Information for Investors
INFORMATION FOR PROSPECTIVE INVESTORS
"CROWD WISDOM"1 OR "THE MADNESS OF CROWDS"2?
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The crowdfunding rules adopted by the State Securities Board allow any resident of the state, regardless of income or net worth, to invest in a private securities offering by a Texas small business.

The rule applies only to intrastate crowdfunding, which limits investments to companies based in Texas and which derive most of their revenue from operations in Texas. Still, it greatly expands the pool of potential investors for private small businesses and startups.

Prior to the rule, a company offering securities exempt from registration was prohibited from accepting funds from investors in offerings using the Internet or other forms of general solicitation unless the investors were "accredited" investors. An accredited investor must meet certain income or net worth requirements.

The new rule permits non-accredited investors to spend up to $5,000 to acquire equity through crowdfunding. There is no cap for accredited investors.

Depending on circumstances, issuers are generally limited to raising $1 million over a 12-month period.

Texas is the 13th state to adopt rules or enact legislation permitting intrastate crowdfunding. The U.S. Securities and Exchange Commission's (SEC) is considering federal crowdfunding rules. The rules were proposed in October 2013 but have not been adopted. Once the federal rules are adopted, companies will not be restricted to raising money in one state from residents of that state.

State rules and legislation enacted to date are considered by some securities experts to be less burdensome than what the SEC is expected to adopt, creating an early opportunity for businesses to start raising money in their home state.

The State Securities Board's crowdfunding rule opens the door for any Texas resident to purchase shares in Texas startups. But that doesn't mean every investor should walk through the door. Here is a look at some issues potential investors should consider:

Deciphering Disclosures. Crowdfunding securities are offered through an exemption from registration, but the method by which they are offered must still meet certain disclosure requirements. Issuers must sell securities through an Internet Texas Crowdfunding Portal. The portal must register with the Texas State Securities Board and allow the Securities Commissioner access to the site. The issuer and portal are responsible for confirming the

Texas residency of prospective purchasers of shares and making available the financial information and risk disclosure required by the crowdfunding rules.

The issuer cannot legally sell securities without disclosing all material facts – information that a reasonable person would consider important in deciding whether to invest. In the summary of an offering, issuers must include:

A description of its company, business plan, operating history, and intended use of the offering proceeds – including compensation paid to executives and directors;
The identity of executive officers, directors, and managers, including their prior experience, and the identity of all persons owning more than 20% of any class of securities in the company;
A description of the securities being offered and of any outstanding securities of the company, the amount of the offerings, and the percentage ownership of the company represented by the offered securities.
An issuer's disclosure statement must be readily available to potential investors when the offer of securities is made on the crowdfunding portal's website.

Issuers must provide current financial statements, but they only need to be certified by the principal executive officer as true and complete. If the issuer has audited or reviewed financial statements in the past three years, they must be provided to potential investors as well.

All of this information must be available to the Securities Comissioner and potential investors for at least 21 days before any securities are sold. During the offering, all communications between the issuer, prospective purchasers, and investors must be posted on the site. The exchange of opinion and information is intended to help individuals make an informed decision about whether to invest.

An issuer can send out a limited notice within Texas that directs people to portal's website.

Startup Risk. Issuers selling equity, debt, and other securities to investors are likely to be untested small businesses with business plans lacking in detail. In other words, common characteristics of a speculative investment.

It is hard enough for professional investors to pick winners. Venture capital firms and angel investors – the latter category consisting mostly of wealthy individuals investing on their own or in small groups – draw on their expertise in different types of startups. Most of their investments fail, but the ones that succeed can produce lucrative returns that outweigh the failures. That's only because they are able to invest large sums and acquire significant stakes in startups, something individual investors won't be able to do through crowdfunding.

An inexperienced investor may not be a good judge of a company's prospects. It takes time to learn about a specific business sector and to read and understand even the limited disclosure materials issuers are required to provide.

Depending on its business sector, approximately one-third to one-half of new businesses survive their first years, according to research by a Case Western Reserve University professor. A separate study of new high-tech businesses started in 2004 found that 68% had survived by the end of 2008.

Flying Solo. Investors are ultimately responsible for their own decisions. According to the rules, a crowdfunding portal must warn that in "making an investment decision, investors must rely on their own examination of the issuer and the terms of the offering, including the merits and risks involved. . ."

In addition, the portal must also inform prospective investors that no federal or state regulator has confirmed the accuracy of the disclosures any issuer has made.

No-Trading Zone. A crowdfunding portal must obtain an "affirmative acknowledgement" from prospective investors that there isn't a ready market for any securities they purchase. Equity acquired through crowdfunding is completely different from buying shares of a publicly traded companies or a mutual funds, which can be easily sold.

To sell securities acquired through crowdfunding, the equity holder must disclose that the security hasn't been registered and, for nine months after the issuer's last sale, can only sell to a Texas resident. It's up to the seller to confirm the buyer's Texas residency.

For buyers, the risk is acquiring an interest that was purchased months or years earlier, when the company's business plan was first disclosed to investors. The company's progress, or lack of, may not be apparent to later investors.

You can lose your shirt, $5,000 at a time. An issuer can't accept more than $5,000 from a non-accredited investor – a downside limit that follows the principles of the SEC's proposed rules and generally tracks the actions of other states. Investors enticed by the new opportunity to invest in startups could, however, seriously dent their bank accounts by putting $5,000 each into a number of offerings. Risky small businesses are not the place for even a small fraction of your emergency household savings or other money you may need in the short term.

The $5,000 limit can also tilt the balance of power away from non-accredited investors. There is no cap on investments by accredited investors. As a result, accredited investors could buy a much larger – and possibly more influential – equity stake in a company than less wealthy investors.

Fraud investigations. Although crowdfunding offerings are offered under an exemption from registration, issuers and portals remain subject to civil, administrative and criminal actions under the Texas Securities Act for fraudulent or unregistered activity.

Fraud investigations and prosecutions, however, usually do not result in a recovery of investor funds, and there is no reason to think that will change if fraud occurs in equity crowdfunding.

What can a startup do with $1 million? An issuer can raise $1 million over a 12-month period, but that total is reduced by the amount of securities sold in a cerain other non-crowdfunding offerings. The offering limit could be enough to give one issuer a big financial boost but mean comparatively little to another with the need for vastly more capital.

Companies can raise unlimited amount of money in other private offering exemptions from registration, but they can only sell to accredited investors.

Equity v. Rewards: Know the Difference. The most recognizable type of crowdfunding is reward-based. Think Kickstarter, IdieGoGo, and dozens of other facilitators that provide a platform for individuals and start-ups to raise money for an unimaginably vast range of projects. It's a massive market: According to research firm Massolution, crowdfunding initiatives raised more than $5 billion worldwide in 2013, with all but a tiny fraction raised through the reward-based model.

In reward crowdfunding, contributors don't receive any kind of financial stake in a company or project raising money for a technology product, movie, or video game. Instead, they typically receive promotional items or the opportunity to buy a product at a discounted price.

That's a far cry from purchasing equity or debt securities in a company and expecting to reap a profit down the line. Equity investors may be less patient than contributors to an independent film project that never gets off the ground.

The history of reward crowdfunding may not hold many lessons for the nascent market of equity crowdfunding. For what it's worth, a recent study from the Wharton School of the University of Pennsylvania, drawn from Kickstarter data, suggests there is little outright fraud in rewards crowdfunding and that the "vast majority of founders seem to fulfill their obligations to funders." More than 75% of projects, however, fail to meet their promised deadlines for product delivery.

Wisdom or madness? Equity crowdfunding is certainly an example of how rapid advances in technology are changing the way capital is raised.

Proponents of crowdfunding say the web portals typify the new approach to raising capital. Facilitating the open exchange of information about an investment, crowdfunding advocates say, can tap into the "wisdom of the crowd" -- a theory that says a group, through its collective intelligence, can often make a more rational decision than an individual.

The quality of information from the crowd may not, however, be any better than the vitriol, rumors, and false misinformation sometimes found on Internet “chat rooms” set up to discuss a publicly traded security.

Even proponents of the wisdom of crowds acknowledge that it requires specific conditions to work. In his 2004 book “The Wisdom of Crowds,” which popularized the concept, James Surowiecki said wisdom requires a diverse group of individuals who aren’t overly influenced by others’ opinions. Making a decision simply based on the consensus of the group is a path to a poor decision.

The history of financial speculation goes back centuries and has repeated itself, cycle after cycle. Speculative bubbles are typically driven in part by individuals who cast aside their own judgment and blindly join a crowd that seems to have formed a consensus on the next strike-it-rich venture.

In “Extraordinary Popular Delusions and the Madness of Crowds,” his groundbreaking 1841 study of speculation and mass behavior, Charles Mackay wrote, “Every age has its peculiar folly: some scheme, project, or fantasy which it plunges, spurred on by the love of gain, the necessity of excitement, or the mere force of imitation.”