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Crowdfunding changes expected to be revolutionary

By Katherine Connor
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Monumental changes are in store for the future of investing and entrepreneurship, courtesy of two titles in the Securities and Exchange Commission's JOBS Act.

When finalized, they will allow for online investment in early-stage companies from anyone in the country, a major shift that those in the industry say will have wide and positive ripple effects.

"People are underestimating the potential impact of this," said Howard Leonhardt, co-founder of Startup California, founder of the California Stock Xchange and a participant in crafting the crowdfunding legislation.

The two titles of the seven-title Jumpstart Our Business Startups Act that directly pertain to crowdfunding are Title II, Access to Capital for Job Creators, which took effect Sept. 23; and Title III, Crowdfunding, which is roughly 30 days into a 90-day public comment period, although it was unanimously approved by SEC.

Title II of the JOBS Act removed a ban on general solicitation for investment, as well as the requirement that those seeking funds have a previous relationship with the investors they target, a condition in place since 1939.

Before Title II implementation, entrepreneurs could only approach accredited investors with over $1 million in assets that they had an established relationship with, which Leonhardt said discouraged participation from the middle and lower classes.

Title III, which Charles Sidman, head of the Crowdfunding Professional Association board, said was the more revolutionary of the two, abolishes the previous requirement that only people with $1 million in assets, excluding home and vehicle, can be targeted for investment.

Under this pending title, investors with less than $100,000 in annual income would be able to invest 5 percent of their income or $2,000 a year, whichever is higher, in early-stage companies. Potential investors with incomes over $100,000 would be subject to a 10 percent cap on investment, and investors with over $250,000 would fall under accredited investor exemptions.

Title III also allows entrepreneurs and startups to advertise their offerings, which was previously illegal.

"They're both obviously very important, but I think Title III is more revolutionary, because since the Great Depression people less well off were simply prohibited from participating in this early-stage market, where the greatest returns happen," Sidman said. "If you're not rich you can't get rich, and if you are rich you can get even richer."

These crowdfunding investments will largely take place through online portals, which Leonhardt said are one of many spinoff sectors ready and waiting for the green light, along with third-party verification and security providers.

As it stands, the legislation calls for detailed vetting of all parties involved — investors, investees and broker dealers — to minimize fraud and loss, although Sidman acknowledged that the details of these measures are still being worked out and may need to be tweaked as effectiveness is analyzed.

Companies must take reasonable steps to understand and verify investors' income levels via tax returns and other confidential documents, and must publish their method of valuation for the company for the benefit of investors.

Gabriela Dow, vice president of strategic initiatives for San Diego's Startup Circle, said that while the crowdfunding change is a welcome one and security measures are inevitable, she's concerned that too much regulation will stifle the growth of the smallest firms.

"There is no question that the entrepreneur investment and venture capital sector is continuing to experience rapid democratization and decentralization as avenues for crowdfunding increase," Dow said.

"This is a great development …. And the latest legislation offers some positive aspects, like legitimizing these new channels and requiring more transparency, but the stringent level of disclosures, reporting and auditing is likely to be too burdensome for some early stage startups." She said continued and increasing comments from the startup community as the regulatory requirements are completed could ease that burden.

Leonhardt also said that part of the security will lie in crowdsourcing, with investors able to comment on companies and share their success or horror stories with other potential funders. In addition, portals themselves will have the ability to institute their own criteria for listing and removing companies.

In terms of a local versus national focus, Sidman said he didn't foresee much change from current investment habits, although Leonhardt seemed to think there might be more of local investment focus, as people invest small amounts in the ideas of people they know and trust.

"Crowdfunding is a win for everybody," Leonhardt said. "Even if your investment isn't a huge lottery win for you personally, you win because society in general has more economic activity and more job creation. Even if it's someone else's investment bet that's a big win, you get to have that innovation as well."