If you have been thinking that equity crowdfunding is just the natural next step for donation or reward-based crowdfunding, think again.

A lot of momentum is building behind groups like CFIRA and CFPA to move the SEC forward to enact the JOBS Act that will legalize equity crowdfunding in the U.S. Events such as the recent Women Transforming Financial Markets Symposium hosted by NowStreet’s Dara Albright have vividly articulated how the chance to “democratize” equity capital fundraising is a tremendously exciting and promising opportunity for start-ups and small investors to increase wealth and job creation and boost the U.S. economy.

Much of this enthusiasm is born out of the significant success of “traditional” donation and reward-based crowdfunding sites such as RocketHub and Kickstarter, which have raised hundreds of millions of dollars for projects and ideas which likely would not have found funding from traditional sources. To put equity crowdfunding and traditional crowdfunding in the same sentence, however, as if the former is the simple and logical extension of the latter, is a dangerously inaccurate depiction. This type of oversimplification will lead to the type of confusion and unpreparedness that could put this new industry at risk in its infancy.

Though I am as enthusiastic and supportive of equity crowdfunding as the next hopeful entrepreneur, some of the current discussions I’ve witnessed make me nervous that the parties involved – issuers, investors, infrastructure and support service providers – are not going to be ready for the significant regulatory changes that will come along with a move to equity crowdfunding.

Though the devil will be in the still-in-development details, even at this stage there have clearly emerged four areas where potential issuers and investors should prepare for equity crowdfunding to look more like traditional capital raising than crowdfunding.

**PART I - DISCLOSURE**

For many first-time entrepreneurs, the success of crowdfunding has brought into question even the concept of the tried-and-true business plan. At a recent eFactor social entrepreneurship conference, a budding entrepreneur asked a panel of Angel and VC investors “Do we even need business plans anymore, or is it just about a pitch pack and a video?” This is a question that has been raised more frequently as social media and fundraising become increasingly intertwined.

On today’s crowdfunding sites, the projects that effectively tug at the heart strings or appeal to excitement and emotion are often the most successful, like helping a grandmother to fund a project to capture all of her family’s secret recipes to share with her progeny, or helping a teacher to get supplies
for her under-funded class. In these cases, the postings rarely include more than a basic description, a heartfelt plea, and as many touching photos as possible.

For anyone considering equity crowdfunding however, it is critical to realize that the bar for disclosure will be much higher. The response that the panelists gave to the entrepreneur hoping to skip the business plan phase? “Sure, a pitch book is great to pique my interest, but as soon as I’m interested I’ll be asking for the 10-20 page business plan with full financial estimates.” Equity investing is not charity; it is about expectation of growth and return. Not only will investors demand more information, but the SEC will require it. As was mentioned at the last SEC Forum held to discuss implementation of the JOBS Act, the move from crowdfunding to equity crowdfunding is a shift from a wholly unregulated space to the most regulated industry in the world.

The underlying reason for these disclosure requirements is to combat fraud. Though the argument can be made that charities can also be fraudulent, givers are ready to part with their money, do not expect a return, and are unlikely to follow-up on their donation. Disclosure requirements on public offerings aim to reduce fraud and level the playing field among investors, protections that some fear are only more necessary when offerings become available to unaccredited investors. The SEC is in a tough spot here, being asked to balance the need for increased access to capital for entrepreneurs, with a role as guardian of the public good and grandmother’s pension. Though expectations are that the disclosure requirements will be significantly less burdensome than full public registration offerings, history and experience indicate that the SEC will require as much disclosure as they can without being charged with destroying the spirit of the act. This may, depending on the amount of the proposed raise, include financial information, use of funds statements, business plans, risk factors, cap tables, etc., etc., etc.

PART II - SOLICITATION AND MARKET MAKING
The wisdom in most recent articles about crowdfunding, such as David Drake’s piece “Crowd Funders Erode VCs Fundamentals: 4 Things You Must Know about Crowd Funders”, highlights that crowdfunding is a tool, and that the responsibility lies with the fundraiser to “bring the crowd”. This is the case for both traditional and equity crowdfunding, but the difference between the type of solicitation allowed in traditional and in equity crowdfunding will have significant implications for how those crowds are built.

Just a few weeks ago I attended a panel on fundraising for entrepreneurs. One of the panelists was a successful investor in the VC space, and was sharing the importance of building momentum on crowdfunding platforms. He suggested that entrepreneurs should not tap all of their personal investors before posting on a crowdfunding site, and instead use those investors as the first to give via the crowdfunding portal. The best strategy, he instructed, would be to ask one donor to give on day one, a few more on day two, more on day three, and so forth, in order to show the type of momentum curve that attracts other donors. When the lone securities expert on the panel pointed out that entrepreneurs that engaged in that strategy with equity crowdfunding would risk being charged with market manipulation, the VC looked genuinely shocked and embarrassed (remember that VCs’ investments are generally in the private world and not covered by SEC market regulation). This is another big difference between the unregulated donation crowdsourced space and equity crowdfunding.
The colorful dog and pony shows that are common in charitable crowdfunding, and not so far off from investor road shows, may be prohibited for equity crowdfunding as the SEC tries to build in protections for grandmothers and unsophisticated new investors. Though general solicitation rules indicate that the manner of solicitation will not be restricted, fundraisers must realize that everything they say or do can be used against them in either civil or criminal actions raised by disappointed investors.

PART III - RECORD KEEPING AND FOLLOW-UP
The biggest question that potential equity crowdfunders should be asking themselves is “what happens after I’ve successfully raised funds via equity crowdfunding?” In today’s donation-based crowdfunding world, often times the answer is “nothing”. Perhaps the fundraiser will post pictures showing their class project, or their trip to visit their ailing nephew courtesy of generous supporters, or at most, some have promised advanced prototypes of products, most of which have not panned out. Kickstarter recently stopped allowing advanced prototype sales due to the complexity of follow-up and the reputational risk of fundraisers failing to follow through.

Issuers must realize that after an equity crowdfunding round they will not be facing a group of semi-interested donors, but a potentially active and vocal set of shareholders, as well as regulating bodies such as the SEC. Failure to manage shareholder records and reporting to the SEC is not like late delivery on pre-sale products – companies without the appropriate records may face SEC noncompliance penalties such as fines, trade suspension, and even federal court proceedings.

In addition to the SEC, crowdfunding issuers will face shareholders, who, unlike donors, will expect more regular communication. Those shareholders who are new to investing may even have unreasonable expectations around the input they are welcome to offer to the entrepreneurs. Proactive and appropriate communication will be critical to managing shareholders and building the desired level of engagement.

Private companies often struggle with the level of record keeping required to keep track of issuances, shareholders, transfers, and new requirements such as cost basis for each share sold. When these private companies consider going public, they often spend huge amounts of money and time on consultants and lawyers just to help get the securities records they have not kept accurately or up-to-date in order to qualify for an IPO. In the world of equity crowdfunding, start ups of even one or two employees will face these same challenges going forward. Can you imagine a two person firm trying to manage securities holdings and transfer recordkeeping and reporting, plus communication with hundreds of shareholders on its own? While some crowdfunding portals are developing stakeholder communication and management modules, issuers should be sure to understand their capabilities prior to engagement, and need to find the right partner to manage the bulk of the recordkeeping and reporting work that will come after a successful equity crowdfunding round.

PART IV - FUTURE FINANCING IMPLICATIONS
The aim of equity crowdfunding, of course, is to get more dollars into the hands of more entrepreneurs, and to increase the rate of successful small businesses in the US. Access to even a few thousand dollars from millions of potential investors opens up an incredible flow of resources to these entrepreneurs, and for investors provides an aggregation of thousands of opportunities that they would not normally have access to. Many traditional crowdfunding sites today post special features on projects that have seen large increases in funding and the positive attention draws forth even more interest and funds.

One current unknown that requires consideration however, is the view that Angels and VCs will take of issuers that have raised funds via equity crowdfunding. On the positive side, Angels and VCs will be able to identify those ideas for which a market has already identified itself, based on the interest of other investors or followers via the crowdfunding portals. Additionally, serious investors also note that much of their time is wasted hearing pitches on businesses in areas that they just don't invest in. Crowdfunding portals will provide an opportunity for investors to search for their specific areas of interest and expertise and access opportunities far beyond those available via their personal networks.

The other side of the coin, however, has been voiced by several VCs and Angels I’ve met with over the last few months. To some, a start up business that already has dozens (or more) of unaccredited shareholders with unknown expectations about return and exit period is a bright red flag. They shuddered while hypothesizing that inexperienced shareholders with only a few shares might still become extremely active if those shares were bought with retirement savings or college tuition. In the most extreme reaction, one VC suggested that any entrepreneur who expects to need additional fundraising rounds from Angels or VCs should completely avoid early stage equity crowdfunding.

It is impossible to tell today whether Angels and VCs will ultimately be attracted or repelled by equity crowdfunding. It is clear, however, that each issuer must think through their lifecycle of funding needs, the implications of taking on early unknown shareholders, and the potential reaction of later stage investors.

I believe equity crowdfunding is an exciting, important and extremely valuable addition to the capital-raising abilities of America’s small businesses, and that it is going to happen. But, before it can come to pass, and to prevent a disaster that would end equity crowdfunding without fulfilling its potential, all players in the industry—issuers, portals, brokers and service providers need to be prepared to meet the disclosure, solicitation, shareholder communication and recordkeeping requirements that are sure to come. In the world of equity crowdfunding, grandmothers are welcome as both issuers and investors, but they’d better know what they are getting themselves into.