



Why Venture Capital Will Not Be Crowded Out By Crowdfunding

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1. Introduction

As the recovery period from one of the worst recessions in our history continues, life for fledgling and even experienced entrepreneurs has been tough.¹ Indeed, President Obama remarked “credit’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 business off the ground.”² In response to the 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, 2012.³ Among other things, the JOBS Act increases a business’s access to capital by enabling them to sell securities to both accredited and non-accredited investors without completing the full disclosure requirements typically required for public offerings.⁴ More specifically, Title III of the Act, which is likely to go into effect in 2014⁵, presents the option for an issuer, (the company), to use the Internet to access capital from public investors (the “crowd”) at much lower costs than in a registered offering and with fewer regulatory burdens than in an exempt unregistered offering. This concept, which has been termed “crowdfunding”, refers to the practice of using the Internet to raise capital by way of small investments from a large number of investors.⁶ Allowing non-accredited investors to invest in private, startup companies will not only challenge 80 years of securities doctrine, dating all the way back to the Securities Act of 1933 (“Securities Act”),⁷ but it will also change the investment landscape for startup companies.

In fact, the landscape may change so dramatically that one of the most prominent venture capitalists, Fred Wilson, suggested that venture capital could be swept away altogether by a flood of crowdfunding money that will be unleashed by the JOBS Act.⁸ According to his line of thought, if each family or individual invests 1% of their assets in crowdfunding, it will equate to around \$300 billion, which is 10 times greater than the \$30 billion that VC funds have deployed per year, on average, over the past few years.⁹ The logic follows that since the \$300 billion in crowdfunding, which has been said to be a conservative measure in other pundits’ views,¹⁰ will dwarf the amount that venture capitalists put into the system, then their role as aggregators of cash will be minimized, leading to less utility and an overall decrease in their value.¹¹ Wilson also noted the concerns that too much money may be going into closed-end funds and that other ways of funding new companies are outper-

forming investments made by VCs.¹² The genesis of crowdfunding as an option for entrepreneurs who are looking to raise capital will have a significant effect on the VC industry. The converse is true as well, in that traditional means of financing, specifically VC funding, will have an effect on crowdfunding. Beyond the impact that crowdfunding and traditional VC funding will have on each other lie many other perils for companies looking to crowdfunding as means of financing and for investors seeking to invest through crowdfunding portals.

The goals of this paper are: 1) to explain and analyze the relationships and overall dynamics that will exist between crowdfunding and VCs; 2) to elucidate why investors should avoid or, at the very least, be wary of investing money through the crowdfunding medium; and 3) to elaborate on the reasons that crowdfunding should only be used as a last resort for budding entrepreneurs. Part 2 of this paper will highlight the different methods startups have used to obtain capital prior to the enactment of the JOBS Act, and the crowdfunding provision. VC funding will be the main focus here. The relationship between the inability to access capital and the failure rate of a startup will be analyzed. This Part will also examine the high failure rate of startups with an emphasis on VC’s expectations and strategies. Part 2 will conclude by citing the reasons that the demand for financing from startup companies is not being met. Part 3 of this paper will inspect and scrutinize the JOBS Act with a specific focus on Title III: Public Securities Crowd Investing. This Part will spell out how non-accredited investors will be able to participate in investing in startups, including the investment amount limitations and required company disclosures that will be provided to investors. Finally, an in-depth analysis will be conducted and viewed from the investor’s perspective and the company’s perspective in highlighting potential complications that may arise through participation in crowdfunding activities. In the context of investors, the focus will be on fraud and the risks associated with not having appropriate VC protections. Shifting to the lens and perspective of the company, the focus will be on the negative consequences of resorting to crowdfunding; namely the deterrence of potential funding from VCs in the future.

Part 4 of this paper reaffirms the notion that crowdfunding and VCs can, and will, coexist. This part will propose some practical solutions that properly balance

the JOBS Act's goal of increasing access to capital for startups and the SEC's objective of protecting investors, especially non-accredited investors, from fraud, malfeasance, and other unintended consequences.

2. Startup Financing

A. Overview

It is estimated that around two million new businesses are formed each year, of which around 550,000+ are considered "startups."¹³ To understand the different financing rounds, or funding stages, that a startup company proceeds through, it is best to think of the new venture on a timeline. On the far left is when the idea of the business was conceived, and the business model was created. The company then moves from left to right as the idea gains credibility and forward momentum.¹⁴ Throughout this process, ideally the company is hitting the milestones previously put in place by investors like VCs and angels, resulting in the new rounds of funding along the way. These funding rounds are known as the seed round, Series A round, Series B round, Series C round and so on, with the goal if an eventual exit for the investors, which generally means either an IPO or an acquisition.¹⁵

Traditionally, nascent companies are initially funded through credit cards and savings ("bootstrapping"), and then the entrepreneur may reach out to friends and family.¹⁶ This effort may cover up to about \$250,000, and then the startup will look elsewhere for funding.¹⁷ Angels, who are high net worth, accredited investors seeking high returns through private placements in startup companies, may be approached at this point. Angels are typically looking to invest an amount ranging from \$10,000 to \$1,000,000.¹⁸ Angels are normally seeking high growth potential companies and often focus solely on particular industries where they have particular expertise or at least familiarity.¹⁹ Assuming that the company is fortunate enough to receive angel funding,²⁰ once that amount has been exhausted, the startup will typically turn to VC firms for further funding. Although this process may sound simple, in practice, obtaining the necessary funding at the different stages of development can be so difficult that many businesses fail due to lack of money.²¹

B. Lack of Funding and the Funding Gap

It is well known that small businesses often face an uphill battle when attempting to raise money through both traditional and alternative 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 post-recessionary times that are affected by tighter underwriting standards imposed by banks.²³ Estimates suggest that there is a \$60 billion shortfall in the supply of early-stage private equity financing each year in relation to total demand.²⁴ A joint report by PriceWaterhouseCoopers and the 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 in the smallest number of early stage deals compared to the other stages of portfolio company growth.²⁵ To provide context, in 2012 VCs invested in 3,826 deals in total, of which only 876 were early stage investments (22.8%). In contrast, in 2001 VCs invested in 4,590 deals in total, of which 1,321 were early stage investments (28.8%).²⁶ Just over a decade ago, the chance of obtaining VC funding was more likely than it is now, especially at the earlier stages of development. Nevertheless, procuring VC investment has never been an easy feat. In fact, it has been said that for every 30-40 investment proposals that slide across the desk at a VC firm, only one will be invested in.²⁷ So, the question becomes: if startups have a dire need for funding at an early stage of development, then why are VCs failing to meet this demand?

C. Venture Capital Funding

VCs are very selective and offer only limited assistance to startups; investing on average less than a quarter of their total investments in early-stage companies.²⁸ This can be attributed to two main reasons. First, VCs mainly seek to invest greater sums of money – on average between \$2 million and \$10 million – than startups require.²⁹ Second, VCs have a preference for investing in less risky companies – those having already endured the initial startup phase to advance with proven track records and clearer exit prospects.³⁰ In 2012, the median U.S. fund size was \$150 million, which was a 12% increase from the median size of \$134.5 million in 2011.³¹ Normally, VC funds, despite getting hundreds or even thousands of investment proposals, invest in 10-12 portfolio companies.³² The general partner, or VC firm, is responsible for sourcing, evaluating, and negotiating the terms of the investments that are made in the startup companies.³³ Therefore, the ability of investment funds to invest is constrained by the ability, expertise, and experience of their managers.

Resource-Constraint

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.³⁴ 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 fund is therefore resource-constrained with regard to human capital,³⁵ and this is one of the major reasons that VCs fail to meet the demand for financing of startup companies.

Counter To VC Model

Another key reason that VCs do not meet the demands of startups seeking financing relates to their high risk of failure and the limited partners' expectations in terms of return on investment.³⁶ The NVCA estimates that 40% of portfolio companies fail, 40% of portfolio companies return moderate amounts of capital, and only 20% (or fewer) produce high returns.³⁷ In another study conducted by Shikhar Ghosh, Senior Lecturer at Harvard Business School, no matter how "failure" is defined, the statistics are still discouraging.³⁸ Ghosh states that the failure rate is much higher than the industry may report, with as many as three-quarters of venture-backed firms in the U.S. not even returning investors' capital.³⁹ Consequently, VCs have to hit home runs if they want to give their limited partners a respectable return on their investment.⁴⁰ 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, to make up for the underachievers in the portfolio.⁴¹ 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.⁴² This 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, and life sciences.⁴³ As a result, many startups outside of those industries may go unfunded, because being profitable is not enough. For example, even though a 10% return would be a great return for a retail investor investing in common investment products, 10% is not a very good return for a portfolio com-

pany. In sum, the selectivity and the stringent investment criteria VCs call for limits the universe of startup companies that can be candidates for VC funding.

Geographic Limitations

In addition to the inability of VCs to properly evaluate and monitor numerous portfolios and the need to invest in specific kinds of business models that have the ability to be "home runs", simple logistics also play a role in VCs failing to meet the high demand for financing by startups.⁴⁵ As mentioned earlier, VCs tend to be actively involved in the portfolio companies, meaning they have significant participation in and oversight of each portfolio company.⁴⁶ Accordingly, VC investment is inherently a local, or at most, a regional activity.⁴⁷ Data from 2010 and the first half of 2011 reveals that the top five regions for VC investment accounted for roughly 76% of the total VC investments made.⁴⁸ More specifically, the data shows that approximately 39% of total VC funding by region was invested in Silicon Valley.⁴⁹ Thus startups located in less prominent areas go unfunded.⁵⁰ Lack of funding often precipitates the high failure rate among startup companies. With this in mind, the JOBS Act was created to help alleviate this problem.

3. Crowdfunding

A. Overview

The concept of crowdfunding, or collecting small amounts from the general public in support of a larger goal (e.g. a politician collecting small donation amounts from general public to win an election), is nothing new; however Internet-based crowdfunding is relatively new.⁵¹ Crowdfunding originated in the United States as a "donation" model in which people provided money to fund different projects without expecting to receive an ownership interest or profit in return.⁵² There are different types or uses of crowdfunding that can be categorized by distinguishing what the investor is promised in return for their contributions: 1) donation model; 2) reward model; 3) pre-purchase model;⁵³ 4) lending model (peer-to-peer lending); and 5) equity model.⁵⁴ The first four types of crowdfunding have been legally put into practice in the past; however the fifth type, the equity model, is what Title III of the Jobs Act enables. The equity model differs from the other types, because here the contributor of funds expects to receive a share of the profits or return of the business they are helping to fund; this causing the transaction to be deemed a sale of securities and therefore subject to federal securities laws.⁵⁵ Unless an exemption applies, a sale of securi-

ties 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 “Regulation Crowdfunding,” increases a business’s access to capital by allowing them to sell securities without registering or completing the complete disclosure requirements ordinarily mandated for public offerings. The goal of the Regulation Crowdfunding 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.

How Does It Work?

Under the Regulation Crowdfunding, a company will be able to raise up to \$1 million over a twelve-month period. Crowdfunding websites will display business plans/funding requests on their site and anyone will be able to view them and decide whether to invest or not. Individual investors will be limited to contributing: i) 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 ii) 10% of annual income or net worth, not to exceed \$100,000, if either annual income or net worth is more than \$100,000. The transaction is required to be done through a “broker” or “funding portal” that must comply with certain disclosure requirements. 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. The Regulation Crowdfunding also encompasses other rules and requirements such as provisions that the company will disclose how the funds will be used, will be audited if it raises \$500,000+ within the 12-month period, will agree to a broad-based background check conducted by the intermediary, and others stipulations intended to preclude fraud and protect investors.

Crowdfunding could very well mark a “revolution in how the general public allocate[s] capital,” or at a minimum it may democratize the process of deciding how and whose ideas are financed. In fact, the impetus for passing Title III 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.”

Copious examples of non-equity based, large, successful crowdfunded projects exist such as the “Pebble” proposal in which over \$10 million was raised in just thirty-six days to fund a highly customizable wristwatch that works in unison with a smart-phone. Crowdfunding has the potential to provide startups with access to a completely new class of potential investors and thus to new sources of capital. It has been successful in the past under the non-equity based categories and it has been publicly endorsed and even signed into law, so what are the downsides to crowdfunding?

B. Problems With Crowdfunding

Investor Perspective

i. Fraud

To achieve the goal of increasing a small businesses’ access to capital, the Regulation Crowdfunding decreases the number of regulatory hoops that parties must jump through in order to participate in an exempted crowdfunded offering.⁶⁶ With less regulation under the crowdfunding exemption, for potential investors, there is a greater risk of fraud. One of the main reasons that security regulations exist is to prevent fraudulent dealings by issuers.⁶⁷ 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 ii) their financial sophistication aids them in better comprehending the risks affiliated with such investments.⁶⁸ 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 shown that the general public is largely financially illiterate.⁶⁹ The unsophisticated investor will have a much more difficult time understanding the risks associated with crowdfund investing.⁷⁰ Moreover, issuer disclosures are usually distributed to investors in a very dense form containing financial verbiage that is unfamiliar and unintelligible to the average small investor.⁷¹ As noted by two law professors recently, disclosures are often too long and complex, and when an ordinary investor is inundated with them, they lack the necessary skills to identify and fully comprehend what the information means and how to use it effectively.⁷²

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.⁷³ Most people are familiar with the concept of cybercrime, or fraud conducted over the Internet; yet people may not real-

ize that a considerable amounts of securities fraud has been conducted over the Internet in the recent past.⁷⁵ In 1992, in a very similar manner 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. 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.⁷⁶ Soon thereafter, numerous cases of security fraud were brought forth.⁷⁷ Specifically, “pump and dump” schemes occurred in which an unscrupulous promoter would: 1) purchase a very low priced, thinly capitalized, and relatively unknown stock, known as a “microcap” stock; such stocks were often not covered by professional analysts; 2) endorse and stimulate buying activity around the stock, using the Internet to reach the public; and then 3) sell the stock at an artificially inflated price, which is caused by the momentum built from using the Internet to garner interest from the public in the first place.⁷⁸ The promotional materials frequently were comprised of misrepresentations of the microcap stock and price would often crash once the promoter dumped his or her position, leaving the investors with practically nothing.⁷⁹ The scheme was made possible due to the SEC’s decision to eliminate the restriction on general solicitation and advertisement.⁸⁰ This phenomenon serves as a reminder that some fraudulent activities in financial markets that are closely connected to the Internet.

One final view on why crowdfunding may lead to trouble for investors revolves around the disincentive investors will 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 are less than \$100,000; up to 10%, not to exceed \$100,000, if annual income or net worth are greater than \$100,000), it does not make economic sense for an investor to sue for damages.⁸¹ It is not practical for an investor to sue, even though a private right of action is enumerated in the Regulation Crowdfunding. The most an investor will be able to contribute towards a crowd-funded venture is between \$10,000 and \$100,000, and often investors will have contributed even less (closer to the \$2,000 mark), therefore it is unlikely investors will have sufficient damages to warrant bearing the costs associated with litigation (a private suit brought by an individual could be cost-prohibitive).⁸² Moreover, even a successful lawsuit might not results in the recovery of

losses “since it is possible that the crowdfunding issuers are ‘uncollectible.’”⁸³ A class action lawsuit may not be a viable alternative, given that the total offering amount for a crowdfund exemption is capped at \$1 million.⁸⁴ The economic impracticality of this situation may be viewed from an attorney’s perspective as well. Typically, an attorney litigating this type of matter would be working on a contingent fee basis (normally 20-30% of the award, if the suit is successful), which would not be worthwhile for the attorney to undertake.⁸⁵ Given the small, investment amounts and the attorney’s fees associated with litigation, it is clearly unappealing and economically impractical to imagine recourse through the court system.

In conclusion, the problem of fraud is derived from the fact that the company (entrepreneur) has all of the power. As one professor explains, “[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...”⁸⁶ This scenario lends itself to fraud and investors need to be cautious in making their investments through the Regulation Crowdfunding.

ii. Horizontal Risks and the Absence of VC Protections

Assuming the investor makes a sound investment into a successful startup company through a crowdfunding opportunity, and the company conducts itself in a legitimate manner, the investor still may not realize an above-average financial return (high risk-high return concept) due to the absence of investor protections against horizontal risk. The concept of horizontal risks relates to the fact that promising investment opportunities in startups appeal to competing investors, who are often sophisticated VC’s.⁸⁷ Without adequate protections similar to those available to VCs, an early-stage crowdfunding investment, even in a successful startup company, can result in significantly lower financial returns.⁸⁸

The concept of horizontal risks was depicted in The Social Network, when Eduardo Saverin’s ownership stake was diluted from his original 30 percent stake down to less than 1 percent when Facebook obtained VC financing. In that case, other pre-existing ownership interests, including Mark Zuckerberg’s stake were, at most, minimally diluted.⁹⁰ Saverin’s failure to negotiate the

essential investor protections led to this substantial dilution. Similarly to Saverin's situation, individual crowdfunding investors will not be in a position to negotiate the kinds of protections that VCs demand.⁹¹ Professor Bradford explains the dilemma by arguing that most crowdfunding investors will not have the knowledge or experience necessary to understand the role of control rights or protective covenants. Furthermore, even if a crowdfunding investor grasps the importance of such protections, it is uncertain how he or she would negotiate for the protection. "The small amount invested by each crowdfund investor and the remote, impersonal nature of crowdfunding preclude any meaningful negotiation."⁹² The overarching concept of the VC being in a position of power, seeking control of the startup, and diluting prior investors in the process is not novel, nor is it exclusive to crowdfund investors.⁹³ In fact, the problem known as minority shareholder oppression has existed for years and is specifically referred to by different names, including squeeze-outs, freeze-outs, or washouts.⁹⁴ In substance, these are all VC "tools" that can take advantage of pre-existing early-stage investors by reducing the value of their shares by very significant amounts.⁹⁵

Clearly, crowdfund investors should proceed with caution. As painful as it would be for a crowdfund investor to contribute capital to a mismanaged, failed, or fraudulent startup company, it would be even more unfortunate for the investor to invest in a startup that ultimately becomes a tremendous success and yet fails to earn an adequate return for him or herself, while the later stage VCs profit immensely.⁹⁶

Company Perspective

Companies seeking investments from crowdfund investors should also be aware of potential problems. The use of crowdfunding can result in a situation where VCs will be deterred from investing in future rounds of financing for a number of reasons.⁹⁷ Crowdfunding creates a capital structure that is unappealing to VCs. VCs have little interest in competing with masses of retail investors, because they do not want to deal with the inconveniences that may arise from having numerous shareholders; major concerns include potential corporate actions that would trigger voting requirements and approval.⁹⁸ A large, diverse shareholder base could very well lead to a logistical nightmare. In addition, deals with many small and unsophisticated shareholders can introduce an increased likelihood of lawsuits and liabilities

for VCs down the road; a risk exposure that VCs would certainly seek to avoid.⁹⁹

Beyond discouraging later investors, like VCs, from investing due to such risks, the use of crowdfunding in the first place may create an unintended signaling problem.¹⁰⁰ One viewpoint might be that only the riskiest companies will be the ones seeking crowdfunding, because the entrepreneur's family, friends, and business associates denied them.¹⁰¹ In other words, crowdfunding may be seen as a last resort, or a sign that the venture is even riskier than the typical startup. It has been argued that this is 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."¹⁰²

4. Conclusion

In the early days, VCs were seen as great investors and job creators. More recently, reports have criticized VCs as providing lower than expected returns while being much too dominant and severe in their deal terms and demands.¹⁰³ Despite the criticisms, VCs are experienced investors and often become value-added partners in the development of their portfolio companies. VCs provide substantial amounts of funding, invest in multiple rounds of investment, participate in active management of the company, and make introductions that help lead to more business or funding over time.¹⁰⁴ Due to the advantages of association with high quality VCs, crowdfunding will not replace VCs in the case of startups that fit the proper investment profile. However, as the anecdotal evidence shows, VCs turn down up to 99% of the business plans that are submitted to them, which attests to the point that crowdfunding and traditional VCs will coexist. VCs target particular kinds of companies, which leave companies outside of that specification in desperate need of funding from alternative sources like crowdfunding. Some observers have predicted that crowdfunding investors and VCs may end up investing in the same kinds of companies.¹⁰⁵ The argument is that the online portals, or crowdfunding websites, are accessible by VCs too, so they will have the opportunity to analyze companies they might have missed initially.¹⁰⁶ 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.¹⁰⁷ Since the interactions are likely to be dynamic, what can be done to protect the

various parties involved?

Solutions

The SEC will undoubtedly play a key role in curbing fraud in the crowdfunding realm.¹⁰⁸ The SEC is tasked with creating rules and requiring certain disclosures; their task is complex due to the inherent conflict in allowing companies to access capital more easily and cheaply from a broader range of investors, while also protecting those investors effectively.¹⁰⁹ If the SEC introduced too many complicated rules in the course of enabling crowdfunding, then it would have defeated the purpose of Title III of the JOBS Act. Suggestions that might have served to complicate the process included creating a “semi-accredited” investor class to ensure that investors are sophisticated enough to understand the risks and low probability of success of their investments. While the SEC struck a balance between freedom to explore this new form of investment and adequate protection for the participants, the true test lies in how the online portals conduct their operations.

Online portals must be thorough in their reviews, background checks, and other 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 in turning down companies not deemed to be worthy of investment.¹¹¹ The more reputable and trustworthy these third-party intermediaries are, the less likely that fraud will occur.¹¹² Taking the concept 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/feedback.¹¹³ This will help to impede fraud, yet it will not be a solution for 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.¹¹⁴ Price-based dilution occurs when shares are issued at subsequent round at a lower price per share than what the existing investors paid (a “down-round”).¹¹⁵ Without price-based anti-dilution protection, crowdfunders could see the value of their existing investment be reduced to a nominal value following subsequent rounds of financing. Share-based dilution occurs when the company issues additional shares of common stock, which makes the convertible

preferred stock held by crowdfund investors much less valuable.¹¹⁶

Fortunately, there are anti-dilution protections available and commonly negotiated for, in addition to other types of protections such as tag-along rights and preemptive rights.¹¹⁷ 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 contracts being negotiated with VCs, crowdfund investors would at least have the protections initially - whether they remained in the contract pursuant to the negotiation would be determined on a case by case basis. Even so, standard contracts with this boilerplate language would provide a better starting point in the negotiation for the crowdfund investor.

Along the same theme of investor awareness, another potential solution to horizontal risk would be an easy-to-read disclosure table.¹¹⁸ The table would highlight what investor protections the particular investee/company was offering.¹¹⁹ 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, however investors and investees contemplating involvement should proceed carefully. Beyond the more obvious risk of fraud are more obscured 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 may dissuade larger, later-stage investors like VCs from participating in follow-on rounds of funding.

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