Crowdfunding may be more bust than windfall

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NEW YORK (AP) — Small businesses looking for a windfall of investor money from crowdfunding may find that it's more of a bust.

President Barack Obama and members of Congress have touted a law that makes crowdfunding, a method of soliciting money over the Internet, as a way for startups and other small companies to raise money and create jobs. A year after the law was passed as part of the Jumpstart Our Business Startups, or JOBS, Act, entrepreneurs wanting to raise as much as $1 million annually from online investors are still waiting to get going. The Securities and Exchange Commission is in the process of writing rules to regulate the process.

But business owners anticipating their chance to solicit online investments may not want to count on crowdfunding to finance their entrepreneurial dreams. People involved in small business investing warn that many entrepreneurs will find that potential investors aren't interested in their ventures because they don't have an attractive track record or look like they'll provide a good return.

"I think there's going to be an enormous amount of companies that go online, and nothing happens," says Brian Cohen, chairman of New York Angels, a group of angel investors. Angel investors are individuals who are willing to invest in very small or young companies.

There's likely to be a fundamental difference between the expectations of entrepreneurs and investors, Cohen says. The entrepreneurs will want money to build their companies, and may not be thinking in terms of returning the cash to their investors. Investors will want to see their investment grow — so they can sell and take a profit.

"These are nice businesses, a lot of mom and pops, but there's no clear method in which an investor can get a return," Cohen says.

Crowdfunding isn't expected to be a jackpot for investors because even the savviest investors — those at venture capital companies — don't have a great success rate. Three-quarters of U.S. companies that get venture capital investments don't return their investors' money, according to Shikhar Ghosh, a senior lecturer at Harvard Business School. The National Venture Capital Association, a trade group, estimates that between 25 percent and 30 percent of companies that receive venture funding fail.

The JOBS Act allows companies to raise up to $1 million a year. It aims to protect individual investors by limiting the amount they can put into a company. People with annual income or net worth of $100,000 or more can invest no more than 10 percent of their income or net worth, up to a maximum of $100,000. People whose net worth or annual income is below $100,000 are subject to lower limits on potential crowdfunding investments.

Crowdfunding websites can't start soliciting smaller companies and potential investors until the SEC finishes rules governing the process. The JOBS Act called for the rules to be completed at the end of 2012, but SEC officials told a House hearing on April 11 that they don't know when the agency will be able to issue the rules, which they described as complex.

It's taking time because the SEC is wary about small businesses, says James Angel, a Georgetown University associate professor who specializes in financial markets regulation.

"The way they look at it is, small companies are very risky and therefore bad investments," Angel says. "They say, we are serving the public interest by protecting investors by keeping them from raising money in the capital markets."

"My fear is that the SEC will weigh this thing down with so many requirements that no one will use it." Angel says. "There's nothing in the (JOBS) Act to prevent the SEC from requiring these companies to actually file a full-blown 10-K just like larger companies do now."

A Form 10-K is an annual report that publicly traded companies must file with the SEC disclosing their finances and other significant information. They also must file quarterly reports and other documents throughout the year. That could be a large financial and administrative burden.

The SEC is likely to make the requirements tough because it has failed in recent years to detect fraud in the markets — most notably, the billion-dollar scheme created by Bernard Madoff, says Scott Shane, a professor of entrepreneurship at Case Western Reserve University's Weatherhead School of Management.

"If you're someone like the SEC, you're going to get in trouble if there's a big fraud and you don't catch it," Shane says. You're going to be conservative about writing the rules."

That caution extends to some of crowdfunding's biggest proponents, who expect that many companies that seek money will be too young for many investors' comfort— some of these businesses may be little more than an idea. Some of the skeptics are already involved in a type crowdfunding that's authorized by the government because the investors meet requirements for net worth — for example, they have more than $1 million in assets, not including their primary residence. The law assumes these investors are more sophisticated than those likely to take part in crowdfunding under the JOBS Act.

"We don't take idea stage companies — they're too risky," says Chance Barnett, CEO of Crowdfunder, a social networking site for investors and companies seeking capital. "We want to see them be much farther along than an idea on a napkin."

Companies must have a good track record and managers who have shown they can run a successful business, Barnett says.

"The assumption is that everyone gets funded, but nothing can be further from the truth," Barnett says. "A majority (of companies seeking funding) aren't companies that are deserving of capital today."

CircleUp, another crowdfunding service, turns down 98 percent of the companies that want to solicit funding on its site because it believes they're not likely to be good enough investments, Chief Operating Officer Rory Eakin says.

"We look at a number of different things — the experience of the management teams, do they have expertise, a plan for growth, the skill set to deliver on that plan," Eakin says. "Is it distinguished in its category, does it stand out for customers and potential investors?"

"Crowdfunding will not be a panacea for all small businesses — certain businesses are investment worthy and others are not," he says.

Stacey Shiring is optimistic that her three-year-old business, Creative Invites and Events, will be able to raise money when the rules are written and the crowdfunding sites are up and running. She doesn't know how much she'll seek, but she plans to use the money to expand her website. And she's happy the SEC is taking time to write regulations.

"A lot of good is going to come from it. Being diligent and making sure they do it right is a big concern," says Shiring, who sells invitations at her store in Cincinnati.

Shiring has already gotten investments from family and friends. She wants to use crowdfunding because her customers also want to invest and she wants them to be able to do so in a formal way. She expects that through crowdfunding online, they will be able to study her company's financial documents and make an informed investment decision.

Some companies are able to raise money even when they're not expecting to give much in return. Some of projects funded on websites like Kickstarter have been able to raise $100,000 or more. In return for giving money, donors — they're not investors — tend to get free samples of products or T-shirts.

With that kind of success in mind, a flood of companies are likely to seek funding when the crowdfunding investment sites are up and running, says Sean Carr, director of intellectual capital at the University of Virginia's Batten Institute, a part of the Darden School of Business.

"There are plenty of capital constrained entrepreneurs right now. They'll take whatever opportunities come along and if they think it'll be relatively easy to do it that way, they'll try it," he says.

But Carr is also wary about the number of good investments that will be available online, and wonders whether many of the companies will be resorting to crowdfunding because they can't raise money through family, friends or business associates.

"If I were an investor, my antenna would be going up," he says. "If you couldn't get funded that way, then this must be a lemon."