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Funding draws a crowd

A new law will allow startups to raise cash through crowd funding, without the help of venture capital firms.

By Steve Garmhausen
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It's no surprise that space and satellite ventures have a tough time raising money. Last year, Manhattan-based boutique investment bank Near Earth, which caters to the industry, tried to raise capital for NanoRacks, a company that builds research labs for the International Space Station. Near Earth Vice President Ian Fichtenbaum likened the process to "hitting at the back of a ketchup bottle."

But help for firms like NanoRacks may be on the way in the form of a new law that will allow small firms to offer equity through crowd funding. The law has yet to go into effect—it awaits Securities and Exchange Commission rule making—but it has already spawned a fierce debate about likely winners and losers. Some warn that fraud and administrative headaches will hurt investors and businesses alike. Others say crowd funding poses a stiff challenge to venture capital firms, which have had free rein over startups.

"They'd better recognize that they've got to reinvent themselves," said Cliff Schorer, who is entrepreneur in residence at Columbia Business School's Eugene Lang Entrepreneurship Center.

The Jumpstart Our Business Start-ups Act of 2012, which became law in April, will allow small companies to advertise and sell up to $1 million a year in private stock online to hundreds of investors—and with less red tape and regulation than apply to big companies.

Until now, crowd funding, at least in the United States, has been exclusively an exercise in philanthropy. A growing group of websites are collecting money from the public to help artists, inventors, filmmakers and others realize their dreams—with donors receiving public recognition or nominal gifts in return. But it has been illegal to solicit equity investments from a population of unqualified investors with less than $1 million in assets who were not friends or family. That has changed with the JOBS Act, a measure pushed by entrepreneurs and small business groups and passed by a Congress desperate to create jobs.

At the same time, evolving technology and the vast reach of the Internet have made crowd funding feasible. The cost of launching technology companies, which typically are the bull's-eye for angel investors and venture capital firms, has fallen rapidly in recent years. Because startups can now develop clout with a couple hundred thousand dollars rather than many millions, it's easier for them to sidestep venture capital firms and angel investor groups altogether.

Indeed, supporters say equity crowd funding signals a new era for entrepreneurs, giving them access to new sources of capital and the ability to test ideas and products VCs and angels are reluctant to fund.

"This opens up another channel of funding for entrepreneurs," said Mr. Schorer. "Entrepreneurs are the winners."

A THREAT TO VCS
At the same time, it could mean more competition for VCs, which are already struggling to produce attractive returns for investors, according to a recent Kauffman Foundation report.

Fred Wilson, managing partner at Union Square Ventures, recently told a group of entrepreneurs that venture capital has been shifting from an industry skewed to favor investors to one that favors entrepreneurs—and will only become more so. Equity crowd funding, he said, is "bad news for the venture capital industry, but terrific news for the entrepreneurs."

Other VCs and angel investors, though, insist crowd funding is not a threat. "Equity crowd funding wasn't designed for the types of businesses angels and VCs are interested in," said David Rose, an angel investor and entrepreneur who founded Gust, an online platform that brings entrepreneurs together with investors. "Nobody's really concerned."

They also question crowd funding's viability, predicting, for example, that communicating with hundreds of mom-and-pop investors—and being second-guessed by them—will turn off many entrepreneurs, not to mention VCs, when the entrepreneurs attempt to attract later rounds of traditional funding. Unsophisticated investors are more likely to buy shares based on exaggerated valuations, the argument goes. To invest in a later round, more savvy angels or venture capitalists would insist on lowering the valuation—which would incur the wrath of the original shareholders. They argue, too, that entrepreneurs who work with amateur investors will miss out on the advice, networking opportunities and tough love provided by VCs and angels, not to mention the stamp of approval a venture investment confers.

"They give you a huge amount of help finding top talent," said Bruce Bachenheimer, director of the entrepreneurship program at Pace University's Lubin School of Business. "[With crowd funders] if anything, you'll spend all day on the phone with Aunt Jenny."

RISKS INVOLVED
Under the current system, a tiny number of the best startups receive backing, and even then many of them fail. Crowd-funding skeptics argue that opening a funding spigot for companies the experts have passed over will do little more than fund failures and potentially weaken investor protections.

"[The SEC's] problem is how we weed out the Tokyo Joes and the Nigerian royal family from crowd funding," said Joseph Bartlett, a lawyer with Sullivan & Worcester who advises startups. "The fear is that the rules will either make it too tough to raise money or so easy that anyone can raise money."

Meanwhile, players in the startup arena, such as Near Earth's Mr. Fichtenbaum, are beginning to plot out how they might benefit from equity crowd funding. Near Earth is thinking about ways to offer advice and guidance to small investors. It may create its own service or partner with other firms to do so, Mr. Fichtenbaum said.

"People will be excited, but at the end of the day, they're going to look for guidance about who's doing something real, who they can trust and who's effective to invest their money with," said Mr. Fichtenbaum.

Second Market, a New York firm that provides a platform for trading illiquid assets, including private stock, is keeping tabs on crowd funding developments as well, said Managing Director Adam Oliveri.

"We smell opportunity for sure," he said.

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