WASHINGTON STATE DEPARTMENT OF FINANCIAL INSTITUTIONS

Are You an Informed Investor?

CROWDFUNDING

The Internet has become an inexpensive and easy way for individuals and businesses to raise money for their activities. Congress recently passed the JOBS Act, which directs the Securities and Exchange Commission (SEC) to create rules exempting crowdfunding from the securities registration laws. Once implemented these rules will remove restrictions on start-up companies seeking investors over the Internet. Investors should be on the lookout for unscrupulous issuers and intermediaries who may attempt to engage in crowndfunding in advance of the rules or misuse crowdfunding to steal from investors through false and misleading representations.

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 creative people finance their projects. The concept has recently been promoted as a 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 firms and investment advisers, who must recommend investments that are based on their clients' investment objectives and levels of sophistication. Through crowdfunding, individuals will be able to invest in entrepreneurial start-ups through an intermediary, such as a broker-dealer or a "funding portal." By law, "funding portals" will not be allowed to provide investment advice.

What is a funding portal? It is a website, also called a "platform," that advertises the investment opportunities and facilitates the payment from the investor to the issuer.

Why Investors Need to be Extremely Cautious about Crowdfunding

- Crowdfunding investments cannot be offered legally until the SEC adopts rules to permit them. So beware of offerings that seek investments immediately. Investors should also be aware that crowdfunding offerings which solicit funds in exchange for products to be produced in the future may also be in violation of Washington's securities laws

- All investments have risk, but small business investments have even greater risk than normal. About 50% of all small businesses fail within the first five years. Investors need to understand the risks that are specifically relevant to small businesses and start-up companies.

- Issuers using crowdfunding portals to raise money may be inexperienced. Their track records may be unproven, unsubstantiated or outright fraudulent. The issuers may sound sophisticated and legitimate, when in reality their businesses may only exist on paper.

- The information about the investment is limited to what is provided through the crowdfunding portal. Investors may need to rely on their own research to determine the issuer's track record.

- 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 are mostly illiquid and investors must be prepared to hold their investments indefinitely. It also may be difficult or impossible to resell these types of securities due to the lack of a secondary market.

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 crowdfunding portal, in an online newsletter, on a message board or in a chat room — you should assume it is a scam until you have done your homework and proven otherwise. If you have any questions about crowdfunding offerings, contact the Washington State Securities Division at 360-902-8700.

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