

NEW OPPORTUNITIES IN THE ALTERNATIVE ASSET MARKETPLACE: **CROWDFUNDING**

CREATIVE DESTRUCTION, CROWDFUNDING AND ENTREPRENEURIAL FINANCE

CREATIVE DESTRUCTION AND ENTREPRENEURIAL FINANCE

Creative Destruction is a term that was coined by economist Joseph Schumpeter back in 1942. In his book, *Capitalism, Socialism, and Democracy*, Schumpeter wrote that the opening of new markets and the organizational development of companies illustrated a process of industrial mutation “that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in.”¹

Crowdfunding could be a poster-child for Creative Destruction. It is disrupting long-established business models and revolutionizing entrepreneurial finance by helping individuals and companies find capital for a variety of projects or needs, as well as, for the development of innovations that, for any number of reasons, might not have been able to find funding through traditional sources.

WHAT IS CROWDFUNDING?

In its earliest iterations, crowdfunding was largely a term used to describe donation-based methods of raising capital for philanthropic, creative, and social endeavors by attracting donations and pledges from interested parties via online platforms.² It has since grown to include platforms that are debt-based (i.e. Online Lending) or equity-based (think private security offerings). The characteristic that all of these platforms have in common is their desire to create new marketplaces to connect those seeking capital with those looking to invest or redeploy capital outside of the traditional capital markets.

The industry is evolving and has been experiencing rapid growth. The first wave of growth was driven by the financial crisis, ‘credit crunch,’ and subsequent ‘Great Recession’ which limited the availability of capital from traditional sources. The second is being driven by investor demand for alternative investments and regulatory changes that (among other things) are set to allow non-accredited investors to participate in private security offerings (equity crowdfunding)—subject to the issuance of final rules by the Securities and Exchange Commission (SEC).

Crowdfunding Blogs described the evolution and benefits of the industry like this:

“For many years, business was done the same old way. If an inventor wanted to bring a product to market, he or she would have to come up with funding to prototype, design, manufacture, and market those products. Capital however was limited to very staid means that included loans, venture capital or angel investors... With the downward turn in the stock markets, capital became even harder to come by...

Enter crowd funding as a way for entrepreneurs and inventors to have access to capital, and almost as importantly have a forum on which to present their new products... In a world where the two hardest things for a business owner to come across are capital and sales, crowdfunding has proven to be the best of both worlds. This allows not only funds to be raised [but] also markets to be created for additional sales of the product.”³

Global crowdfunding volume quintupled between 2009 (\$530 million) and 2012 (\$2.7 billion). Projections suggest that total volume during 2013 was more than \$5 billion, but that is expected to double during 2014 (see chart below) as the regulatory changes related to equity crowdfunding—Title III of the Jump Start Our Business Startups Act (JOBS Act)—are finalized by the SEC. As of the publication of this paper, the SEC has not issued final rules for Title III.

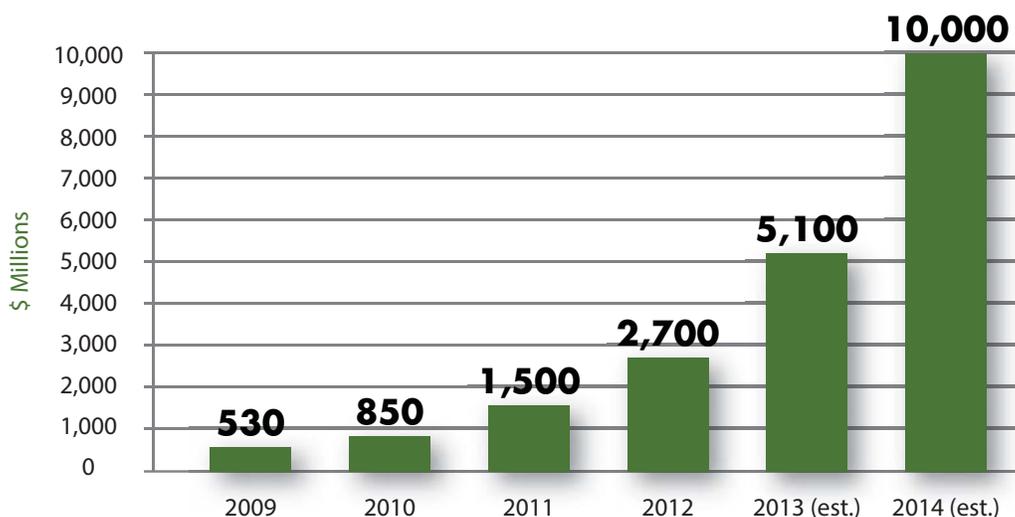
NOTABLE CROWDFUNDING CAMPAIGNS

Donation-based crowdfunding campaigns have financed some impressive products and ideas. These include:

- Pebble: A customizable smart watch for iPhone and Android, raised more than \$10 million
- Bitvore: A means of monitoring and analyzing Big Data, raised \$4.5 million
- 3Doodler: A 3D printing pen that lets the user draw in three dimensions, raised more than \$2 million
- Scanadu Scout: A device for tracking vital signs via smartphone, raised \$1.6 million
- Kano: An easy-to-assemble, portable desktop computer, raised \$1.5 million

Source: *Forbes.com, blog.clarity.fm*

Growth Worldwide Crowdfunding Volume
2009 through 2014 (est.)



Source: *Bostinno.streetwise.com, Crowdfundinsider.com, blog.clarity.fm*

EARLY IN THE CROWDFUNDING GROWTH CYCLE

Currently, crowdfunding models offer diverse opportunities. Depending on the platform, an individual may receive: the satisfaction of donating to a good cause, a reward for supporting the endeavor or idea, or a financial return on a loan or investment.

- **Rewards and donation-based crowdfunding:** Some of the most familiar crowdfunding platforms, such as Kickstarter and Indiegogo, are donation- and/or rewards-based. Since Kickstarter was founded, about six million people around the world have pledged approximately \$1 billion to 20,000 different projects. One of those projects was Oculus VR. About 9,500 people pledged \$2.5 million to the company and, in return, received sincere thanks, posters, t-shirts, and Rift prototype kits (a virtual reality head-mounted display and software for developers), as determined by the pledge amount.

In early 2014, Facebook purchased Oculus VR for about \$2 billion. No doubt, some of the people who pledged wish the project had been available through an equity-based crowdfunding offering which would have given them the opportunity to purchase shares in the company with the potential to benefit from an eventual sale.

- **Debt-based crowdfunding:** Platforms like Lending Club and Prosper offer investors the potential for financial rewards through peer-to-peer lending. For example, Lending Club's stated mission is to "create a more efficient, transparent and customer-friendly alternative to the traditional banking system that offers credit-worthy borrowers lower interest rates and investors better returns."⁴

Other lending platforms, such as SoFi, focus on the student loan industry, introducing lenders to borrowers who would like to refinance private and federal student loans. Their goal is to build "an innovative marketplace to fix finance—starting

with the \$1 trillion dollar student loan industry."⁵

- **Equity-based crowdfunding:** The JOBS Act is set to fundamentally change the nature of crowdfunding by opening the door to equity-based crowdfunding. Instead of pledging, donating, or lending, individual and institutional investors have opportunities to invest in companies and projects in return for equity—ownership interest in a project.

Some platforms, like Realty Mogul, offer a marketplace where investors can find and pool assets to purchase private securities of entities which invest in real estate properties. Others, like CircleUp, connect investors with consumer and retail companies that want to grow their brands using methods like hiring more employees, expanding production, improving marketing, or engaging markets in other ways.

These broad categories of crowdfunding will soon become more highly differentiated. According to a recent report from World Bank, organized online communities sponsored by specific industries, organizations promoting a particular culture or group, religious groups, and/or alumni of various organizations and schools have begun to explore crowdfunding as a means of raising capital for targeted projects.⁶

As reported on PBS's Mediashift website, the model used for the World Bank report predicts that the volume of crowdfunding globally has the potential to reach \$93 billion by 2025. This prediction assumes that institutional money will NOT be channeled through crowdfunding portals. Since institutions have already been investing in both equity and debt crowdfunding through a number of platforms in the United States and Britain, the actual growth in volume will likely be much larger.⁷

THE JOBS ACT: OPENING THE DOOR TO EQUITY CROWDFUNDING

In the United States, the passage of the JOBS Act has the potential to significantly change the crowdfunding landscape. The purpose of the new law was to give the American economy a boost by modifying rules related to raising capital and investing, particularly as those rules related to Regulation D (Reg D) private securities under the Securities Act of 1933. Changes under the JOBS Act included:

- Raising the threshold for mandatory registration and public reporting from 500 shareholders of record to 2,000
- Permitting 'general solicitation' for Reg D offerings made under new rule 506(c)*
- Providing registration exemptions for limited-size offerings sold in small amounts to a large number of investors (i.e. equity crowdfunding)

**Note that while Title II of the JOBS Act ends the ban on general solicitation and advertising, current investors in Reg D offerings must still be accredited or otherwise qualified to invest.*

Although the JOBS Act was passed in 2012, the SEC is still working to develop rules that will guide the implementation of Title III (equity crowdfunding). According to Gigaom, a company that analyzes emerging technologies:

"The problem, in short, is that the SEC is being asked to create a crowdfunding regime that does three things at once: 1) provides an easy, low-cost way for startups to raise money online; 2) protects investors from new forms of fraud; and 3) creates incentives for financial firms to run crowdfunding websites."⁸

Until the SEC rule-making process is complete, only accredited investors—individuals with substantial net

worth who meet very specific SEC criteria or other qualified institutional investors—are able to invest in private equity through crowdfunding campaigns or private offering platforms. Once the SEC's rules for Title III have been finalized, crowdfunding will be open to all investors, regardless of net worth and income. The final SEC rules will include specific requirements and limitations. For example, limits on both the amount of capital which may be raised via crowdfunding and the amount individual investors may invest.

U.S. INTRASTATE EQUITY CROWDFUNDING EXEMPTIONS

Some states are not waiting for the SEC's final rules on Title III. Nowstreetwire.com offered the following:

"While national securities-based crowdfunding as written under Title III of the JOBS Act remains illegal, individual states have begun adopting their own legislation to legalize crowdfunding under Rule 147, the intrastate exemption. Officials in nearly a dozen states, including Georgia, Alabama, Kansas, North Carolina and Wisconsin, have enacted or proposed new laws to make it possible for its local businesses to secure financing from local residents. The country's first publicized unaccredited equities crowdfunded raise was completed in the fall of 2013 in Georgia utilizing the Invest Georgia Exemption (IGE). Details can be found at SparkMarket, leading provider of intrastate crowdfunding solutions."⁹

RETIREMENT MARKET

According to the Investment Company Institute's most recent data, total assets in IRAs reached over \$6.5 trillion in Q4 2013; an increase of approximately \$1.0 trillion from the previous year.¹⁰

These tax-advantaged accounts represent a potentially significant source of investment capital for advisors, investment managers and new crowdfunding platforms.

IS IT A REVOLUTION? AN EVOLUTION?

No matter what you call it, crowdfunding is reshaping the financial industry in some very significant ways.

While many of the projects funded to-date have been based in developed nations, World Bank anticipates that crowdfunding will help facilitate “the Rise of the Rest” by helping entrepreneurs around the world, particularly in emerging markets, find financing for projects that will help their countries and economies develop more fully.¹¹

CUSTODY SOLUTIONS FOR A DIGITAL WORLD

Just as the financial industry is being reshaped, innovative financial services companies are reshaping themselves to better serve the demand for offerings through these new online platforms and portals. Custodians are working to provide a range of solutions for both individual and institutional investors that may want to invest in private securities and crowdfunding campaigns.

The most basic responsibilities of a custodian are not changing but, in an increasingly digital world, the ways in which these services are being delivered and how the assets are being accessed, documented and held is evolving.

SPECIALIZED SERVICES AND CUSTODY SOLUTIONS ON MULTIPLE LEVELS

- **Platforms and Portals:** New platforms and portals are looking to qualified custodians for a range of solutions. While most often considered for their ability to support the custody needs of a platform’s investors, many platforms themselves are also finding a need for a qualified custodian to provide key custody support to core business functions. For example, helping them to comply with the SEC’s amended Custody Rule by acting as the qualified custodian for any private funds or special purpose vehicles (SPVs) that may be part of a platform’s business structure.
- **RIAs or Fund Managers:** Registered Investment Advisors (RIAs) must comply with the requirements of the amended SEC Custody Rule. A qualified custodian can provide custody for private funds such as hedge funds or separately-managed accounts (SMAs) that invest in a variety of assets. Additionally, as RIAs and Fund Managers look to securitize or leverage certain investments, they are looking to these same service providers for custody solutions for SPVs.
- **Individual Investors:** Individuals can access alternative assets using both taxable and tax-advantaged accounts. Platforms and portals are also entering into strategic relationships with qualified custodians that specialize in holding alternative assets in self-directed IRAs as well as taxable accounts. Retirement accounts are also able to invest in private funds or engage an RIA to separately manage their account (SMA) by providing a distinct portfolio of alternatives based on individually set criteria, adding another method of investing for advisors and their clients.

SPECIAL PURPOSE VEHICLES

Special purpose vehicles (SPVs) are legal entities that are typically structured as an affiliate or subsidiary of a parent company to fulfill a specific (and sometimes temporary) purpose. Some of the most common uses of SPVs include:

- **Bankruptcy-remote entity:** Some platforms have created a subsidiary entity to hold the assets. Used as a form of protection for investors, the intention is that in the event a parent company or platform files for bankruptcy, creditors of those entities should not be able to claim any of the assets in the SPV.
- **Leverage:** As investors and RIAs look to maximize the potential of certain types of assets, some RIAs are utilizing a leverage provider and creating an SPV to offer leveraged funds to investors.
- **Securitization:** SPVs are used in the process of securitizing an asset. The securitization process can be structured in a variety of ways depending on the intent. For example: most online lending platforms are structured in a way that essentially securitizes the online loan. While at the same time, an SPV could be used to pool loans of various qualities that could then be sold as a type of asset backed security (ABS) to investors.

ROLE OF AN INDEPENDENT QUALIFIED CUSTODIAN

In 2009, after a series of high profile cases of fraud by RIAs, the SEC amended Rule 206(4)-2 under the Investment Advisors Act of 1940. The SEC's intent was to strengthen the existing Custody Rule, as it is commonly called, in an effort to deter the misappropriation of client assets or the misrepresentation of the ownership of those assets by RIAs; attempting to limit the ability to defraud investors. Essentially requiring that a qualified custodian play the middle-man, to an extent, between investors and investment advisors; maintaining custody of the assets and providing investor statements directly to investors where required.¹²



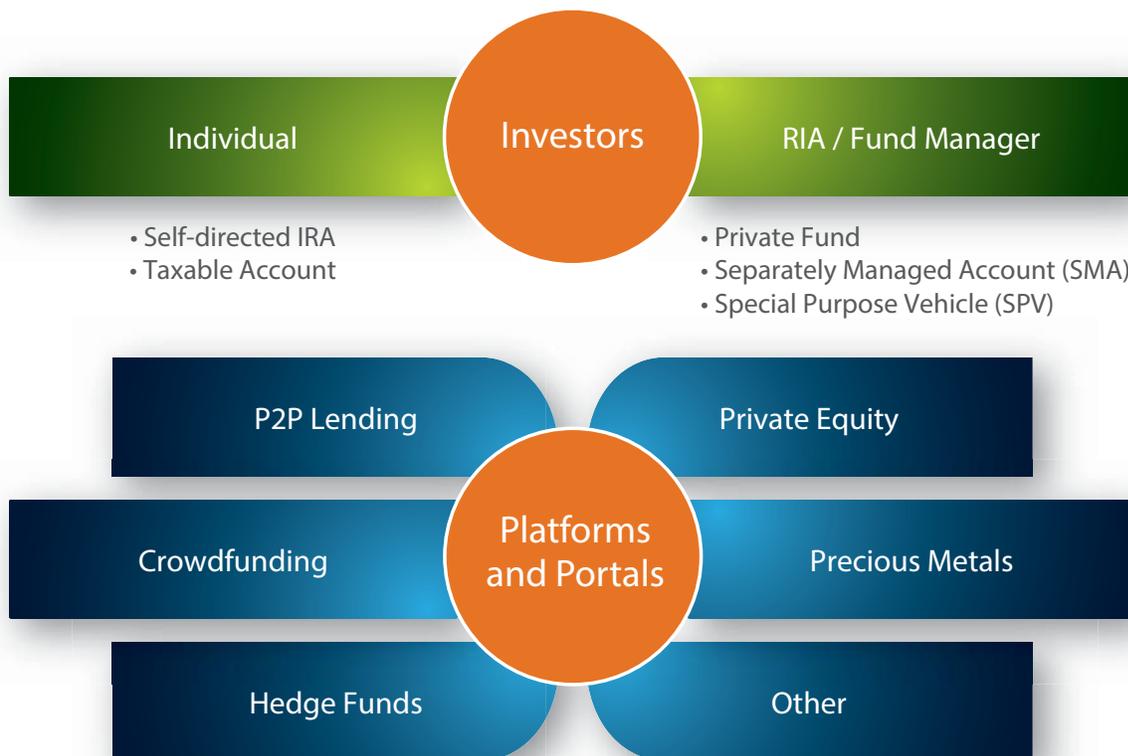
Source: Millennium Trust Company, Schematic Illustration

The amended Custody Rule outlines the following key requirements for advisors:

- Annual surprise examination of the RIA by an independent public accountant
- Use of a 'qualified custodian' to maintain client cash and securities as well as to send periodic account statements directly to the client, with certain exceptions
- In regards to limited partnership, LLC or other type of pooled investment vehicle, if not using an independent qualified custodian the RIA is responsible for (i) engaging an independent PCAOB accountant for the audit of the advisor and (ii) providing a written, internal controls report related to the controls upon custody of client assets by the advisor or a related party which is also verified and reconciled by a PCAOB accountant.

CUSTOM CUSTODY SOLUTIONS

As outlined by the amended Custody Rule, the core role of an independent qualified custodian is to hold cash and assets on behalf of a client and with certain exceptions to send required periodic account statements directly to the client. While all qualified custodians are meant to fulfill this same function, not all of them are willing to custody new or unique assets. However, realizing the potential, some innovative custodians are focusing on offering specialized services and creating custom solutions for custody of alternative assets for individual investors, RIAs and fund managers as well as for the various investment platforms and portals.



Source: Millennium Trust Company, Schematic Illustration

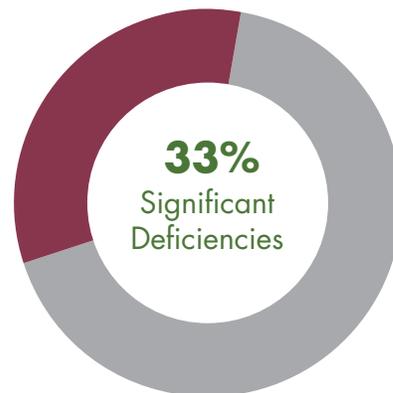
THE SEC CUSTODY RULE RISK ALERT

On March 4, 2013, the SEC issued a Risk Alert on compliance with the Custody Rule. The SEC's Office of Compliance Inspections and Examinations found significant deficiencies in custody-related issues at about 140 RIAs (more than one-third of the firms examined).¹³ The Risk Alert reviewed the definition of custody:

"An adviser has custody if it or its related person holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them.¹⁴ For example, an adviser that serves as the general partner of a pooled investment vehicle ("PIV") (or holds a comparable position) generally has custody of client assets because the position of general partner gives legal ownership or access to client funds and securities.¹⁵

The custody rule prescribes a number of requirements designed to enhance the safety of client assets by seeking to insulate them from improper activities or financial reverses of the investment adviser, including insolvency. The custody rule’s key safeguards include:

- Use of “qualified custodians” to hold client assets...
- Notices to clients detailing how their assets are being held ...
- Account statements for clients detailing their holdings...
- Annual surprise exams...
- Additional protections when a related qualified custodian is used...
- The audit approach for advisers to pooled investment vehicles...”¹⁶



The Alert also detailed the advisor deficiencies it had uncovered, including failure to recognize that they had custody, failure to meet the custody rule’s surprise examination requirements, failure to satisfy qualified custodian requirements and failure to comply with the audit approach for pooled investment vehicles. Deficiencies have resulted in actions that include remediation, enforcement referrals, and subsequent litigation.

CONCLUSION

There are a number of new opportunities and exciting developments in the world of alternative investments. Crowdfunding is merely one example of how creative problem solvers are using technology to ‘rethink’ long-established business models and industries. It is too early to tell whether this is a full-fledged revolution or merely part of a larger process; laying the groundwork for the gradual evolution of the financial industry.

Both institutional and individual investors are increasingly looking to alternative investments as a way to diversify their holdings. Individuals and businesses are looking for capital for a variety of reasons. Crowdfunding platforms and supporting financial service providers—like qualified custodians—are working closely to develop key technologies and service solutions to meet the needs of both. They are essentially building new marketplaces to not only help investors access these assets while continuing to comply with regulatory requirements and addressing concerns about the safekeeping of client assets, but also to transform the way entrepreneurs, individuals and companies raise capital.

This paper is for informational purposes only. It is not intended to be and should not be taken as a recommendation to invest in any specific type of alternative investment, or alternative investments in general. The characteristics and risks vary with each type of alternative assets and each alternative must be studied carefully. Investors should always consult with investment, legal and tax professionals before investing.

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