A Guide to Crowdfunding for Local Investors

It is often said that small businesses are the "backbone of our economy" and the "cornerstones of our communities," especially during tough economic times. Existing regulations do not allow for all citizens to invest in these vital ventures. Despite the recognition of their critical economic function, for years, small businesses have faced tremendous hurdles acquiring the funds necessary to open, operate, or expand.

Crowdfunding is a new, and constantly evolving, phenomenon that is opening up exciting new avenues for small businesses to raise capital by allowing individuals, who were previously unable to invest under federal law, to monetarily support promising companies and projects.

Over the past few years, crowdfunding has entered popular rhetoric as a few high-profile projects and popular sites, like Kickstarter, which allow people to give money for non-monetary rewards, have received considerable attention. However, the most recent iteration of crowdfunding, as envisioned by the Michigan Legislature in HB 4996, is different than small donations for prizes.

This new model – *investment-based crowdfunding* – gives small businesses an additional tool to raise much needed capital while allowing non-accredited investors the opportunity to purchase equity securities. Under investment crowdfunding, businesses seeking capital sell ownership stakes to lower net worth investors in the form of equity or debt, further expanding the investing landscape. In this model, individuals who fund become shareholders with the potential for financial return.

Engaged appropriately, investment-based crowdfunding can spur economic development by helping small businesses build to the point where they can occupy vacant storefronts, stimulate the local economy, and create new jobs. However, selling shares through crowdfunding is a decision that impacts the financial condition of both companies and investors, and thus, requires significant preparation and due diligence.

In early September, a team of graduate students from the University of Michigan's Ford School of Public Policy was engaged to study and support implementation of crowdfunding in Michigan. The team conducted research and analyzed legislative proposals in Michigan and regulatory action at the federal level while interviewing crowdfunding experts and interested parties along the way.

The main takeaway from these efforts is that all stakeholders – small businesses, investors, local governments, and online facilitators - must be well informed before implementing crowdfunding. Only then will this new tool to be successful here in Michigan.

As a result of these discussions and analyses, the Ford School team has developed the following framework for potential investors to consider in order to establish a successful partnership with a local business or startup through crowdfunding.

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Crowdfunding 101: What All Investors Should Know Before Investing Money

Crowdfunding is the process of soliciting funds from the general public, including individuals who do not meet accredited investor requirements, to create projects or fund businesses. However, this general definition only grazes the surface of the crowdfunding landscape. This section will give an overview of how the crowdfunding model has evolved, the various ways it is practically implemented, and why it is an exciting development for investors, individual businesses and the state of Michigan at -large.

Before Crowdfunding - Traditional Models and their Limitations in the Current Market

Under the Securities Act of 1933, most entrepreneurial investment activity revolves around venture capitalists and angel investors. The US Securities and Exchange Commission (SEC) defines these two groups as "accredited" investors, the primary population segment allowed to invest in debt and equity securities, financial instruments that represent an ownership position in a company. Due to the SEC's limitations, businesses generally only have three venues through which they can raise capital – accredited investors, bank loans or to a limited number of non-accredited investors.

Currently, to qualify as an accredited investor, the SEC requires that an individual earn more than $200,000 per year ($300,000 for a married couple) or have a net worth over $1 million, excluding primary residence.[i] Based on 2010 data, the Government Accountability Office estimates that only 7.2% of US households qualify as accredited investors.[ii] With few exceptions, everyone else falls into the non-accredited investor category, and therefore, is unable to participate directly in the securities market.

Defining the Securities Market Right Now

High-risk, high-reward seeking investors generally focus on a few high-technology industries, mainly those in software, biotechnology, medical devices, media and entertainment, wireless communications, Internet and networking.[iii] However, most small businesses are what investors deem "lifestyle businesses" or companies that we are familiar with and visit when we want a bite to eat or someone to fix our cars. Lifestyle businesses do not typically offer the investment returns venture capitalists and angel investors desire, especially within the five to seven year timeline they typically demand.[iv]

And while venture capitalists' hesitation to invest does not close the door on financing options for small businesses entirely, the restrictions of the traditional bank loan market basically does. Ami Kassar writes a blog for the New York Times called "Searching for Capital" in which he routinely profiles the small business lending market. In his post, "The State of Small-Business Lending," Kassar, a loan broker by trade, forecasts doom for the small business community by writing "if you're trying to start a business today, you can almost forget about going to a bank for financing".[v] As of June 2013, the number of non-farm and non-residential loans of $1 million dollars (a common loan amount for small businesses) had declined 27% since June 2008.[vi] And while it

Non-Accredited Investor: an individual that earns less than $200,000 per year ($300,000 for a married couple) or has a net worth under $1 million, excluding primary residence.

Crowdfunding: a funding method where companies raise small amounts of money from a large number of people.

Equity Crowdfunding: allows companies to raise capital from a large number of people in exchange for equity. This is not limited only to individual businesses but could potentially be used to crowdfund *real estate investments*, where investors take an ownership interest in a piece of property.

Crowdfunding for Loans: allows companies and individuals to raise money that will be repaid to lenders after a specified time, typically with an interest rate attached (e.g. Microfinancing, Funding Circle).

Donation-based Crowdfunding: allows individuals to finance companies through individual donations, often with rewards based on the amount pledged (e.g. Kickstarter).

Lifestyle Business: companies set up and run by their founders primarily with the aim of sustaining a particular level of income.

Venture Capitalist: an investor who either provides capital to startup ventures or supports small companies that wish to expand but do not have access to public funding. Venture capitalists are willing to invest in such companies because they can earn a large return on their investments if these companies are successful. They can also experience major losses when their picks fail, but are typically wealthy enough that they can afford to take the risks.

looks like the percentage of small businesses who believe obtaining credit is difficult is down from earlier this year (25%), it still has a way to go before reaching pre-recession lows of 9%.[vii]

Forms of the Crowdfunding Model

Recognizing the limitations of the traditional system, businesses have been exploring opportunities to secure funding outside of traditional financial institutions for years.

The term crowdfunding is not universal and there are multiple options available for businesses looking to raise funds. This means potential investors have a choice of what model best suits their interests and can pick from a variety of investing options.

Donation-based crowdfunding, probably the most well-known form of the model, has gained significant prominence in recent years. The model allows individuals to make a contribution to a project or cause with no expected monetary or non-monetary return. However, project creators can offer non-monetary rewards in exchange for monetary contributions. Reward offerings can range from thank you notes to the final product that the project is aiming to produce, and are typically structured around the level of contribution.

In 2009, US-based Kickstarter launched as a donation crowdfunding portal. Since then, Kickstarter and its patrons have provided more than $820 million in donations to help start and advance small businesses.[viii] While this model is exciting, it also has its drawbacks. On average, online donation campaigns only raise $4,776 per campaign and collect $25 per contribution, numbers too small to sufficiently finance most startup or existing businesses.[ix]

Debt crowdfunding, also known as peer-to-peer lending, allows people to lend money to an individual or company with the understanding that the loan will be repaid with interest. Recent permutations of this model date back nearly a decade. For example, in 2004, Kiva began offering peer-to-peer microlending services online to entrepreneurs all over the world, providing reasonably priced loans to businesses that traditionally would be unable to secure adequate financing. As this type of micro-financing, or crowdfunding for loans, began to expand as a safe and effective financing tool, businesses started to modify the highly successful model to suit their individual needs. This model usually targets a very specific type of business, though almost anyone can be an investor.

The Next Frontier: Equity-Based Crowdfunding and its Market Applications

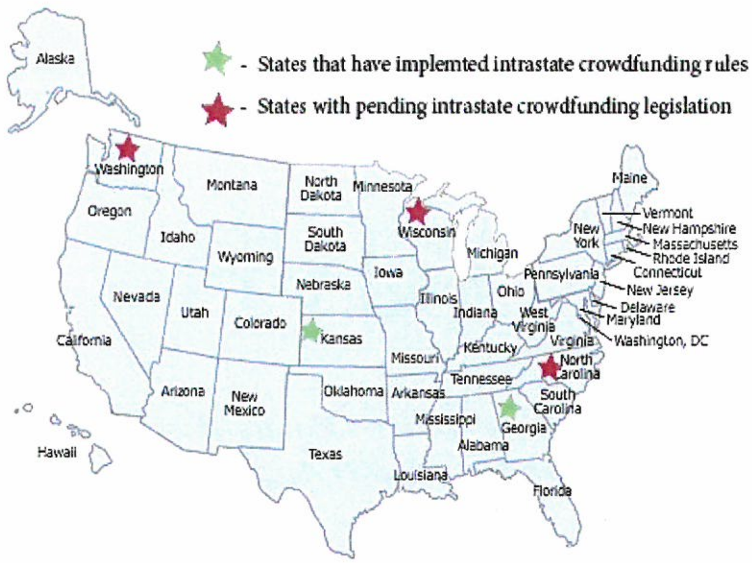
The newest approach to crowdfunding, and the focus of the remainder of this guide, is **equity-based crowdfunding**. Equity crowdfunding allows businesses seeking capital to sell micro ownership stakes, allowing individuals to become shareholders, potentially earning a financial return. This model is not limited to businesses but could potentially be used to crowdfund real estate investments, where investors take an ownership interest in property.

As background, the U.S. Congress passed the Jumpstart our Business Startups (JOBS) Act in April 2012.[x] The Act allows non-accredited investors (about 92.8% of households) the opportunity to invest their money in securities and receive the same protections as wealthy investors. Title III specifically allows individuals to invest up to the greater of $2,000 or 5% of their annual income or net worth if either is less than $100,000.[xi]

However, the SEC has not finalized the regulations necessary to implement the JOBS Act. Though it is expected that the SEC will release proposed final rules (which allow non-accredited investors to participate) within a year, we are not certain what the specific regulations will be.

On the other hand, some forward-looking states like Michigan are using an existing SEC intrastate exemption to open up alternative financing options for local businesses and investors within their state.

Kansas, Georgia and Wisconsin have passed laws allowing open state-based securities offerings for businesses and investors within the state border. Washington and North Carolina currently have legislation pending in their state legislatures. Without these exemptions, you are limited to raising money exclusively from family members and friends, with a cap of 35 investors.

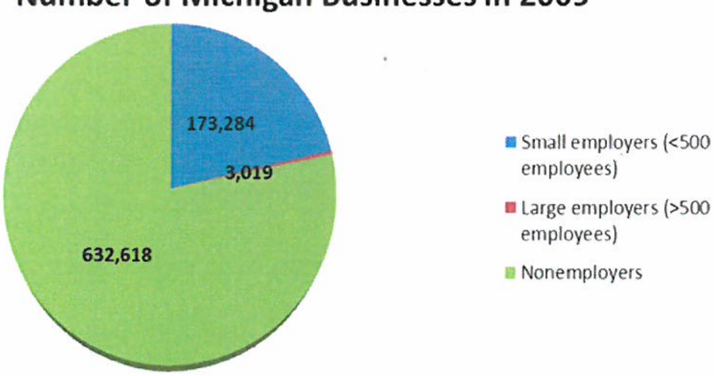


Crowdfunding: How Michigan Can Benefit

Equity crowdfunding is a means to build up small businesses, which are essential to Michigan's economic health and well-being. Small businesses represent 98.3% of all employers and employ 52.3% of the private sector workforce in Michigan. Of the small businesses opened in 2009, over 50% were in retail trade, health care and social assistance, construction, and accommodation and food services.[xii] These industries more commonly contain "lifestyle businesses" – companies set up and run by their founders primarily with the aim of sustaining a particular level of income. These types of businesses may be well suited for the crowdfunding model.

Just as importantly, crowdfunding is also placemaking. Allowing Michiganders to invest in their own towns strengthens ties between local residents and has the ability to create stronger and more inclusive municipalities. Furthermore, investing locally bolsters the local and state economies. Studies have shown that money spent at independent businesses stay within the community at a higher rate than national chains; other studies have shown that shopping at local retailers can have a multiplier effect, re-circulating every dollar spent 8-10 times around the local community.

Number of Michigan Businesses in 2009



Source: US Dept. of Commerce, Census Bureau, Bureau of Economic Analysis

Local retailers are more likely to hire and source from their surrounding community, stimulating the local economy and creating more jobs. In fact, a study comparing independent businesses and chains found that local retailers returned 52% of their revenue to the local economy, spending more on local labor, goods for resale and services. In comparison, national chains only returned 14% of their revenue.[xiii]

Small Businesses in Michigan by Industry (2008)

U.S. Dept. of Commerce, Bureau of the Census, Stats. of U.S. Busi-

What Investors Must Consider Before Participating in Crowdfunding

As an investor, it is important that you understand the potential risks and rewards that crowdfunding can offer and how this tool could impact your overall financial condition. We recommend that potential investors review the following considerations to determine if equity investing in a small business or startup company is a sound personal financial decision. Our considerations are divided into two distinct parts:

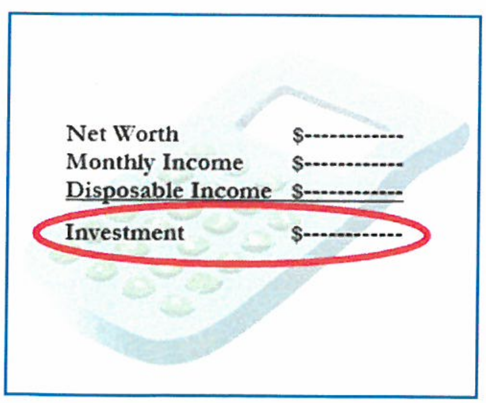
1) Deciding if crowdfunding right for you; and
2) Deciding if a particular business is a good fit with your investment goals.

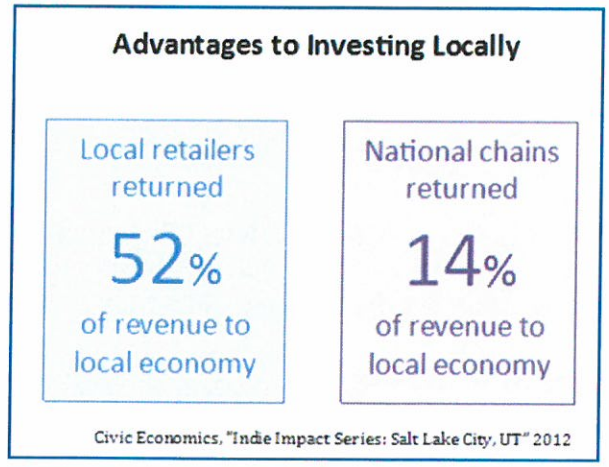
Considerations: How Compatible Are Your Crowdfunding and Investment Goals?

Crowdfunding is a new and potentially powerful financial tool that can be used by non-accredited investors who were previously unable to participate in the direct investment market. This expansion to non-accredited investors is an exciting opportunity that requires a substantial amount of due diligence – determining investment amount, understanding risk, tax implications, investment goals, and evaluation. There are some steps that you, as a potential investor, should consider before choosing to commit financially to a crowdfunding campaign. Understanding the risks and benefits of crowdfunding will ultimately make you a more informed and successful investor in this new space. It may be wise to consult with your local government entities or downtown development authorities to take advantage of any educational resources they may provide.

Determining the Appropriate Investment Amount: It is important to think about how securities fit into your overall financial portfolio in the short- and long-term. Michigan has set an individual cap for non-accredited investors of $10,000 per entity over a 12-month period. While $10,000 is the maximum, the "right" amount may vary by investor and project. Furthermore, $10,000 is only the maximum per project – you may decide to invest in multiple businesses.

Investing in a crowdfunding campaign is a decision that can heavily affect your overall financial situation. Therefore, as an investor, you must proactively determine how much you can reasonably afford to invest, and potentially lose, in a given entity. Before participating in a crowdfunding campaign, you should consider the value you place on the investment, both monetarily and philosophically, and how a crowdfunding investment differs substantially from investments that you may have made in the past. For example, crowdfunding will likely involve a more personal ongoing relationship between investor and business, whereas traditional investments may have involved less contact and been more passive. Some crowdfunding investments have the potential to yield financial returns, while others will help create a stronger community. While not necessarily mutually, exclusive these differences should be considered prior to your participation.





Must Accept Some Risk: You should be fully aware of the risks associated with crowdfunding and the potential impacts to your personal finances. Ultimately, you must be prepared to potentially lose some or all of your investment. You will be required to certify your understanding of this consideration in writing during the initial investment period.

Tax Implications: Financially, crowdfunding investments may have an impact on your annual tax obligations, and your financial outlook both in the short- and long-terms. Accordingly, you should be aware of these and any similar consequences before you participate in a crowdfunding campaign.

Long-Term Investment Goals: Crowdfunding creates a relationship between a business entity and a group of investors. Further, the recent legislative action in Michigan specifically targets non-accredited investors who may be unfamiliar with the many intricacies of investing. It is important to understand how the investing relationship will evolve over time and consider from the outset any potential exit opportunities. This process will involve you coming to a decision on a timeline for your investment. You must determine whether you intend to make a long-term or short-term investment consider each of these scenarios as a part of your overall investment strategy.

Periodic Review and Reevaluation: Since crowdfunding establishes a long-term relationship between business and investor, it is important that you decide upfront how you will review your investment. Think deliberately about what would make this investment a success or failure.

- Are you expecting a personal financial return? If so, how much do you expect and over what time period?
- Would you be satisfied with a more limited personal return if the local business were continuing to operate, thereby contributing to your local community and the local economy?

Answering these types of questions will help facilitate a meaningful dialogue between you and the business owner and will also help set proper expectations from the outset.

Considerations: Is this Business a Good Fit?

Determining whether crowdfunding is well-suited for your investment objectives is only the first step. You must then carefully evaluate the compatibility of specific investment opportunities with your goals.

Issuer Must Disclosure Detailed Business and Investment Plans, Use Them: While each business is unique, and as such, will likely approach crowdfunding differently to fulfill their specific needs, there are some considerations that all non-accredited investors should be especially mindful of when examining securities offerings. Each business entity seeking to raise capital through crowdfunding must make available both the terms and conditions of the investment and their business plan. You should examine these plans carefully, and make sure you are comfortable with them before investing. At the very minimum, you should understand the company's mission, its management team, the company's plan for using the capital it is seeking, and your role, as an investor and equity shareholder, in the operations of the company.

Goal Alignment: You should understand your role and responsibilities as an investor in the business, and determine if these expectations are compatible with the business' interests. It is important for the success of the investment that both the business entity and investors have similar expectations in terms of their business relationship and investment returns. In examining your role and responsibilities as an investor, you should feel comfortable in how the business intends to use your investment and in its long-term strategic vision. Specifically, consider the market that this business occupies, the challenges associated with operating in such a space, and the business' ability to fulfill all legal responsibilities to government regulators and its shareholders. Think about how volatile this business is to outside influences, including what competition or challenges might the business face in reaching the goals outlined in their business plan. Furthermore, investors should examine a company's business plan and consider whether their future goals are something worth investing in. Lastly, if you have a personal relationship with the business, determine whether that is a significant factor that could play into your investment decision.

Requirements after HB4996 Checklist

In the end, investing is a complicated personal decision, especially for non-accredited investors new to this area. If you are ever unsure about an investment or have any questions, consult a professional before proceeding. But if you plan on crowdfunding, make sure you meet the following requirements or take the following steps:

1. Be a resident of Michigan
2. Only invest up to $10,000 per issuer over a 12-month period
3. Read and understand Disclosure Statement
   - o Understand the company's mission, its management team, the company's plan for using the capital it raises, and your role as an investor and in the operations of the company
   - o Be aware of the minimum target offering and your right to cancel your investment if this minimum is not reached by the time specified in the Disclosure Statement
4. Certify in writing and initial next to each paragraph of the certification document
5. Deposit funds for securities with bank or other financial institution identified by the issuer in the Escrow Agreement
6. Access and read Quarterly Report filed by the Issuer

Endnotes

[i] 17 CFR § 230.215
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[iv] Anderson Center for Entrepreneurship & Innovation, "Growth vs. Lifestyle Businesses". http://www.andersoncei.utk.edu/competitions/undergraduate-business-plan-competition/growth-vs-lifestyle-businesses/
[v] Kassar, A. (2013, January 8). The state of small-business lending. *The New York Times.* Retrieved from http://boss.blogs.nytimes.com/2013/01/08/the-state-of-small-business-lending/?_r=1
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[viii] *Kickstarter-stats.* (2013). Retrieved from http://www.kickstarter.com/help/stats?ref=footer
[ix] Reconsider Tech Sheet, pg 1.
[x] Jumpstart Our Business Startups Act (JOBS Act), H.R. 3606 (Apr. 5, 2012)
[xi] Jumpstart Our Business Startups Act (JOBS Act), H.R. 3606 (Apr. 5, 2012). Title III, Sec. 302 (a)(B)(i)
[xii] U.S. Small Business Administration, Office of Advocacy. (2012). *Small business profile: Michigan*
[xiii] Civic Economics, "Indie Impact Series: Salt Lake City, UT" 2012

Stakeholder Interviews

Angela Barbash, CEO/Founder, Reconsider; CEO/Investment Advisor, Revalue
Jeff Bekiares, COO, SparkMarket
Deborah Burand, Clinical Assistant Professor of Law, International Transactions Clinic, University of Michigan School of Law
Amy Cortese, Journalist, Editor, Author of *Locavesting*
Robert Guenzel, Retired Washtenaw County Administrator and Lecturer at the Gerald R. Ford School of Public Policy
Donald Hart, Financial Director, Practice Space
Kevin Hitchen, Co-Founder, Localstake
Representative Nancy Jenkins (Clayton), Michigan House of Representatives
David Klingenberger, CFO, The Brinery
Adam Lee, CEO, Bohemian Guitars
Susan Pollay, Executive Director, Ann Arbor Downtown Development Authority
Craig Ruff, Special Advisor to the Governor on Education and Lecturer at the Gerald R. Ford School of Public Policy
Paul Schrieber, Mayor of the City of Ypsilanti
Skip Simms, Ann Arbor SPARK

This report was written by Chris Falcone, Matthew Papadopoulos, Erin Sullivan and Jessica Teng, Master of Public Policy students at the University of Michigan's Gerald R. Ford School of Public Policy. It was written for the City of Adrian as an assignment for Professor Elisabeth Gerber's Applied Policy Seminar (APS), a semester-long class in which students consult for clients on real life projects. The views expressed in this report do not reflect the opinions of the University of Michigan. Because we are not financial advisors, we recommend consulting professionals before crowdfunding or investing.

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