowdfunding for equity financing, one thing becomes clear; they won't be able to stop it. The internet is too ubiquitous and thus governments would have to shut down the internet to shut down crowdfunding. Perhaps this is one of the underlying goals of subversive SOPA, PIPA and ACTA-like initiatives. Finally, it does seem that there are some young entrepreneurs, both on the startup side and crowdfunding side, who choose to disrespect authority and existing regulations in an effort to establish a new and revolutionary investment paradigm that stands separate and apart from Wall Street. We hope we have provided some useful guidance to participants in the crowdfunder space, especially with an eye towards the current and existing regulations that can kill off industry providers and startup issuers in their infancy. We will continue to monitor, analyze and report on the spread of global crowdfunding and its impact on the young innovators who are daring to explore this new form of capitalism.

StartupFactory, LLC is one of the first companies to monitor the crowdfunding industry and the developments impacting this evolving financial ecosystem on behalf of our clients and prospects. Developments in crowdfunding will be fast-paced and, in a rush to be first to market, some crowdfunding entities will unintentionally violate current securities laws and put startup issuers and themselves at great liability. One of our goals is to be the premier information provider for timely, unbiased coverage on the rapidly developing crowdfunding Industry. We welcome and invite all forms of research, information, and commentary that may help us in our pursuit of delivering quality crowdfunding research and analysis.

To learn more about startup capital finance, ask for our article entitled:
An Introduction to Startup Financing.

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