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FTC ruling sheds some light on investor protection in crowdfunding

One of the increasingly common ways artists seek to fund their creative endeavors is through crowdfunding platforms like Kickstarter and Indiegogo. In a nutshell, crowdfunding is an Internet-based method of raising capital, in which the person seeking funds will set up an account on a crowdfunding website and launch a campaign soliciting donations or investments from third parties. These funds are then pooled together to fund the project.

This fundraising mechanism grew from relative obscurity less than a decade ago into what has become a billion-dollar industry. Musicians, filmmakers and artists of all types have turned to Kickstarter and other artist-centric crowdfunding platforms to finance their creative endeavors.

In fact, Kickstarter recently reported that it has received more than $1 billion in pledges during the first five years of its existence. With such explosive growth in a relatively short period of time, it is no surprise that crowdfunding has become the subject of increasing government oversight.

There are two primary types of crowdfunding — equity and rewards-based crowdfunding.

Equity crowdfunding websites, like Startup Valley and Crowdfunder, provide investors with the opportunity to receive an equity interest in a project in exchange for their monetary contribution.

Rewards-based websites, like Kickstarter, allow individuals to fund a particular project in exchange for a gift or reward. Individuals who participate in rewards-based crowdfunding do not receive any equity in the underlying project or business.

Equity crowdfunding grew in popularity in 2012 after Congress enacted the Jumpstart Our Business Startups (JOBS) Act. This statute lifted the prohibition against advertising investment opportunities to the general public, which in turn allowed entrepreneurs to raise capital through securities offerings over the Internet.

Earlier this year, the Securities and Exchange Commission issued long-awaited revisions to Title IV of the JOBS Act, which sought to revive the use of Regulation A offerings (renamed Regulation A+ offerings) to gain access to capital through the Internet. These modifications increased the maximum amount a company may raise (from $5 million to $50 million) and allowed companies to solicit investments from nonaccredited investors.

Unfortunately, it is estimated that a Regulation A+ offering could cost companies close to $100,000 in legal and accounting fees to prepare all necessary offering documents and to comply with pertinent state and federal reporting obligations. Given the substantial time and expense associated with Regulation A+ offerings, it is doubtful that developing artists or small-budget film producers will find much use for equity crowdfunding platforms.

(C)onsumers should be able to trust their money will actually be spent on the project they funded."

Rewards-based crowdfunding, however, does not offer to sell stock or equity in a company and is therefore not impacted by the formalities of a traditional securities offering. It is therefore not subject to the rules or regulations promulgated by the SEC and discussed above.

IN THE LIMELIGHT

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This does not mean, however, that those who seek to raise funds through rewards-based crowdfunding websites are immune from potential liability emanating from deceptive or misleading campaigns.

On June 15, for example, the Federal Trade Commission reached its first-ever ruling with respect to an allegedly fraudulent crowdfunding campaign. This ruling was entered against Erik Chevalier, who launched a Kickstarter campaign in 2012 to finance the production of a science fiction board game called The Doom That Came to Atlantic City.

Chevalier set out to raise $35,000 and promised to deliver pewter figurines to backers who pledged at least $75. In total, Chevalier's campaign raised approximately $122,000, which was made up of more than 1,200 pledges in excess of $75.

Chevalier never produced his game, however, and he never delivered any of the figurines promised to his "pledge investors."

According to Chevalier, the project was held up due to legal problems with Hasbro. This appears to have been a lie, however. In reality, Chevalier used the funds on "unrelated personal expenses such as rent, moving himself to Oregon, personal equipment and licenses for a different project."

In 2012, the FTC initiated proceedings against Chevalier based upon his misuse of funds received through Kickstarter. Its recent ruling against Chevalier highlights the government's intent to more closely scrutinize crowdfunding campaigns in order to protect those who pledge funds to support project creators.

According to Jessica Rich, director of the FTC's Bureau of Consumer Protection, "Many consumers enjoy the opportunity to take part in the development of a product or service through crowdfunding, and they generally know there's some uncertainty involved in helping start something new ... But consumers should be able to trust their money will actually be spent on the project they funded."

As part of his settlement with the FTC, Chevalier is prohibited from conducting any future misleading crowdfunding campaigns or from employing anyone to run a misleading crowdfunding campaign. His deviously deceptive actions made for a good test case for the FTC.

While few clients are likely to initiate a crowdfunding campaign with similar motives, the FTC's ruling — and its public statements made in the wake of this ruling — should still serve as notice that despite a lack of explicit regulations, they should take adequate measures to assure that their campaign clearly articulates precisely what the funds they seek to raise will be used for.

This will better serve both the interests of those looking to raise funds and those who help raise those funds.

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