INFORMED INVESTOR ALERT
CROWDFUNDING

The Internet has become an inexpensive and easy way for individuals and businesses to raise money for their activities. But easy money can often mean big fraud. Under the new JOBS Act, there will be much less regulation and review by authorities to keep the market place safe. So investors beware. Investors should be on the lookout for unscrupulous issuers and intermediaries who may attempt to engage in crowdfunding through false and misleading representations.

WHAT IS CROWDFUNDING?

Crowdfunding is an online money-raising strategy that began as a way for the public to donate small amounts of money, often through social networking websites, to help artists, musicians, filmmakers and other entrepreneurs to finance their projects. The concept has recently been promoted as an easy way of assisting small businesses and start-ups looking for investment capital to help get their business ventures off the ground.

Traditionally, investment opportunities are offered by professionals such as broker-dealer agents and investment adviser representatives, who have a duty to recommend investments that are based on their clients' investment objectives and levels of sophistication. Through crowdfunding, individuals are able to invest in entrepreneurial start-ups through an intermediary, such as a "funding portal." By law, "funding portals" are not allowed to provide investment advice and most likely will not have a duty of care toward clients' investments.

WHAT IS A FUNDING PORTAL?

A funding portal is a website, also called a "platform," that advertises the investment opportunities and facilitates the payment from the investor to those looking for money. Some portals advertise a variety of investment opportunities on one website, allowing the investor to select one or more projects in which to invest.

HOW CROWDFUNDING WORKS

Right now, crowdfunding sites do not give investors equity ("stock") in the company. Instead investors get other kinds of premiums or "gifts". For example, Joe's small business sells goat cheese made from his special pygmy goats. To keep his business afloat or to help it grow, Joe can turn to the Internet to seek online donations from the public who contribute small amounts of money and expect no profit in return, but may expect an in-kind gift. Joe usually sends a sample of his cheese as a thank you for the donation; large donors might even get a cheese named in their honor.

New legislation has directed the SEC to write rules that will change how Joe can raise money online. Once the rules are written, Joe will be able to use the Internet to raise up to $1 million each year by selling investments like stocks in his company to thousands of investors. Because Joe will be issuing shares in his company in exchange for investment capital, his supporters are no longer donors; they become investors and will expect a financial return for their investment. But the investor should beware because under the new laws, neither Joe , his business or his offer will be vetted by securities authorities. Investors will be on their own.

WHY INVESTORS MUST BE EXTREMELY CAUTIOUS ABOUT CROWDFUNDING INVESTMENTS

- The lack of regulation and a physical presence of companies selling their shares over the Internet means losing money is fast and the ability to close shop and disappear is easier than ever.

- Because state regulators are not allowed to review crowdfunding issuers or their offerings, full and complete disclosure may not be available to investors.

- All investments have risk, but small business investments have even greater risk than normal. About 50 percent of all small businesses fail within the first five years.

- The information about the investment is limited to what is provided through the funding portal. Investors may need to rely on their own research to determine the issuer's track record. Securities regulators will not have authority to review or vett the issuer, offering or business.

- Investors may have limited legal ability to take action against the issuer should the investment not perform as represented. Due to limited regulatory oversight over these offerings, investors may be left on their own to pursue costly private lawsuits when things go wrong.

- Crowdfunding investments (i.e. shares of stock) cannot be offered legally until the SEC adopts rules to permit them. Beware of offerings that seek investments immediately.

- Issuers using funding portals to raise money may be inexperienced. Their track records maybe unproven, unsubstantiated or outright fraudulent.

- Crowdfunding investments are mostly illiquid. "Liquidity" or being able to cash out whenever you want is usually not available in small business investments and investors must be prepared to hold their investments indefinitely. This is because it may be difficult or impossible to resell these securities. There are usually very few resale buyers for small companies. The ability to resell is called a "secondary market".

- Funding portals must be registered with the Securities and Exchange Commission (SEC), belong to a self-regulating organization (SRO), and comply with other rules the SEC may issue. If you are using a funding portal, you should check their registration.

- Crowdfunding portals claiming an accreditation or "seal of approval" from a standards program or board may not be legitimate.

THE BOTTOM LINE

It pays to be skeptical of investment opportunities you learn about through the Internet. When you see an offering on the Internet — whether it is on a funding portal, in an online newsletter, on a message board or in a chat room you should be cautious until you have done your homework and proven that it isn't a scam. If you have any questions about how crowdfunding works, contact the Hawaii Securities Branch at (808) 586-2740.

(Source: North American Securities Administrators Association (NASAA) Investor Education Program. For more information visit the website at nasaa.org)