

**Democratizing Commercial Real Estate Investing: the Impact of the JOBS Act and
Crowdfunding on the Commercial Real Estate Market**

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**Submitted to the Program in Real Estate Development in Conjunction with the Center for Real Estate
in Partial Fulfillment of the Requirements for the Degree of Master of Science in Real Estate
Development**

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ABSTRACT

This thesis systematically evaluates how rapid developments in the nascent crowdfunding industry, combined with recent regulatory changes, will impact the commercial real estate markets. The phenomenon of crowdfunding, defined as raising numerous small amounts of capital from a large number of people, or the crowd, has been accelerated by the recent passage of the Jumpstart Our Businesses Start-up Act (JOBS Act). The JOBS Act legalizes and facilitates the sale of securities used to crowdfund equity and debt investments, giving rise to a proliferation of new crowdfund entrants in various business sectors, including the commercial real estate arena. This thesis first gives a detailed analysis of the JOBS Act legislation and how it alters the current regulatory and business landscape. The focus then turns to the commercial real estate markets, tracing the evolution of commercial real estate as an institutional asset class and the influence large, institutional investors such as pension funds and real estate investment trusts exert on this market. The authors also examine the impact on the average investor and conclude that these large institutional investors have bifurcated the market, leaving the average investor unable to gain exposure to “hard” commercial real estate assets. The authors then link the research to crowdfunding, first with a chapter on the emerging and dynamic crowdfund industry in general, and then on specific commercial real estate crowdfunding sites, also discussing sites related to this sector. The authors strengthen this primary research with field investigations, conducting interviews with real estate developers, investors, and securities lawyers specializing in regulatory law. They concurrently surveyed 138 well-vetted real estate professionals (the MIT Center for Real Estate alumni). The thesis then projects the size of the potential dollar value of the commercial real estate crowdfund market based on existing value and turnover in the commercial real estate markets. The final chapter imagines what this market will look like in 2015; concluding that crowdfunding will have a profound effect on the commercial real estate market.

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This thesis is written with love and gratitude for my parents, Rick and Becky Burgett, without whom none of this would be possible. I am lucky to have such amazing parents who have provided me with endless opportunities and love. I love you all. Thank you to my friends and family for their love and support during this year and thesis writing process. Thank you to the MIT CRE professors, faculty and staff for their continued encouragement and inspiration – this year has been formative and challenging but an experience I will cherish. Most importantly, I am thankful for the hard work John has put into this thesis. I am forever grateful for his support, advice, and friendship, and feel lucky to have had such a wonderful writing partner.

- Bonnie

This thesis represents the end of a wonderful and fascinating journey, one that I am very pleased and privileged to have taken. I would first like to express my gratitude to the entire MIT faculty, but in particular to David Geltner, for his kindness, guidance and endless enthusiasm. Some of the toughest days were changed for the better by his reminders that “MIT is all about fun.” I would also like to express equal gratitude to my classmates for all of their support and encouragement; I have seen few teams of their caliber and capability, it was truly an honor to be part of this one. I would like to thank my children, John and Kelly for their love, support and patience with a father who missed sending them off to their first year of college. I love you both so much. Thank you to my brother Jeff and his wife Lynn for their endless support, providing me with the joys of their wonderful family over countless dinners. I would also like to thank Jamil Baz, Bruce Lakefield, Leo O’Connor, and Nassim Taleb for their friendship and guidance, providing me with the inspiration and courage to reach this day. Finally, I would like to thank Bonnie. Her dedication, creativity, intelligence and work ethic are beyond compare. She made this project a pleasure, providing this journey with the perfect ending.

- John

Most importantly, thank you to our thesis advisor, Walt Torous, and the professionals that graciously took our survey or were interviewed for this thesis.

Finally, we briefly reference in Chapter 8 the role the crowd played in catching the Boston Marathon bombing suspects. This tragic event occurred at the mid-point in our year here at MIT and will forever be etched in our memories. We hope that our reference to this event is representative of the notion that the crowd, in search of common good, works together to overcome a few bad apples. The conception of the phrase “Boston Strong,” that unified the crowd in the wake of this event demonstrates this unity in common good. Therefore, we respectfully dedicate this thesis to the memory of MIT Police Officer Sean Collier and the marathon bombing victims, and in thanksgiving for our brave law enforcement who worked tirelessly to bring the suspects to justice.

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Chapter I: Introduction

Thesis Objective

The objective of this thesis is to assess the impact of crowdfunding and the Jumpstart Our Businesses Start-up Act (“JOBS Act”) on the commercial real estate (“CRE”) markets, with special attention on the “sub-institutional” sector. The collision of crowdfunding with commercial real estate provides a rich environment to observe the disruptive and dis-intermediating impacts of crowdfunding on a staid, almost club-like commercial real estate industry, an industry having seen few major innovations since the introductions of the REIT structure in the 1960s and commercial mortgage securitization in the 1990s.

The term crowdfunding is just beginning to find its way into the popular lexicon but with various definitions. The Oxford Dictionary defines crowdfunding as “the practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet.” As the crowdfunding industry matures, separate major business categories have emerged: donation, reward, lending, and equity. Several early entrants have had considerable success, each dominating their respective sectors: the donation sector with Indiegogo.com and Kiva.com (a hybrid lending-donation site, loaning money with no interest), the reward sector by Kickstarter.com, and the for-profit peer-to-peer lending sector by LendingClub.com and Prosper.com. The amount of capital changing hands as well as the number of participants is staggering: Kiva has funded approximately \$500 million in no-interest loans from almost one million lenders since 2004. Kickstarter.com has raised over \$500 million from over three million donors since their launch in April 2009. LendingClub, a for-profit peer-to-peer lender founded in 2006, has booked over \$2 billion in loans to 160,000 borrowers.

However, regulatory limitations have stunted the growth of the equity and lending crowdfund sector in the U.S.¹ From a legal perspective, the sale of equity in exchange for future compensation or issuing debt with an attached coupon or interest payment both represent the sale of a security, and therefore subject to Securities and Exchange Commission (SEC) regulations. Several early crowdfund entrants such as Profounder.com, Propser.com, and Buyabeer.com, who ignored these laws by not

¹ This thesis is specifically focused on the United States market although numerous crowdfunding sites have been successful abroad. Crowdfunding is a highly international concept and will play a significant role in cross-border investment, however that is beyond the scope of this paper and introduces a number of other legal issues.

registering their securities or their firms as broker-dealers, were issued cease and desist orders by the SEC. These SEC actions provided a “wake-up call” to an Internet start-up industry accustomed to operating outside the purview of regulatory oversight. Only Prosper survived their interaction with the SEC after restructuring their business model. Simultaneously, the U.S. government realized the impact crowdfunding could have and the need to encourage its use while regulating the industry.

The passage of the JOBS Act on April 5, 2012 is, as President Obama described, “a game changer” for both the crowdfund industry and for all entrepreneurs, regardless of the asset class involved, including the commercial real estate industry. The primary objective of the JOBS Act is to facilitate capital formation that can cultivate small business growth. In accomplishing this goal, the JOBS Act focuses on regulating the sale of securities to “the crowd” in an effort to protect them against fraud, while it simultaneously loosens the regulatory constraints that govern the sale of securities to investors. The JOBS Act is not effective until the SEC releases the rules, which are being written concurrently with this thesis. The first evidence of the JOBS Act becoming a reality occurred on July 10, 2013, when the SEC released the first JOBS Act-related rules: lifting the ban on soliciting private placement securities.

In anticipation of SEC rulemaking, equity crowdfunding sites are now emerging in all sectors, including the commercial real estate sector. Some of these sites are in beta mode while others function under the existing regulatory structure.

To grasp the arguments made in this thesis, one must have a detailed understanding of the four primary components that intersect to create “crowdfunded commercial real estate.” These components, illustrated in the Venn diagram below (Figure 1) are as follows: the current security regulations and the JOBS Act, the commercial real estate capital markets, the commercial real estate asset markets, and Internet platforms and crowdfunding in other industries. Crowdfunding exists at the intersection of these components.

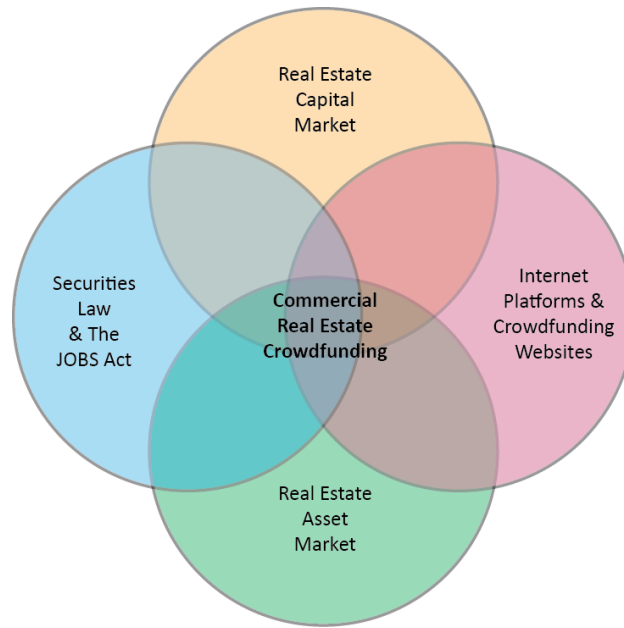


Figure 1: Venn Diagram: Genesis of Crowdfunded Commercial Real Estate (Authors)

The most important component accelerating the growth of this phenomenon is the JOBS Act and the rapid evolution of Internet platforms. Through researching these components, we seek to demonstrate that crowdfunding will not only be a disruptive and important part of the U.S. capital market but will decisively change the commercial real estate industry.

Research Methodology

We completed this thesis using three methods: traditional information gathering and research, interviews, and a survey. We gathered Information primarily from academic sources, by researching existing securities laws, and by reviewing The JOBS Act. Research pertaining to the commercial real estate sector and securities law was almost entirely academically sourced. Research on crowdfunding was derived from both academic literature and, given the temporal nature of the subject, carefully selected web-based sources.

We conducted fourteen (14) interviews, which included six real estate developers in varying markets who had developed projects from \$1.0 million to over \$250 million. These face-to-face interviews provided background information and also served as a “reality check” regarding the potential impact of crowdfunding on the commercial mortgage markets. In addition, we interviewed several MIT faculty members with expertise either in commercial real estate, crowdfunding, or entrepreneurship.

Finally, we sent a detailed survey, created with input from faculty members from both the MIT Center for Real Estate and the MIT Sloan School, to the 827 MIT CRE alumni. The target population for the survey was subjects with expertise in the commercial real estate industry; the 827 MIT Center for Real Estate alumni plus forty-two personal contacts in the real estate industry proved ideal, with 138 full responses.

Thesis Structure

This thesis comprises this introduction and seven additional chapters.

Chapter I introduces the JOBS Act, which is unique in the regulatory history of the United States. Previous regulatory acts passed by Congress have had the common themes of restraint, limitation, and restriction. They were designed to place rules on activities that the marketplace had previously engaged in, whether in the trading or origination of securities, the operation of exchanges, or in how the market participants might interact. The JOBS Act is the opposite: it is expansionary. It defines a new type of company, a new type of security issued by that company, and a new marketplace that will issue and trade these new securities. Congress amended the Securities Act of 1933 and the Exchange Act of 1934 in the JOBS Act and has now charged the SEC with the responsibility of writing the rules to enforce the law. Therefore, the JOBS Act and the related existing regulations must be explored in detail alongside the SEC rulemaking process.

Chapter II studies the details of the JOBS Act. Since the JOBS Act amends existing securities legislation, this chapter reviews the Securities Act of 1933, Regulation D, Regulation A, the Securities Exchange Act of 1934, and state “Blue Sky” laws. This chapter has several objectives: to give the reader a detailed understanding the current SEC regulatory landscape, to provide a similar understanding of how the JOBS Act amends these existing laws, and how the JOBS Act will impact the crowdfunding industry. Specific to the last point, the summary objective is to relate to the reader an understanding of how these laws might ultimately impact the purchase and sale of equity securities on “funding portals,” the expansion of the private placement markets and how it might impact the potential course of Regulation A.

Since this thesis focuses on how crowdfunding will specifically impact the commercial real estate markets, we next examine the commercial real estate marketplace in detail. Commercial real estate is defined by asset type and by investor sector to show how these assets are currently funded and how a

new funding mechanism such as crowdfunding might add value to the existing marketplace. Chapter III examines the existing market for commercial real estate, defining the overall marketplace and then exploring the bifurcation between the institutional and sub-institutional markets. This chapter will familiarize the reader with the landscape of commercial real estate markets, identify how this market is segregated by asset size, and evaluate the level of access different investor groups have to each of these markets. We then examine these markets in detail, assessing their relative size and funding mechanisms within the context of how each might adapt to crowdfunded capital. We touch on recent innovations in the commercial sector, such as REIT structures and how they actually serve the real estate investing needs of the average investor. This chapter also examines allocation mechanisms for institutional investors by comparing these portfolios to the portfolios of the average investor and observing the average investor's investment options for exposure to the commercial real estate sector.

Given that crowdfunding is a relatively new, Internet-driven phenomenon, we must also explore the use of the web as it relates to real estate. Chapter IV surveys the current “non-crowdfund” online commercial real estate marketplace. This chapter examines how the commercial real estate industry is currently using online marketing, social networking, and the Internet in general to further enhance the commercial real estate marketplace. First, we examine how the Internet has changed the nature of investing in the stock market as well as the general marketplace for goods and services. We then turn to the real estate market, where the residential markets have innovated using the web in contrast to the commercial real estate industry. We examine online residential real estate sites to find historic parallels to the commercial markets, paying particular attention on disruptions these online residential vendors have caused. The rest of this chapter evaluates and defines the landscape of the commercial real estate vendors such as LoopNet.com and Auction.com. By examining the existing, non-crowdfunding commercial real estate websites, we expose the deficiency and ultimate opportunity to transform this market.

Chapter V examines the current landscape of the crowdfund industry. The research considers the “name brand” non-commercial real estate websites and evaluates their growth, popularity, and capital-raising achievements. Then, within the context of the existing industry, we review and assess the nascent commercial real estate sector, site by site, giving a detailed snapshot of an industry in its infancy. Using media sources and web searches, we selected crowdfund sites, which we then analyzed with data provided by *Alexa*, a firm specializing in the measurement of web traffic. From the web traffic data *Alexa* produces, we determined a global and U.S. rank for each crowdfund site. In our analysis, we

presume that the most heavily trafficked sites are also the most important sites to that sector, inferring a high correlation between web traffic/use and the success of those websites.

Chapter VI then discusses the existing real estate crowdfunding sites, assessing their popularity, stature, and progress to date.

Along with this thesis, we conducted a survey targeting real estate professionals. The survey's results, along with face-to-face interviews with investors, securities lawyers, and developers, enhance our work. Both groups were asked similar questions designed to understand their investment strategies, funding needs, dexterity with technology, and, most important, their assessment of crowdfunding as it pertains to commercial real estate. Chapter VII provides an analysis, interpretation and summary of the interview data and presents the details of the survey data. We used comments collected either from the survey or from the face-to-face interviews to support the themes discovered in the survey data analysis.

Finally, Chapter VIII brings together all components and surmises the impact of crowdfunding on commercial real estate.

Chapter II: The JOBS Act in the Context of Historic Securities Regulation and Reform Measures

“For start-ups and small businesses, this bill is a potential game changer. Right now, you can only turn to a limited group of investors—including banks and wealthy individuals—to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot has changed in eighty years, and it’s time our laws did as well. Because of this bill, start-ups and small businesses will now have access to a big, new pool of potential investors—namely, the American people. For the first time, ordinary Americans can go online and invest in entrepreneurs they believe in,” President Obama declared when signing the Jumpstart Our Business Startup Act (“JOBS Act”) into law on April 5, 2012. The JOBS Act was introduced as a response to the 2008 financial crisis, and, perhaps as important, as the government’s attempt to keep up with the technological innovations introduced to the financial sector by the Internet. This legislation is unique in the history of securities law, with the goal of creating and expanding what is allowed under the law rather than placing limitations and prescriptions on businesses. The intent of the JOBS Act is to allow small companies to access pools of capital from many investors—an opportunity previously available only through large financial channels such as investment banks.² One method of raising capital from multiple investors is specifically addressed by name in this new legislation and is the focus of this thesis: the phenomenon of “crowdfunding.”

Obama further stated, “Of course, to make sure Americans don’t get taken advantage of, the websites where folks will go to fund all these start-ups and small businesses will be subject to rigorous oversight. The SEC will play an important role in implementing this bill.”³ Following the JOBS Act being signed into law, the U.S. Securities and Exchange Commission (“SEC”) was given a 270-day deadline to enact appropriate rules and regulations to implement this legislation. The deadline passed and, as this paper is being written, the Securities and Exchange Commission still grapples with devising a regulatory structure that protects investors but also keeps the spirit of the law intact.⁴ Although the legislation has been signed in law, it is not effective until the SEC releases its rules and regulations pertaining to administering this law, the first of which was released on July 10, 2013. Nevertheless, relying on the actual JOBS Act legislation, this chapter summarizes the legislation and sets the stage to surmise the impact on the commercial real estate industry

² Cunningham, “The JOBS Act,” 22–24.

³ “Remarks by the President at JOBS Act Bill Signing | The White House,” 1.

⁴ SEC Wire, “SEC Meeting 6/8/12 Comments on Emerging Growth Companies.”

While the purpose of this chapter is to explore the JOBS Act, before doing so, it is important to understand the historic contextual framework of securities regulation and what the JOBS Act amends. The JOBS Act represents the latest effort in a series of regulatory laws and reforms that began in 1933. The following regulatory reforms have been enacted over the last eighty years, and while this list is not exhaustive, it includes the major securities acts signed into law over the 1933 to 2012 period:⁵

- Securities Act of 1933
- Securities Exchange Act of 1934
- Trust Indenture Act of 1939
- Investment Company Act of 1940
- Investment Advisors Act of 1940
- Sarbanes-Oxley Act of 2002
- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
- Jumpstart Our Business Startups Act of 2012

These regulations each happen to occur after a financial calamity and attempt to address and prevent some related cause or result of that calamity. The Securities Act of 1933 and the Securities Exchange Act of 1934 aimed to reform a securities industry whose practices were thought responsible for the Crash of 1929 and the Great Depression that ensued. As the Depression subsided, within the framework of these new laws, the financial sector began to expand and investment firms began to proliferate. This evolution precipitated the need to regulate a growing asset management sector and accompanied the enactment of the Investment Company Act of 1940 and the Investment Advisors Act of 1940. The Sarbanes-Oxley Act of 2002 was largely a response to numerous corporate and accounting scandals, including Enron, Tyco, Adelphia, Peregrine System, and WorldCom. The 2008 financial crisis resulted in the Dodd-Frank Reform and Consumer Protection Act of 2010. While the precise causes of the 2008 financial crisis remain somewhat obscure,⁶ it is accepted that large Wall Street investment banks played a major causal role and thus their behavior needed to be more closely monitored. Although these legislative acts were intended to protect the public, they were also restrictive and placed burdens on businesses which in some ways simultaneously stifled growth.

⁵ "The Laws That Govern the Securities Industry."

⁶ Lo, "Reading About the Financial Crisis."

Finally, in 2012, the most recent reform measure, The JOBS Act, seeks to loosen previous securities regulations and to encourage small business growth; from a historic regulatory perspective, the JOBS Act is unique. Previous legislation was based entirely on prescribing rules to limit the activity of firms engaging in financial activities. The JOBS Act is the first act in the history of securities law that is expansionary, acknowledging and creating new sources of funding for small companies. This thesis will explore how the JOBS Act could ultimately democratize the commercial real estate industry for small businesses and individuals. Thus, this chapter will focus primarily on the JOBS Act and the predecessor acts that it is meant to amend, specifically The Securities Act of 1933 subsections Regulation D and Regulation A. The source documents for the remainder of this chapter were the actual public law documents: The Securities Act of 1933, The Exchange Act of 1934 and The JOBS Act. Other references are noted accordingly

*The Securities Act of 1933*⁷

The primary objectives of The Securities Act of 1933 (The Act or '33 Act) are to govern the issuance process of new securities and to protect the buyers of these securities. "Often referred to as the 'truth in securities' law, the [']33 Act requires that investors receive financial and other significant information concerning securities being offered for public sale; and to prohibit deceit, misrepresentations, and fraud in the sale of securities."⁸ The regulatory framework of the '33 Act is designed to enable investors to make informed investment decisions based on complete, factual information, but not to advise them about the securities' investment merits.

A specific definition of "securities" is critical to understanding this chapter and its discussion of regulations. The Securities Act of 1933 defines a "security" as follows:

"(1) The term 'security' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any

⁷ Ratner and Hazen, *Securities Regulation*.

⁸ "The Laws That Govern the Securities Industry."

security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”⁹

Each federal securities statute has its own definition of “security,” but “the most expansive part of the definition of security, the catch-all category, is the term ‘investment contract’.”¹⁰ This concept was clearly defined in 1946, when the U.S. Supreme Court decided *SEC v. W. J. Howey Co.*, which clarified the definition of a "security" under the Securities Act of 1933.

In *Howey*, an orange grower offered prospective customers an opportunity to own an orange grove by purchasing from Howey a land parcel, coupled with a service contract from Howey or from another service provider. However, the land contract specified that land could not be purchased without a service contract, and Howey retained all discretionary decisions and control over the growing, harvesting, marketing, and selling of the oranges. Although Howey technically sold land to grow oranges, the Court held that it was in fact selling a security, which the Court defined to include any scheme that involves "an investment of money in a common enterprise with profits to come solely from the efforts of others . . . whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value." The Court further defined a profit-seeking business as one where "[t]he investors provide the capital and share in the earnings and profits ... [and] the promoters manage, control, and operate the enterprise."

Applying the above description, almost any enterprise that sells unregistered securities to such investors in which the investors are not also officers and employees of the enterprise, would be selling such securities in violation of the Securities Act of 1933.¹¹ In summary, the Supreme Court defined an investment contract as involving the following four elements: (1) an investment of money (2) in a common enterprise (3) with an expectation of profits (4) arising solely from the efforts of the promoter or a third party.

⁹ Ratner and Hazen, *Securities Regulation*, Sec 2(a)(1).

¹⁰ Bradford, "Crowdfunding and the Federal Securities Laws," 2012, 10.

¹¹ Pope, "Crowdfunding Microstartups," Vol.13:4 986–987.

Both the Supreme Court and the lower courts have refined the *Howey* test over the years, but its basic elements remain unchanged—with one significant exception. The word “solely” has been eliminated from the efforts-of-others part of the test. Instead, the question is “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”¹² When applied to the realm of commercial real estate, unless the person is the developer, manager, or employee exerting an effort to generate income from the property, any investment would be considered a security. Today, people commonly invest in commercial real estate through registered securities such as shares of a Real Estate Investment Trust (discussed later in the thesis) or through a private placement exempt from registration.

Under the regulations, all securities sold in the United States fall into one of two categories, either registered or exempt from registration. To register securities, the company must provide a description of the company’s properties and business, a description of the security offered for sale, information about the company’s management, and financial statements certified by independent accountants. Registration statements and prospectuses become public shortly after the company files them with the SEC. All companies, domestic and foreign, are required to file registration statements and other forms electronically in order for investors to access them using the SEC’s Electronic Data Gathering and Reporting (EDGAR) system. Securities are often registered in connection with an Initial Public Offering (“IPO”) of typically large companies with the intent of trading on exchanges such as NYSE or NASDAQ.

However, not all offerings of securities must be registered with the SEC, and thus fall under the “exempt from registration” category. The most common exemptions from the registration requirements are detailed in Regulation D and Regulation A of the ’33 Act.

Regulation D—Defines Certain Securities “Exempt” from The Securities Act of 1933

As stated above, under the Securities Act of 1933, any offer to sell securities must either be registered with the SEC or meet an exemption. Regulation D defines this exemption with a series of six rules, Rules 501-506, which establish three transactional exemptions from the registration requirements

¹² Bradford, “Crowdfunding and the Federal Securities Laws,” 2012, 10.

of the Securities Act of 1933.¹³ Rules 501-503 set forth definitions, terms, and conditions that apply throughout the remainder of the Regulation. The specific exemptions are detailed in Rules 504, 505, and 506. Even with the Regulation D exemption, companies must file a Form D after they sell their first securities. Form D (which, since 2008, can be filled out electronically) is a short notice form that includes the names and addresses of the firm's executives and promoters. These exemptions also have certain financial standards, and even if there are no specific disclosure requirements, companies must provide enough information free from false or misleading statements to avoid violating anti-fraud provisions under the law.

The following provides the circumstances for an exemption from the registration requirements of the federal securities laws given the following conditions under Rules 504, 505, and 506.

Rule 504 of Regulation D

- The company can offer and sell no more than \$1,000,000 of their securities in any 12-month period with no ceiling on the number of investors;
- Permits the payment of commissions (though they must be disclosed to the investors);
- This exemption is not available to a "blank check company;" typically applies to a corporate shell used as an acquisition vehicle for merger, such as a special purpose acquisition company or "SPAC";
- The company is not allowed to solicit or advertise their securities to the public;
- Purchasers receive "restricted securities," with the restriction noted in a legend. Rule 144 (Rule 144 pertains to the resale of restricted securities, such as "control" securities having been issued to founders and executives during the formation of a new company. These rules involve a six-month or one-year holding period and have other stipulations preventing their resale)¹⁴ governs the sale of these securities; however, this restriction is altered by a further requirement that if the securities can be registered in the state in which they are sold, they will no longer be considered restricted by virtue of state regulatory requirements.

Therefore, companies can sell securities that are not restricted, if one of the following circumstances is met:

¹³ Astarita, "Introduction to Private Placements from SECLaw.com - the Leader in Securities Law News, Information and Commentary."

¹⁴ "Rule 144: Selling Restricted and Control Securities."

- The company registers the offering exclusively in one or more states that require a publicly filed registration statement and delivery of a substantive disclosure document to investors;
- A company registers and sells the offering in a state that requires registration and disclosure delivery and also sells in a state without those requirements, so long as the company delivers the disclosure documents required by the state where the company registered the offering to all purchasers (including those in the state that has no such requirements); or the company sells exclusively according to state law exemptions that permit general solicitation and advertising, so long as the company sells only to “accredited investors,” which is defined in Rule 501 and will be discussed further in the chapter.

Rule 505 of Regulation D

Rule 505 of Regulation D is similar to Rule 504 except for the number of securities that can be sold, its restriction to accredited investors, and the state-by-state registration allowance. Again, Rule 505 allows some companies offering securities to have those securities exempted from the registration requirements of the federal securities laws. To qualify for this exemption, a company:

- Can only offer and sell up to \$5.0 million of its securities in any twelve-month period;
- May sell to an unlimited number of “accredited investors” and up to thirty-five other persons who do not need to satisfy the sophistication or wealth standards associated with other exemptions;
- Must inform purchasers that they receive “restricted securities,” meaning that the securities cannot be sold for six months or longer without registering them; and
- Cannot use general solicitation or advertising to sell the securities.
- Financial statements need to be certified by an independent public accountant;

Rule 506 of Regulation D

Rule 506 of Regulation D provides a "safe harbor" from state registration requirements for the private offering exemption in Section 4(2) of The Securities Act. Companies using the Rule 506 exemption can raise an unlimited amount of money from an unlimited number of accredited investors.

The hedge fund and private equity industries have both flourished under the auspices of Regulation D Rule 506. Most real estate partnerships and ventures also raise money using this exemption through private placements. A company will be considered for this exemption by satisfying the following standards:

- The company cannot use general solicitation or advertising to market the securities;
- The company may sell its securities to an unlimited number of "accredited investors" and up to thirty-five other purchases. (Unlike Rule 505, all non-accredited investors, either alone or with a purchaser representative, must be sophisticated—that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.);
- Companies must decide what information to give to accredited investors, so long as it does not violate the antifraud prohibitions of the federal securities laws, but companies must give non-accredited investors disclosure documents that are generally the same as those used in registered offerings. If a company provides information to accredited investors, it must make this information available to non-accredited investors as well;
- The company must be available to answer questions by prospective purchasers;
- Financial statement requirements are the same as for Rule 505;
- Purchasers receive "restricted" securities, meaning that the securities cannot be sold for at least a year without registering them.

The term “Accredited Investor” is critical to this analysis and to the remainder of the thesis. As the thesis progresses, it becomes evident that this class of citizens has an expanded ability to invest in opportunities not available to a large portion of population, but the JOBS Act relaxes the hurdles that exist for non-accredited investors through crowdfunding, which is therefore poised to democratize the investment arena.

An “Accredited Investor” is defined in Rule 501(a) by the following criteria:¹⁵

- “A bank, insurance company, registered investment company, business development company, or small business investment company;

¹⁵ “Accredited Investors SEC.GOV.”

- An employee benefit plan, within the meaning of the Employee Retirement Income Security Act (ERISA), if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5.0 million;
- A charitable organization, corporation, or partnership with assets exceeding \$5.0 million;
- A director, executive officer, or general partner of the company selling the securities;
- A business in which all the equity owners are accredited investors;
- A natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1.0 million at the time of the purchase, excluding the value of the primary residence of such person;
- A natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or
- A trust, not formed to acquire the securities offered, with assets in excess of \$5.0 million whose purchases a sophisticated person makes."¹⁶

There is however another exemption method, Regulation A, that allows non-accredited investors the ability to invest in securities and caters to small businesses, although historically it has rarely been used. While Regulation D and the terms defined above play a critical role in the creation of the securities and investment market today, the '33 Act was also cognizant of the burden this would place on small businesses. Regulation A is meant to address this issue; however, this has not been as widely used as the Regulation D exemptions.

Regulation A

Under the heading "Small Issues Exemptive Authority," the Act sets out the details for what is known as Regulation A. This exemption from the Securities Act of 1933 allows small businesses access to capital by exempting them from the registration if the securities offering was below \$5.0 million. Under this exemption, the securities are not restricted and can be offered and sold publicly. The issuer may solicit interest in the offering prior to filing any offering statement, giving issuers the ability to gauge interest before incurring the expense of filing. Regulation A is quite similar to the exemption granted using Regulation D, Rule 505 but with the following differences: (1) under Regulation A the issuer can solicit both interest and the securities (after SEC review and approval); (2) non-accredited investors may

¹⁶ Ibid.

purchase these securities; and, (3) there is no restriction on the resale of Regulation A securities. However, Regulation A does not preclude these offerings from being subject to state laws.

While disclosure is the primary method of protecting investors, the '33 Act attempts to “fashion exemptions that balance investor protection and capital formation,” the two primary responsibilities of the SEC.¹⁷ Although the Regulation A exemption seems to provide an attractive path to capital access for small businesses, historically it has not, with fewer than eight Regulation A offerings per year throughout the period from 1999 to 2010. The problem occurs at the State regulatory level since Regulation A has not provided an exemption from registration with individual state regulators; therefore, the federal exemption accomplishes little for a company with aspirations to raise capital on a national level, as they would need to comply with state “Blue Sky” laws. Despite the impediment Blue Sky laws pose to raising money under the Regulation A exemption, the changes to this regulation in the JOBS Act, discussed later in the chapter, make this a much more attractive option for the future.

“Blue Sky” Laws with regard to Regulation A and Regulation D

“Every state has its own securities laws—commonly known as ‘Blue Sky Laws’—that are designed to protect investors against fraudulent sales practices and activities. While these laws can vary from state to state, most states’ laws typically require companies making small offerings to register their offerings before they can be sold in a particular state. The laws also license brokerage firms, their brokers, and investment adviser representatives.”¹⁸ Essentially, this means that there are fifty more securities regulators in addition to the SEC with which issuers would have to comply with in order to access capital on a national level, unless the offering is done under Regulation D 506.

As mentioned above, under the Regulation D 506 exemption, exempt offerings are also excused from state registration requirements. This was accomplished through the enactment of the National Securities Markets Improvement Act of 1996 (NSMIA) in October of 1996. The Act was passed in response to the states’ inconsistent governing of Regulation D offerings. One change that NSMIA amended was Section 18 of the Securities Act of 1933, creating a class of securities referred to as “covered securities,” which were no longer subject to state securities laws. Covered securities include: securities listed (or approved for listing) on the NYSE, AMEX, and the NASDAQ/National Market, and

¹⁷ Campbell, *Regulation A and the Jobs Act*, A-2.

¹⁸ “Blue Sky Laws.”

securities of the same issuer, which are equal in rank or senior to such listed securities; mutual fund shares; securities sold to certain *qualified purchasers* certain securities exempt under Section 3(a) of the Act (including government or municipal securities, bank securities, and commercial paper); and securities exempt from registration under the '33 Act if sold in transactions complying with Rule 506 of Regulation D under the Act. "NSMIA is an important regulatory precedent as it essentially 'preempts' state securities registration requirements while still preserving the right of the states to investigate and prosecute fraud."¹⁹

The NSMIA rules also made Regulation D the preferred method for small firms to raise capital. In 2009 (and shockingly, only since 2009), the SEC started electronically tracking Regulation D offerings by date and size of issue. A SEC report underscores the reliance on Regulation D offerings by the capital markets. "In 2010, Regulation D offerings surpassed debt offerings as the dominant offering method in terms of aggregate amount of capital raised in the US with \$905 billion. The amount of capital raised through Regulation D offerings may be considerably larger than what is disclosed on Form D because there is no closing filing requirement. The median Regulation D offering is modest in size: approximately \$1 million. Consistent with the original intent of Regulation D to target the capital formation needs of small business, there have been a large number of smaller offerings: 37,000 unique offerings since 2009.

There is a strong presence of foreign issuers in the Regulation D offering market. Over the period 2009 to the first quarter of 2011, they account for approximately 25% of capital raised. Among broader trends in capital raising, there has been a shift from public- to private-capital raising over the past three years, due to both a decline in public issuances and an increase in private issuances: public issuances fell by 11% from 2009 to 2010, while private issuances increased by 31% over the same period."²⁰ "Although capital raised in the U.S. by domestic issuers is almost twice that raised by foreign issuers, the capital raised by foreign issuers increased by 5% from 2009 to 2010, accounting for nearly the entire increase in total capital raised in the US during the period."²¹

With Regulation D offerings surpassing debt offerings by raising \$905 billion (and, the report clearly states the real number is considerably larger), the markets have voted on the preferred route to raising capital. As mentioned before, this is the preferred method by many real estate developers and

¹⁹ "SECLaw.com Blue Sky Laws - State Securities Laws -Intro from SECLaw.com."

²⁰ Bauguess and Ivanov, "Capital Raising in the US," Abstract.

²¹ Ibid.

investment companies, and has also been the driving source of funds behind the hedge fund and private equity industries.

Last, NSMIA has introduced a new term, “qualified purchaser,” to define an investor. With respect to Regulation D offerings, the SEC has defined a “qualified purchaser” as an “accredited investor.” However, as of the writing of this paper, the SEC has not defined a “qualified purchaser” with respect to Regulation A offerings, thereby creating some questions as this pertains to implementation of the JOBS Act.

The Securities Act of 1934

Enacted on June 6, 1934, The Securities Act of 1934 (“Exchange Act”) is the foundational legislation governing the trading of securities in the *secondary* market. The Exchange Act also established the Securities and Exchange Commission (SEC).

The Exchange Act is over 370 pages long, consisting of thirty-nine sections. Most of the legislation is outside the scope of this paper, as it is not modified by the JOBS Act. With that said, the following list, although not exhaustive, summarizes some of the Act’s major governance features: regulates all exchanges, establishes margin requirements and places restrictions on borrowing by exchange members, brokers and dealers, prohibits the manipulation of security prices, establishes shareholder approval for executive compensation, creates rules on corporate governance, creates audit requirements for companies, and regulates the municipal bond markets and government securities.²² The requirements of a broker-dealer and related registration are significant as they relate to the JOBS Acts requirements for online funding portals.

Pertinent to this paper, the Exchange Act establishes an ongoing registration requirement for securities (this is an extension of the ‘33 Act, which only applies to issuance of securities) based on the number of shareholders and the assets of a company, and establishes the registration process and regulations for brokers and dealers. In 1938 the Maloney Act “established the first Self-Regulatory Organization (SRO), the National Association of Securities Dealers (NASD), which later evolved into the current Financial Industry Regulatory Authority (FINRA). The Maloney Act expanded the SEC’s authority in the over-the-counter market by authorizing the SEC to define and prevent fraud in that market. The

²² Reporting, “SECURITIES EXCHANGE ACT OF 1934.”

Maloney Act provided for the establishment of any number of SROs, in which membership would be voluntary. Originally, the drafters seemed to believe that there would be an SRO in each Federal Reserve Bank district; in fact, this never happened. The NASD is the only registered national securities association that came into existence.”²³ This Act is relevant to this thesis in that the SEC and FINRA will play a crucial role in administering the JOBS Act and thus will impact any crowdfunding portal or company. While the JOBS Act is revolutionary in its expansionary legislation, it does not allow for unregulated creation of crowdfunding sites, as stated by Obama when signing the JOBS Act into law.

The Jumpstart Our Business Startups Act (“JOBS Act”)

Viewed as a bipartisan bill, the Jumpstart Our Business Startups Act was passed by the House of Representatives on March 8, 2012 and the Senate on March 22, 2012. President Barak Obama then signed *Public Law 112-106, House Bill Number H.R. 3606*, into law on April 5, 2012. The broadly worded Bill description following the title is, “To increase American job creation and economic growth by improving access to public capital markets for emerging growth companies.” The JOBS Act targets Emerging Growth Companies (“EGC’s”), defining them as companies issuing stock or equity that have annual receipts or revenues of less than \$1.0 billion in their most recent fiscal year.

Most important, the JOBS Act introduced a new term to securities law: “crowdfunding.” The stated intent of the law was to allow startups and small businesses to use the Internet to raise equity capital from investors across the country and around the globe. The JOBS Act allows small companies, including startups, to raise, through crowdfunding, up to \$1.0 million per year, provided that within a five-year period their market value does not exceed \$700 million. “For such companies, the act has also created exemptions to accounting and auditing rules, as well as to rules that require public companies to report details concerning executive compensation and other financial data.”²⁴ Thus the JOBS Act relaxes now-burdensome reporting requirements that can financially tax small firms and hinder their growth. The JOBS Act also lifts the ban on general solicitation under Regulation D and amends Regulation A to allow for up to \$50 million in securities to be sold up from the original \$5 million.

²³ Lofchie and Messulan, *SECURITIES SELF REGULATORY ORGANIZATIONS*, 3.

²⁴ Cunningham, “The JOBS Act,” 1.

The JOBS Act consists of seven parts, each titled accordingly:

- Title I: Reopening American Capital Markets to Emerging Growth Companies
- Title II: Access to Capital for Job Creators
- Title III: Crowdfunding
- Title IV: Small Company Capital Formation
- Title V: Private Company Flexibility and Growth
- Title VI: Capital Expansion
- Title VII: Outreach on Changes to the Law²⁵

The Appendix contains a more detailed summary of the specific sections of each title within the JOBS Act.

Title I: Reopening American Capital Markets to Emerging Growth Companies

Title I contains eight sections with definitions used throughout the remainder of the Act. Perhaps the most important definition is that of an “Emerging Growth Company,” or “EGC.” Section 101 defines an “Emerging Growth Company” (EGC) as a firm with less than \$1.0 billion in annual revenue that had its first sale of common equity after December 8, 2011.

Sections 102, 103, and 104 relax requirements pertaining to shareholder approvals, audited financial statements, internal controls, and auditing standards for EGCs. Section 108 requires the SEC to review reporting requirements mandated by the '33 Act for public companies to streamline filing for EGCs. Again, these sections intend to lift burdens for companies as they grow so they can stimulate the U.S. economy.

Section 105 addresses the availability of information on EGCs. It exempts broker-dealers from certain restrictions under the law so they may issue verbal, hard copy, or electronic research on an EGC without constituting an offer to sell securities, thereby loosening marketing standards for EGC's seeking to raise capital. The section also allows an EGC to solicit qualified institutional buyers (defined as institutional investors who meet certain criteria, or “QIBs”²⁶) or accredited investors to purchase

²⁵ “Reopening American Capital Markets to Emerging Growth Companies.”

²⁶ Qualified Institutional Buyer (or QIB) is a legal designation assigned to a purchaser of securities who meets a certain minimum level of sophistication, size, and market savvy with respect to complicated or risky securities.

securities and to “test the waters” of potential future sales by disseminating information about the company without an offer to sell securities. This change permits companies to gauge level of interest in their securities without having to go through an expensive and time-consuming registration process. Prior to this amendment, broker-dealers could not discuss an offering without making an actual sale offer.

At the same time, this section prohibits the SEC, or any national securities associations, from applying either rules or regulations concerning the publication of research reports on EGCs and conflict-of-interest rules or regulations concerning an Initial Public Offering (IPO) of an EGC.

Section 107 allows an EGC to forgo exemptions granted under the Act and gives the EGC the right to voluntarily comply with all the requirements a non-EGC would be subject to. Basically, EGC’s have the right to refuse the exemptions under this clause; however, once an EGC refuses the exemption, it is irrevocable; they cannot go back to EGC status.

Title II: Access to Capital for Job Creators

Section 201 changes the way raising capital has occurred since the ’33 Act by requiring the SEC to modify Regulation D so that general solicitation and advertising prohibitions do not apply if all buyers are accredited investors. The section also extends this exemption to buyers believed qualified institutional buyers, thus increasing the potential buyer pool. This change to securities law is monumental for industries that have operated under eighty years of solicitation constraints such as the hedge fund and private equity fund industries. Furthermore, the modification will state that these offers do not become public offerings by virtue of advertising or general solicitation. However, issuers will be required to verify that these security buyers are accredited investors, but the verification method still awaits SEC rulemaking. As will be discussed in Chapter VI, websites that are available to accredited investors under this legislative modification have already emerged. While this opens the door for website marketing, Title III further addresses these Internet platforms and portals. Title II does state that

Issuers and their banks may elect to market private placement, stock, or bond offerings only to QIB clients to save time and transaction costs. The United States Securities and Exchange Commission defined the QIB designation in Rule 144a of the Securities Act of 1933. Rule 144a defines a QIB as a firm meeting a minimum threshold of \$100M in discretionary securities investments. In addition, a firm with the QIB designation must operate as a qualifying business type such as an insurance company, pension plan, investment firm, investment advisory, etc. QIB investors are eligible to access certain capital-raising deals marketed to rule 144a customers only. Securities regulators in other countries have variations of the QIB status; however, SEC rule 144a is characteristic of the global QIB}

platforms and portals are exempt from the requirements to register as a broker-dealer in order to sell securities under Regulation D Rule 506, subject to conditions. These conditions are similar to those addressed in Title III. Furthermore, portals cannot be subject to statutory disqualification such as a felony conviction or securities fraud conviction. If these obligations are met, these platforms or funding portals are exempt from the requirement to register as a broker-dealer in order to sell securities under Regulation D Rule 506.

Title III: The Crowdfund Act

This Title is perhaps the most important section of the legislation as it pertains to this paper. Section 301: Short Title states that this section of the Act may be cited as the “Capital Raising Online While Deterring Fraud and Unethical Disclosure Act of 2012” or the “CROWDFUND Act”.

Section 302, titled “Crowdfunding Exemption,” defines terms under which transactions of \$1.0 million or less are exempt from certain registration requirements, thus allowing companies to easily raise up to \$1.0 million per year.

However, it establishes maximum annual purchase limits for crowdfunded securities based on income and net worth thresholds of the investor and states that the securities must be purchased through a “funding portal.” The purchase limits are as follows:

- The greater of \$2,000 or 5% of the annual income or net worth, if either the annual income or the net worth of the investor is less than \$100,000.
- If the annual income or net worth of the investor is greater than \$100,000, the investor can purchase up to 10% of either of those amounts with an annual cap not to exceed \$100,000.

Section 304 requires the SEC to create rules that would relax the current laws requiring the newly defined intermediary, “funding portals,” to register as broker-dealers, provided that they remain subject to SEC authority—instead they would register as funding portals, not broker dealers. Intermediaries must register with the SEC as either a broker or a funding portal as well as with “any applicable self-regulatory organization,” but as the only self-regulatory body is FINRA, the portal must register with FINRA. This section introduces a new term, “Funding Portal,” and outlines requirements for these intermediaries and related revisions to existing securities law.

A “Funding Portal” is defined in a revision to the Securities Exchange Act of 1934, section 3(a)(80) with the following language: “The term “funding portal” means any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to section 4(6) [15] of the Securities Act of 1933 (15 U.S.C. 77d [16]), that does *not*:

- Offer investment advice or recommendations;
- Solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;
- Compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
- Hold, manage, possess, or otherwise handle investor funds or securities; or
- Engage in such other activities as the Commission, by rule, determines appropriate.”²⁷

The Funding Portal must provide disclosures, including disclosures pertaining to risk and other investor education materials that the SEC may, by rule, deem appropriate.

The portal must ensure that each investor review the investor education information and understand that they could lose their entire investment. Portals must also administer questions demonstrating that the investor understands the type of high risk they are taking by investing in startups and small firms and also that these investments generally are not liquid.

The portal is also required to assist in protecting investors from fraud committed by Issuers by taking the following actions:

- Conducting background checks (with the SEC enforcement division)
- Within 21 days provide the SEC with any information provided by the issuer
- Ensure that offering proceeds are only provided to the issuer when aggregate capital raised is equal to or greater than the target offering amount
- Ensure that the annual investor investment limits have not been exceeded
- Take steps to insure the privacy of the information collected as determined by the SEC in future regulations
- Not compensate promoters, finders, or lead generators for providing the portal with the

²⁷ Reporting, “SECURITIES EXCHANGE ACT OF 1934.”

- personal identity of potential investors
- Prohibit its officers, directors, or partners from having any financial interest in an issuer using its services
- Meet other requirements as the Commission may, by rule, prescribe for the protection of investors

In order for Issuers to be eligible for the crowdfund exemption, Issuers must file with the commission and provide to investors, their funding portal, and potential investors key pieces of information. This required information includes basic information as well as descriptions of the business, business plan, and the financial condition of the issuer and past offerings. The stated use and purpose of the proceeds, including the target amount and deadline for reaching the targeted amount, must be provided along with regular updates during the raising process. This section also establishes audited financials and income tax reporting requirements based on the target amount. Most important, the Issuer must provide a description of the ownership and capital structure of the issuer, how the shares may be affected by other securities in the capital structure or diluted, and how the securities offered are being valued and risks to purchaser associated with being minority shareholders.

Finally, the section establishes the liability of Issuers for making fraudulent statements or omitting material facts in connection with an offering. This section also restricts the transfer of crowdfunded securities except under four conditions: a transfer to the Issuer, a transfer to an accredited investor, a transfer as part of a registered security offering, or a transfer to a family member as part of a divorce proceeding or as a result from the death of a family member.

The SEC is then tasked with designing rules that govern the disqualification of issues, brokers, and funding portals, however as mentioned before, as of the writing of this paper, the SEC had missed the deadline for issuing these rules.

Although the portal cannot receive commission, which restricts their profitability, the portal or platform is permitted to co-invest in the securities offered on their site. Furthermore, this section allows those who provide ancillary services, such as lawyers and accountants, to bring investors to the intermediary without registering as a broker-dealer. Section 305, Relationship with State Law, limits the authority of the SEC to interfere with state security examiner's ability to enforce or to examine funding portals. It also establishes that the exemption from state requirements applies only to registration,

documentation, and offering requirements, and then details the condition that allows states to charge fees on the issuance of crowdfunded securities.

Title IV: Small Company Capital Formation

Sec. 401. Authority to Exempt Certain Securities

This section of the Act deals with Regulation A. Initially, the Regulation A exemption applied to offerings up to \$5.0 million, but a recent amendment as part of the JOBS Act changed that limit to \$50.0 million sold within a 12-month period. Under this new amendment as part of the JOBS Act, the issuer will have to prepare annual audited financials, and the SEC has the right to request more detailed information regarding business operation, financial condition, corporate governance principals, and use of investor funds. This information would be made available to the public. Also, the SEC will, no later than two years from the date of enactment of the JOBS Act, review the proposed \$50.0 million offering size to insure it is still appropriate.^{28 29}

As discussed earlier, Regulation A has fallen into disuse, and this Section of the Act is meant to revive it, but there are questions around how effective this amendment is given the introduction of the term “qualified purchaser” as it pertains to Regulation A. This section stipulates that these offerings are “covered securities” under NSMIA, which essentially relieves companies from Blue Sky registration just as NSMIA did for Regulation D offerings. However, there is a critical wrinkle: if “offered or sold to a qualified purchaser, as defined by the Commission pursuant to paragraph (3) with respect to purchase or sale.” While NSMIA clearly defines ‘qualified purchaser’ as an ‘accredited investor’ with respect to Regulation D, for Regulation A the law states that a ‘qualified purchaser’ is to be defined by the Commission or SEC. This leaves Title IV currently in a state of ambiguity with respect to Blue Sky registration at the state level. Last, it again mandates that the SEC conduct a “Blue Sky Study” and transmit a report to House committees on financial services and banking no later than three months from enactment of the JOBS Act.

As mentioned, this Regulation A also allows the issuer to solicit interest or “test the waters” before offering without providing offering documents. Liability standards for the issuer similar to

²⁸ Campbell, *Regulation A and the Jobs Act*.

²⁹ Ratner and Hazen, *Securities Regulation*.

Regulation D are established to protect against fraud. These standards also mentions possible future disclosures, such as distribution to investors of an offering statement, including audited financials, description of the business and its financial condition, its corporate governance structure and uses of investors' funds. It also establishes that the issuer has to file annual audited financials with the SEC. Despite these possible reporting requirements and annual filing requirement, Regulation A is now a more attractive exemption and likely to be used increasingly in the future.

Title V: Private Company Flexibility and Growth

Title V of the JOBS Act modifies the Securities Exchange Act of 1934 regarding the threshold requirements for registration. Under old provisions of the Exchange Act, if a company had fewer than 750 shareholders and less than \$1.0 million in assets, the firm was exempt from registration. Those limits were amended to less than \$10.0 million in assets or either of the following shareholder thresholds: more than 2,000 shareholders or more than 500 non-accredited investors.

For purposes of the shareholder thresholds discussed in 501, Section 502 excludes employee stock compensation plans from threshold counts, which is important for start-up companies that often use this compensation method.

Title VI: Capital Expansion

Title VI focuses primarily on banks and is parallel in scope to Title V as it applied to small companies. The rationale behind this act is that by freeing up small banks from expensive reporting requirements, they can lend more aggressively and better support local small businesses.³⁰

Summary of the JOBS ACT

While the JOBS Act has been passed and signed into law, it does not become effective until the SEC and FINRA write the governing rules to implement it, as described in Title III Section 303. On April 12, 2012 the SEC issued the following statement: "The Act requires the Commission to adopt rules to implement a new exemption that will allow crowdfunding. Until then, we remind issuers that any offers

³⁰ Cunningham, "Small Company Capital Formation," 142.

or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws.”³¹

On April 8th, 2013, almost a year after the JOBS Act was signed into law, David Blass, a chief counsel at the SEC, addressed an event sponsored by the industry advocacy group *CrowdCheck*. When asked for a timetable about when the rules governing the new legislation might be finalized, Blass responded: “It just is not possible for me to say a date in which it will or will not be up and running...I don’t think anybody who gives you a prediction on timing really knows what they’re talking about, unless they’ve been through the process and knows what goes into making an SEC rule final.”³²

Blass also noted that the timeline would depend largely on the priorities of former New York federal prosecutor Mary Jo White, who on the same day, was confirmed by the Senate as the new head of the Securities and Exchange Commission.³³ It is not surprising that a chief counsel would express some confusion about the organization’s current priorities. Since the 2008 financial crisis, the SEC has had four different Chairmen, with Mary Jo White the most recent.

While the passage of this legislation has generated much excitement in the nascent crowdfunding community, there will be no direct impact until the SEC writes the rules to implement the laws. With that said, there has been a significant indirect impact as the industry waits and prepares for various versions of rulemaking by the SEC. Since the JOBS Act was signed into law, many new equity-driven sites have been launched that define themselves as “crowdfunding sites,” but all are opened to the limited crowd of accredited investors.

The JOBS Act and Fraud

While the primary function of the SEC is to protect the public interest, the Exchange Act directs the commission to accomplish this task while also working to promote capital formation. Section III, 80, c) of the ’33 Act states: “CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION. Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the

³¹ “SEC Warns Issuers on Premature Use of Crowdfunding Exemption - Dodd-Frank News Center.”

³² “Crowdfunding Delays, SEC Silence Spark Hostility on Capitol Hill.”

³³ Ibid.

protection of investors, whether the action will promote efficiency, competition, and capital formation.”³⁴ As one examines the dual roles of the SEC with respect to micro-startups, it is possible that the SEC rule makers could interpret protecting investors and facilitating capital formation as a zero-sum game, perhaps to the detriment of the crowdfunding industry.

The SEC has various regulatory tools at its disposal to monitor securities transactions in an effort to protect the public against fraud. If one examines the life cycle of a security, these protections start with the requirement that securities are registered at issuance. Once issued, a security can only be bought or sold through SEC-registered broker-dealers. Finally, if those securities are bought or sold on behalf of an investor by an investment advisor, the SEC regulates the asset management industry requiring investment advisors to register with the SEC.

Registration of securities is the SEC’s most fundamental and first line of defense in protecting the public. While this mechanism can be an effective deterrent to fraudulent activity, the legal and accounting costs associated with registration can provide a substantial barrier to entry for small firms. That cost becomes even more prohibitive as a small company seeks to sell its securities on a national basis, as it incurs multiple layers of regulatory compliance for each state in which it registers.

Transaction of securities in the secondary market must be conducted through broker-dealers, which are highly regulated by the SEC. The primary activity that defines a broker involves the receipt of transaction-based compensation and the requirement that any firm who receives such must register as a broker-dealer. The spirit behind this rule is the intuitive concept that a commissioned based salesman has an inherent conflict of interest when dealing with a client. The JOBS Act legislation addresses this issue clearly as it pertains to portals, stating that this exemption is not available to anyone who receives (or whose associated persons receive) “compensation in connection with the purchase or sale of such security.” With regard to the funding portal’s exemption from registration, the SEC has taken a broad view on the definition of compensation, stating: “Congress did not limit the condition to transaction-based compensation. The staff interprets the term ‘compensation’ broadly, to include any direct or indirect economic benefit to the person or any of its associated persons. At the same time, we recognize that Congress expressly permitted co-investment in the securities offered on the platform or mechanism. We do not believe that profits associated with these investments would be impermissible

³⁴ Reporting, “SECURITIES EXCHANGE ACT OF 1934.”

compensation for purposes of Securities Act Section 4(b).”³⁵ Clearly, they view that any compensation to any employee associated with a transaction would nullify this exemption. This interpretation of compensation will force many (if not all) portals engaged in a for-profit enterprise without co-investment business models to register as broker dealers with the SEC.

The exception of compensation received through co-investment is the legal mechanism facilitating the business models of many of the new crowdfund sites, including several of the real estate investment sites and the venture capital sites. The venture capital sites have recently received additional comfort from the SEC’s issuance of “no action letters” to Angels List and FundersClub. These letters contain language acknowledging that neither company is engaged in a business that charges transactional based fees or compensates employees based on transaction fees. There is also a focus on third party “finders” who may have an arm’s length relationship with the portal but seeks compensation. This is based on the SEC view that “transaction-based compensation incentives may lead to abusive or even fraudulent sales activities, which the registration and regulation of brokers are intended to deter. As a result, the SEC's view is that any person receiving transaction-based compensation in connection with another person's purchase of securities typically must register as a broker or be an associated person of a registered broker, even if there are virtually no other indicia of broker activity.”³⁶

The Investment Advisors Act of 1940 provides additional protection (inclusive of subsequent amendments to this act made by the Dodd-Frank Act) against investor fraud. This act requires all U.S.-domiciled investment advisors who manage more than \$100 million to register with the SEC and if less than \$100mm, to register with the state in which they are domiciled. It also requires Investment advisors associated with a broker dealer (or vice versa) to fill out a special section detailing the relationship between the two entities.

Given the Madoff incident, the effectiveness of this system is still questionable: Bernard L. Madoff Investment Securities LLC was registered with the SEC as a Registered Investment Advisor when it was discovered that it had been running the largest Ponzi-scheme in history. As of the writing of this paper, Bernard L. Madoff Investment Securities LLC is still registered with the SEC as an investment

³⁵ “SEC Website: Frequently Asked Questions on Title II of the JOBS Act.”

³⁶ Jennings, Gutierrez, “South Carolina Lawyer: Main Street Goes Wall Street,” 3.

advisor domiciled in in the State of New York. The Form ADV states that Madoff manages \$17 billion for twenty-three clients and has a clean disciplinary record. In the disclosure section for the related broker-dealer, the first question asks: “In the past ten years, have you or any advisory affiliate: (1) been convicted of or plead guilty or nolo contendere (“no contest”) in a domestic, foreign or military court to any felony? (2) been charged with any felony?” The firm’s answer to both questions is “no.” However, the firm’s founder and CEO, Bernard Madoff is currently serving a 150-year prison sentence for committing a litany of felonies related to securities fraud.³⁷

A compliance officer and broker-dealer interviewed for this thesis brought up the fact that Madoff targeted a small group of investors that ultimately conducted no due diligence on his firm before investing. The interviewee asserted that had any one of them made a few phone calls, the fraud would have been easily uncovered. As a result, many supporters of crowdfunding subscribe to the idea that the crowd is smarter than the individual. There is a split between those who believe crowdfunding provides a self-regulatory environment that will prevent fraud and those who believe crowdfunding is “ripe for fraud.” The survey conducted and discussed in Chapter 7 reveals that there is significant concern over fraud.

Conversely, other portions of this thesis will discuss how crowdfunding and Internet technology ultimately increase market transparency and efficiency. Many believe this transparency reduces the prevalence of fraud. The only case of fraud found during the research process was a video game listing on Kickstarter.com that was ultimately shut down within four days and without any money received or transferred to the sponsors. Social media and Internet chatter was responsible for uncovering this issue, similar to the way in which eBay.com and Amazon.com seller ratings ultimately weed out fraudulent or poor sellers while building trust in others³⁸

Nevertheless, the course of the SEC rulemaking on crowdfunding is in a somewhat unpredictable state. It could be presumed that the SEC will endeavor to write rules in a manner consistent with the spirit of the laws as intended by both the legislative and executive branches of government. Clearly, the intent of the act is to enable small companies to easily access the capital

³⁷ “SEC Form ADV Madoff

http://www.adviserinfo.sec.gov/iapd/content/viewform/adv022005/Sections/iapd_AdvDisciplinarySection.aspx?ORG_PK=2625&RGLTR_PK=50000&STATE_CD=&FLNG_PK=0262B11C00080

³⁸ “Crowdfund Capital Advisors - How the Crowd Detects Fraud.”

markets. The difficult task for the SEC is to preserve that intent, but within the context of protecting the public interest, i.e. protect investors from fraud and misrepresentations, ultimately helping them avoid taking catastrophic losses.

The capital markets have nonetheless flourished without regulation as well as under the securities law, and real estate has proven an important wealth generator. The next chapter discusses the current commercial real estate market and its evolution under these laws over the past eighty years. The current state of the commercial real estate market establishes an understanding of how crowdfunding will change the future of both the capital and asset commercial real estate markets.

Chapter III: Commercial Real Estate: Current Landscape for Investing

Land and property rights have arguably played a significant, if not the most significant, role in world history, making real estate one of the oldest and most basic forms of investment. From ancient battles over territories and the feudal land system to today's era of Donald Trump, the history and perception of real property ownership is one of wealth, power, and stature. There is a traditionally positive association with ownership.³⁹ "Ownership connotes wealth, power, security, freedom from want, and independence; these things, in turn, increase our individual liberty by giving us the space the resources necessary to lead our lives according to our own design."⁴⁰ Real estate today can provide investors with an ongoing income yield as well as wealth appreciation and a number of other financial benefits. While mainly referring to residential ownership, there is evidence that many are left out of both the ownership class as well as the investment class, and this continues to divide the population between owners and non-owners and the rich and the poor.⁴¹ Crowdfunding for commercial real estate presents an attractive business model, bridging the gap between the institutional and "sub-institutional" investment markets, while allowing the average investor to allocate a portion of their net worth to this important asset class.

In order to fully realize the potential of crowdfunding to democratize investment options in the underlying physical property, this chapter delves into the current real estate investing landscape and argues that a hurdle to investment still exists. In fact, the real estate industry is still largely viewed as a "club" due to the financial and informational hurdles of the industry. This "club" has in turn created a commercial real estate asset market divided between large deals dominated by institutional players and a "non-institutional" or "sub-institutional" market. The counterintuitive result is that the majority of real estate available for investment or development is deemed non-institutional, and while non-institutional real estate warrants investment and localized attention, it remains an asset difficult to acquire by the everyday investor.

Over the last century, the advent of Real Estate Investment Trusts (REITs), Comingled Real Estate Funds (CREFs), Mortgage Backed Securities (MBS), and other financial innovations have opened the door to more investors; there are still significant barriers for the average investor to invest in commercial real

³⁹ Singer, "Ownership Society and Takings of Property," 311.

⁴⁰ Ibid.

⁴¹ Ibid.

estate assets. While investment in real estate presents a unique opportunity to directly own the underlying physical asset, these assets are typically large and worth millions of dollars each. Thus, “It is generally not possible for small individuals who are not very wealthy to own whole commercial properties directly. But it is possible for wealthy individual investors, as well as investment institutions (such as pension funds or life insurance companies), to own large commercial properties or portfolios of properties directly.”⁴² As commercial real estate investing evolved institutional firms dominated and shaped the market, in essence creating two separate commercial real estate markets – an institutional market and a non-institutional market. It is exactly this non-institutional property segment that now presents a unique and exciting investment opportunity via crowdfunding. This chapter presents the backdrop central to our thesis premise: crowdfunding for real estate has the potential to disrupt the current state of the real estate market. There is a large market opportunity created by the hurdle to investment by non-accredited investors despite a desire to invest in hard real estate coupled with the large amount of sub-institutional real estate available for investment via crowdfunding.

Real Estate Portfolio Allocations

Despite the longstanding history of real estate as an important wealth generator, it was not until the 1980’s that commercial real estate was truly recognized as an asset class and a component in asset allocation models. Prior to this time few institutions invested in this so-called “alternative” asset class despite Markowitz’s Modern Portfolio Theory dating back to the 1950’s. Harry Markowitz pioneered Modern Portfolio Theory, which presented the concept that a well-diversified portfolio consisting of uncorrelated assets will, over time, outperform a portfolio comprised of any one of those assets. As commercial real estate evidences little correlation to other asset classes it was seen as a key component to asset allocation models, a diversifier of overall portfolio risk.⁴³

There are many reasons to include commercial real estate in one’s investment portfolio in addition to diversification and inflation protection. In fact, real estate as an asset class proves to be a better risk adjusted investment than many other options in the market with lower volatility. Investors can also achieve returns from both income yield and asset appreciation, making it an attractive asset class to many. “A portion of the investment allure of real estate stems from its hypothesized ability to

⁴² Geltner, *Commercial Real Estate Analysis and Investments*, 129.

⁴³ *Ibid.*, 524, 534.

generate improved risk-adjusted returns when added to a stock and bond portfolio. The logic is straightforward Markowitz [1959] with the attractiveness of real estate a function of its expected return, the standard deviation of its expected return and the correlation of its expected return with the expected returns on the stocks and bonds currently held in the portfolio.”⁴⁴

Some studies find, “that most efficiently diversified balanced portfolios have real estate investments in the range of 10 to 15 percent of total assets.”⁴⁵ Other studies “have generally concluded that real estate holdings of 20 percent or more would benefit the typical pension fund by improving diversification and thereby increasing return per unit of risk incurred. But real estate investment on that scale-or anything like it-has not occurred.”⁴⁶

Nevertheless, numerous studies on pension fund and REIT property risks and returns confirm, “that real estate, when added to a portfolio of common stock, bonds, and bills, can lead to significant diversification benefits.”⁴⁷ Thus, it is no surprise that, although slowly, institutional investors and firms have increased their investment allocations in commercial real estate over the decades following the work of Markowitz. This argues for the average investor to have increased access to investments in commercial real estate, just as they have gained access to investing in other capital markets such as the stock and bond markets via the Internet.

Current Options for Investing in Real Estate

In Figure 2 (below), Geltner and Miller generally outline the major types of capital asset markets and investment products available across all industries.⁴⁸

	Public Markets	Private Markets
Equity Assets	Stocks REITs Mutual Funds	Real Property Private Equity Hedge Funds
Debt Assets	Bonds MBS Money Instruments	Bank Loans Whole Mortgages Venture Debt & LBO’s

Figure 2: Capital Asset Markets (Geltner, Miller)

⁴⁴ Hartzell, Hekman, and Miles, “Diversification Categories in Investment Real Estate,” 1986, 230.

⁴⁵ Ennis and Burik, “Pension Fund Real Estate Investment Under a Simple Equilibrium Pricing Model,” 1991, 27.

⁴⁶ Ennis and Burik, “Pension Fund Real Estate Investment Under a Simple Equilibrium Pricing Model,” 1991, 20–30.

⁴⁷ Hartzell, Hekman, and Miles, “Diversification Categories in Investment Real Estate,” 1986, 238.

⁴⁸ Geltner, *Commercial Real Estate Analysis and Investments*, 11, Exhibit 1–5.

Figure 3, (below) further refines these categories and expanding the chart to focus on real estate options available to investors it is evident that there are multiple options, but each one has its limitations, and most are unavailable to non-accredited investors.

	Public Markets	Private Markets
Equity Assets	REITs (Public) Mutual Funds ETFs	Real Property, Direct Ownership Private Equity Funds Private REITs TICs CREFs Limited Partnerships Joint Ventures
Debt Assets	CMBS RMBS	Private Mortgages

Figure 3: Real Estate Capital Assets (Geltner, Miller)

Figure 4 (below), another Geltner and Miller diagram, is an illustration of the real estate investment system and highlights the barriers to smaller investors when it comes to investing in the underlying physical asset and private investment products.⁴⁹

⁴⁹ Ibid., 130.

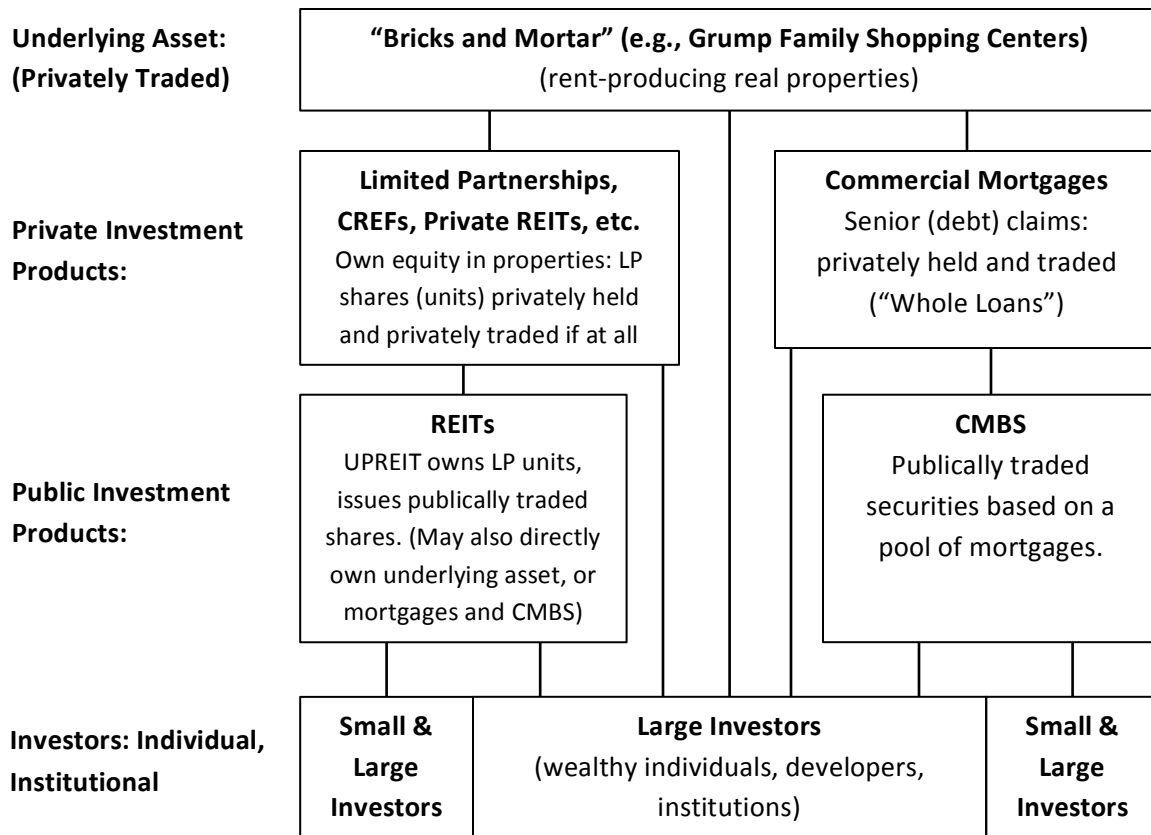


Figure 4: Diagram of the Real Estate Investment System (Geltner, Miller)

This diagram illustrates that the majority of non-accredited individual investors only have access to the commercial real estate investments through the public market or their Pension Fund, IRA, or 401k. Aside from SEC accreditation limits under registration exemptions discussed in the previous chapter, private markets often have too high of a capital requirement to be an option for most individuals. Private REITs, real estate funds, and limited partnerships often have investment minimums starting at just \$10,000 to \$50,000 or higher, thus presenting a defacto limitation to non-accredited (non-wealthy individuals) investors.

Geltner and Miller estimate that real estate makes up 78% of the private equity market in the U.S. and 49% of the private debt market, leaving many American investors unexposed to a significant sector of the capital markets.⁵⁰ Given the inherent inefficiencies of the private markets where buyers and sellers, investors and sponsors are left to randomly find each other, this sector represents a significant portion of the capital markets subject to inefficiency. The survey revealed that developers

⁵⁰ Geltner, *Commercial Real Estate Analysis and Investments.*, Page 17

and deal sponsors as well as investors find this matching process to be difficult. This is where crowdfunding and Internet disruption would assist in the matching of parties with increased efficiency. The potential of crowdfunding to disrupt the real estate private equity sphere is high, as crowdfunding provides both informational and transactional efficiencies. By linking investors and developers through the Internet the matching process is improved, thus altering many of the disadvantages currently existing in these private markets.

The passage of the Real Estate Investment Trust Act of 1960 created the REIT structure, a tax-exempt real estate investment vehicle which has proved to be an important piece of the real estate ownership and lending market in the U.S.⁵¹ It was the first step in democratizing real estate investing as recognized by famed Real Estate Economist Robert Shiller when he stated that, “REITs were created by law in 1960 to democratize the real estate market and make it possible for investors to participate in this huge asset class. That was absolutely the right thing to do, because portfolio theory tells us people should diversify across major asset classes, and real estate is one of them.”⁵²

“The original purpose of the REITs was to enable the ‘little person’ to invest in real estate through a financial vehicle resembling a mutual fund. To discourage real estate companies, especially developers, from establishing REITs strictly as a tax avoidance scheme, the law places restrictions on REITs with which they must comply or lose their tax exempt status.”⁵³

Today REITs must satisfy the following requirements in order to maintain tax-exempt status:⁵⁴

- 1) Invest at least 75 percent of its total assets in real estate assets
- 2) Derive at least 75 percent of its gross income from rents from real property, interest on mortgages financing real property, or from sales of real estate
- 3) Pay at least 90 percent of its taxable income in the form of shareholder dividends each year
- 4) Be an entity that is taxable as a corporation
- 5) Be managed by a board of directors or trustees
- 6) Have shares that are fully transferable
- 7) Have a minimum of 100 shareholders

⁵¹ Han and Liang, “The Historical Performance of Real Estate Investment Trusts,” 1995, 235.

⁵² NAREIT, “The REIT Story.”

⁵³ Miles and McCue, “Historic Returns and Institutional Real Estate Portfolios,” 191.

⁵⁴ “REIT.com.”

- 8) Have no more than 50 percent of its shares held by five or fewer individuals during the last half of the taxable year
- 9) Have no more than 25 percent of its assets consist of stock in taxable REIT subsidiaries

Furthermore, “Because such a high level of both resources and knowledge is required, very few investors are able to participate directly in the ownership or financing of commercial real estate properties. Investment in real estate through REIT ownership, however, does not require large and long-term financial commitment typical of other real estate investment alternatives. The ownership of most REITs can also be easily transferred with very low transaction costs, since shares of most REIT stocks are publically traded.

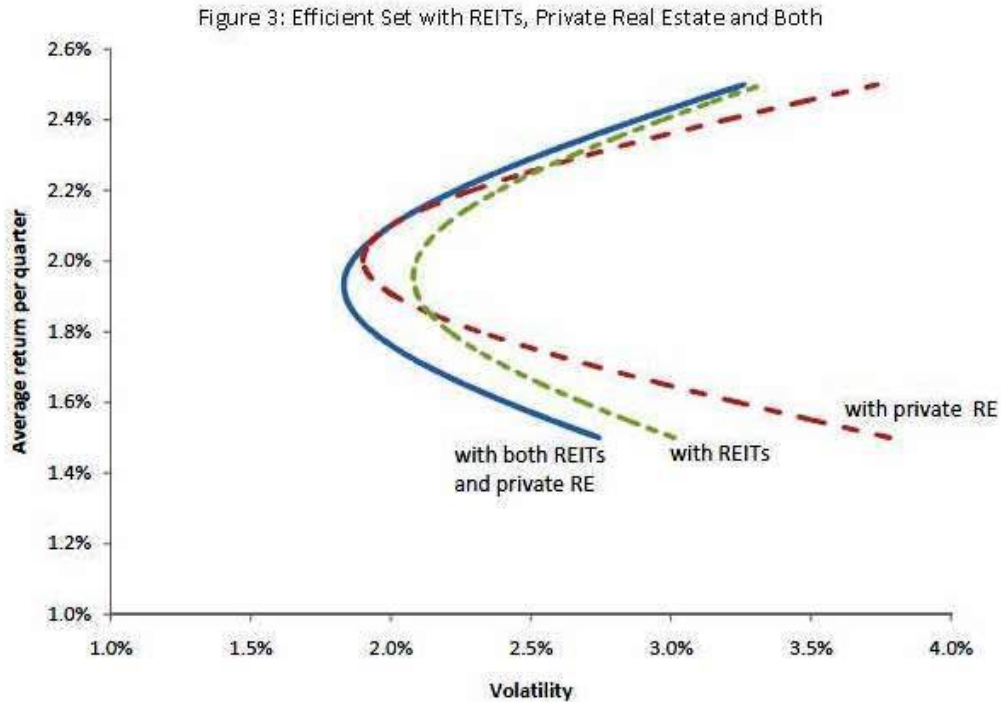
Therefore, REITs provide a mechanism to pool resources that enables investors, especially small investors to gain the economic and other benefits of commercial real estate investments. In today’s illiquid commercial real estate markets, REITs have attracted more and more attention as liquid real estate investment vehicles, even from institutional investors such as pension funds.”⁵⁵ REITs, CREFs, and other institutional real estate firms “are able to 1) purchase larger properties, 2) spread risk among more investors, 3) build a diversified portfolio and 4) provide more liquidity.”⁵⁶ REIT investors typically want the dividend yield and share price appreciation. Conversely private real estate investments and comingled real estate funds (CREFs) typical measure performance by total return from real estate.⁵⁷ REITs however do have several shortcomings, such as a much higher correlation to the equity markets. As a result, the Pension Real Estate Association (PREA) advocates that investors need to have both types of real estate products in a portfolio, shown in Figure 5 (below).⁵⁸

⁵⁵ Han and Liang, “The Historical Performance of Real Estate Investment Trusts,” 1995, 235.

⁵⁶ Miles and Mc Cue, “Historic Returns and Institutional Real Estate Portfolios,” 192.

⁵⁷ Ibid.

⁵⁸ “Portfolio Theory Provides a Mechanism to Examine the Role of Asset Classes, E.g. Private Real Estate and REITs, Within a Portfolio. An Efficient Set Shows the Best Risk/return Combinations Available from a Set of Asset Classes (i.e. the Portfolios with Lowest Risk for a Given Target Return, or Alternatively the Highest Average Return for a Given Risk Budget). Given the Limitations of Portfolio Theory as Applied Here, the Specific Results Should Be Taken with a Grain of Salt; the Discussion Is Meant to Illustrate General Issues Concerning REITs and Private Real Estate Within a Mixed-asset Portfolio Rather Than Prescribe Specific Strategic Asset Allocations. The Graph Above Shows Three Efficient Sets, Representing the Best Possible Portfolios in Terms of the Return/volatility Trade-off Under Three Different Scenarios. In All Three Scenarios, Investors Can Allocate to Equities, Treasuries, Corporate Bonds, and Hedge Funds. Two of the Efficient Set Curves (the Dashed Lines in the Exhibit) Correspond to the Cases Where Either REITs or Private Real Estate Are Added to the Basic Asset Classes. The Third Curve Corresponds to the Case Where Investment in Both REITs and Private Real Estate Is Allowed. (Source: PREA) Source: PREA: NAREIT, MIT



Source: PREA

Figure 5: Pension Real Estate Association's Efficient Frontier: REITs and Private Real Estate

Although REIT shares provide some diversification benefits and are a more liquid proxy for commercial real estate, they do not fully satisfy investor's allocation needs.

The chart in Figure 6 (below) illustrates the advantageous and disadvantages of various real estate investment options.⁵⁹

Center for Real Estate, Thomson Reuters Datastream. Based on Portfolios Including Equities, BBB Corporate Bonds, Treasuries, Hedge Funds, Along with REITs And/or Private Real Estate. Data from Q2 1994 to Q2 2010. Private Real Estate and REITs Measured with Same Property Type Weighting; REITs and Private Real Estate Are Net of Fees. Other Asset Classes Represented by the Russell 3000, B of A Merrill Lynch BBB Corp. Index, B of A Merrill Lynch 7-10 Year Treasury Index, and the Dow Jones Credit Suisse Hedge Fund Index.' 'Public and Private Real Estate: Room for Both in a Diversified Portfolio' E. Todd Briddell, President and CIO, and Alan Supple, Portfolio Manager, Europe, URDANG Securities Management."

⁵⁹ Briddell, Todd E. and Supple, Alan, "Public and Private Real Estate: Room for Both in a Diversified Portfolio," 2.

The Advantages and Disadvantages of Various Investment Types

Investment Form	Advantages	Disadvantages
Direct Real Estate	<ul style="list-style-type: none"> • Can target specific markets/property types • "Hard asset" investment • Specific cash flow from rental income • Can manage specific risk profile through leverage 	<ul style="list-style-type: none"> • More asset specific risk • Requires a property/asset manager • Illiquid – physical assets take time to buy and sell • High transaction costs
Collective or Pooled Investments in Direct Real Estate	<ul style="list-style-type: none"> • More diversified portfolio of underlying properties • Potential for increased liquidity (open-end) 	<ul style="list-style-type: none"> • Illiquidity (closed-end) • Open-end funds claim to offer liquidity, but underlying assets are illiquid • High transaction costs
Listed Real Estate Securities (REITs)	<ul style="list-style-type: none"> • Daily liquidity and pricing • Transparency of reporting • Easier to diversify portfolio and deploy capital rapidly • Low correlation to bonds • Attractive potential dividend income • Long-term returns similar (and in some cases superior) to direct real estate investing 	<ul style="list-style-type: none"> • Moves more in line with short term movements in broad equities markets

Source: Urdang

URDANG Research

2

Summer 2011

Figure 6: Comparative Analysis Real Estate, Pooled Investments and REITs (Urdang)

While REITs and ETFs, categorized as “soft” real estate investments have the advantages of liquidity and accessibility, they also come with the downside of high (and often hidden) management expenses and fees. Tim Courtney, chief investment officer at Exencial Wealth Advisors, states that “an investment portfolio of more than \$10.0 Million could benefit by including both "hard" real estate, meaning direct ownership—either full or partial—of commercial, residential or other properties, as well as "soft" real estate, such as shares of real estate investment trusts or other securities.”⁶⁰ The economic reality that “hard” investments are only available to wealthy investors with large portfolios serves to further bifurcate this market, creating a class of wealthy investors with more desirable portfolios and a class of the less wealthy with inferior portfolios. Crowdfunding could provide access to these investors and potentially eliminate these investment deterrents.

Following the REIT Act in 1960, several additional acts reformed and further evolved the REIT structure, encouraging additional investment into both real estate and REITs. Most notably the TAX Reform Act (TRA) of 1986 stimulated industry growth by eliminating real estate limited partnerships tax advantages, lengthening real estate depreciation schedules and replacing accelerated cost recovery with

⁶⁰ Gregory Zuckerman, “WSJ Best Ways to Invest in Real Estate.”

straight line depreciation schedules.⁶¹ The Savings and Loan crisis in the 1980's resulted in the Financial Institutions Recover, Reform, and Enforcement Act of 1989 (FIRREA). In order to cleanse the thrift industry of underwater assets, this Act created the Resolution Trust Corporation, charged with selling assets of the failed thrift industry, fueling the development of the commercial mortgage backed securities.⁶² In 1992, a critical IRA ruling on the Taubman Centers Inc. initial public offering introduced the concepts of an umbrella partnership or UPREIT which, "enabled property owners to contribute their properties to a REIT without realizing an immediate taxable gain."⁶³ A year later the Omnibus Budget and Reconciliation Act of 1993 (OBRA) relaxed the five-or-fewer ownership restriction for institutional investors. These two events lead to an increase in both property and capital in the REIT industry, OBRA specifically lead to an increase in ownership shares by institutions.⁶⁴ The REIT Modernization Act of 1999 (RMA) amended the 1960's act and transitioned REITs from "passive real estate portfolios to actively managed corporations with increased access to investor capital." During this time period, "total equity REIT market capitalization soared from just \$26.0 billion in 1993 to over \$400.0 billion in 2006. This period (early 1990s up through the present) has come to be known as the modern REIT era."⁶⁵

Yet, prior to this time, "the amount of Investor capital allocated to the asset class [had] been fairly modest."⁶⁶ In reference to the large amount of REIT IPO's of this period, "Buttimer, Hyland, and Sanders (2005) find that the capital demand hypothesis best describes the REIT IPO market. The hypothesis contends that a change in the economic environment, such as a series of regulatory changes, can lead to an increase in investment opportunities and the demand for capital."⁶⁷ It is plausible to apply their hypothesis to the recent JOBS Act's regulatory changes coupled with a continued desire to democratize real estate investing and foresee crowdfunding's impact on the market just as REITs changed the investing landscape. However, the REIT industry history has also played a role in the bifurcation of the real estate market.

Prior to the REIT Modernization Act (RMA), which took effect on Jan. 1, 2001, REIT's had to operate in "a generally passive manner" which resulted in a, "conservative acquisition and management

⁶¹ Han and Liang, "The Historical Performance of Real Estate Investment Trusts," 1995, 237.

⁶² Geltner, *Commercial Real Estate Analysis and Investments*, 144.

⁶³ Feng, Price, and Sirmans, "An Overview of Equity Real Estate Investment Trusts (REITs)," 314.

⁶⁴ *Ibid.*, 312.

⁶⁵ *Ibid.*, 308.

⁶⁶ *Ibid.*, 310.

⁶⁷ *Ibid.*

philosophy.”⁶⁸ Thus, as the REIT market expanded in the 1990’s these firms were targeting “core” properties, traditionally defined as relatively low risk and low return due to their prime locations and substantial occupancy rates. “Smaller, older, or less fully utilized properties, as well as development or redevelopment projects, have traditionally been viewed as being more risky by these investors and as such are often referred to as non-institutional or noncore properties.”⁶⁹

This acquisition philosophy assisted in segmenting out certain property types as institutional, as did the REITs large amount of investable capital, which allowed for larger properties to be purchased. On a parallel track, pension funds, mutual funds, and other retirement and investment firms contributed to the creation of the institutional real estate class. “Pension funds, in particular, have provided tens of billions of dollars to fund dozens of new investment vehicles and firms, creating an entirely new field of institutional investment management.”⁷⁰

The passage of the Employee Retirement Income Security Act of 1974 (ERISA) was instrumental in encouraging increased investment in real estate by institutions such as pension funds. “ERISA took into account long term investing and modern portfolio theory that suggested more diversification and thus more investment in commercial real estate.”⁷¹ Again, this regulatory change stimulated investment in commercial real estate by pension funds and the like, and although adding diversification to its clients’ portfolios this contributed to the diversion between institutional and non-institutional real estate assets. While many investors remain passively invested, if invested at all, through soft real estate investment products there is a significant amount of opportunities in hard real estate available with the correct connections, wealth ability, and/or regulatory ability to invest.

“Scott Miller Jr., a managing partner of Blue Bell Private Wealth Management LLC in Blue Bell, Pa. [states] ‘for an investor who understands their local market, is willing to do the research, is patient enough to get a great buy and has the skill set to perform the necessary and ongoing maintenance, hard real-estate investments will prove to be more profitable’ than soft ones.”⁷² And it is exactly this local, non-institutional market that the crowdfunding opportunity appears to have the greatest opportunity.

⁶⁸ Miles and Mc Cue, “Historic Returns and Institutional Real Estate Portfolios,” 192.

⁶⁹ Geltner, *Commercial Real Estate Analysis and Investments*.

⁷⁰ Ennis and Burik, “Pension Fund Real Estate Investment Under a Simple Equilibrium Pricing Model,” 1991, 20.

⁷¹ Geltner, *Commercial Real Estate Analysis and Investments*, 143.

⁷² Gregory Zuckerman, “WSJ Best Ways to Invest in Real Estate.”

Defining the Institutional Asset Market

In order to evaluate the impact of crowdfunding on the future of commercial real estate it is also important to look at the existing commercial real estate market and the lending and investing landscape available to developers and deal sponsors as well as passive investors. This section divides the commercial real estate market into two sectors, the “sub-institutional” market, defined as properties with a value of less than \$2.5 million and all the “institutional” market, comprised of all properties valued in excess of this amount but also that fit the definition of “core” assets. The Chapter then evaluates the potential impact of crowdfunding on each sector, with a particular focus on the sub-institutional market. There are various methods to define these markets, explored in greater detail below.

Through tracing the history of modern commercial real estate investment, this chapter has argued that there are many ways to invest in this sector but for most investors, there is a hurdle to investing directly into the hard asset, while at the same time a division has emerged between property classes. So, where and how can the average investor invest directly into a development deal or basic physical property? This “sub-institutional” market provides the perfect opportunity.

Real Capital Analytics (“RCA”), National Council of Real Estate Investment Fiduciaries (“NCREIF”), The CoStar Group, and National Association of Real Estate Investment Trusts (“NAREIT”) are all among the preeminent sources of commercial real estate data, and as such were the primary sources used in defining institutional versus sub-institutional real estate for the purposes of this thesis.

As a starting point, the PwC Real Estate Investor Survey (formerly the Korpacz Real Estate Investor Survey), now in its 26th year, surveys participants that “represent a cross section of major financial equity real estate investors who invest primarily in institutional-grade property” through online questionnaires and telephone interviews. The publication goes on to define Institutional-Grade Real Estate as “Real property investments that are sought out by institutional buyers and have the capacity to meet general prevalent institutional investment criteria.” In reference to this survey Shilling describes institutional investment grade properties to include, “CBD and suburban office buildings, major retail properties, urban high-rise and garden apartment buildings as well as industrial warehouses which are completed and substantially leased, which are occupied by major business interests and which have a significant user demand resulting in stable income flow, low leasing risk, good long-term growth

potential and a fairly safe rate of return.”⁷³ The definition of “core” properties earlier in the chapter is essentially the same as Shilling’s definition of institutional investment grade properties.

Real Capital Analytics was founded in 2000 as a global research and consulting firm focused on proprietary research concerning the commercial real estate investment market. The firm collects and analyzes commercial real estate transactional data and publishes related reports.⁷⁴ Per the RCA website (www.rcanalytics.com) institutional is defined as, “an investor, such as a bank, insurance company, retirement fund, hedge fund, or mutual fund which is financially sophisticated and makes large investments, often held in very large portfolios of investments.”

The site further segments Capital Sectors as:

Institutional:

- Endowment: investment on behalf of endowments
- Pension Fund: public or private pension fund
- Insurance: Public or Private insurance company
- Bank: public or private bank
- Finance: Non-bank finance company (public or private)
- Investment Manager: Investment manager or advisor
- Other/Unknown: Other institutions

Public:

- REIT: Real Estate Investment Trust traded on a public market; must have REIT-type tax status
- REOC: Real Estate Operating Company, publically traded development/property management/non-REIT property owner/operator
- Listed Funds: Publically traded funds investing directly into real estate

Private:

- High net worth: private family wealth invested directly
- Non-traded REIT: non-traded Real Estate Investment Trust; must have REIT-type tax status

⁷³ Shilling, “Is There a Risk Premium Puzzle in Real Estate?,” 501–525.

⁷⁴ “Real Capital Analytics - Commercial Real Estate Investment Trends and Information,” 5.

- Developer/Owner/Operator: Non-traded privately held development/property management/owner/operator
- Other: other privately held investment firm

Equity Fund:

- Equity Fund: non-institutional private equity funds

User/Other:

- Corporate: corporate user or retailer
- Government: government user/seller
- Non-profit: other non-profit user
- Educational: Educational user (non-endowment investments)
- Religious: Religious users; not pensions or investments of churches

It is important to note that the average investor is nowhere on this list.

RCA records data on properties and portfolios with a value greater than \$2.5 Million, acknowledging, “While there is substantial investment activity which falls below these thresholds, it is not captured in the statistics.” “RCA began US office, industrial, retail and multi-family apartment (all core) data tracking and analysis for transactions \$5.0 Million USD or greater in January 2001; for transactions \$2.5 Million or greater in January 2005.” They then began tracking US hotel data in 2004, US development site data in 2005, and global (non-US) all core, hotel, and development data with a value over \$10.0 Million USD in 2007.

Prior to 2005, RCA tracked sales in excess of \$5.0 Million; however the securitization frenzy and state of the market encouraged RCA to lower the bar to \$2.5 Million. A 1992 study by Hartzell, Pittman and Downs refers to the Russell/NCREIF database for a large sample of institutional grade properties, and further along in their paper confirm that all properties under \$5.0 Million were considered non-investment grade, while all properties above \$30.0 Million were automatically deemed investment grade. For properties between \$5.0 Million and \$30.0 Million, they used brokers to weed through the buildings determining Class A properties as investment grade, although subject to human bias.⁷⁵ In fact,

⁷⁵ Hartzell, Pittman, and Downs, “An Updated Look at the Size of the US Real Estate Market Portfolio,” 11.

“By the early 2000s, the average individual property in the NCREIF index was worth over \$35.0 Million.”⁷⁶

CoStar’s Commercial Repeat-Sales Indices Methodology paper states that, “In the CRE marketplace, \$5.0 million and \$2.5 million are the traditional cut-off points for determining what is high-end and what is low-end.” Given RCA’s cut-off of level of \$2.5 million and relevant capital sector definitions we can use this property value as one gauge in defining institutional grade real estate, but it’s the data collected by CoStar that further defines this market separation and highlights the magnitude of non-investment grade real estate in the US.

The CoStar Group is a leading information provider for commercial real estate in the US providing a wide range of products and services to the industry. As such, it has tracked transactions in all sectors since 1996, and as of the end of 2011 contained over 1.7 million commercial property transaction data points from 250 different metro areas. Unlike RCA, NCREIF, or NAREIT, the pricing data ranges from \$100,000 to over \$39.0 billion. In 2010, they created and released the CoStar Commercial Repeat-Sales Index or “CCRSI”.

CoStar’s Commercial Repeat-Sales Indices Methodology paper states, “The CRE market is characterized by heterogeneity and is highly segmented. This has proven to be a challenge to the research community, which has primarily focused on investment grade of high-value transactions – a very small fraction of total CRE transactions. Because of this narrowly focused view, the valuation of the CRE market tends to be a generalization based on the performance of a small segment.”⁷⁷ As a result CoStar has maintained an extensive historical database with property sales records covering all sizes and locations of CRE transactions in the US.⁷⁸ “Our goal was to capture the multifaceted and diverse picture of the commercial real estate market... We found that the traditional approach to determining market tiers based on transaction prices resulted in a biased index. In response to this finding, we developed a unique methodology segregating high-value and low-value transactions based on the physical characteristics of properties rather than prices.”

⁷⁶ Geltner, *Commercial Real Estate Analysis and Investments.*, Page 256

⁷⁷ CoStar Methodology, Page 5

⁷⁸ CoStar Methodology, Page 5

By not tracking properties below \$2.5 million RCA ignores a very important real estate sector. Furthermore, NCREIF and NAREIT are focused on purely institutional firms and their properties, which represent an even smaller subset of the market. Although in 2001 NCREIF's data-contributing members represented over 70% of the property holdings of the entire tax-exempt fiduciary branch and held what is considered institutional "core" properties, this property segment is still relatively small in comparison to the entire commercial real estate sector of the US and is limited to tax-exempt firms.⁷⁹ In fact, according to NCREIF's 2013 Data and Products Guide, its National Property Index consisted of only 7,276 properties with a gross fair market value of over \$315.0 billion out of a total U.S. commercial real estate market that was estimated to be close to \$11.5 trillion in 2009.⁸⁰

Finding that a pure cut-off based on transaction value skewed the firm's price index, CoStar defines investment grade real estate based on physical characteristics. "Investment Grade properties as a group consist of larger-sized, reasonable-quality properties that match the type most often purchased by institutional investors." For example, this segment would contain Class A and B offices with rentable building area greater than 35,000 square feet, industrial properties built in the last 20 years with more than 80,000 square feet, multifamily properties with 30 or more units, and retail properties with more than 25,000 square feet.

The most important finding from CoStar is that "investment grade properties comprise roughly 30% of the total transactions and capture 77% of the transaction value. The remaining general commercial properties tend to be smaller and fall into low price brackets." This indicates two things: (1) there is a large amount of real estate available for investment by non-institutional investors, and (2) there is a significant capital hurdle to trading in the investment grade arena. Shilling muses in reference to the skew of the response distributions to the PwC (Korpacz) survey and the expectation of discount rates of above 11% (in nominal terms) that, "Evidently, institutional investors prefer to invest in real estate only if the case is so obvious as to justify its undertaking. This must mean that institutional investors miss many worthwhile investment projects."⁸¹ Shilling's statement substantiates the existence of a large yet still worthwhile investment market missed by the majority of institutions.

⁷⁹ David, "A Random Walk down Main Street," 141.

⁸⁰ Florance et al., "Slicing, Dicing, and Scoping the Size of the Us Commercial Real Estate Market."

⁸¹ Shilling, "Is There a Risk Premium Puzzle in Real Estate?," 501-525.

“With respect to transaction volume, most of the property sales are concentrated in the lower price bracket, those below \$1.25 million. The number of transactions diminishes as price increases. Transaction value, on the other hand, is heavily concentrated in the high price brackets. In particular, those transactions greater than \$5.0 million account for the major share of total transaction value, even though the number of these high-priced transactions represents a small fraction of the total number of transactions.”⁸²

CoStar does filter data based on multiple factors such as arm’s length transactions and build-to-suit transactions, as well as some physical size criteria such as multifamily properties with less than 10 units or properties under 2,500 square feet. In 2012, the index boasted over 100,000 data points since 1996 and almost \$500.0 billion in transaction values. Using 85,428 repeat-sale data points from 1996 to 2010 CoStar produced the following data in Figures 7, 8, and 9 (below):

CHART 4

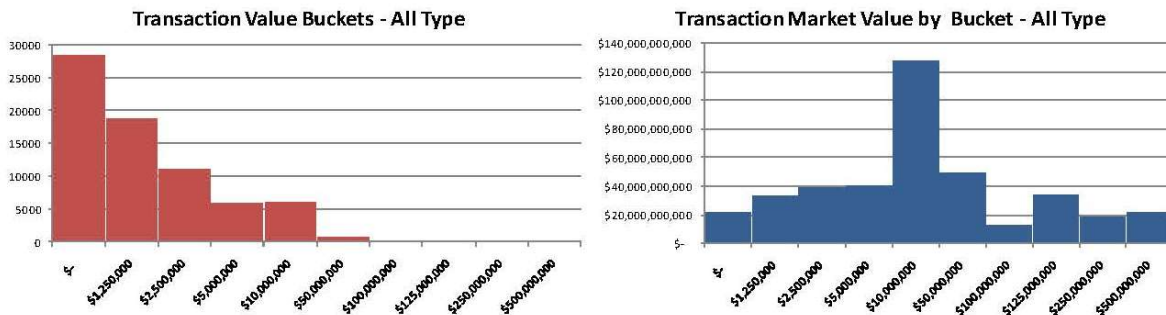


Figure 7: Commercial Real Estate Transaction Values (CoStar - Chart 4)

⁸² COSTAR GROUP, “CCRSI-Methodology: Repeat Sales Indices.”

CHART 5

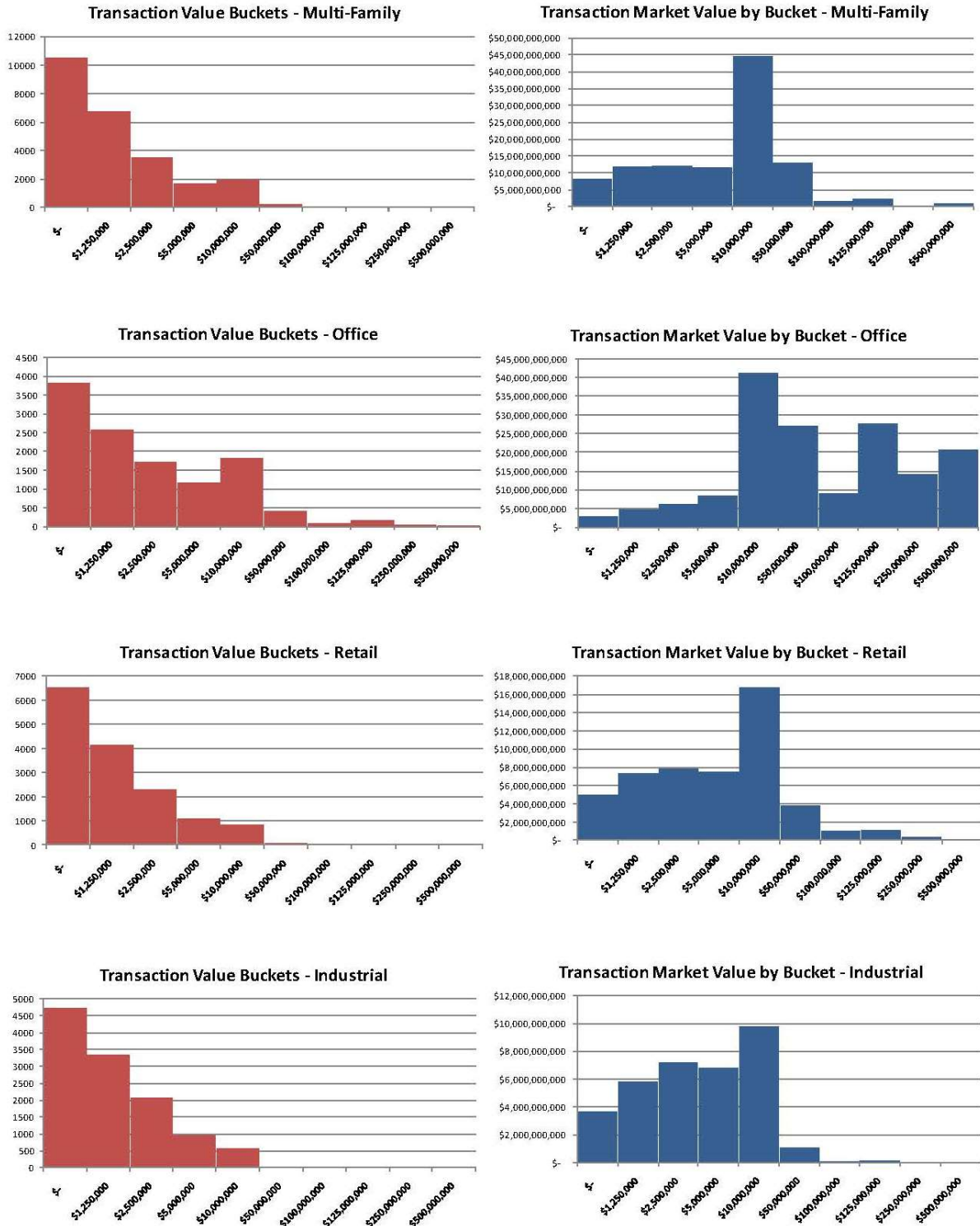


Figure 8: Commercial Real Estate Transaction Values by Property Type (CoStar - Chart 5)

Figure 9 (below) comes from the same data as the CoStar charts above but differentiates between “General Commercial” and “Investment Grade” properties per the CoStar definition. “General Commercial” analogous to this thesis’ use of the term “sub-institutional” while the CoStar term “Investment Grade” mirrors the term “Institutional” used in this thesis. This rests on the method and characteristics used to separate these two classes of assets as well as assuming Institutional real estate firms dominate the higher valued, “investment grade” property class.

CHART 7

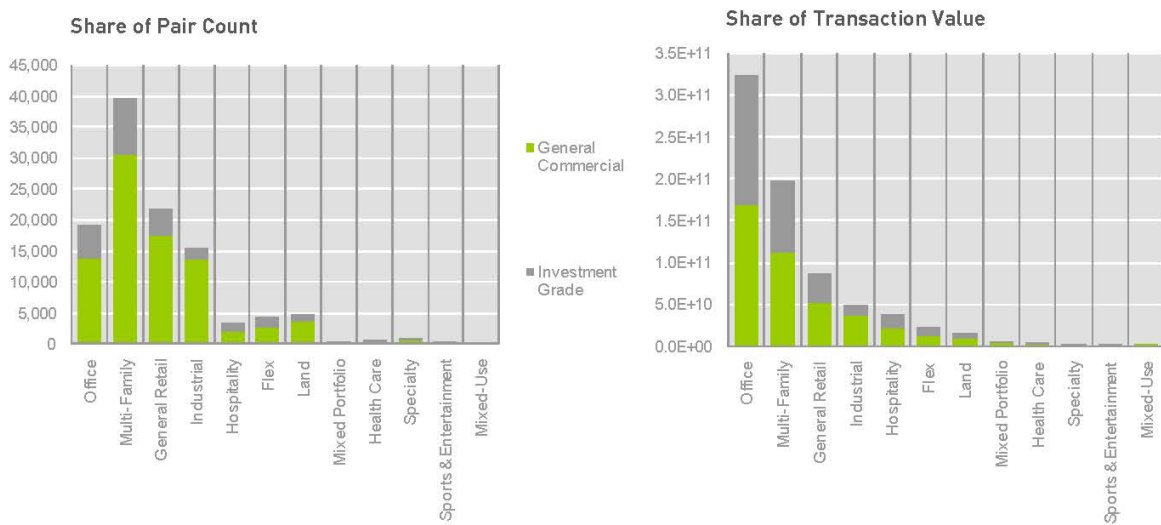


Figure 9: Pair Count and Transaction Volume of General Commercial and Investment Grade by Property Type (CoStar)

As of May 2013, CCRSI had data for more than 125,000 repeat sales since 1996, and the data included in Figure 10 (below) continues to validate this separation between investment grade and non-investment grade. The CoStar chart utilizes the same definitions of “general commercial” and “investment grade” as discussed above, but presents them in a time based bar chart as opposed to by property type.

U.S. Pair Count, Data through May of 2013

U.S. Pair Volume, Data through May of 2013

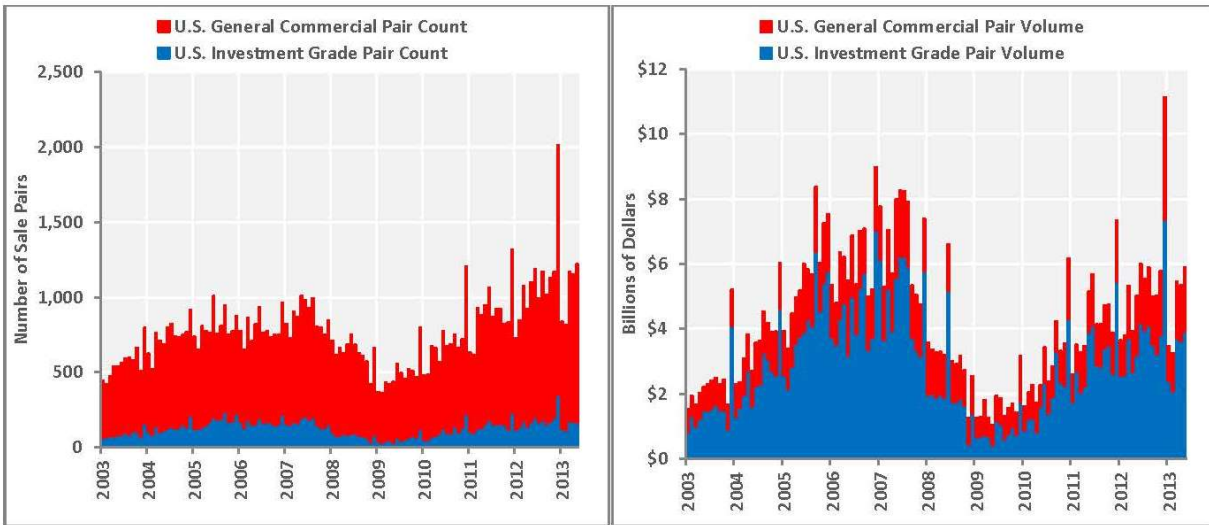


Figure 10: Pair Count and Transaction Volume of General Commercial and Investment Grade by Year (CoStar)⁸³

Furthermore, it is important to note that to further analyze pricing and performance, commercial real estate is further divided by property type, sub-property types, regions, metro areas, and sub-markets. Many institutions specialize based on property type or location or use these characteristics to diversify their portfolio. Specifically, there are markets deemed to be “core” markets where many institutional firms focus their investing, and rarely invest elsewhere due to risk aversion. These markets are typically large MSA’s demonstrating economic strength, and are thus theoretically safer investment markets with a higher quality and quantity of commercial real estate investment options. These core markets would include cities and areas such as Atlanta, Boston, Charlotte, Chicago, Dallas, Denver, Houston, Los Angeles/Orange County, Manhattan/New York City, Northern Virginia, Pacific Northwest, Philadelphia, Phoenix, San Diego, San Francisco, Seattle, Southeast Florida, Suburban Maryland, and Washington, DC. “The CCRSI prime markets are selected based on a number of factors including 1) total market size, 2) average price per square foot, 3) transaction volume, 4) level of institutional ownership, and 5) expert opinion.” In fact, property type, size, and location are the most important factors institutional investors consider when diversifying their portfolio or evaluating an acquisition.⁸⁴ Despite the focus on location and property type, “The Korpacz survey shows that there is

⁸³ COSTAR, “CCRSI June2013 Press Release Commercial Real Estate Prices Shake Effects of First Quarter Seasonal Slowdown with Strong Showing in April.”

⁸⁴ Louargand, “A Survey of Pension Fund Real Estate Portfolio Risk Management Practices,” 361.

less of an expected return difference between location and property type than there is between institutional and non-institutional.⁸⁵ Again, this indicates that there are a substantial number of cities and towns left out of the institutional real estate firm's focus, but more than ample opportunity for the developer or investor with local knowledge.

Traditionally, the single family home rental realm was reserved for small investors looking to capitalize on their local expertise without raising equity from investors, but recently "institutional" investment firms have ventured into this sphere in the wake of the 2008 financial crisis. The fourth quarter 2012 PwC (Korpacz) Survey reports that with "falling home prices, limited mortgage credit, and better rental options" the market for institutionally owned-single family rentals is emerging. The survey participants estimate "the single-family rental market to be a \$1.0-\$3.0 trillion asset class." This is in large part due to the ability to buy single-family homes in bulk from the government and other large entities grappling with clearing out foreclosed residential properties. "Recent media articles have named several real estate companies, REITs, pension funds, and endowment funds, such as Blackstone, Colony Capital, Carrington Capital Management, Oaktree Capital Group, Two Harbor Investment Corp., and Alaska Permanent Fund, as well as newly formed companies like Sylvan Road Capital, as major players in this emerging sector."⁸⁶ Crowdfunding could breach of the levy between these two investment worlds, assisting local investors, many of who have superior local knowledge, in exploiting these investment opportunities alongside these large institutional investors.

Lending and Capital for Sub-Institutional Markets

Property value, size and location are all important characteristics to classifying a property as core or institutional, but so are the methods of capitalization available to the sector. The availability of non-bank financing magnifies the split between institutional and non-institutional participants and properties. Furthermore the capital methods available to each sector further highlights the need for crowdfunding in the commercial real estate market. While institutional firms source capital from retirement accounts or through public offerings, the capital sources for private individuals and the sub-institutional market are limited. Interviews and surveys discussed in Chapter 7 of this thesis revealed that the majority of the sub-institutional market still relies on traditional bank loans and personal or

⁸⁵ Geltner, *Commercial Real Estate Analysis and Investments*.

⁸⁶ Alison H. Packer, Director, Financial Instruments, Structured Products and Real Estate, "PWC Korpacz Q4 2012," 15.

private equity. Many of these developers or deal sponsors source equity from friends and family or with the help of third party brokers. Institutional firms have less of a need for leverage, specifically REITs have no incentive to use leverage from a tax deductibility standpoint, and thus have a much lower leverage ratio.⁸⁷

Although non-institutional properties have smaller dollar requirements they are still viewed as higher risk and as such are able to borrow less debt but usually at a higher interest rate. Other factors important to loan terms for this sub-institutional class are personal guarantees or personal net worth and liquidity. It's not unusual for these commercial properties to house owner-occupant businesses and thus the loan to resemble more of a business loan. The traditional commercial bank loan offers shorter terms of three, five, seven, or ten years and has some guarantee or recourse component. As one interviewee stated, "it is a tradeoff between quality and quantity of equity brought to the table." Thus, these loans are not purely real estate based in their underwriting and contribute to the vast heterogeneity of this market class and its relative informational inefficiency.

Interviews also revealed that the current leverage ratios offered by bank financing are in the range of 50-55% loan-to-value ("LTV"), with rare exceptions, up to 65% can be achieved depending on a given the deal and/or the quality of the sponsor. Prior to the 2008 financial crisis 80% LTV was common and there were even loans issued with LTV's as high as 100%. Fannie Mae, Freddie Mac and other government backed methods of capitalization for residential investments or small commercial (mainly multifamily) properties have been important lending sources to smaller investors in the past, but are now a potentially threatened and uncertain source for the future in the wake of the 2008 financial crisis.

But remember, these lending standards are still mainly applicable to buyers or companies with a track record, and as presented later in Chapter 7, both the interview and survey data corroborate that for those attempting to break into the industry capital is very difficult to come by. Nevertheless, as this thesis explores recent legislation allowing for crowdfunding up to \$1.0 million per business per year, this equity amount allows for a substantial amount of buying power within the sub-institutional market as the table in Figure 11 (below) exemplifies.

⁸⁷ Feng, Price, and Sirmans, "An Overview of Equity Real Estate Investment Trusts (REITs)."

LTV	50%	55%	60%	65%	70%	75%	80%
Equity	\$1,000,000	\$1,000,000	\$ 1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$ 1,000,000
Debt	\$1,000,000	\$1,222,222	\$ 1,500,000	\$1,857,143	\$2,333,333	\$3,000,000	\$ 4,000,000
Purchase Price	\$2,000,000	\$2,222,222	\$ 2,500,000	\$2,857,143	\$3,333,333	\$4,000,000	\$ 5,000,000

Figure 11: Leverage Ratio Using Crowdfunding Thresholds (Authors)

Geltner and Miller state that, “In fact, constraints on equity capital are probably not as widespread as is often assumed in real estate, even for relatively small individual investors. Comingled real estate investment funds, limited partnerships, tenancy-in-common funds, and syndications of various types, in addition to both public and private REITs, are among the many types of vehicles that are widely used to funnel equity capital into commercial real estate. Real estate entrepreneurs are adept at setting up partnerships and corporations of various types, including limited partnerships in which the ‘outside’ equity capital providers have very little control over property or asset management. This may be difficult for very small individual investors just starting out, but once a track record of successful investment can be shown, it is much easier to obtain equity partners.”⁸⁸ Thus, crowdfunding might be most useful for those establishing a track record or for those needing to expand their capital network even if they have a strong track record and knowledge of setting up real estate partnerships.

“The idea that ‘entrepreneurial fervor’ (Beauregard, 1994), backed by abundant capital, fuels real estate development,” implies great success and increased development should young, unseasoned professionals full of local knowledge gain easier access to capital through crowdfunding.⁸⁹ “The restless nature of capital continuously seeking higher returns enhances the state of flux, even in a business of spatially fixed products.”⁹⁰ Investors looking to gain access to hard real estate investment also stand to benefit from lower investment hurdles and ease of investing via crowdfunding.

One barrier to investors and real estate professionals that has not been discussed yet greatly contributes to the informational inefficiency of the commercial real estate market is the lack of commercial real estate present on the internet. The next chapter highlights this problem after discussing how other industries have benefited from the Internet. Thus just the introduction of CRE crowdfunding on the internet helps to propel this industry closer to informational efficiency than what currently exists.

⁸⁸ Geltner, *Commercial Real Estate Analysis and Investments*, 358–359.

⁸⁹ Charney, “Three Dimensions of Capital Switching Within the Real Estate Sector,” 740.

⁹⁰ Ibid.

Chapter IV: An Examination of the Influence of the Internet on Commerce and Existing Online Real Estate Sites

Surveys, research, and interviews reveal that the commercial real estate industry still heavily relies on relationships and third party brokers for both deal and investor sourcing, with minimal reliance on social media or websites. While the commercial real estate sector will, by virtue of inherent characteristics, remain less efficient than the stock, bond, or other markets, it is still technologically behind most industries and thus less efficient in that regard. Through first examining the impact of the Internet on other investment and commerce industries, then evaluating the impact on the residential real estate market, and finally taking a cursory look at the commercial real estate resources currently available on the web, this chapter highlights the deficiency of technological use in the commercial real estate market and presents the opportunity for change.

The Influence of Online Stock Trading Websites

Although the public stock and bond market operates in a highly efficient and developed manner in comparison to the private market where buyers and sellers must spend a large amount of time “finding” each other, the impact of the Internet trading’s availability on the behavior of the average investor is a prime starting point for evaluating the web trading’s potential impact on commercial real estate. Admittedly, certain features of the commercial real estate market are embedded, such as the heterogeneity of the assets, larger transaction fees, and illiquidity. However, the inherent efficiencies of the Internet possess the ability to enhance transparency and facilitate matching buyer and seller, consequently increasing liquidity and reducing high transaction fees.

The introduction of online trading and other online marketplaces proved disruptive and ultimately democratizing for areas of the financial industry. As discussed in Chapter 2, democratic access to commercial real estate investing and owning continues to evade the industry, but crowdfunding has the potential to change this.

Notable online stock exchange trading sites emerged in the first half of the 1990’s and quickly changed the investing landscape. This technology disrupted the traditional roles of the stockbroker and the banking system. Day trading and fee reduction resulted from this phenomenon, as did increased financial services competition. The lower fixed and marginal costs of providing financial services through

the Internet enabled “newer, smaller companies to challenge established providers of these services.”⁹¹ E*TRADE (NASDAQ: ETFC) and Ameritrade (NYSE: AMTD) were among the most successful financial services firms that materialized from this era when they launched Internet trading platforms in 1996 and 1994 respectively.⁹² Lower costs, the need for fewer traders and human personnel, and availability of services twenty-four hours a day to customers allowed this online market to prevail as a successful method of financial trading. Increased availability, ease of trading, and customer control over their accounts encouraged investors to open 12.5 million online brokerage accounts between 1995 through mid-2000.⁹³ As a result, investors also became more active and, “between 1995 and 1998 the number of households investing directly in stock grew by over 30% (Kennickell, Starr, McCluer and Surrentt, 2000).”⁹⁴

Day trading also emerged as this segment of customers attempted to profit through intra-day trades and small changes in daily pricing rather than through long-term hold positions. In spring 2000, approximately 20% of the new orders flowing into NASDAQ were from firms catering to day traders.⁹⁵ The development of Internet trading reduced costs to investors while opening this market up to more people interested in actively participating in trading and investments. There is evidence of increased availability of information as well, all leading to a more democratized and efficient market.

How Non-Real Estate Online Marketplaces Changed the World

During the same time, new online entrants such as eBay, Amazon, and Yahoo! appeared. Founded in 1995, eBay (NASDAQ: EBAY) has radically changed the way people buy and sell goods through an online auction platform, thereby democratizing the consumer goods market. “What I wanted to do was create an efficient market, where regular people could compete with big business,” said eBay founder Pierre Omidyar. “In fact, as Omidyar explains, he believed the Net could create a perfect marketplace—where everyone was on equal footing and the marketplace set the price.”⁹⁶ The site was a great success; in 2012 the online marketplace boasted \$14.1 billion in net revenue. According to the

⁹¹ Barber and Odean, “The Internet and the Investor,” 41.

⁹² “E*TRADE Financial - Investment Services, Online Trading, Retirement, Banking.”

⁹³ Barber and Odean, “The Internet and the Investor,” 41.

⁹⁴ *Ibid.*, 49.

⁹⁵ *Ibid.*, 51.

⁹⁶ Maney, “USATODAY.com - 10 Years Ago, eBay Changed the World.”

eBay website, more than 90 million users worldwide trade more than \$1,900 worth of goods each second.⁹⁷

eBay has also been instrumental in fostering “the idea that trust between strangers can be established over the Internet.”⁹⁸ “eBay is a remarkably efficient market created by connecting individuals who wouldn’t otherwise be connected. It was the world’s first example of online social networking. While skeptics questioned whether people would trust doing business with strangers online, Pierre [Omidyar] firmly believed that people are basically good, and that any issues would work themselves out by the community.”⁹⁹ Omidyar recognized that eBay “had an incredible social impact,” and that “people have more in common than they think.”¹⁰⁰ Leveraging eBay’s resources, the company used crowdsourcing and the power of the eBay community for philanthropic purposes, similar to early crowdfunding concepts examined in the next chapter.

eBay is also a testament to the ability to sell anything over the web, from the first “test” posting of a broken laser pointer which sold for \$14.83 to a, “grilled-cheese sandwich with the image of the Holy Mother that sold for \$28,000.”¹⁰¹ By the mid-2000s, the site was the world’s largest used car dealer and had sellers ranging from individuals to major corporations.¹⁰² Why can some variant of the eBay model not extend to the commercial real estate marketplace?

The Rise of Online Residential Real Estate and Its Effect on the Market

The Internet has disrupted traditional marketplaces; it has “eliminated travel agents, decimated classified ads, depressed stock brokers, and taken the swagger out of car dealers, but it hasn’t dented the fortunes of real estate brokers.”¹⁰³ While eBay, Amazon, and other sites started in the early to mid-1990s had, by the mid-2000s, changed the commerce landscape, not until the early to mid-2000’s did well-known residential real estate sites such as Zillow, Trulia, and Redfin come into existence. In fact, Zillow founder Richard Barton recalled when planning to start a web-based real estate business that it

⁹⁷ eBay Website, “eBayInc FactSheet Q1.”

⁹⁸ Maney, “USATODAY.com - 10 Years Ago, eBay Changed the World.”

⁹⁹ eBay Website, “eBayInc FactSheet Q1.”

¹⁰⁰ Maney, “USATODAY.com - 10 Years Ago, eBay Changed the World.”

¹⁰¹ Ibid.

¹⁰² Ibid.

¹⁰³ Stone, “Why Redfin, Zillow, and Trulia Haven’t Killed Off Real Estate Brokers - Businessweek,” 58.

had been “ten years since the Internet had taken off, and [he] couldn’t believe how the [real estate] industry hadn’t changed much.”¹⁰⁴ Business-to-business sites and software had entered the real estate realm, but business-to-customer services remained minimal for residential real estate, and even less so for the commercial real estate industry.

“In January 1995, there were approximately 100 real estate websites that offered properties for sale. By the end of that year, the figure had risen to over four thousand sites and up to approximately 8,000 sites by the end of 1996 (Heller and Krukoff, 1997). Some of the sites involved the home pages of single properties while others included listings of over 500,000 properties. While complete marketing and purchasing information was initially lacking in the majority of the sites, this [was] rapidly becoming the minority of the listings. In 1996, the National Association of Realtors (“NARS”) estimated that of the two million homes for sale in the United States, only a few thousand were listed on the Web.”¹⁰⁵ In the late 1990s the MLS system finally transitioned from printed booklets to the web.¹⁰⁶

By 1999, 50% of American homes had personal computers, up from 30% in 1996, and 90% of those users were online.¹⁰⁷ The same year online retail sales had doubled to \$20 billion and were projected to grow.¹⁰⁸ Yet, the percentage of consumers using the internet for residential real estate purchases remained relatively low (37%), although it had grown from 2% in 1995.¹⁰⁹ “A survey (Reichert and Lange, 1999) of individuals who bought homes in Ohio during a two month period (September and August) in 1998 showed that 73.5% of those buyers had access to the Internet and [only] 38.7% used it in some facet of the home buying process.”¹¹⁰ Still, years later, in 2006 researchers found that only 39% of Internet users were going online to look for a place to live.¹¹¹

Despite the lack of real estate websites and unchanged percentage of people turning the web for real estate, during the late 1990’s and early 2000’s many economists were speculating that the Internet would “be responsible for the decline and perhaps the elimination” of real estate brokers, but

¹⁰⁴ Ibid., 60.

¹⁰⁵ Michael T. Bond and Michael J. Seiler, “Uses of Websites for Effective Real Estate Marketing,” 203.

¹⁰⁶ Sawyer, Crowston, and Wigand, *Digital Assemblages*, 19.

¹⁰⁷ Muhanna, “E-commerce in the Real Estate Brokerage Industry,” 1.

¹⁰⁸ Ibid.

¹⁰⁹ Ibid., 2.

¹¹⁰ Ibid.

¹¹¹ Gee, “Residential Real Estate Data on the Internet,” 105.

this has not proved to be the case.¹¹² Instead, residential brokers and agents accepted technology and instead of fighting the possible elimination of their profession, through embracing the technology have managed to maintain their presence. The actual driver behind adopting new technology wasn't "a fear of losing business, but largely from a desire to leverage the new medium to attract new buyers and reduce marketing and customer acquisition costs."¹¹³ In fact, one study finds that increased technological proficiency, among other traits, by real estate agents increases their earnings.¹¹⁴ As a result, social media, blogs, videos, listing sites and other technological resources have dramatically changed the home buying and selling process for both residential real estate professionals and customers.

*"Real estate has always relied on using information about properties and potential clients to create sales. This has been enabled of late through the rapidly increasing uses of [technology]. For example, in 1995 less than 2% of agents, home sellers, and buyers accessed the Internet for information about real estate and agents were just beginning to use mobile phones. But, by 2009, agents' mobile phone use was essentially ubiquitous; nearly 98% of agents were using other forms of [technology]; and, more than 90% of all purchases began with prospective buyers looking for available houses by using one of the many house-listing sites available via the Internet (National Association of Realtors; 2009)."*¹¹⁵

Process changes to the residential real estate industry due in part to computerization include: (1) shifting the house search process to buyer (more often done via an online search prior to engaging an agent); (2) aggregate listings for public viewing (the publically viewable MLS and many other sites); (3) multi-channel communications (ubiquity of mobile phone and email); and, (4) semi-automation of some process steps (digital forms, online applications, digital signatures).¹¹⁶

Today, residential real estate brokers and agents rely on mobile devices and web services to (1) effectively conduct business in any location and (2) attract and retain businesses. Popular tools used by these professionals to conduct and manage their business include DocuSign, ZipForms, Dropbox, and

¹¹² Ibid.

¹¹³ Muhanna, "E-commerce in the Real Estate Brokerage Industry," 10.

¹¹⁴ Jud, Winkler, and Sirmans, "The Impact of Information Technology on Real Estate Licensee Income," 9.

¹¹⁵ Sawyer, Crowston, and Wigand, *Digital Assemblages*, 3.

¹¹⁶ Sawyer, Wigand, and Crowston, "Redefining Access," 217 Table 1.

Customer Relationship Management (“CRM”) solutions like Top Producers.¹¹⁷ “Moreover, at least the initial stages of transacting business on the Internet has even become easier due to the Electronic Signatures in Global and National Commerce Act or E-SIGN, which became law on October 1, 2000. Under E-SIGN, any "act of endorsement or execution that can be recorded and that manifests one's intent to be bound by a document can be deemed a signature," (Weinstock and Leno. 2000:B6).”¹¹⁸

Residential real estate professionals also heavily on social media such as Facebook, Twitter and LinkedIn to network, market themselves and properties, and attract new clients. While many are attempting to figure out how and when agents will be removed from the equations, one paper postulates that while technology reduces the agent’s role as an information intermediary the agent actually becomes more “socially embedded” and that for digital architectures to work human interaction and support is vital.¹¹⁹ The presence and use of technology in residential real estate is seen as a “socioeconomic phenomenon enacted through socio-technical arrangements.”¹²⁰ The vast usage of social media by residential real estate agents and continued vitality of the residential real estate agent profession testifies to the power of a social network and personal connections. Similarly, eBay, crowdfunding, and crowdsourcing thrive off of the sense of community and feeling of social connectivity despite the technical medium. Community engagement appears to be a critical ingredient to the success of an online medium.

Technology and the web have now become crucial components to the residential real estate profession, and a 2012 survey conducted by the National Association of REALTORS® illustrates the large percentage of agents and brokers that use these web-based resources, depicted in Figure 12 (below).

¹¹⁷ National Association of REALTORS, “REALTOR Technology Survey Report 2011-2012.”

¹¹⁸ Aalberts and Townsend, “Real Estate Transactions, the Internet and Personal Jurisdiction,” 28.

¹¹⁹ Sawyer, Crowston, and Wigand, *Digital Assemblages*, 1,2.

¹²⁰ *Ibid.*, 5.

Social Media & Networking

Facebook and LinkedIn continue to be the social media tools that REALTORS® use most, although use of both has decreased somewhat since 2011. Brokers are slightly more likely than Agents to say they do not use any of these social media tools.

For real estate business purposes, which of the following do you participate in?



Because "None of the above" was not included as an option in 2011, 2011 and 2012 results cannot be compared.

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Figure 12: Realtor.com Web-based Marketing Usage (National Association of REALTORS®)

But what is more important to the residential real estate industry is the pervasiveness of information now available to non-real estate professionals and the average homebuyer. “The real estate sector has historically had ‘single traditional intermediaries.’ Buying and selling houses has occurred with the help of real estate agents and their agencies, such as RE/MAX, Coldwell Banker and Edina Realty. Today, however, searching for a house can be done via EC [e-commerce]-only intermediaries. Previously, alternatives to real estate agency-controlled ‘multiple listing services’ (MLSs) of homes for sale were very limited. As a seller, it was necessary to rely on a real estate agency for listing ‘distribution.’ And, as a buyer, it was necessary to rely on a real estate agency to gain access to the best listings.”¹²¹

In 1999, only 37% of buyers searched online for a home, but a decade later 90% of home buyers used the internet as part of their search.¹²² According to the National Association of REALTORS® 2012 Profile of Home Buyers and Sellers, “nine in 10 home buyers today rely on the internet as one of their

¹²¹ Chircu and Kauffman, “Strategies for Internet Middlemen in the Intermediation/disintermediation/reintermediation Cycle.”

¹²² Richardson and Zumpano, “Further Assessment of the Efficiency Effects of Internet Use in Home Search,” 516.

primary research sources, and 52% turn to the web as their first step.” In 2012 real estate related searches on Google.com grew 22% year-over-year, and “approximately one-fifth of real estate related searches happened on mobile devices, and Google real estate related searches on mobile devices grew 120% year-over-year from 2011 to 2012,” based on Google Internet Data in the third quarter of 2012.¹²³ In fact, real estate related searches on Google.com have grown 253% over the past 4 years.¹²⁴ However, it is possible that this growth is somewhat attributed to the recovering housing market post 2008 financial crisis, nevertheless, it demonstrates the importance the web now plays in the residential real estate process.

Even in 2001, before Zillow and Trulia, some Realtors (10%) expected that listing a property online would result in a higher sales price and 30% expected a shorter time on the market, and 75% believed that a listing received an increase in the number of inquiries if listed online.¹²⁵ These results can be attributed to increased information and transparency. “The most visible evidence of increased transparency of information is the public access to the MLS. Data in regional MLS can be accessed via the www.realtor.com site, many local brokerages, franchises, individual agent’s web sites, and community portals. The evidence indicates that people are doing just that: online house looking is a 21st century fashion (Boyce and Rainey, 2002; Kim and Heineman, 2003).”¹²⁶ Today REALTORS® use a number of sites to list their properties and advertise, but a few stand out as the most prevalent. The following graphs, Figure 13 and Figure 14(below), from the National Association of REALTORS® present the most widely used sites by members of the Association.

¹²³ “The Digital House Hunt: Consumer and Market Trends in Real Estate” A Joint Study from The National Association of REALTORS® and Google. Published January 2013.

¹²⁴ National Association of Realtors and Google, “The Digital House Hunt: Consumer and Market Trends in Real Estate.”

¹²⁵ Ford, Rutherford, and Yavas, “The Effects of the Internet on Marketing Residential Real Estate,” 106.

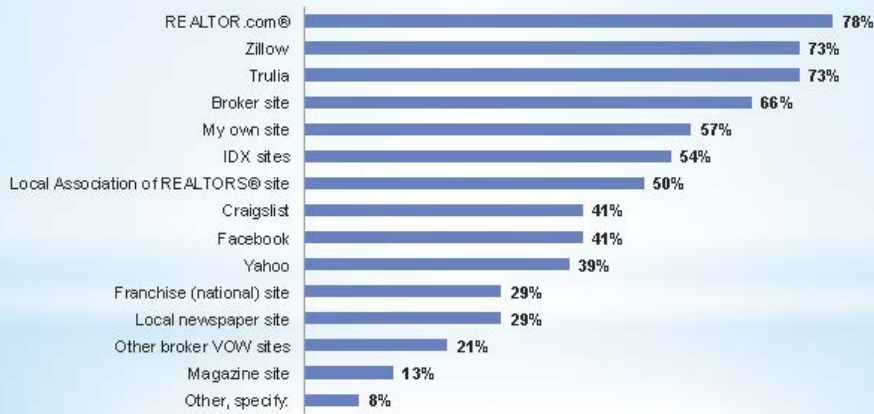
¹²⁶ Sawyer, Wigand, and Crowston, “Redefining Access,” 218.

Lead Generation & Listings

REALTOR.com®, Zillow and Trulia are the top three websites where agents and broker associates display their listings. Majorities also display their listings on their broker's site, their own websites, and on IDX sites.

What are the web sites where your listings are displayed?

Asked of Agents and Broker Associates Only*



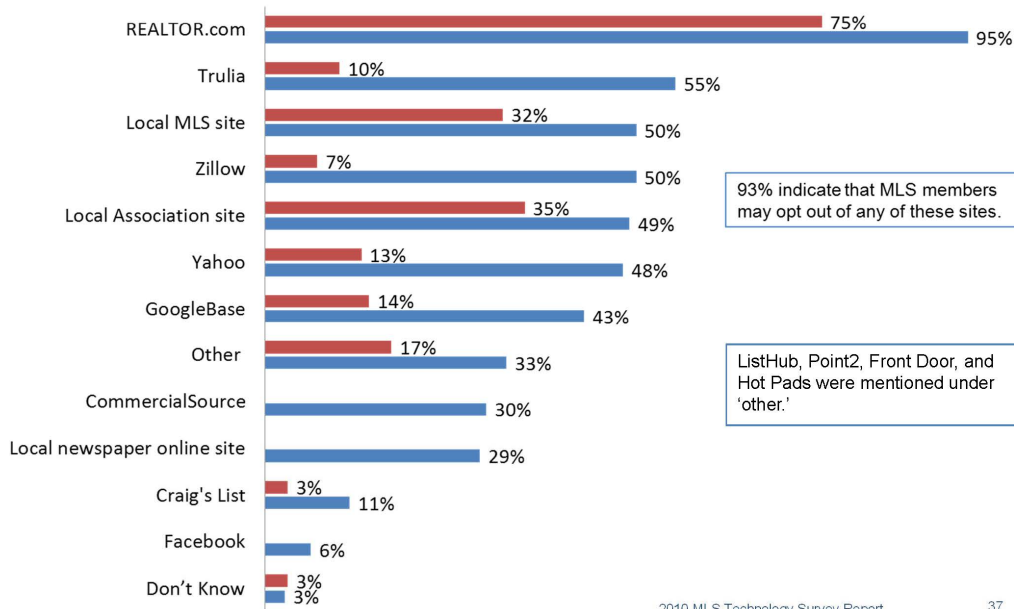
*This question was asked of all respondents (including Brokers) in 2011; therefore comparison with 2010 results is not possible. 42

Figure 13: Realtor.com Web-based Lead Generation (National Association of REALTORS®)

Syndication

Where is the MLS placing listings?

Comparison chart of the following years
 ■ 2007 ■ 2010



93% indicate that MLS members may opt out of any of these sites.

ListHub, Point2, Front Door, and Hot Pads were mentioned under 'other.'

Percentages will not add up to 100% as respondents were able to select more than one answer.

2010 MLS Technology Survey Report

37

Figure 14: MLS Listing Placement Ranking (National Association of REALTORS®)

Publishing MLS listings to these sites increases market efficiency and empowers buyers, similarly to how online trading site empowered investors and improved efficiency while lowering costs. “Because the residential real estate market is idiosyncratic and local, market information is costly to obtain. It is in just this type of market environment that institutional arrangements evolve that serve to lower search and transactions costs.”¹²⁷ Both broker intermediation and the web do in fact reduce search costs. “The Web allows buyers to quickly and cheaply locate and learn about homes on the market. This information can then be used to identify those properties that are most likely to meet their needs.”¹²⁸ Buyers now use the internet to find homes, learn about neighborhoods, assess school districts, look up crime statistics, find agents, compare mortgages rates, and much more. Although Buyers will now look at more homes online and ultimately search more intensively they are more likely to find a better match.¹²⁹

“Over the past several decades, the markets for residential properties have been impacted by developments in real estate marketing and finance that include policies of financial deregulation, innovations in information technologies, and financial innovations in the form of financial derivatives and mortgage contracts. Financial deregulation rests on the presumption that market competition will provide efficiency and market discipline will provide a form of natural regulation that assures a high degree of systemic stability but requires that buyers and sellers of properties, and lenders, borrowers, and investors are equally able to make informed decisions.

In contrast, any innovation that increases the availability of information equally to all participants can be expected to lead to real improvements in efficiency. Unlike the other innovations that have impacted the housing market, the Internet as a search tool should increase efficiency in housing markets by providing information for both buyers and sellers without increasing financial instability.”¹³⁰

However, so far, none of the public sites such as Zillow that provide MLS data have “usurped the MLS’s centrality; but these expand the options for consumers and agents to share and find house

¹²⁷ Zumpano, Johnson, and Anderson, “Internet Use and Real Estate Brokerage Market Intermediation,” 135.

¹²⁸ Ibid., 144.

¹²⁹ Ford, Rutherford, and Yavas, “The Effects of the Internet on Marketing Residential Real Estate,” 97.

¹³⁰ Richardson and Zumpano, “Further Assessment of the Efficiency Effects of Internet Use in Home Search,” 515.

information.”¹³¹ While the fact that the internet has not dis-intermediated real estate agents baffles economists, many studies looking at this do find evidence of some increased market efficiency. Despite the increase in Internet usage in the home buying process, 88% of homebuyers still use an agent.¹³² Other research shows the power has shifted to buyers and sellers away from agents. However, agents still play an important role in the transaction when it comes to technical questions, negotiations, and ethics, and thus may never be replaced completely.¹³³

The following sites are some of the top residential real estate sites catering to buyers and sellers first and then to industry professionals:¹³⁴

- *National Brokerage Firms:* Realtor.com, Coldwellbanker.com, Century21.com, Remax.com, kw.com
- *Search and Service Sites:* Zillow.com, Trulia.com, Redfin.com, Homes.com, HomeGain.com
- *Apartment and Rental Sites:* Apartments.com, Apartmentratings.com, Rent.com, Rentals.com, Forrent.com
- *Foreclosure Sites:* Foreclosure.com, foreclosurestore.com, RealtyTrac.com
- *For Sale by Owner Sites:* allthelistings.com, forsalebyowner.com, FSBO.com, homesalez.com
- *Auction Sites:* Auction.com, Williams & Williams (WilliamsAuction.com), Ameribid.com
- *Classified Type Sites:* Craigslist.org
- *Vacation Rentals:* Airbnb.com, vrbo.com
- *Other Resource Sites:* hud.gov, local tax assessors sites, NeighborhoodScout.com, Google Earth

“Over the last decade, the Internet has seeped into that bedrock of the U.S. economy: the housing market. Four sites -- Redfin and Zillow, based in Seattle, and Trulia and Realtor.com, based in the San Francisco Bay Area -- attract 61 million of the 67 million visitors to real estate websites each month in the U.S., according to ComScore.”¹³⁵

¹³¹ Sawyer, Crowston, and Wigand, *Digital Assemblages*, 20.

¹³² National Association of Realtors and Google, “The Digital House Hunt: Consumer and Market Trends in Real Estate.”

¹³³ Gee, “Residential Real Estate Data on the Internet,” 106.

¹³⁴ “The Most Popular Real Estate Websites - BusinessWeek.”

¹³⁵ Stone, “Why Redfin, Zillow, and Trulia Haven’t Killed Off Real Estate Brokers - Businessweek.”

Realtor.com, the official site of the National Association of Realtors and operated by Move, Inc., aggregates listings from over 800 MLS's across the United States, which is more than any other real estate site. Consumers are able to search approximately 98% of all listings in the U.S. from Realtor.com, which also has arguably the freshest information from MLS as 80% of listings are updated within 15 minutes and the remainder updated within 24 hours of any change.¹³⁶ Guides, advice, and blogs are also available on the site. Site visitor numbers continue to grow as does the mobile application usage, but while consumers spend more time on the site than competitor's, unique monthly visitor traffic on Zillow and Trulia trumped Realtor.com in April 2013.¹³⁷

Zillow, Inc. (NASDAQ: Z) operates a portfolio of online and mobile based brands that "serve the full life cycle of owning and living in a home: buying, selling, renting, financing, remodeling, and more. The Zillow, Inc. portfolio includes Zillow.com, Zillow Mobile, Zillow Mortgage Marketplace, Zillow Rentals, Zillow Digs, Postlets, Diverse Solutions, Buyfolio, Mortech, HotPads, and Agentfolio."¹³⁸ The company's brands assist "homeowners, buyers, sellers, renters, real estate agents, mortgage professionals, landlords and property managers find and share vital information about homes, real estate and mortgages," and strives to, "empower consumers with information and tools to make smart decisions about homes, real estate and mortgages."¹³⁹ The platform aims to eliminate stale data, lagging price changes and incorrect statuses, thus aiding the informational efficiency in the residential real estate market.¹⁴⁰

Zillow, which is headquartered in Seattle and created by "a group of Internet veterans from Expedia, Amazon.com and Microsoft," was incorporated in late 2004 and launched in February 2006. The company is known for its "Zestimates" which is its proprietary estimate of current home values or rent estimates for over 110 million homes. As of first quarter 2013 the company reached record revenue and traffic levels. Although the company was an instant hit, recording its millionth visitor 2 days after launching and quickly being named to TIME Magazine's 50 Coolest Websites, it has continued to grow in

¹³⁶ "About Move - Move.com."

¹³⁷ Move.com, "MOVE_News_2013_4_3_General_Releases.pdf."

¹³⁸ "Bay Area Real Estate Information Services Joins Zillow Partnership Platform - Jul 19, 2013."

¹³⁹ "What Is Zillow? - Zillow."

¹⁴⁰ "Bay Area Real Estate Information Services Joins Zillow Partnership Platform - Jul 19, 2013."

popularity reaching 52 million unique visitors monthly.¹⁴¹ “Zillow Mobile had more than 241 million homes viewed in April. That is 93 homes per second, every single day.”¹⁴²

“Trulia, Inc. (NYSE: TRLA), is [another] leading online marketplace for home buyers, sellers, renters, and real estate professionals. Since launching in 2005, Trulia has grown from being a startup with two employees to being a public company with more than 500 employees across three offices.”¹⁴³ Trulia differentiates itself by giving “home buyers, sellers, owners and renters the inside scoop on properties, places, and real estate professionals,” and focusing on providing “unique info on the areas people want to live that can’t be found anywhere else: users can learn about agents, neighborhoods, schools, crime, commute times, and even ask the local community questions.”¹⁴⁴ The site displays more than four million real estate listings and rental listings nationwide to 24 million monthly unique users. Additionally, “more than 500,000 registered real estate professionals contribute to the Trulia Voices community.”¹⁴⁵ The site emphasizes that it is a community on the web that can bring buyers local knowledge not found elsewhere.¹⁴⁶

Founded in 2004 on the belief that the real estate search and buying process could be better for customers, Redfin.com describes itself as “technology-powered real estate broker”. Founder and CEO Glen Kelman told CBS News’s 60 Minutes in 2007 that, “Real estate, by far, is the most screwed up industry in America. We feel like things that Amazon or eBay or Yahoo! have done in other industries, we can do for the real estate industry.”¹⁴⁷ At the time he appreciated the idea that an online site like Redfin could potentially disrupt this unchanged industry.

Unlike Zillow and Trulia, Redfin actually employs real estate agents and uses its technological foundation to power its services. Furthermore its agents are paid based on customer satisfaction ratings, not on commission, resulting in lower transaction fees to customers made possible by leveraging

¹⁴¹ Zillow Press Release on Website 7/20/13

¹⁴² Zillow Press Release on Website 7/20/13

¹⁴³ Per press release dated 7/17/2013

¹⁴⁴ “About Us - What We Do - Trulia.”

¹⁴⁵ “Trulia Fast Facts About Us - What We Do - Trulia.”

¹⁴⁶ “About Us - What We Do - Trulia.”

¹⁴⁷ Stone, “Why Redfin, Zillow, and Trulia Haven’t Killed Off Real Estate Brokers - Businessweek.”

technology. As of July 2013 Redfin served 22 U.S. markets and had closed over \$8 billion in home sales.¹⁴⁸

Finally, internet sites such as Airbnb.com and Vrbo.com have simultaneously changed the vacation rentals market by allowing owners or small real estate agents in resort towns to easily market and rent vacation homes or condos. Conversely vacationers have the advantage of viewing all options and directly negotiating with owners.

In May 2013, HousingWire Magazine released an “Inaugural List of Top 50 Real Estate Technology Firms”. The list recognized tech leaders “set to revolutionize the real estate transaction from every angle.”¹⁴⁹ In the press release, Paul Jackson, founder and CEO of HousingWire, stated, “As the nation’s real estate markets begin to return to normal, we are seeing a surge of interest within the social and tech communities, as they look to innovate in the real estate space.”

“Innovation and positive disruption are what moves any market forward, and the real estate business is seeing an emergence of incredible technology. Today’s innovations will change how homes are listed, marketed, managed, and sold – and everything in between. The HW RETech:50 were selected on the basis of an open nomination process. The HousingWire editorial board reviewed all nominations received to select the 50 firms that are most likely to have an impact on the real estate transaction in the next 12 months.” – HousingWire RETech50 website, July 20, 2013

¹⁴⁸ “Redfin Report Finds That Middle-Aged Women Are Fastest Growing Group of Single Female Homeowners | Redfin.”

¹⁴⁹ Jane Larkin, “HousingWire Releases Inaugural List of Top 50 Real Estate Technology Firms - MarketWatch.”

The 50 sites listed in Figure 15 (below) were chosen from over 200 nominations.

- | | | | |
|--------------------|-----------------------|---------------------------|-------------------------|
| 1. 10k Research | 14. Dream Commerce | 27. Mobile Real Estate ID | 40. RESAAS |
| 2. Agent Evolution | 15. Equator | 28. Mobile Realty Apps | 41. Sentrilock |
| 3. Altos Research | 16. Happy Grasshopper | 29. Placester | 42. Showing Suite |
| 4. Auction.com | 17. HomeFinder.com | 30. Point2 | 43. Terratum |
| 5. Benutech | 18. HomeLight | 31. Ready4Remodel | 44. Top Producer |
| 6. BombBomb | 19. Homes.com | 32. Real Satisfied | 45. touchCMA |
| 7. BoomTown! | 20. HomeZada | 33. Realtor.com | 46. Trulia |
| 8. Cartavi | 21. House Happy | 34. Realty Pilot | 47. VScreen |
| 9. CloudCMA | 22. Hubzu | 35. Realty Mogul | 48. WebsiteBox |
| 10. CoreLogic | 23. Kevzio | 36. RealtyTrac | 49. Williams & Williams |
| 11. Curvator | 24. Lone Wolf RE Tech | 37. Redfin | 50. Zillow |
| 12. Doorsteps | 25. LPS | 38. Reesio | |
| 13. Dotloop | 26. Market Leader | 39. RES.NET | |

Figure 15: HousingWire RETech Top 50 Real Estate Websites (HousingWire Magazine)

The Growth of Online Real Estate Auction Sites

While many of the sites on HousingWire’s list provide services to professionals or are important listing sites that have already been mentioned, two firms (Auction.com and Williams & Williams) on the HousingWire list operate online real estate auctions. In fact, “at first the early Zillow employees contemplated holding online auctions for homes as a way to disrupt the housing market before deciding that was impractical.”¹⁵⁰ But other sites did venture into this realm and have experienced success.

The success of eBay and other online auction sites encouraged companies to take traditional real estate auctions to the web. Auctioning real estate is nothing new and is an accepted and established method of trading real estate, but online auctions for real estate is still relatively new. Traditional auctions required buyers and sellers to conduct business at a common place, but the power of the Internet and advantage of online auctions is the “ability to bring buyers and sellers together in a virtual, asynchronous environment and provide them with the information and tools necessary to make educated choices and trades.”¹⁵¹ In some states, such as Texas, distressed properties, as part of the foreclosure process, are literally auctioned on the courthouse steps and buyers must attend in person with cashier’s checks – a rather archaic process.

¹⁵⁰ Stone, “Why Redfin, Zillow, and Trulia Haven’t Killed Off Real Estate Brokers - Businessweek.”

¹⁵¹ Ku and Malhotra, “The On-line Auction Phenomenon,” 353.

This foreclosure process also results in associating real estate auctions with distressed properties. Real estate auction companies have capitalized on the large amount of distressed properties in the wake of the 2008 financial crisis, and have actually “used the surge of distressed asset sales to gain a foothold in the commercial real estate investment sales market.”¹⁵² As a result, there are more investors purchasing through online auctions than only a few years ago and it’s becoming more accepted in both the residential and commercial real estate industries as a viable method of trading properties.¹⁵³ Yet, it remains to be seen whether or not this will continue to attract sellers with non-distressed properties wanting to sell through the online auction method.

An additional downside to online auctions is the removal of the ability to negotiate relevant terms other than price that in many industries, particularly real estate, can be just as important as price.¹⁵⁴ Nevertheless, Auction.com, the leading online commercial real estate auction site, has sold more than \$20 billion in assets since 2007 and in 2012 sold \$3.6 billion in commercial real estate.¹⁵⁵ “The company serves customers from the largest financial institutions in commercial real estate to the individual consumer and agent.”¹⁵⁶ “Auction.com’s commercial division has largely been focused on working with distressed assets being sold by banks, lenders, special servicers and other motivated sellers. In 2012, the company began expanding its business development efforts to reach more institutional commercial real estate owners. For example, Auction.com has sold assets for large owners such as Blackstone, General Growth Properties, Kimco Realty, Gramercy Property Trust and GE Capital.” Auction.com will continue to work to overcome the stigma associated with auctioned properties, however Auction.com, AmeriBid, and HFF have seen institutional quality assets command “good pricing, even market pricing in some cases,” although most have a lender involved.¹⁵⁷ “AmeriBid sold a land parcel last year for \$28.7 million at auction that was the highest priced third party foreclosure sale in Maryland in 2012.”¹⁵⁸ “Even very valuable properties can sell for top dollar at auction.”¹⁵⁹ Most

¹⁵² Beth Mattson-Teig, “Are CRE Auctions Moving into the Mainstream?,” June 19, 2013.

¹⁵³ Ibid.

¹⁵⁴ Ku and Malhotra, “The On-line Auction Phenomenon,” 355.

¹⁵⁵ Beth Mattson-Teig, “Are CRE Auctions Moving into the Mainstream?,” June 19, 2013.

¹⁵⁶ Beth Mattson-Teig, “Are CRE Auctions Moving into the Mainstream?,” June 19, 2013.

¹⁵⁷ Ibid.Ibid.

¹⁵⁸ Ibid.

¹⁵⁹ Ibid.

importantly conducting the auctions online opens the bidding up to a wider audience, which is a benefit for the seller but also a way to ensure efficient market pricing.¹⁶⁰

The online commercial real estate auction segment somewhat bridges the gap between residential online real estate sites and the commercial real estate sector adding a sense of democratization to the institutional commercial real estate club.

Existing Commercial Real Estate Websites and the Future of Commercial Real Estate on the Web

Despite the large number of residential real estate websites, the online commercial real estate realm remains extremely underserved. Using the provision of research as a yardstick, the online residential real estate industry is thriving because of the research they provide to the marketplace, yet research is almost non-existent in the online commercial sector.

Ironically, while commercial real estate developers and professionals are reacting to the Internet's impact on the industries that could affect the usage of real estate assets, they are not assimilating this technology into the commercial real estate sector itself. For example, the industry is working diligently to predict the effect that online shopping will have on the future of the underlying real estate assets, such as retail space and warehouse and distribution centers, or how the rise of virtual commuting could reduce future office space needs. Yet they are ignoring the primary effects that the internet marketplace could have on their own industry.¹⁶¹

Many MLS systems will accommodate small commercial property lease and sales listings, but these listings are minimal and often targeted towards owner-occupied commercial properties and small multifamily properties. CoStar and LoopNet (now owned by CoStar) provide online listing services and data targeted toward the commercial real estate industry, but are used much less frequently for commercial real estate transactions than the MLS system is used for residential. Real Capital Analytics and Real Capital Markets also provide services to the trade as do REIS and Argus Software (although not a web based listing utility). CoStar, LoopNet, and MLS were the most frequently mentioned resources in the "other" category of the survey conducted for this thesis.

¹⁶⁰ Ibid.

¹⁶¹ "Technology Outlook: Where Is Technology Taking the Real Estate Industry?"

CoStar and many of these services are expensive and thus geared toward the large institutional firms that can afford them, not the average investor. The CoStar Group (NASDAQ: CSGP) also employs approximately 1,200 people to call brokers, buyers, sellers, and other commercial real estate professionals to gather and verify trade information, thus maintaining high informational expenses despite the use of technology. The company website claims that the company logs more than 5.1 million data changes per day, makes more than 10,000 calls a day to brokers, owners, developers, and other commercial real estate professionals, canvasses more than 500,000 properties nationwide annually, and takes more than 1 million photographs for its database annually.¹⁶² The site covers more than 59 billion square feet of commercial property and provides sale and lease listings as well as tenant information and sales comparable information.¹⁶³

While Costar is the number one commercial real estate intelligence site in the world and touts the fact that professionals “close the deal,” and then can “leave the property research, verification and updating to us,” the lack of reliance on crowdsourcing information might eventually become a hindrance to their business model.¹⁶⁴ In fact a recent Housing Wire article reported that, “after spending five years as a commercial real estate broker, Michael Mandel knew the industry was desperately missing a critical component, transparency. That lack of transparency in the market led Mandel to create CompStak, which uses crowdsourcing to create a comprehensive database of commercial real estate and lease information.”¹⁶⁵

Nevertheless, “CoStar Group is the primary provider of websites for commercial real estate information, analytics, and marketing services. Through LoopNet, the company operates the most heavily trafficked commercial real estate marketplace online with more than 7 million registered members.”¹⁶⁶ Yet, CoStar’s combined website traffic from all of its sites is approximately 10 million unique monthly visitors.¹⁶⁷

CoStar was founded in 1987 before the internet took off and has been able to maintain its foothold and adapt to technology, however, “despite the obvious utility of the listings and their promise

¹⁶² COSTAR GROUP, “CoStar - Analyze Commercial Properties, Research Sales Comparables -.”

¹⁶³ “CoStar Landing Page.”

¹⁶⁴ COSTAR GROUP, “CoStar - Analyze Commercial Properties, Research Sales Comparables -.”

¹⁶⁵ Christina Mlynski, “Crowdsourcing Comes to Commercial Real Estate.”

¹⁶⁶ “About CoStar Group (CSGP)–Commercial Real Estate Intelligence Provider.”

¹⁶⁷ Ibid.

for the transaction process and market transparency, one third of commercial real estate listing sites went bankrupt in 2001 and 2002,” that were active in 2000.¹⁶⁸ “However, even these failed attempts illustrated the promise for the transaction process and market transparency in real estate management. Appropriate online facilities make transactions more efficient, faster and less costly. Transparency in both the transaction process and in the description and analysis of supply provides potential tenants with more control and a broader choice.”¹⁶⁹ A study conducted on 63 commercial real estate sites online at the turn of the century assumed that the high percentage of failure could be attributed to the “specific design and implementation of the real-estate listing sites.”¹⁷⁰ It is also entirely possible that thirteen years ago the commercial real estate industry was resistant to the Internet feeling that increased transparency was a threat to their livelihood.

While commercial real estate sites continue to struggle and lag behind the residential real estate industry and other industries, there are a few signs that commercial real estate is finally recognizing the need for more Internet presence. Harkening back to the late 1990’s when residential real estate brokers were venturing into the online marketing world, commercial real estate companies are just now approaching the online marketplace creating individual sites to market office and retail spaces and buildings. Up until this point apartment and condominium developers were the only ones to use this media, however they also were catering to the residential market. A January 2013 New York Times article reported that, “In terms of marketing tone, the commercial real estate industry has long played the quiet cousin to the brasher residential business. While apartment [buildings] are routinely sold using splashy, multifaceted ad campaigns, commercial brokers and developers have favored lower-key, brochure-based approaches. But the two branches of the family may be growing closer. In recent months, the marketing teams for some New York office buildings have decided to get the word out by deploying the type of stylish Web sites once used only by luxury condominiums.”¹⁷¹

Most notable was the article’s recognition that, “these sites add transparency to a business that can seem clubby and secretive.”¹⁷² Could this represent a harbinger that the commercial real estate industry has left the door open just a crack for those who are “not in the club”. Commercial real estate

¹⁶⁸ Martens and Koutamanis, “Realestate Online Information Systems,” 561, 562.

¹⁶⁹ Ibid., 563.

¹⁷⁰ Ibid.

¹⁷¹ C.J. Hughs, “New York Office Builders Raise Their Online Voices.”

¹⁷² Ibid.

professionals are recognizing that flashy sites and renderings sell the feel of the building or development much better than standard data points such as square footage. Historically, certain commercial real estate products were viewed as too complicated to market online as compared to residential apartments or condominiums, that seems to be changing as commercial real estate professionals see the power that these sites have in leasing a building and thus aiding in securing financing, investors and other tenants.¹⁷³ Nevertheless, just like the residential real estate industry, commercial real estate professionals realize the importance of the broker during the negotiation and closing portion of the process.¹⁷⁴

Given the higher level of expertise and attention required of a commercial real estate property or development, it may not be possible for the commercial real estate industry on the Internet to exactly replicate what has occurred in the residential real estate market or with online marketplaces such as eBay. Similarly, although there will be more access to information and an increase in people trading and making real estate investments, the heterogeneity of real estate will prevent commercial real estate on the internet from resembling online stock trading. Nevertheless it is evident that the commercial real estate industry is late to the technology and web-based data game and there is a lack of online information and investment ability for non-commercial real estate professionals. Accordingly crowdfunding presents a prime opportunity to fill this void. Crowdfunding for commercial real estate has the potential to provide this positive disruption allowing more people to buy and invest in commercial real estate just as they have been able to in other industries.

The sites mentioned in this chapter highlight the explosive growth in the online industry as a whole, but also the creation of online communities that trust each other enough to transact via the internet which generated increased transparency, information sharing, and positive industry disruption that moves the market forward. The next chapter explores the creation and growth of crowdfunding from its crowdsourced foundation, and the beautiful disruption it created within the marketplace and online world.

¹⁷³ Ibid.

¹⁷⁴ Ibid.

Chapter V: Crowdfunding Overview – The Evolution of Crowdfunding and Current Crowdfunding Landscape

“The concept of crowdfunding finds its root in the broader concept of crowdsourcing, which refers to using the crowd to obtain ideas, feedback and solutions in order to develop corporate activities.”¹⁷⁵ In evaluating crowdfunding, it becomes quite evident that crowdfunding is at the intersection of microfinance and crowdsourcing. “In the case of crowdfunding, the objective is to collect money for investment; this is generally done by using social networks, in particular through the Internet (Twitter, Facebook, LinkedIn and different other specialized blogs). In other words, instead of raising the money from a very small group of sophisticated investors, the idea of crowdfunding is to obtain it from a large audience (the “crowd”), where each individual will provide a very small amount. This can take the form of equity purchase, loan, donation, or pre-ordering of the product to be produced.”¹⁷⁶ Both Prosper and Lending Club (both examined later in more detail) provide prime examples of business models that have successfully and profitably harnessed power of the crowd that exists at this nexus of crowdsourcing and microfinance.

Microfinance Roots

While crowdsourcing is a relatively new phenomenon, the notion of using large groups to aggregate and distribute capital is not. “Microloans, also known as microfinancing, peer-to-peer lending, and crowdfunding, started out as a means for individuals, such as impoverished borrowers who lack collateral and underprivileged women in third world countries, to provide for themselves. The way microloan markets operate is quite straightforward. There are no banks. Interested individuals come together on a microloan platform and directly borrow and lend with each other.”¹⁷⁷

Concepts relating to microloans can found as early the 4th century, when the first private credit union, called “lun hui,” was founded in China. In the West, the concept resurfaced in the 1740’s, with Jonathan Swift’s establishment of the first Irish Loan Funds. Swifts idea was later cloned by other charitable (and non-charitable) organizations eventually growing to 300 different loan funds by 1840. “Microlending has been practiced for centuries all over the world, as demonstrated by “susus” in Ghana,

¹⁷⁵ Belleflamme, Lamber, and Schwienbacher, “Crowdfunding: Tapping the Right Crowd,” 2.

¹⁷⁶ Ibid.

¹⁷⁷ ZHANG, “From Lun Hui to Prosper. Com,” 30.

“chit funds” in India, “tandas” in Mexico, and “pansanaku” in Bolivia. Modern applications emerged in the 1970s, the Grameen Bank in Bangladesh being the most prominent example.”¹⁷⁸

Grameen Bank, founded in 1983 by Muhammad Yunus, is a highly successful micro-lending bank that makes uncollateralized loans to groups of villagers and relies on joint liability between the member of the group to ensure and encourage repayment.¹⁷⁹ The “Bank of the Poor” works on a system of trust, a set of values, and training programs for the impoverished borrowers.¹⁸⁰ The bank and its founder were awarded the 2006 Nobel Peace Prize as a result of the success this model has had in fighting poverty around the world. This model has been replicated in forty countries including the United States, and per the 2011 annual report the bank had lent to over 8.3 million people serving over 80,000 villages.¹⁸¹ Grameen’s success demonstrates the power of microfinance and the community. The concept of crowdsourcing harnesses the power of the community and crowd.

The Power of Crowdsourcing

In 2008 the Search for Extraterrestrial Intelligence (SETI) Institute used crowdsourcing to solve a difficult problem they had encountered. The Institute had upgraded their radio telescopes and the new receivers were generating 500 times the data they had been previously producing. The data overwhelmed the computational capabilities at the Institute, presenting the scientific team with too much data and inadequate computational capability. SETI conceived of and launched a new concept: “distributed computing.” With an open call to the public to offer up their computers during dormant hours to run SETI computations, a “crowd” of 170,000 users offered up 300,000 computers, creating the world’s largest supercomputer.¹⁸² The SETI project has since grown to 3.6 million users in 226 countries and has logged over 1 million years of CPU time.¹⁸³ SETI is a dramatic example of crowd and community.

The term “crowdsourcing” first appeared in June of 2006 in Wired Magazine written by Contributing Editor Jeff Howe. He developed the concept and the term when referring to a crowd driven phenomenon he had recently observed to create a disruptive practice of outsourcing, which had been significantly reducing labor costs by moving low-skill jobs to lower wage centers in Asia. The byline for

¹⁷⁸ Ibid.

¹⁷⁹ Rai and Sjöström, “Efficient Lending in Village Economies,” 1.

¹⁸⁰ “Grameen Bank | Bank for the Poor - Home.”

¹⁸¹ Rai and Sjöström, “Efficient Lending in Village Economies,” 1.

¹⁸² “SETI@home Ramps Up To Analyze More Data In Search Of Extraterrestrial Intelligence.”

¹⁸³ David P. Anderson, “SETI_PPP.ppt.”

his article: “Remember outsourcing? Sending jobs to India and China is so 2003. The new pool of cheap labor: everyday people using their spare cycles to create content, solve problems, even do corporate R&D.”¹⁸⁴

The article goes on to describe several new market entrants in 2006 that were upending traditional business models. Among various examples, Howe cites iStockphoto, a new company that disrupted the cottage industry for stock photos by crowdsourcing photos at a fraction of the existing price, and InnoCentive, a site that outsourced corporate research and development to home based tinkerers who are paid a fee to solve problems that were vexing corporate research departments. These examples demonstrate the community’s ability to shift jobs to those that need it and are early examples of crowdfunding’s ability to democratize the U.S. investment realm.

The Birth of Crowdfunding

The first use of the term “crowdfunding” is attributed to Michael Sullivan, the founder of a now defunct website Fundavlog.com. In his blog, last edited on December 12, 2012, Sullivan gives his definition of crowdfunding as, “Inspired by crowdsourcing, describes the collective cooperation, attention and trust by people who network and pool their money together, usually via the Internet, in order to support efforts initiated by other people or organizations. Crowdfunding occurs for any variety of purposes, from disaster relief to citizen journalism to artists seeking support from fans, to political campaigns.”¹⁸⁵ Fundavlog was a failed attempt to create an incubator for video-blog related projects and events. Part of the business model included a rudimentary capability to fund these projects. This scheme was “based on reciprocity, transparency, shared interests and, above all, funding from the crowd.”¹⁸⁶

However, the efforts of two advertising executives who attempted to use crowdfunding to purchase the company that made their favorite beer, the Pabst Blue Ribbon Brewery Company, overwhelmingly demonstrates the potential capital raising impact of crowdfunding. In November 2009 Michael Migliozi II and Brian William Flatow created a one page website called BuyBeerCompany.com for the purpose of raising capital to buy Pabst. In addition they created a Twitter account and circulated a press release. They collected pledges via their website, Facebook and Twitter. The contributors would

¹⁸⁴ Howe, “The Rise of Crowdsourcing,” 1.

¹⁸⁵ “SullivanBlog.”

¹⁸⁶ Daniela Castrataro, “A Social History of Crowdfunding,” 1.

receive a “crowdsourced certificate of ownership” and beer worth the amount of the pledge. The concept was a startling success; by December 1st the founders collected \$14.75 million in pledges. By the end of January they had over \$100 million and by February 22, 2010 they had pledges of \$200 million from over 5 million investors. In written testimony to the Committee on Oversight and Government Reform United States House of Representatives Mr. Migliozi recounted: “In the fall of 2009, I read a New York Post article that Pabst Brewing Company was up for sale and the asking price was \$300 million. In jest, via our corporate twitter account, I tweeted maybe we can crowdsource this and before I could even hit the send button, I knew this would be, at the very least, a great case study to evaluate crowdsourcing, its behavior, its magnitude.”¹⁸⁷

Their success drew media attention and which alerted the SEC. The SEC determined that they were selling unregistered securities in violation of Section 5(c) of the Securities Act. On March 24, 2010 Migliozi received a FedEx from the SEC summoning him to a deposition in the SEC’s Philadelphia offices.¹⁸⁸ When BuyABeerCompany.com was closed in April 2010 over 7 million users, averaging \$38 per pledge had pledged a total of \$282 million.¹⁸⁹ The two men eventually received and consented to a cease and desist order. They settled with the SEC without admitted or denying any of the agencies charges and took down their website in April 2010.¹⁹⁰ Interestingly, had they not been shut down by the SEC, they probably would have achieved their goal. Ultimately Pabst was sold in the summer of 2010 to a private investor, a consumer brands specialist named C. Dean Metropoulos. According to the Wall Street Journal, Mr. Metropoulos’s firm paid approximately \$250 million for Pabst.¹⁹¹ The SETI and Pabst examples cited above provide an interesting glimpse into the potential of both crowdsourcing and crowdfunding, both harbingers of the emergent crowdfund industry. The remainder of this chapter will focus on the breadth and depth of the crowdfunding phenomenon by evaluating the current crowdfunding environment.

The recent growth of the crowdfunding phenomenon is the product of several factors. While the components of the concept are not new, as evidenced by the formation of “lun hui”, the Irish loan funds, Wikipedia or the SETI project. What is new is how the additional ingredient of social media has

¹⁸⁷ Michael Migliozi, “Testimony:Connecting Investors and Job Creators.”

¹⁸⁸ “SEC Enters Cease and Desist Order in Connection with Online Campaign to Buy Beer Company.”

¹⁸⁹ Michael Migliozi, “Testimony:Connecting Investors and Job Creators.”

¹⁹⁰ “SEC Enters Cease and Desist Order in Connection with Online Campaign to Buy Beer Company.”

¹⁹¹ De La Merced, “S.E.C. Stops Would-be Buyers of Pabst Beer.”

galvanized these components giving rise to crowdfunding. Figure 16 (below) illustrates the dramatic rise in crowdfunding’s popularity and reaction to regulatory events.¹⁹²

Figure 1: Google Search Volume for “Crowdfunding” (100 represents peak search volume)

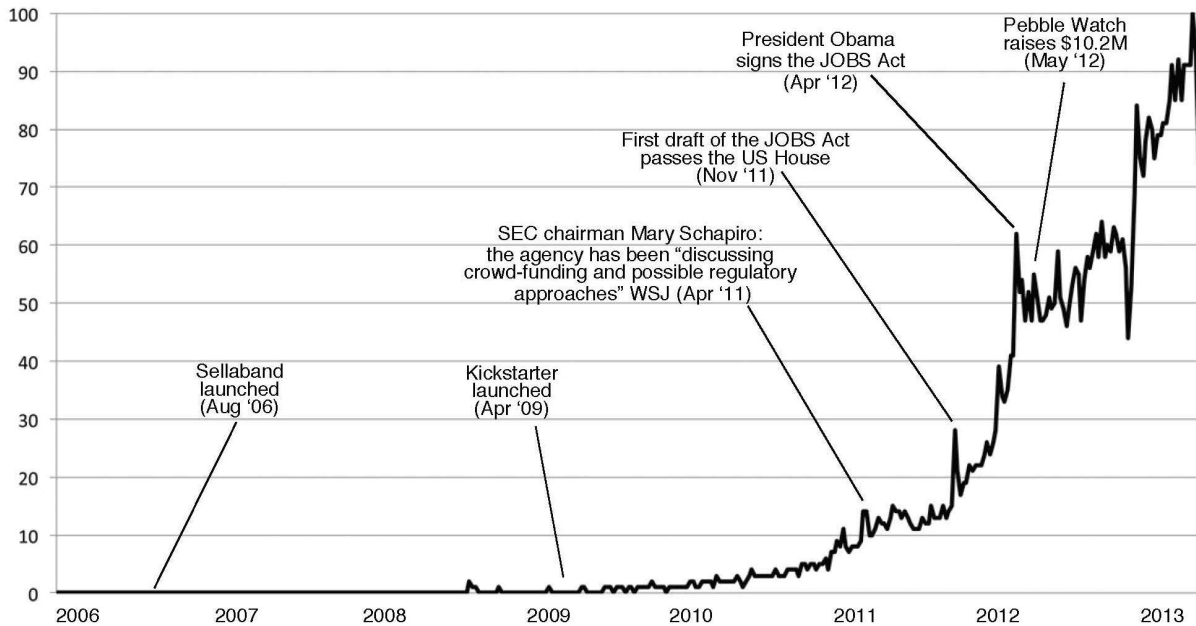


Figure 16: Google Search Volume for "Crowdfunding" (Agrawal, Catalini, Goldfarb)

The most compelling example of crowdfunding’s power and utility to fund a commercial endeavor began on April 11, 2012, when technology firm *inPulse* turned to Kickstarter.com after it failed to raise additional venture capital needed for a new type of “smart-wristwatch” that integrated with a user’s smartphone.¹⁹³ Rebranded as Pebble Technology, the new firm requested \$100,000 of funding via the pre-order/reward model on Kickstarter.com. Backers spending \$115 would receive the \$150 Pebble watch for \$115 (\$99 for the first 100 pledges), when they became available. Within 2 hours of launching the campaign, Pebble had met the \$100,000 goal. Within 6 days, the project had raised \$4.7 million, becoming the most successfully funded project in the history of Kickstarter.¹⁹⁴ On May 10th Pebble was forced to limit the number of pre-orders. Funding was closed on May 18th with \$10,266,844 pledged by 68,928 people.¹⁹⁵ Ironically, Pebble had been turned down by traditional tech venture capital firms, but

¹⁹² Agrawal, Catalini, and Goldfarb, *Some Simple Economics of Crowdfunding*, 40.

¹⁹³ “Rejected By VCs, Pebble Watch Raises \$3.8M on Kickstarter - Bloomberg.”

¹⁹⁴ Netburn, “Pebble Smartwatch Raises \$4.7 Million on Kickstarter Funding Site.”

¹⁹⁵ Newman, “Pebble Smartwatch Pre-Orders Are Sold Out, \$10+ Million Pledged.”

the crowd relished the idea, wanted to be the first to have this technology, and enjoyed helping in this creation thus enabling this success.¹⁹⁶

The pebble watch phenomenon was possible under the pre-order model of crowdfunding which at the time was one of the few legal methods to crowdfunding, but within the same time period of the Pebble campaign the JOBS Act was signed into law. As mentioned earlier, crowdfund businesses can be broadly categorized by the following: donation, reward or pre-order, lending, or equity. The donation model is charity based with nothing expected in return. Other crowdfunding campaigns, such as a recent one by celebrity Spike Lee, rely on the rewards model. In this case people receive “rewards” such as dinner or a party with the celebrity, tickets to the movie, or a signed movie poster, depending on the level of donation.

Kickstarter’s surprise success with the Pebble watch caught the attention of the country, popularizing the new phenomenon of crowdfunding. The next section of this chapter examines the most popular sites in each of these categories and the most popular overall.

Existing Crowdfunding Sites

One of the challenges in evaluating a nascent industry or business model such as Crowdfunding is obtaining the correct metric that accurately gauges the impact of a website on a marketplace. Understanding that there are limitations inherent in any one measure, web traffic is perhaps the best indicator of a sites activity and popularity.

In order to select the appropriate sites that would merit traffic analysis, research was performed using various media sources, research citations, and web based references to crowdfunding. After successfully identifying the crowdfund websites that had attracted the attention of the media, that list was then expanded by conducting multiple web searches, first for “the top 10, 20, 50 and 100” crowdfund sites overall and then repeating the process searching by category. The categories of sites selected represent the major branches of crowdfunding mentioned above: donation, reward, pre-ordering, lending and equity. An additional category has also emerged, the service sector. This sector is comprised of websites that offering subscription and/or hourly services such as crowdfund campaign design to the growing crowdfund industry. Finally, this information was aggregated; those sites whose

¹⁹⁶ Agrawal, Catalini, and Goldfarb, *Some Simple Economics of Crowdfunding*, 3.

names were routinely reoccurring were then segregated for further analysis.

The analysis of the crowdfund marketplace was prepared from data provided by the website traffic analytics company *Alexa* (a subsidiary of Amazon). “*Alexa’s* traffic data is based on a global panel of Toolbar users. This panel represents a sample of all Internet users. The panel consists of millions of people using toolbars created by over 25,000 different publishers, including *Alexa* and Amazon.”¹⁹⁷ The *Alexa* global traffic rank is a measure of how a website is performing from a traffic perspective relative to all other sites on the web over the past three months. The rank is calculated using a combination of the estimated average daily unique visitors to the site and the estimated number of page views on the site over the past three months. The site with the highest combination of unique visitors and page views is ranked #1.

Alexa also ranks the site by country. The primary focus of this analysis, the US traffic rank, utilizes the same methodology described above, but reports the information country by country. The rank by country is calculated using a combination of the estimated average daily unique visitors to a site and the estimated number of page views on that site from users in that country over the past month rather than the three months used for the global rank. The site with the highest combination of unique visitors and page views is ranked #1 in that country.

It is important to note two features of this data: first, it is dynamic, recalculated on a daily basis; the data presented was sampled on July 16, 2013. Second, the accuracy of the data is much greater for sites ranking above #100,000 than for sites that rank below #100,000. This is due to the statistical effects of frequency distribution where a few things are very probable and most things are not, also known as “the long tail”. On the web there are a small number of very popular sites, and a very large number of sites with low traffic. When evaluating the *Alexa* data, “any site with an *Alexa* Traffic Rank greater than 100,000 can be considered to be part of The Long Tail”.¹⁹⁸ The summary point here is that the quality of the ranking information is much greater when a website is ranked above 100,000 than below 100,000 and that for sites ranked below 100,000, the information becomes directionally indicative rather than rank quality specific. While global rankings are included in this analysis, the primary focus is on the U.S. crowdfunding markets and all sector rankings are based on the US ranking data. Also, the data excludes non-U.S. based sites, some of which are in the top 10 global rankings.

¹⁹⁷ “*Alexa* Web Information Service FAQs.”

¹⁹⁸ “*Alexa* FAQ.docx,” 2.

The number of sites selected for inclusion for both tables was conducted using a “bottoms up” process, determined by examining the overall each sector evaluating the number of sites garnering significant web traffic and selecting the sites with a rank of less than 300,000. Equity Real Estate sites are the exception. While RealtyMogul.com and Fundrise.com meet the criteria, ranking 111,843 and 120,662 respectively, the other equity real estate sites discussed more in the following chapter do not. Their inclusion can be attributed to their importance to the subject of this thesis and also to illustrate the nascent state of this subsector within a very dynamic and quickly evolving industry.

Of the ten equity-real estate sites examined, only two are approaching the top 100,000 ranking, with RealtyMogul.com ranking 111,843 and Fundrise.com ranking 120,662. The data quickly becomes statistically insignificant, subject to the effects of “the long tail” effects described earlier. The remaining sites rankings range from RealtyShares.com at 344,149 to undetectable (999,999 denotes that the data was too small to be measurable), in the cases of CrowdMason.com, Fquare.com, Globorex.com and iFunding.com.

A comprehensive aggregated list of sites and associated data used for this section is available in the Appendix to this thesis. Based on the table in Figure 17 (below), the most popular site examined is Kickstarter.com, with a rank of 834. The most popular real estate crowdfunding site is RealtyMogul.com, ranking 111,843. To put these sites into contextual reference, the top 10 *Alexa* rankings, in order are: Google.com, Facebook.com, YouTube.com, Amazon.com, Yahoo.com, Bing.com, eBay.com, Wikipedia.com, Craigslist.org and WindowsLive.com.

TABLE A: Alexa U.S. and Global Rankings (Data observed 7/17/13)

THESIS RANK (U.S.)	U.S. RANK	WEBSITE NAME	CROWDFUND SECTOR
1	358	www.kickstarter.com	Reward
2	1,062	www.indiegogo.com	Donation, For Profit
3	1,522	www.gofundme.com	Donation, For Profit
4	2,978	www.lendingclub.com	Lending
5	5,660	www.prosper.com	Lending
6	5,884	www.massivemov.com	Reward
7	6,133	www.youcaring.com	Donation, Not For Profit
8	6,283	www.angel.co	Equity/Venture
9	7,129	www.giveforward.com	Donation, For Profit
10	7,206	www.quirky.com	Reward
11	7,307	www.kiva.org	Donation, Not For Profit
12	12,405	www.crowdrise.com	Donation, For Profit
13	13,713	www.donorschoose.org	Donation, Not For Profit
14	15,753	www.fundrazr.com	Donation, For Profit
15	17,529	www.razoo.com	Donation, For Profit
16	18,509	www.firstgiving.com	Donation, For Profit
17	19,232	www.rockethub.com	Donation, For Profit
18	20,531	www.fundly.com	Donation, For Profit
19	21,566	www.fundanything.com	Donation, For Profit
20	22,086	www.pledgemusic.com	Donation, For Profit
21	26,084	www.fundable.com	Equity
22	27,177	www.rally.org	Donation, For Profit
23	30,659	www.crowdtilt.com	Donation, For Profit
24	39,453	www.crowdfunder.com	Equity
25	40,692	www.fundraise.com	Donation, For Profit
26	50,758	www.gogetfunding.com	Reward
27	55,648	www.launcht.com	Services
28	68,112	www.circleup.com	Equity
29	70,470	www.rockthepost.com	Services
30	79,849	www.pave.com	Equity
31	81,713	www.fracturedatlas.com	Donation, Not For Profit
32	82,521	www.wefunder.com	Equity/Venture
33	86,907	www.fundageek.com	Reward
34	90,531	www.seedinvest.com	Equity/Venture
35	94,986	www.earlyshares.com	Equity
36	98,105	www.seedandspark.com	Reward
37	108,409	www.givezooks.com	Donation, For Profit
38	109,584	www.appbackr.com	Reward
39	111,843	www.realtymogul.com	Equity/Real Estate
40	112,906	www.crowdit.com	Reward
41	114,886	www.microventures.com	Equity/Venture
42	117,875	www.startsomegood.com	Donation
43	120,662	www.fundrise.com	Equity/Real Estate
44	125,560	www.jumpstartcity.com	Reward
45	128,119	www.icrowd.com	Equity
46	133,747	www.solarmosaic.com	Lending
47	135,094	www.pledgie.com	Donation, Not For Profit
48	160,292	www.peerbackers.com	Reward
49	167,745	www.equitynet.com	Services
50	175,157	www.microryza.com	Donation, For Profit
51	176,683	www.peerform.com	Lending
52	195,409	www.somolend.com	Lending
53	200,173	www.opportunity.org	Donation, Not For Profit
54	204,341	www.ibankersdirect.com	Equity
55	221,850	www.growvc.com	Equity/Venture
56	262,455	www.invested.in	Services
57	290,562	www.give2gether.com	Services
58	293,044	www.bolstr.com	Services
59	344,149	www.realtyshares.com	Equity/Real Estate
60	408,753	www.prodigynetwork.com	Equity/Real Estate
61	485,910	www.collaperty.com	Equity/Real Estate
62	611,928	www.primarq.com	Equity/Real Estate
63	999,999	www.crowdmason.com	Equity/Real Estate
64	999,999	www.fsquare.com	Equity/Real Estate
65	999,999	www.globerex.com	Equity/Real Estate
66	999,999	www.ifunding.com	Equity/Real Estate

Figure 17: Alexa Data Table A

This data indicates that the rewards site Kickstarter.com leads the top 11 crowdfunding sites defined by web traffic rankings above #10,000. Given the success of the Pebble watch it should be no surprise that Kickstarter leads the pack. While researching this paper and interviewing commercial real estate developers, several interviewees when questioned about the term “crowdfunding” said that they did not know what the term “crowdfunding” meant, but they had heard of Kickstarter.com. During another interview, a respondent who said that he had not heard of crowdfunding actually owned a Pebble watch that his wife had purchased on Kickstarter.com. The survey conducted for this thesis revealed that 79% of respondents knew what crowdfunding was and 69% had heard of Kickstarter.com, but only 36% had heard of Kiva.org and 18% had heard of Proper.com. Consistent with the *Alexa* rankings of commercial real estate crowdfunding sites only 17% of survey participants were familiar with Fundrise.com, 4% knew of Collaperty.com, and 8% had heard of RealtyMogul.com.

Following Kickstarter.com’s *Alexa* ranking are the for-profit donation model sites Indiegogo.com and GoFundMe.com, lending sites LendingClub.com and Prosper.com, rewards site Massivemov.com, not-for-profit donations site YouCaring.com, equity venture capital site AngelsList.com, for-profit donation model site GiveForward.com, rewards model site Quirky.com, and the not-for-profit lending model site, Kiva.org.

Further segmenting the data in Table A, 36 crowdfunding sites have a U.S. ranking below 100,000. The donation model sector dominates with group with 18 sites and the “for-profit” donation model sites represent 13 of those 18 spots. Equity and reward model based sites comprise the next largest group, each with 8 sites, and finally lending model sites and service sites each have 2 sites on the list. The equity real estate model sector does not appear until 111,843, represented by RealtyMogul.com.

Table B, Figure 18 (below), re-ranks the data by sector and subsector: donation for profit, donation not for profit, equity, equity-real estate, equity-venture capital, lending, reward and services.

TABLE B - Alexa Rankings by Sector (Data observed 7/17/13)

THESIS RANK (U.S.)	U.S. RANK	WEBSITE NAME	CROWDFUND SECTOR
2	1,062	www.indiegogo.com	Donation, For Profit
3	1,522	www.gofundme.com	Donation, For Profit
9	7,129	www.giveforward.com	Donation, For Profit
12	12,405	www.crowdrise.com	Donation, For Profit
14	15,753	www.fundrazr.com	Donation, For Profit
15	17,529	www.razoo.com	Donation, For Profit
16	18,509	www.firstgiving.com	Donation, For Profit
17	19,232	www.rockethub.com	Donation, For Profit
18	20,531	www.fundly.com	Donation, For Profit
19	21,566	www.fundanything.com	Donation, For Profit
20	22,086	www.pledgemusic.com	Donation, For Profit
22	27,177	www.rally.org	Donation, For Profit
23	30,659	www.crowdtilt.com	Donation, For Profit
25	40,692	www.fundraise.com	Donation, For Profit
37	108,409	www.givezooks.com	Donation, For Profit
50	175,157	www.microryza.com	Donation, For Profit
7	6,133	www.youcaring.com	Donation, Not For Profit
11	7,307	www.kiva.org	Donation, Not For Profit
13	13,713	www.donorschoose.org	Donation, Not For Profit
31	81,713	www.fracturedatlas.com	Donation, Not For Profit
42	117,875	www.startsomegood.com	Donation, Not For Profit
47	135,094	www.pledge.com	Donation, Not For Profit
53	200,173	www.opportunity.org	Donation, Not For Profit
21	26,084	www.fundable.com	Equity
24	39,453	www.crowdfunder.com	Equity
28	68,112	www.circleup.com	Equity
30	79,849	www.pave.com	Equity
35	94,986	www.earlyshares.com	Equity
45	128,119	www.icrowd.com	Equity
54	204,341	www.ibankersdirect.com	Equity
39	111,843	www.realtymogul.com	Equity/Real Estate
43	120,662	www.fundrise.com	Equity/Real Estate
59	344,149	www.realtyshares.com	Equity/Real Estate
60	408,753	www.prodigynetwork.com	Equity/Real Estate
61	485,910	www.collaperty.com	Equity/Real Estate
62	611,928	www.primarq.com	Equity/Real Estate
63	999,999	www.crowdmason.com	Equity/Real Estate
64	999,999	www.fsquare.com	Equity/Real Estate
65	999,999	www.globorex.com	Equity/Real Estate
66	999,999	www.ifunding.com	Equity/Real Estate
8	6,283	www.angel.co	Equity/Venture
32	82,521	www.wefunder.com	Equity/Venture
34	90,531	www.seedinvest.com	Equity/Venture
41	114,886	www.microventures.com	Equity/Venture
55	221,850	www.growvc.com	Equity/Venture
4	2,978	www.lendingclub.com	Lending
46	133,747	www.solarmosaic.com	Lending
51	176,683	www.peerform.com	Lending
52	195,409	www.somolend.com	Lending
5	5,660	www.prosper.com	Lending
1	358	www.kickstarter.com	Reward
6	5,884	www.massivemov.com	Reward
10	7,206	www.quirky.com	Reward
26	50,758	www.gogetfunding.com	Reward
33	86,907	www.fundageek.com	Reward
36	98,105	www.seedandspark.com	Reward
38	109,584	www.appbackr.com	Reward
40	112,906	www.crowdit.com	Reward
44	125,560	www.jumpstartcity.com	Reward
48	160,292	www.peerbackers.com	Reward
27	55,648	www.launcht.com	Services
29	70,470	www.rockthepost.com	Services
56	262,455	www.invested.in	Services
57	290,562	www.give2gether.com	Services
58	293,044	www.bolstr.com	Services
49	167,745	www.equitynet.com	Services

Figure 18: Alexa Data Table B

As indicated by the data, the sectors that exist with the least regulation have provided the most active and successful early entrants, namely the donation and rewards sectors. Websites such as Kickstarter.com, Kiva.com and Indiegogo.com have helped to move the term “crowdfunding” into the popular lexicon. The passage of the JOBS Act, while not yet effective, has brought with it tremendous optimism, expressed by the formation of dozens of new crowdfunding businesses, specifically the emergence of equity model crowdfund sites such as the commercial real estate crowdfund sites Realty Mogul and Fundrise.

Chapter VI: Commercial Real Estate Crowdfunding Sites

This chapter will specifically examine the existing “crowdfund” real estate sites and related equity and debt-driven sites, analyzing both their business models and how they fit into the current and future regulatory environments. Crowdfunding as it relates to commercial real estate relies primarily on the equity model. As the real estate crowdfund sector grows, it too could become dependent on the loan model, given that the real estate capital stack traditionally relies on a debt component. To that end, this chapter will also examine the peer-to-peer lending sector. This relationship is based on the linkage that as Prosper and LendingClub have both proven highly successful businesses in the debt-related crowdfunding sector, they may also provide useful insights regarding how crowdfunding could impact future real estate debt markets.

For the sake of both clarity and continuity, the following summary provides a brief synopsis of the most critical components of the JOBS Act that could redefine crowdfunding as it pertains to the commercial real estate sector.

First, the JOBS Act defines a new class of company, the Emerging Growth Company, or EGC, as a firm with less than \$1 billion of revenue, and provides these firms with reporting relief from both regulatory and accounting (at the Federal and State level) perspectives. The current reporting requirements are burdensome and expensive and present significant barriers to entry for new businesses. The JOBS Act also allows these firms to solicit both accredited investors and institutional investors.

Second, it modifies Regulation D, allowing all issuers to advertise and solicit new investors, while also placing the burden on these issuers to verify that buyers are either accredited investors or qualified institutional buyers. It also allows providers of ancillary services such as accounting firms and lawyers to market securities without registering as broker dealers, so long as they do not receive any compensation for the transactions. The sites examined in this paper all function under the Regulation D Rule 506 exemption.

Third, the JOBS Act provides an exemption for Crowdfunding, or The Crowdfund Act. This section allows issuers to issue up to \$1.0 million of securities without registration and buyers to purchase up to \$100,000 of these securities based on net worth and income tests. These securities must be transacted through a “funding portal,” defined in an amendment to the Securities Act of 1933.

The funding portal must take on considerable responsibilities. From an investor's perspective, they are required to monitor the net worth and income of potential purchasers, ensuring that they have not exceeded their maximum annual crowdfund securities purchasing limits and that the investors understand the risks inherent in these securities. From an issuer perspective, they must perform background checks and maintain various financial and accounting records from the issuer. They cannot accept or pay commissions to their employees or to third party “finders” that identify leads. They cannot offer advice or provide recommendations or solicit offers to buy securities on their portals, nor can they handle investor funds. They are exempt from the SEC and State-level broker-dealer registration (however, states can seek enforcement actions if they believe a portal has violated a state law), and they must register as “funding portals” with both the SEC and FINRA. In addition, funding portals cannot receive compensation. As mentioned earlier, this exemption from broker-dealer registration is a Pyrrhic victory for portals with for-profit motivations. Funding portals can also co-invest in the firms they solicit on their sites. This is an important facet to the business model that has emerged for both real estate funds as well as venture capital funds. Granting this exemption without the ability to receive compensation will force portals without a co-investment business model to register as broker-dealers.

Fourth, the JOBS Act modifies Regulation A with rules meant to revive the seldom-used small issuer exemption. It changes the maximum offering amount from \$5.0 million to \$50.0 million, allows issuers to “test the waters” by offering securities without offering documents, and grants Regulation A offerings the same state exemption status that exists in Regulation D, making them “covered securities” for sale to “qualified purchasers.” How the SEC chooses to define “qualified purchaser” is the critical variable that will determine how this section of the Act will impact the ability of small companies to raise capital on a national level using Regulation A.

As previously noted, crowdfunding sites can be categorized in the following manner: donation, reward, pre-ordering, lending, equity, and services. From a regulatory perspective, the donation, pre-ordering, reward, and service models are largely outside the purview of securities regulations. Donation model crowdfunding sites do not offer securities to investors, and contributors do not expect to receive anything in return, which is the essence of an investment contract under *Howey*.¹⁹⁹ Similarly, both the

¹⁹⁹ Bradford, “Crowdfunding and the Federal Securities Laws,” 2012, 31.

reward and pre-purchase model do not involve securities under federal law, since the purchase of a good or a loyalty reward does not involve an investment contract as defined by *Howey*.²⁰⁰

In examining the equity model, “it is clear that under the current SEC rules, the equity model does involve the offering of securities and in most cases meets every criterion for the *Howey* test.”²⁰¹ As of the writing of this paper, the existing commercial real estate crowdfunding sites are available only to accredited investors, leaving their current business models virtually unaffected by the JOBS Act. While the exact business model of each firm varies, the methods used to comply with the existing SEC rules are similar and accomplished by restricting access to accredited investors. This screening process assures compliance with the rule of no general solicitation or advertising, as they do not offer securities to the general public but only to accredited investors they have vetted. The pre-screened investors are then allowed to view securities offered on the site, thus assuring compliance with Regulation D 506. The feature common to all these sites (with the exception of iFunding, noted further on) is that they do not charge a “transaction-based” fee, which, as in the case of ProFounder, would trigger the requirement to register as a broker-dealer.

The ProFounder incident demonstrates how the SEC has chosen to apply existing securities laws to the nascent crowdfunding industry. For a brief period of time, ProFounder was the industry leader in crowdfunding. The shuttering of ProFounder on February 17, 2012 provided a regulatory “wake-up call” to the crowdfund industry and some instruction regarding the future of its relationship with the SEC. The firm was founded by Kiva co-founder Jessica Jackley and fellow Stanford Business School classmate Dana Mauriello in 2010. It allowed both accredited and unaccredited investors to invest in different equity classes of startup businesses. Their business model was for-profit; they charged a 5% transaction fee on capital raised. While they later amended their business model to accept only accredited investors, they still raised capital for third parties charging a transactional-based fee. Either criterion was enough for regulators to view them as a broker-dealer. The State of California issued a Cease and Desist Order to ProFounder in August 2011 for operating as an unregistered broker-dealer, leading to their closure in 2012.²⁰²

²⁰⁰ “Crowdfunding_and_the_Federal_Sec_Laws_by_Bradford_2012_COLUM._BUS._L._REV._1.PDF,” 32.

²⁰¹ *Ibid.*, 33–34.

²⁰² State of California, “ProFounder Cease/Desist Order.”

Commercial Real Estate Crowdfunding Sites

As of the writing of this paper, the following list (in alphabetical order) provides a representation of the U.S. based sites focused either directly or indirectly on the non-residential real estate sector: Collaperty, CrowdMason, Fundrise, Globorex, iFunding, Primarq, Prodigy Network, RealCrowd, and Realty Mogul. This sector is dynamic, with new sites launching on a monthly basis; therefore, this list may even become outdated while this paper is being written.

To facilitate a clear understanding of how the existing crowdfunding sites function from a regulatory perspective, this section will begin by segregating existing real estate and real estate-related crowdfunding sites into the following groups:

1) Commercial Real Estate Equity sites

These sites focus solely on investments in commercial real estate assets or investments associated with these assets, such as mortgages. The following sites fall into this group: Collaperty, CrowdMason, Fundrise, iFunding, RealCrowd, and Realty Mogul. The business models of this group rely on the Regulation D 506 Exemption to sell shares via a private placement to accredited investors. Furthermore, they may co-invest in the securities that they offer on their site. This category also includes other models such as those that offer shares through a direct public offering (DPO) utilizing the “Regulation A” small issuer exemption or hybrids.

2) Commercial Real Estate Equity in Beta Mode

These firms plan to launch a site whose business models also rely on Regulation D Rule 506. Globorex and RealtyShares have both identified themselves in this group.

3) Specialty Real Estate Crowdfund Sites: Equity or Debt

Sites Fquare, Primarq and Prodigy Network are all real estate crowdfund sites but with a specialized focus and thus unique business model.

4) Peer to Peer Lenders or P2P

Peer-to-peer lending sites are defined as for-profit sites that sell notes through a shelf-registered bond. Prosper and Lending Club fall into this category and have enjoyed success in this category.

5) Venture Capital

Venture capital sites rely on Regulation D 506 and/or Rule 203(1)-(1) the Investment Advisers Act exemption.

Commercial Real Estate Equity Sites: Collaperty, CrowdMason, Fundrise, iFunding, Real Crowd and Realty Mogul

*Collaperty*²⁰³

Collaperty was formally launched in March 2013. The landing page (as of 7/8/13) claims that the site has 968 members, of which some subset has invested in fourteen deals representing \$27,165,456 of equity raised for investment. The site defines and markets itself as the “First Social Crowdfunding Real Estate Network.” Collaperty features a detailed FAQ section, a glossary, a jobs section, a blog, and a well-appointed landing page. However, it is password-protected and only accredited investors can view real estate deals in compliance with current securities regulations.

The site also features a discussion board with questions and answers. The response to the question “How Does Collaperty make money?” reveals that it currently does not make money. Collaperty currently acts as a social networking site, pairing up investors and sponsors operating the service for free to both sponsors and investors “to validate the business model.”²⁰⁴ The site also indicates that in the future, they intend to launch another free platform that will offer additional premium services such as marketing, deal structuring, and portfolio tracking for a fee.

The FAQ section of the website states that that the company is raising only equity, not debt, and that those investments will only be available in specific states. The site does not indicate which states.

²⁰³ “Collaperty - Crowdfunding Real Estate Network.”

²⁰⁴ “CollapertyWEBSITE.docx,” 6.

Another question asks: “What is crowdfunding?” Collaperty responded that it is not engaged in crowdfunding (per the site’s interpretation of the definition), “as a method of collectively raising capital for investing.”²⁰⁵ The site more accurately describes the activity they engage in, stating “Collaperty uses the group funding and not crowdfunding per the SEC definition.”²⁰⁶

Sponsors can post deals on the site, but in order to view a deal the investor must “follow” the investment (or “deal”) and then request an invite to look at the details of a particular investment if it is “Inviting Investors” or indicates it is in an “Investment Round.” At the point of extending the invitation, the sponsor will also ask the investor to sign a non-disclosure agreement (NDA) prior to allowing the investor to see the details of the deal. Given the approval process, the sponsor controls both whom and how many investors they wish to have for a particular investment. The actual investment in the deal occurs offline between the sponsor and the investor; however, the website does indicate that “Collaperty will continue to provide additional functionality in this space in the future.”²⁰⁷ While the site acknowledges that the company performs some cursory due diligence on deal sponsors, the site states that the investment responsibility is ultimately with the investor: “In an effort to prevent fraud, Collaperty does require any Sponsors joining the platform to provide truthful background information. In addition, before a deal is posted on Collaperty, it is spot-checked by the Collaperty team to ensure the completeness of required deal information. It is important to note that Collaperty does not guarantee the legitimacy of the deal. Investing in real estate is and can be risky. It is highly recommended that members understand these risks and do their own due diligence before connecting and committing to any deal terms.”²⁰⁸

Interestingly, Collaperty offers both sponsors and investors the opportunity to post “reviews” and a rating system to rate the value of their shared investment/capital raising experience. The rationale given is: “In order to develop and promote a healthy community, Collaperty gives members the ability to write reviews. This allows site members who have successfully completed business or built a relationship together to promote and advertise their trustworthy bond. When a review is posted, it will increase the review metric that is visible on the member's profile page. The review feature is also

²⁰⁵ Ibid., 6.

²⁰⁶ Ibid.

²⁰⁷ Ibid., 5.

²⁰⁸ Ibid., 6.

accompanied by a 5-star rating system. The average of the ratings is displayed on the member profile page. Reviews that may be deemed abusive and are against the Terms & Conditions will be removed.”²⁰⁹

The firm currently employs the three co-founders, a development engineer, and an intern. The founders are all recent graduates of Northeastern University. Two of the founders hold degrees in Finance, Entrepreneurship, and Economics; the third has a degree in Engineering. It appears that they may have had some issues on the web development front: recently the site has been down and users have been redirected to a temporary landing page stating the site was “under renovation.”

*CrowdMason*²¹⁰

CrowdMason is somewhat rudimentary and may be in beta mode, although the website does not state this. It features a landing page, sign-in page, a FAQ section with four questions, and a terms of service and privacy policy page. They also feature a YouTube video describing a business model similar to the matching service model as the one developed by Collaperty. The site describes CrowdMason as “an online platform where real estate entrepreneurs can raise equity for their projects and accredited investors can discover real estate investment opportunities.”²¹¹

The website indicates a 2012 Copyright by LJH Ventures LLC (not to be confused with a different LJH, LJH Global Investments). LJH Ventures appears to be located in a New York City apartment. The website does not have a section describing the team or the founder. In researching LJH Ventures, we found that the firm’s principal is an attorney and was formerly a Vice President with a nationally recognized REIT specializing in bridge lending for commercial real estate sector.²¹²

*Fundrise*²¹³

Fundrise is unique among the sites discussed in this chapter. Fundrise, in a groundbreaking deal for commercial real estate crowdfunding, was the first and, as of this paper’s writing, the only equity offering on real property utilizing the Regulation A exemption. Registered securities can be purchased by

²⁰⁹ Ibid., 4.

²¹⁰ “CrowdMason, Real Estate Crowdfunding for Accredited Investors.”

²¹¹ Ibid.

²¹² “BRT Realty Trust - BRT Lending Team.”

²¹³ “The New Way to Invest in Real Estate.”

all investors— both non-accredited (the “crowd”) and accredited—who reside in the states where the securities have been registered. Fundrise is the only site to offer real estate equity investments to local non-accredited investors directly from the website. The company is currently rumored to be working on additional offerings under the same offering structure.²¹⁴ As detailed above, Regulation A is seldom used because of the expenses associated with filing and disclosure, particularly at the state level, as the securities must be registered in every state they will be offered. As a result, the Fundrise deals to date are only available to investors residing in Virginia and Washington D.C. Fundrise offers its securities through Growth Capital Services, a member of FINRA located on 582 Market Street, Suite 300 San Francisco California. GCS website landing describes them as follows: “Growth Capital Services is a compliance solution for independent brokers and investment bankers who facilitate private placements, M&A and secondary transactions.”

The two founders are brothers, and sons of a prominent Washington D.C. developer. The older brother is a lawyer with considerable real estate experience who claims “over fifteen years of real estate investing and having acquired, developed, and financed over \$500 million in deals.” Both graduated from Wharton. The other members of the seven-person team include a CTO (also from Penn), a director of Product development (previously with Marcus and Millichap), a director of Design and Creative, a Director of Analytics, and a director of Communication.

The Fundrise Regulation A offering represents an important development for the online commercial real estate sector, but its continued use and success depends on the rulemaking by the SEC pertaining to the JOBS Act. While the economics of the Fundrise deals done to date may not be economically feasible due to the registration costs, they do demonstrate a strong “proof of concept” which is difficult to ignore. If the new Regulation A+ (as it has been coined in the media) allows for these securities to be “covered securities,” and thus exempt from state registration, and the SEC defines Regulation A qualified purchasers as accredited investors, then raising capital under the Regulation A exemption could become a major capital-raising channel for many small businesses in all industries, including commercial real estate.

²¹⁴ “Fundrise-1351-1a-final.pdf.”

*iFunding*²¹⁵

The iFunding site consists of a landing page, multiple sections describing an investment process, a legal section, and a FAQ section. The password-protected area is open only to U.S. based, accredited investors. The site was launched at some point in 2013. The team of four consists of two founders and two employees, all real estate or real estate finance professionals with varying levels of experience. In addition, they list three advisors associated with the firm.

iFunding acknowledges that the site currently operates under Regulation D, Rule 506: “The JOBS Act, signed on 5th April 2012 by President Obama, establishes a new legal framework for private share offerings. Although it doesn't affect iFunding in the near future, it has opened a world of possibilities for the future. Right now we are busy focusing on providing excellent service to our clients that can do business in the market today. The issue-led offerings available on our platform are permitted through a prior exemption, namely Regulation D, Rule 506.”

Investors who invest with iFunding would “own shares or membership interest in a limited partnership, solely set up for each individual project.” The other sites examined in this chapter that rely on Regulation D, Rule 506 state clearly that they do not charge fees, either based on transactions or any other activity. This cautious approach is to avoid SEC's potentially viewing these sites as engaging in the business of securities sales, which could trigger registration as a broker-dealer. iFunding seems to state the opposite in answering the FAQ, “Are there any fees for investors? Investors are charged a 5% fee only upon successful capital raise for a project they invested in. We also charge our investors for tracking the project, getting them timely updates, and ensuring that their money is returned in a timely and appropriate manner. This fee is 1% for each year their capital is invested.” The website does not mention any affiliation with a broker-dealer, nor does it state that they are a broker-dealer, yet this statement indicates that the site engages in what might be perceived as broker-dealer activity, since the site collects both a transactional fee and a management fee for the services provided.

²¹⁵ “iFunding-Making Real Estate Investing Simple.”

*RealCrowd*²¹⁶

RealCrowd acknowledges that Title III of the JOBS Act will not initially impact their business models, but that the lifting of the general solicitation ban (Title II) will have an immediate impact once the SEC writes the rules. While RealCrowd "will not initially rely on the implementation of the JOBS Act, Title II will lift the ban on general solicitation of certain securities, allowing companies such as RealCrowd to offer our investment opportunities to accredited investors where no prior meaningful relationship exists. Once Title III regulations are fully enabled by the SEC, RealCrowd will be able to offer investment opportunities to the crowd in its fullest sense, opening up to \$30 trillion of capital to invest in real estate opportunities around the nation, truly allowing RealCrowd to bring Main Street back to Main Street."

RealCrowd acknowledges that Title III of the JOBS Act will not initially impact their business models, but that the lifting of the general solicitation ban (Title II) will have an immediate impact once the SEC writes the rules. "While RealCrowd will not initially rely on the implementation of the JOBS Act; Title II will lift the ban on general solicitation of certain securities, allowing companies such as RealCrowd to offer our investment opportunities to accredited investors where no prior meaningful relationship exists. Once Title III regulations are fully enabled by the SEC, RealCrowd will be able to offer investment opportunities to the crowd in its fullest sense, opening up to \$30 trillion of capital to invest in real estate opportunities around the nation, truly allowing RealCrowd to bring Main Street back to Main Street".

While RealCrowd's economic model is not entirely clear, it seems to involve charging an administrative fee to cover expenses and then later setting up a management company to bill the individual LLC's for additional management services. In response to the question, "Do investors pay fees?" the response was, "RealCrowd will charge a nominal fee for its services to arrange for the investments to be made. Depending on the nature of the investment and the complexity of structure, the fees will cover the administrative and legal expenses of structuring the investment, the ongoing reporting, and management of the investment. Additionally, RealCrowd may utilize an affiliated operating company to provide asset management services for the ongoing optimization of the investment."

²¹⁶ "RealCrowd - A Better Way to Invest in Real Estate."

The team of four consists of four co-founders, two of which are experienced real estate professionals who had worked together at a large real estate capital markets firm. The other founders are experienced software engineers. The site is unremarkable, featuring a landing page, a section describing the investment process, a blog section, a FAQ section and a bio page.

Realty Mogul²¹⁷

Realty Mogul website was launched on March 13, 2013. The team of six consists of two co-founders and four employees. It is notable that one of these employees is Sky Kruse, a serial entrepreneur (who co-founded LiveBid, which was sold to Amazon in 1999) and also an angel investor in Realty Mogul. The team members' previous experience is almost evenly divided between technology and real estate.

Like RealCrowd, Realty Mogul relies on the Regulation D Rule 506 exemption to sell its securities. As such, they create a separate limited liability company (LLC) for each property; RealtyMogul is the General Partner and sells shares to Limited Partners. Each deal is designated as an LLC such as Realty Mogul I, Realty Mogul II, etc. Realty Mogul then bills each LLC a flat fee for the services they provide, such as the web listing of the private placement, background checks on the developers, curating the offerings on the site, and accreditation checks on the investors. By selling securities that they originate (as opposed to securities originated by third parties) and charging a "flat fee," RealtyMogul avoids triggering one of the broker-dealer definitions in the Exchange Act.

Realty Mogul engages in two types of businesses. The first business is facilitating loan purchases where investors pool their capital to buy a loan tied to residential property slated for renovation and immediate sale once the work is completed. The loan is secured by the property being rehabilitated, with the term of these investments being short, between 6-9 months. They refer to this type of investment as "Loan Purchase for Residential Fix and Flip." Realty Mogul currently provides loans only for residential property.

The second business is the more traditional investment in commercial real estate, providing equity for a commercial property with a 3-5 year investment horizon. They claim to be selective in the properties accepted for funding, estimating that only 2% of the sponsors who seek equity end up on

²¹⁷ "Passive Real Estate Investing, Simplified. - Realty Mogul."

their website. With that said, their maximum loan to value (LTV) ratio for purchases criteria is fairly aggressive, at 80% as compared to the prevailing market LTV of 50% to 60% by commercial banks. RealtyMogul is clear that the site is not in the development business, and that they only seek to generate passive income for their investors by providing equity to existing, cash-flowing commercial buildings.

The site is very informative, with a good explanation of the investment process, a detailed FAQ section, and a blog.

Commercial Real Estate Equity Sites in Beta Mode: Globorex and RealtyShares

*Globorex*²¹⁸

Globorex has not been formally launched; the site identifies that it is in “beta.” The site has a professional feel and appearance and is easy to navigate. It also has an extensive resource section with a wide range of useful information all related to the commercial real estate markets. Like the other sites examined in this chapter, they provide accreditation verification of investors-to-deal sponsors and background checks of deal sponsors to the investors. The landing page identifies the site as “The Global Real Estate Equity Exchange” with the objective of providing “a complete solution to simplify and streamline equity investing in commercial real estate.” Globorex, like previous sites discussed, focuses on equity and not debt.

Globorex does have three unique and distinguishing characteristics. First, they claim to have developed some proprietary matching service software, one of which is a “matching algorithm” called “SmartMatch” that can match investors with deal sponsors and another that can assign a score to a particular investment based on various parameters. While it is not clear who uses the score, one can speculate that potential investors might find this information useful in assessing an investment’s risk/return attributes. If this is indeed the case, the site could appear to provide research to investors (a broker-dealer activity), which could invite SEC scrutiny. Globorex also provides the ability for investors and sponsors to aggregate the various tasks of investing and/or fundraising into one solution: “It’s like Salesforce.com and Dropbox combined, yet better because it’s designed especially for real estate.”

²¹⁸ “Globorex | The Global Real Estate Equity Exchange.”

Second, the site is actively marketing to industry professionals in order to raise equity capital for real estate investments. An entire section of the website labeled “Advisors, Brokers and Consultants” targets this group. The site points out various advantages for real estate brokers and consultants, stating that Globberex is not a broker, does not charge fees, and therefore there is no fee sharing. The site positions itself as a partner, not a competitor, who will assist industry professionals and augment their ability to manage multiple capital campaigns for their clients. It concludes with the claim that there is “no limit to the number of deals you can create for your clients.” It is not clear from the site how or if they intend to generate revenues.

Finally, Globberex intends to market foreign equity investments to U.S. investors: “Globberex is global. Globberex can help foreign investors access the U.S. market and it can help U.S. investors access the international markets. Globberex works inter-country and intra-country just as well. One account gives you access to a global community of capital seekers and capital providers.”

*Realty Shares*²¹⁹

Like Globberex, RealtyShares is in beta mode. The website feels that way, with one of the three pages not finished. They claim to have 615 people intending to invest \$3,376,000 in equity through the site. According to the site blog, RealtyShares currently focuses on investing in single family homes in Atlanta and Florida by teaming up with local managers with a “first mover advantage that lets them compete with Wall Street.”

The site has a twenty-five page blog called RealtyU that is quite informative, covering topics from crowdfunding and the current regulatory environment to REIT investing. RealtyShares intends to rely on the same model as Realty Mogul, selling Limited Partner shares in a single asset LLC to accredited investors.

Specialty Real Estate Sites: Equity or Debt

*Fquare*²²⁰

Fquare currently focuses exclusively on agricultural investments. The site launched in August 2012, and its business model is to buy grain-producing farms and lease them back to the farmer for a

²¹⁹ “RealtyShares.”

²²⁰ “Fquare – Equity Crowdfunding – High Yields – Agricultural Investments.”

fixed term. This concept is not new; large farm aggregators have aggregated farmland in this manner for years. The practice is known as “a sale-leaseback.” What makes Fquare unique is that they use crowdfunding to raise the equity capital. The Fquare investor receives a lease payment as a dividend in exchange for providing the equity capital to purchase the farmland. The site claims to have “fifty and counting agricultural investors equity crowdfund the purchase of active commercial grain farms.” Investments range from \$1.0 million to \$7.0 million per farm, and accredited investors are invited to invest between \$1,000 and \$300,000 with no maximum investment. Each investment is structured as a Limited Liability Company (LLC) and up to 2000 investors can invest as limited partners in each LLC. Fquare reserves the right to limit the number of investors. The term of maturity for each investment is three, five, or seven years, “with annual extensions if necessary.”

The Fquare website is informative and professional. They stress in the FAQ that they do not charge any fees, either transactional or otherwise. They do charge an administrative fee to operate the LLC, which they stress does not benefit the management company; this fee pays the expenses of operating the LLC. The company has two revenue sources. First, when the LLC purchases the land from the farmer, Fquare charges a 5.9% real estate brokerage fee. At the end of a lease-term, the property is liquidated and Fquare receives 20% of any profits generated from the property’s sale.

It is notable that as of July 4, 2013 the website was advertising returns of 4%, 5% and 6% respectively, for farmland investments maturing in three, five, and seven years. The site also offers secure loans subtitled “distressed debt loans” for 10% to 12%. On July 11, 2013, the specific offerings previously on the landing page were replaced by a statement that investors can achieve “up to 6% yields.” The distressed offerings were no longer available. The change in landing page may have been in response to legal advice. Given that Fquare is operating under Regulation D 506, the site would be prohibited from offering securities to the general public, which it appeared to do by offering individual investments with both maturities and yields on the earlier, July 4th landing page.²²¹ Also notable is that they also announced the launch of an online exchange to trade New York City real estate assets in square foot increments. As of the writing of this paper, there is no evidence of that platforms formation.

²²¹ Screenshot of Website, “See Appendix Page 201 ‘JULY 4TH 2013 LANDING PAGE.’”

*Prodigy Network*²²²

While Prodigy appears to be the largest and most successful equity-based, commercial real estate crowdfunding site, it is not available to U.S. investors. As such, for the purposes of this examination, it is categorized as a specialty real estate site.

Prodigy Network was born out of Prodigy International, a Miami-based real estate broker that specialized in bringing foreign buyers, primarily from Latin America, to U.S.-based real estate investments. The Prodigy Network website claims to have executed “\$8 billion in combined condominium sales in South Florida, New York, Panama, the Dominican Republic, Mexico, and Colombia.” The properties that they either represented or developed include Trump Soho, William Beaver House, Centurion, and The William in New York; Spiaggia, Parc Central, Gansevoort South, Paramount Beach, The Beach House by Richard Meier, Paramount Bay, Sole On the Ocean, Solis, Solaris at Brickell and Brickell on the River in Florida; Green Village in Dominican Republic; Gran Coral and Mareazul in Mexico; Playa Blanca, Moon, Element, Elevation and Yacht Club in Panama and BD Bacatá, Bogotá Art District, Airport Business Hub and Bacatá Express in Colombia.

The website and the investments it offers are only available to foreign investors not living in the United States. Investors who are not Colombian residents can purchase “Real Estate Participations,” or “REPS”, in denominations of \$100,000 for US projects. Colombian residents can invest in an instrument called a FiDi in minimum denominations of \$20,000. The FiDi is an acronym (translating poorly from Spanish to English) for “Figure International Real Estate Investment.” Through their Colombian-based subsidiary, FIDI Global, Prodigy claims to have raised \$178 million dollars in the sale of FiDi’s from 3,100 residents of Bogotá Colombia for the development of the sixty-six story BD Bacatá. When completed in 2015, standing at 240 meters, it will be the tallest building in Colombia. The \$240 million mixed-use development will have two towers housing a 363-room luxury hotel, offices, and several floors of retail. The completion of this project would make it the most successful crowdfunding real estate venture to date.

The crowdfunding concept is a natural fit for Prodigy, and they acknowledge that “Prodigy has transitioned to a new model of developing and promoting crowdfunding as an innovative and dynamic

²²² “Prodigy Network » What Is Crowdfunding in Real Estate?”.

way of doing business. The projects, which have come to frame our new crowdfunding vision, are: BD Bacatá, Bacatá Express, Airport Business Hub, The William, and Bogotá Art District.”

Their mission statement is consistent with this new transition from traditional niche brokerage to crowdfunding developments: “Within the next decade, Prodigy will have institutionalized the investment democratization model with the objective of empowering retail investors by giving them the opportunity to own and develop prime local and international real estate.”

Given that Prodigy has blended two business models, a successful international brokerage business with a crowdfunding business; it is difficult to distinguish one from the other when looking at the overall business. When evaluating the size of their team for comparative purposes, it is not possible to determine how many employees are dedicated to the crowdfunding aspect versus the traditional brokerage business. Taking that fact into account, from their website, they claim to have a team of over thirty employees based in New York, Miami, and Bogotá, with the bulk (over twenty) based in Colombia.

Primarq

As the Primarq landing page states, “PRIMARQ unites homebuyers and homeowners with investors in a marketplace for the trade of residential real estate equity. We solve today's housing finance problem with a more affordable, sustainable and less debt-reliant solution for home ownership. Investors access our largest and most secure asset class and Americans regain the opportunity to own their home.”

Primarq began working on this business concept in 2009, and the website launched in 2010. Notably, this business model focuses entirely on residential real estate and not on commercial, providing equity capital to homeowners or homebuyers in exchange for an equity position in the home. Primarq calls this “equity sharing.” Primarq provides the legal structure, curates the candidates for co-ownership, and provides a secondary market for investors to sell their shares to other Primarq investors.

Internet veteran and crowdfunding pioneer Steve Cinelli is the founder of Primarq. Cinelli was a co-founder of OffRoad Capital in 1999, one of the first sites to deploy a crowdfund strategy before the term crowdfund had entered the Internet lexicon. The Primarq six-person team is impressive, most with years of experience in technology; however none of them exhibit any real estate experience.

Peer-to-Peer Lenders

Both Prosper and Lending Club are for-profit peer-to-peer (P2P) lenders. The sites' business model is to issue notes in exchange for loans to borrower members. While the SEC forced both companies to register the notes they offer,²²³ Prosper received a cease and desist order for improperly selling securities without registration. As a result, Prosper is now engaged in a class action lawsuit with lenders who purchased Prosper Loan Notes from the January 1, 2006 to October 14, 2008 period prior to registration.²²⁴ In such cases, these investors or lenders as plaintiffs “seek rescission on the loan notes, rescissory damages, damages, and attorney’s fees and expenses.”²²⁵ The penalty of rescission alone, notwithstanding SEC sanctions and fines, should signal caution for other crowdfund sites to proceed carefully until provided with further definition about how the SEC intends to evolve its rulemaking process. Any analysis of the crowdfunding-lending model must include mention of the highly successful “hybrid” (blending P2P lending and donation models) lending site, Kiva. Kiva is a unique P2P model insofar as it aggregates capital for lending, but does not charge interest. Lenders participation is driven purely by charitable motives, and they do not seek to earn interest, categorizing the business model as a donation site.²²⁶ As a result, Kiva has thus far avoided SEC scrutiny and will likely continue to in the future.²²⁷

Consequently, Prosper was forced to restructure their business model and file a shelf registration for each series of securities offered. Each loan is a separate series, so there are thousands of pages of offering memoranda on their website. In addition the site has also filed separate state registrations in sixteen states. Various web comments speculate that Prosper will eventually register in all fifty states after they make an anticipated public stock offering.

Venture Capital

New crowdfund entrant FundersClub was recently issued a “no action” letter by the SEC with respect to their online crowdfund activities. An SEC no action letter is issued in response to a written request from a company (or, as in this and most cases, their counsel) seeking guidance from the SEC on

²²³ Bradford, “Crowdfunding and the Federal Securities Laws,” 2012, 40.

²²⁴ “Prosper Class Action Website.”

²²⁵ *Ibid.*

²²⁶ Bradford, “Crowdfunding and the Federal Securities Laws,” 2012, 34.

²²⁷ *Ibid.*, 38.

a particular and unclear aspect of securities law the company is concerned about. The concerns arise either from enforcement actions in the past that relate to the business they are conducting or from action they are contemplating conducting in the future. The no action letter states that if the company embarks on the course of business stated in the request, the SEC would probably not seek enforcement action against the company. In the parlance of SEC communications, the ‘no action’ letter is the highest assurance that company can get that they will not be subject to further SEC scrutiny on the particular activity they sought guidance on. The issuance of this letter to FundersClub (and also Angels Club) was highly unusual, as all previous “no action” letters issued to crowdfund sites were only issued to “not for profit” or “the donation” model sites. The response, written by David Blass, SEC Chief Counsel, states the following: “Based on the facts and representations set forth in your letter, and without necessarily agreeing with your conclusions and analysis, the Staff will not recommend enforcement action to the Commission under Section 15(a)(1) of the Exchange Act if FundersClub and FC Management engage in the proposed activities described in your letter without registering as broker-dealers with the Commission pursuant to Section 15(b) of the Exchange Act.” The letter gives the additional comfort that the SEC would recognize them operating under Rule 203(1)-(1) of the Investment Advisers Act of 1940 which exempts venture capital funds and private equity funds with less than \$150 million under management and foreign private advisors from registration as investment advisors.

Summary

This closer examination of the current landscape for commercial real estate crowdfunding reveals an industry in a nascent yet dynamic state. Of the six sites categorized as “commercial real estate equity,” only three can claim to have actually funded deals: Collaperty, Fundrise and Realty Mogul.²²⁸ Only one has engaged in true crowdfunding: Fundrise. Collaperty and Realty Mogul both have raised capital from accredited investors through the placement of their LLCs using the Regulation D, Rule 506 exemption. When we examined the viability of these firms, only Fundrise and Realty Mogul could publically identify a potentially viable economic model. Collaperty acknowledges that they are in the “proof of concept” stage and in their FAQ section could not identify a viable economic model.

While Fundrise is the only firm that can claim to have engaged in crowdfunding a commercial real estate project, the current business model economics are questionable: they spent over a year to get approval on the first Regulation A offering on a commercial real estate deal and only raised a de

²²⁸ “RealtyMogulFunding.”

minimus amount of money. One could argue that this was a “proof of concept” transaction and that future transactions will be less time consuming and less costly. If that is indeed the case, then Fundrise will have a lead in the Regulation A space, particularly if the SEC takes an expansive view in their rulemaking regarding Title IV of the JOBS Act. The others, CrowdMason, iFunding, and RealCrowd, present websites are of varying quality and some offer interesting information, but none of the three identify their future economic or business models. Nor do the sites state what their businesses have accomplished to date or exactly how they will crowdfund future commercial real estate investments.

The two sites in beta mode, Globorex and RealtyShares, both seem to be constructing informational sites that will conduct future business based on the Regulation D, Rule 506 exemption. This is consistent with business models of the live sites, with the exception of Fundrise. Notably, RealtyShares currently focuses on the residential markets, buying up residential rental properties in the southeast. From the information provided, it is not clear what RealtyShares future intentions are with regard to the commercial real estate markets.

The related specialty sites examined are each in various states of business development and maturity, ranging from the successful—the peer-to-peer lenders, Prosper and Lending Club—to the most recent entrant, Fquare. All have interesting and unique business models that could provide further instruction for the future of crowdfunding commercial real estate. One obvious example is the potential use of peer-to-peer lending to fund commercial real estate debt. Would the crowd be interested in making loans secured by real assets? Another could use the Primarq model to equity share in commercial real estate deals. One could argue that this sector is under even greater pressure than the home buyer to provide equity for deals, with current loan to value ratios in the 50% to 60% range. Could this concept be morphed into the commercial real estate sector? Of the sites discussed in this section, Prodigy Network is the purest example of commercial real estate crowdfunding, but it is not available to U.S. investors, hence its categorization as a “specialty” site. The BD Bacatá deal that Prodigy crowdfunded in Bogota provides ample “proof of concept” regarding the viability of crowdfunding commercial real estate. As discussed in detail in earlier chapters, how this could transpire in the U.S. markets will be a function of SEC rulemaking, which is occurring as this paper is being written. Nevertheless, crowdfunding for commercial real estate will play a significant role in this industry in the future.

Chapter VII: Survey and Interview Methodology and Results

As mentioned in the introductory chapter, the research methodology used for this thesis relied primarily on three resources: (1) traditional scholarly research through sources such as journals, research papers, legislation review, and carefully chosen Internet resources; (2) interviews with industry professionals including investors, attorneys, and developers; and (3) a survey of industry professionals. While the literary research component provided the bulk of the material and invaluable background and data for the report, the interviews provided a qualitative component and the surveys additional quantitative data to supplement and provide support to our findings. The objectives of the interviews and the survey were similar, but the two methods of collection provide different yet complementary information.

Interviews

Objective of the Interviews

As discussed in the methodology below, the interviewees came from a varied background, and we attached a specific objective to each segment of interviewees. For non-real estate professionals, the objective was to discuss the securities regulations and JOBS Act. For real estate developers and investors, the interview questions focused on ascertaining their level of knowledge of crowdfunding for real estate, followed by understanding their business strategy and subsequent need or desire to use crowdfunding in the future. The objective for this segment was to identify and support a need for real estate crowdfunding and measure the attractiveness of this method to the real estate community. Furthermore, these professionals offered their opinion on the use of real estate crowdfunding, thereby adding depth to the research and survey components.

Interview Methodology

Over the course of several weeks in June and July 2013, we interviewed fourteen (14) individuals in person or through Skype or telephone to provide additional context and insight into the traditional research conducted. We have cited and referenced excerpts from these interviews throughout the paper. Interviewees were introduced to the authors by previous business contacts or were people we already knew in the commercial real estate industry. Interview requests and introductions were made through email. The interviewees agreed to voluntarily speak with us for approximately one hour each,

and we clarified our intent to keep all responses confidential and anonymous, which we felt gave interviewees added comfort and thus more liberty in their responses.

Figure 19 (below) is a table describing our interviewees' backgrounds, industries, and other applicable information:

Sector	Date of Interview	Interview Method	Location
Compliance	6/9/2013	Conference Call	New York City
Developer (Residential)	6/13/2013	Conference Call	New Jersey
Developer (Residential, Hotel)	6/13/2013	Conference Call	New Jersey
		Conference Call/In	
Developer (Residential)	6/18/2013	Person	New York City
Broker Dealer/Compliance	6/20/2013	In Person	New York City
Broker Dealer/Compliance	6/20/2013	In Person	New York City
Securities Law, Attorney	6/20/2013	In Person	New York City
Securities Law, Attorney	6/20/2013	In Person	New York City
Securities Law, Attorney	6/20/2013	In Person	New York City
Developer (Residential)	6/21/2013	Skype/In Person	New York City
Academia (MIT)	6/10/2013	In Person	Boston, MA
Developer, MIT Alum	7/2/2013	Conference Call	Saudi Arabia
Developer (Apartments), MIT Alum	6/27/2013	Conference Call	NYC
Investment Advisor, Real Estate			Washington
Investor	6/28/2013	Conference Call	D.C.

Figure 19: Table of Interviews

Below are the questions we posed to real estate developers or deal sponsors, broken into three sections based on the intent of the questioning:

Online/Crowdfunding Familiarity

1. Have you heard of or used any Internet-based real estate providers, such as LoopNet or Auction.com?
2. Have you heard of the term crowdfunding?
3. Have you heard of Kickstarter.com?
4. Have you heard of crowdfunding for commercial real estate?
5. What do you think of the concept of raising capital online?

Real Estate Area of Focus

1. How long have you been a developer?

2. Do you focus on a particular market sector? Strip malls, multi-family, small retail, restaurants?
3. Have you always been in this market? If so, for how long?
4. Why and how did that focus evolve?
5. Do you engage in new construction, rehab-redevelopment, both?
6. Do you have a geographic focus and where have those projects been located?
7. How do you identify suitable projects?
8. How many projects have you completed in the last year? In the last five years?

Finance and Funding

1. What is the size (dollar value) of your projects?
2. Typically, how do you fund your investment? Please describe the capital stack on some recent deals.
3. Have you ever used brokers to raise equity or debt?
4. Do you have equity joint venture investment partners?
5. If so, how did you develop your equity relationships?
6. Have you even gotten equity from real estate private equity funds?
7. If yes, how many different funds?
8. Do you have key relationships for debt financing? If so, how many?
9. How did you develop these relationships?
10. Are these the same institutions that provide construction loans?
11. What is the typical LTV you have been able to obtain since the financial crisis?
12. If none, have you used mezzanine debt to fund deals?
13. How many deals have not gotten completed due to a funding gap in debt or equity?
14. If yes, have you ever been in a joint venture where you are the “local partner” and your partner is a larger, national firm? Or, vice versa?

Survey

The survey was conducted to capture similar data to the interviews but from a much wider audience and in a quantitative method. Given the nature of the topic and the reliance on crowd interest, it was important to reach out to a larger audience than the interviewees to assess interest levels.

Objective of the Survey

A survey was crafted with the intent of (1) measuring respondents' level of familiarity with online real estate tools and crowdfunding; (2) assessing the level of need for new methods of raising capital in the real estate market; (3) gauging the respondents' interest level in using crowdfunding for real estate; and, (4) capturing respondents' demographics to assess any effects on the responses.

Survey Methodology

Using arguably similar methods to crowdsourcing, we reached out to “the crowd” through email, Facebook, Twitter, and LinkedIn. The survey links were anonymous and could be forwarded and answered by secondary contacts, and we encouraged people to forward these to peers in the industry. This allowed more people to answer the survey and encouraged a more diverse response group outside our immediate contacts, thus aiding in a more accurate assessment of the crowd. Finally, this snowballing effect is in some ways similar to how crowdfunding campaigns start on sites such as Kickstarter and Sellaband by first reaching out and spreading the word through family and friends.

Over twelve hundred (1,211) survey links were sent out thru email to 827 M.I.T. Center for Real Estate Alumni (some alumni had multiple email addresses in the system and were sent emails to both addresses to ensure they received it.) This group offered an easily assessable population of academically trained, skilled, experienced real estate professionals, all of whom had connectivity within the commercial real estate industry. The MIT Alumni database served as the primary survey group.

In addition to the MIT group, forty two (42) personal contacts, all of whom were active commercial real estate professionals, received the survey and were, as mentioned, encouraged to forward it to their professional contacts that would be willing to participate. Additional responses were received from LinkedIn, Facebook, MSRED Classmates (22 people), their contacts and the MIT Real Estate Club members. The survey period was predefined to the participants, with the survey sent out on June 26, 2013 and the closing on July 8, 2013. In total 175 people clicked on the survey link; however, after culling responses (or lack of response), we had 138 substantially completed surveys adequate for review and analysis.

Of these 138 responses, eighty-one respondents identified themselves as a “Deal Sponsor or Developer” actively working as the General Partner or lead on a development or investment deal.

Seventeen (17) respondents identified themselves as “Investors” that place money with a deal sponsor. Finally, forty respondents stated that they participated in the real estate market as both a sponsor and investor, a common role. Based on the participant’s capacity in the real estate market, sponsor, investor, or both, they were directed to the appropriate survey questions tailored to their activities within the market.

Subsequently, sponsors were asked twenty-four questions, investors twenty, and both twenty-eight questions. Fifteen (15) questions were the same across all three categories of respondents.

The first four questions in the survey posed to all participants are intended to gauge the impact of the Internet on their current business and to assess their general familiarity with current social media and online real estate sites. The next four questions move into crowdfunding, first asking if they are familiar with the term crowdfunding. The following questions evaluate their familiarity with popular crowdfunding sites and also with existing real estate crowdfunding sites. The survey then delves into real estate development and investing, investigating how the respondents fund their deals and how they find their investors, all focused on how they foresee their future capital needs. The objective of these questions is to test the viability of an alternative funding mechanism, such as crowdfunding. This segues into a series of questions that specifically address crowdfunding, where the respondents are asked to rate their willingness to use a crowdfund platform, from both a sponsor and an investor perspective. Each segment of respondents is asked to rank the importance of site characteristics for a crowdfunding site, and then is asked again to rate their willingness to use a crowdfunding site IF it had certain positive qualities that would enhance its legitimacy, such as the performance of due diligence on both sponsors and investors as well as actively curating deals with a vetting process before they appear on the site. Next, a series of questions revolving around generic business operations and job title help further identify the respondent’s business line and activity. Finally, there are several demographic questions aimed at identifying any factors that may influence their propensity to use the Internet. A full copy of the survey is included in the appendix of this thesis for further review.

To encourage participation as well as spontaneous commentary, the data was collected anonymously. Also, respondents could complete the survey without answering every question. As a result, several questions lack a 100% response rate; however no question had more than six unanswered responses representing 4.3% of the overall sample. Thus, while there are some questions lacking 100% participation, the data still convey valuable information and insight.

Survey Results & Findings

The table in Figure 20 presents the sources of the survey respondents:

MIT Alumni, Classmates	105
LinkedIn	4
Facebook	7
Personal Contacts	13
MIT Real Estate Club & Alumni	9
Total	138

Figure 20: Table of Survey Respondents

Respondents' Demographics

We received responses from every region in the U.S. as well as five responses from Canada and ten responses from locations outside of Canada and the U.S. While the locations were well dispersed, there was a concentration of respondents located in the New England area, specifically the Boston Metro area, followed by the Southwest, particularly Texas, and then the Mideast and West regions. This is not surprising given the large number of MIT Alums that were sent the survey and their propensity to stay in the area. There were also a large number of Texas respondents as a result of personal contacts in the real estate industry in that region as well as the large number of real estate firms with offices in Dallas or Houston. The Mideast region includes New York City, Washington DC, and Philadelphia, which would tend to attract MIT Alums as did the West region with LA, San Diego, San Francisco, and Seattle. The only large metro area without significant representation was Chicago. The results appear in Figure 21 (below).

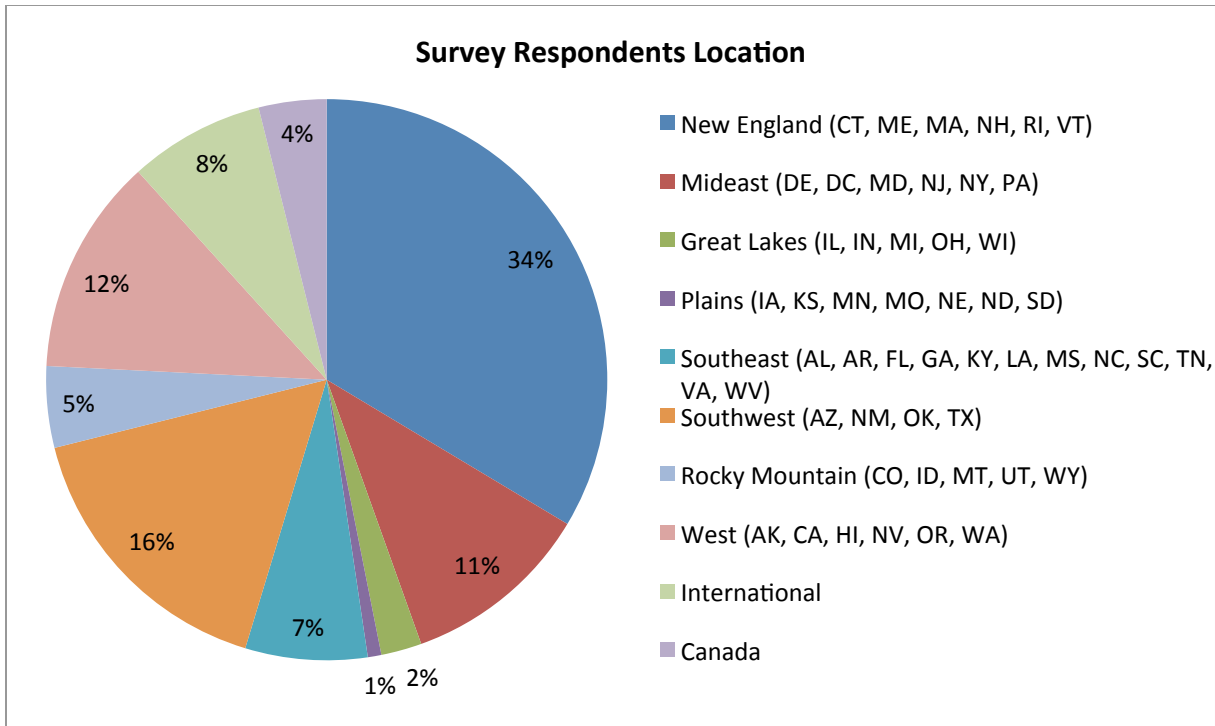


Figure 21: Survey: Chart of Respondents Geographic Location

In Figure 22 (below) the bulk of respondents were between the ages of 30 and 59, consistent with the group of professionals contacted, the age of the MIT program, and the majority of the working population. This demographic characteristic proved valuable and was later used to evaluate the influence of age on the propensity to use crowdfunding.

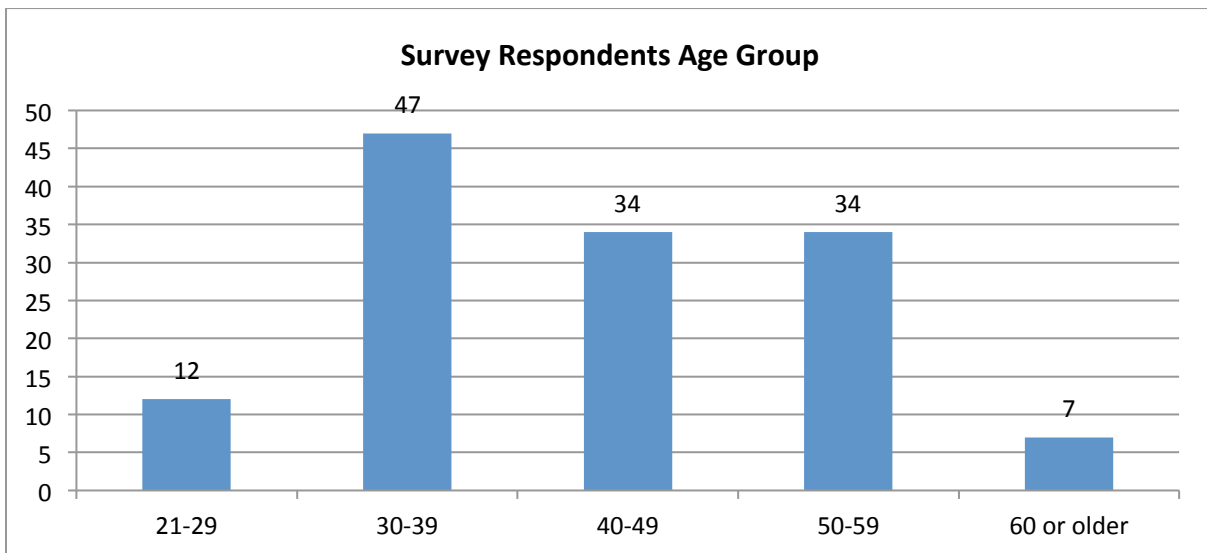


Figure 22: Survey: Bar Chart of Respondents Age Demographic

Regardless of age, roughly 66% of respondents represented that they were either Founders/Owners, Principals, Presidents, CEO's, Executives, Managing Directors, or of similar job title. Project managers accounted for approximately 7%, Vice Presidents roughly 15%, and Associates and Analysts another 11%. This open-ended question asked for current job title, and some respondent's added additional information which indicated that 17% of the 138 people were in acquisitions and/or development and several more were in banking, private equity, asset management, or worked for a REIT. This data indicates a seasoned sample population with robust knowledge of the real estate industry; while this bodes well for the quality of the responses regarding target group, this target group consisted of many large, well-established firms.

Finally, the question was asked whether or not each participant was an accredited investor. Given the demographic group, these results were surprising, with only 47.1% answering yes, 37% no and 10.9% unsure if they were an accredited investor or not (the remaining 4.3% did not answer the question).

Respondents Current Real Estate Sponsorship or Investing Profile

In Figure 23 (below), the data are consistent with respondent's location as well as market conditions and locations of major cities: there is a focus on the coasts and in the southern regions.

Please select which regions you acquire property in or invest in:	
New England (CT, ME, MA, NH, RI, VT)	49.3%
Mideast (DE, DC, MD, NJ, NY, PA)	34.1%
Great Lakes (IL, IN, MI, OH, WI)	20.3%
Plains (IA, KS, MN, MO, NE, ND, SD)	12.3%
Southeast (AL, AR, FL, GA, KY, LA, MS, NC, SC, TN, VA, WV)	35.5%
Southwest (AZ, NM, OK, TX)	32.6%
Rocky Mountain (CO, ID, MT, UT, WY)	28.3%
West (AK, CA, HI, NV, OR, WA)	39.1%
Internationally	21.7%
Unanswered	4.3%

Figure 23: Survey: Table of Geographic Distribution Commercial Real Estate Investments

In examining development by property type, it is clear from Figure 24 (below) that a majority of respondent's efforts focus on the multi-family front, followed by office and retail. This likely reflects current market conditions, the large number of multi-family properties in the U.S., and the investing and

developing characteristics of multi-family, office and retail. Land acquisitions are normal for developers. Residential is popular as well given the lower capital hurdle to acquisition and ease of self-management. Given the decline of mall popularity, the large price tag of the investment, small number of mall opportunities and management intensity, it is no surprise that they are not a popular product. Hotels also take a specialized operating knowledge and tend to be a niche. Many respondents indicated investment or development of a variety of property types not categorized in the survey, including senior care or assisted living, mixed-use developments, infrastructure, and research and development facilities.

Please select all property types that you develop, actively purchase or invest in:	
CBD Office	34.8%
Suburban Office	30.4%
Retail Shopping Centers	36.2%
Malls	13.0%
Limited Service Hotels/Motels	15.9%
Full Service Hotels	18.8%
Residential (single family, multifamily <4 units)	35.5%
Multifamily (>4 units per bldg.)	65.9%
Industrial	29.0%
Land	36.2%
Other (please specify)	13.8%
Unanswered	4.3%

Figure 24: Survey: Table of Property Type Distribution

Figure 25 (below) shows that the vast majority of respondents had developed, acquired, or invested in over \$20 million of real estate in the last five years, with several responses in the billions. Given the time horizon for real estate of at least three to five years and the financial crisis of 2008, the focus period for the study was the previous five-year time period stratified by dollar amount. The stratification allowed the researchers to gather data, which identified the number of respondents who were smaller developers focused on deals deemed “sub-institutional.”

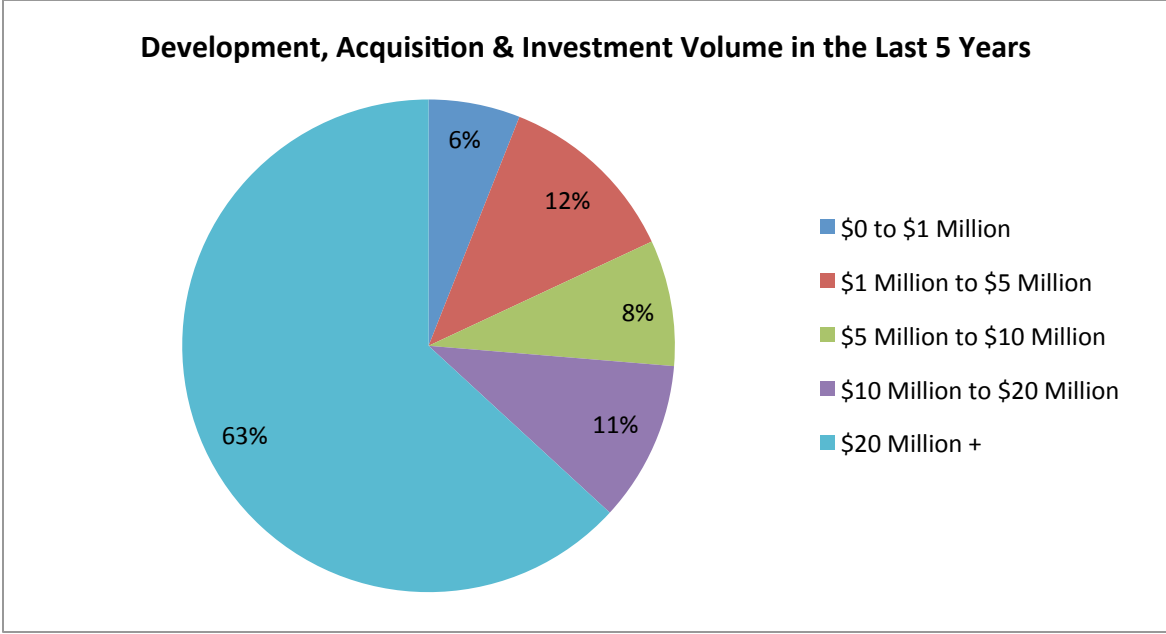


Figure 25: Survey: Chart of Development, Acquisition and Investment Volume in Dollars

Sixteen of the respondents worked for public companies, twelve of which had more than 500 employees. Not surprisingly, thirteen of those sixteen public firms had engaged in over \$20 million in transactions over the course of the last year. Figure 26 (below) indicates a surprisingly large number of small private firms, defined as firms with less than twenty-five employees. This correlates with the large number of founders, owners, presidents, and executives, but it also represents the capital-intensive nature of commercial real estate, regardless of a firm’s size as measured by the number of employees.

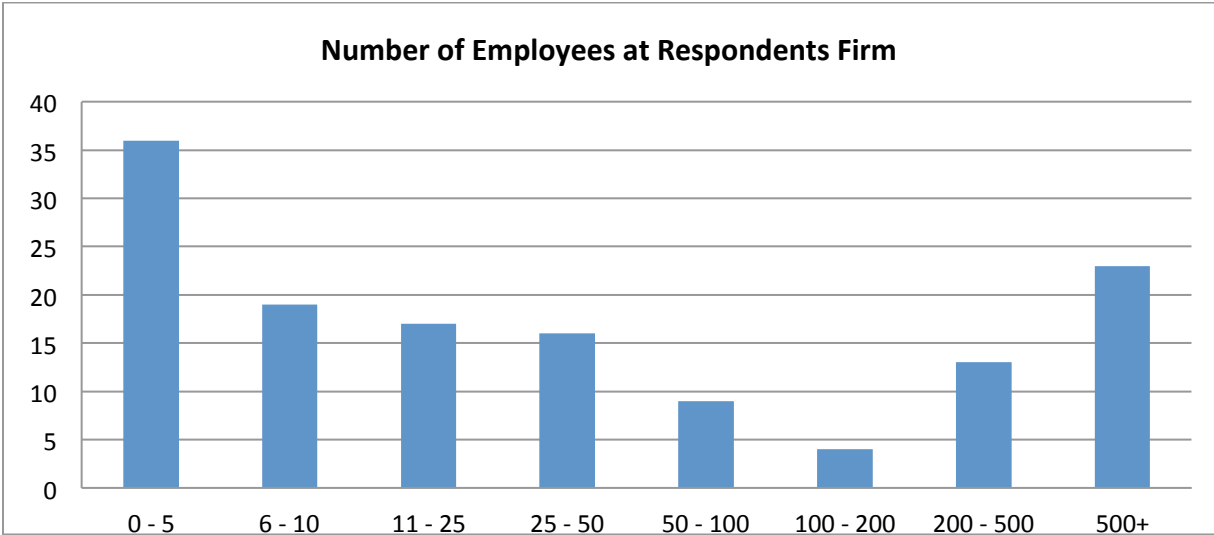


Figure 26: Survey: Bar Chart of Number of Employees at Respondents' Firm

Figure 27 (below) illustrates the funding inclination of the respondents. Both survey results and interviewees confirm many deal sponsors still rely heavily on traditional bank financing and private or personal equity to finance their deals. While several respondents worked for REITs or large firms with institutional capital, private equity and traditional bank loans are still the most prominent capital source. In the “other” category, most people indicated federal funds such as low-income housing tax credits as a capital source, correlating with the large number of multi-family developers and investors. While EB5 funds are emerging as a new capital source for development, those funds also come with governmentally imposed regulatory restrictions, hindering them as a major funding mechanism in the near future.²²⁹

Check all that apply. Which ways do you or your firm fund real estate acquisitions or developments?	
CMBS Debt Financing	15.7%
Traditional Bank or On-Balance Sheet Lending	71.9%
Private Lending	35.5%
REIT Funds	12.4%
RE Private Equity Funds	46.3%
Personal Equity Funds	47.9%
EB5	4.1%
Other (please specify)	14.0%
Unanswered	4.1%

Figure 27: Survey: Table of Funding Commercial Real Estate Assets

Figure 28 (below) shows that investors indicated primarily investing directly into deals or through private mechanisms. This could be a bias in the survey group, reflecting that most investors surveyed are professional real estate investors, as opposed to non-real estate professionals with limited access to private opportunities. Nonetheless, this data clearly reflect the current state of the market in which much of the funding combines private equity and bank loans.

²²⁹ EB-5 stands for Employment Based Immigration with 5th Preference, and is an U.S. Immigrant Investor Program that, per the [uscis.gov](http://www.uscis.gov) website, was “created by Congress in 1990 to stimulate the U.S. economy through job creation and capital investment by foreign investors.” EB-5 investors are foreign nationals who must make a capital investment in a new commercial enterprise in the U.S. that meets government job creation or preservation standards within a certain amount of time. Depending on the project or business location the capital minimum is \$500,000 or \$1 million USD, and in exchange these investors receive a U.S. Visa. An example of its use in real estate is the development of a hotel in an area targeted as an area needing re-investment. The hotel generates area jobs and the equity is raised via EB-5. More information can be found at: <http://www.uscis.gov/>

Check all that apply. Which ways do you currently invest in real estate?	
CMBS or RMBS Bond Purchases	10.5%
REIT Shares	19.3%
RE Private Equity Funds	36.8%
Directly – Equity Investment in Joint Venture	87.7%
Private Lending	36.8%
Other (please specify)	0.0%
Unanswered	1.8%

Figure 28: Survey: Table of Investment in Commercial Real Estate Assets

In Figure 29 (below) the survey further investigated funding issues in an effort to identify or support a need for additional capital sources. Roughly 51% (31.4% less than five deals, 13.2% 5 to deals, 6.6% more than 10 deals) of developers or sponsors said they had lost at least one deal due to a financing gap. The comments section was notable, with some respondents stating that that they answered “none” because they didn’t chase a deal if they knew they couldn’t fund it.

Estimate how many real estate deals you or your firm have lost due to a funding gap or hurdle to raising money.	None	43.8%
	Less than 5 deals in last 5 years	31.4%
	5 to 10 deals in the last 5 years	13.2%
	10 or more deals in the last 5 years	6.6%
	Unanswered	5.0%
If, none or less than 5, did you have to raise mezzanine debt to complete the capital stack for deals you were able to complete?	Yes	14.9%
	No	55.4%
	N/A	25.6%
	Unanswered	4.1%

Figure 29: Survey: Table of Funding Gaps

Figure 30 (below) illustrates the difficulty (and/or additional expense) developers have had in raising both equity and debt, as 40% have paid third parties to raise equity and over 50% have done the same to raise debt. In addition, 15% (exhibit not shown) of the respondents answered that they have had to rely on expensive mezzanine debt to fill a funding gap in order to close a deal.

Have you used a third party to raise EQUITY in the last 5 years? (ex. HFF)	Yes	39.7%
	No	56.2%
	Unanswered	4.1%
Have you used a third party to raise DEBT in the last 5 years? (ex. mortgage broker)	Yes	52.9%
	No	43.0%
	Unanswered	4.1%

Figure 30: Survey: Table of Third Party Assistance Raising Equity and Debt

Funding gaps and the use of a third party to assist in raising capital would seem to imply a need for some firms for crowdfunding. Figure 31 (below) confirms what is stated above, that more than half of the respondents find the capital- raising process to be an arduous and time-consuming task, forcing developers to rely on their relationships or brokers to identify investors. These data point to the need for a cheaper, more reliable funding mechanism. The question central to this thesis is: Could crowdfunding be such a mechanism?

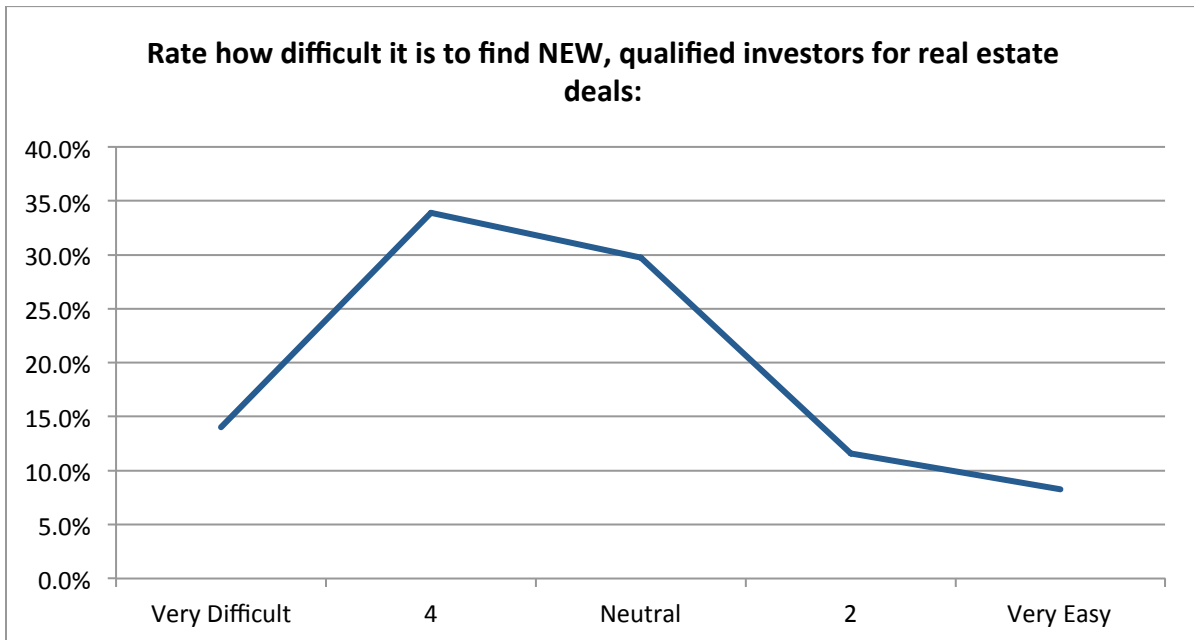


Figure 31: Survey: Graph of Difficulty Finding Qualified Investors

Figure 32 (below) indicates that Investors have similar difficulty identifying qualified commercial real estate investment opportunities.

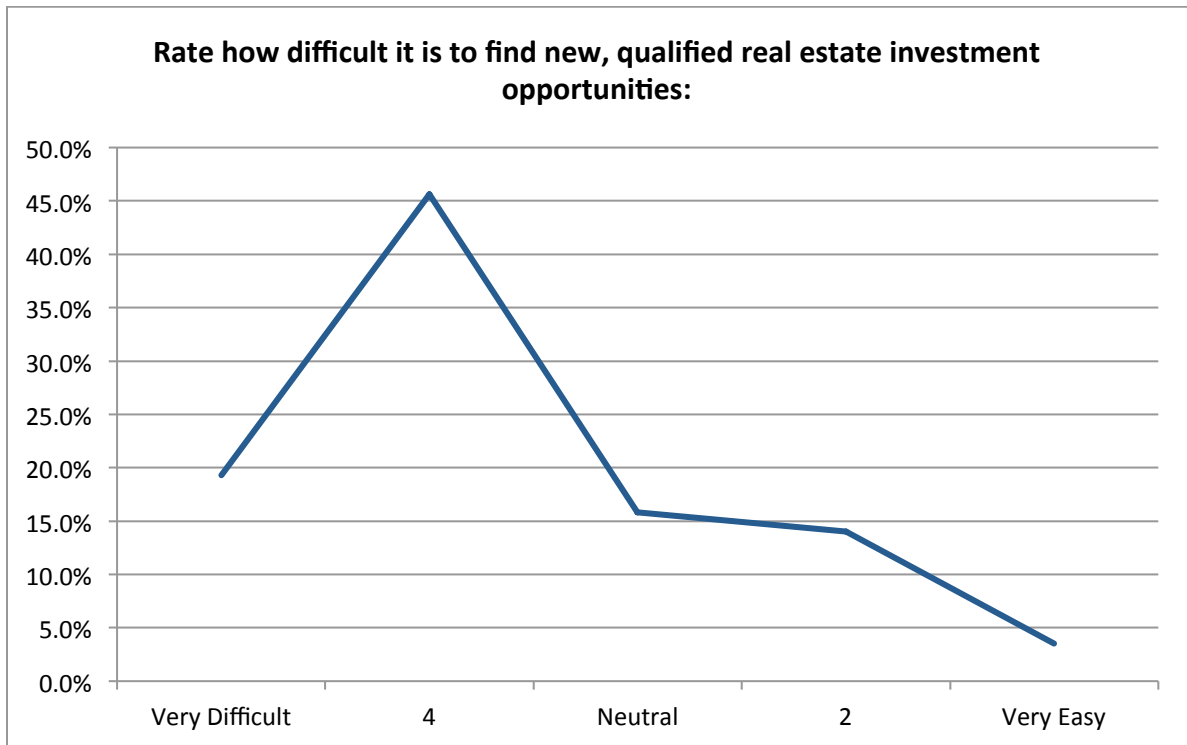


Figure 32: Survey: Graph of Difficulty Finding Real Estate Investment Opportunities

Both graphs confirm that the matching process is inefficient due to continued reliance on relationships.

Respondents Current Internet and Crowdfunding Familiarity

The results in Figure 33 (below) were in response to questions regarding the respondent's general professional use of the Internet. LinkedIn has clearly become a ubiquitous online resource for professional networking. It's become a primary place to post jobs, solicit investors, market deals, promote networking, make or remain in contact, and discuss the marketplace in general. An example of this use is included in the Appendix.

Direct email remains an important marketing tactic for brokers selling real estate and making connections. Other mentioned sources are LoopNet, MLS, PropertyLine, CoStar, and Assessor's and City websites. It was interesting that a significant portion of respondents still viewed the Internet as neutral, minimally important, or not important to their real estate business. Although statistical analysis was not

conducted, the survey data did not seem to present a correlation between a respondent's age demographic and their Internet sophistication.

Check all that apply. Which social media outlets do you actively use for business purposes (i.e. finding real estate development deals or firms for investment)?	
Facebook	10.1%
LinkedIn	68.1%
Twitter	5.1%
Google Circle/Google Plus	12.3%
Blogs	10.1%
Responding to Direct Email Solicitations	42.0%
General Internet Searches	62.3%
Other (please specify)	15.2%
Unanswered	2.9%

Rate how important the internet is to providing business connections and information used for real estate investment purposes.	
Crucial	21.0%
Important	46.4%
Neutral	15.9%
Minimal Impact	14.5%
Not Important	2.2%
Unanswered	0.0%

Figure 33: Survey: Table of Social Media and the Internet Used for Business

Specific questions to analyze respondents' familiarity and use of specific real estate websites revealed that 57% had heard of Auction.com and of that group 45% was interested in using it in the future. 12% of all 138 respondents had actually bid or purchased real estate or mortgages on the site. This could be construed as a positive indication of growing acceptance of purchasing or investing real estate online.

Figures 34 and 35 (below) show that 80% of the respondents knew what crowdfunding was and almost 70% had heard of Kickstarter.com but were not familiar with other popular crowdfunding sites Kiva and Prosper.

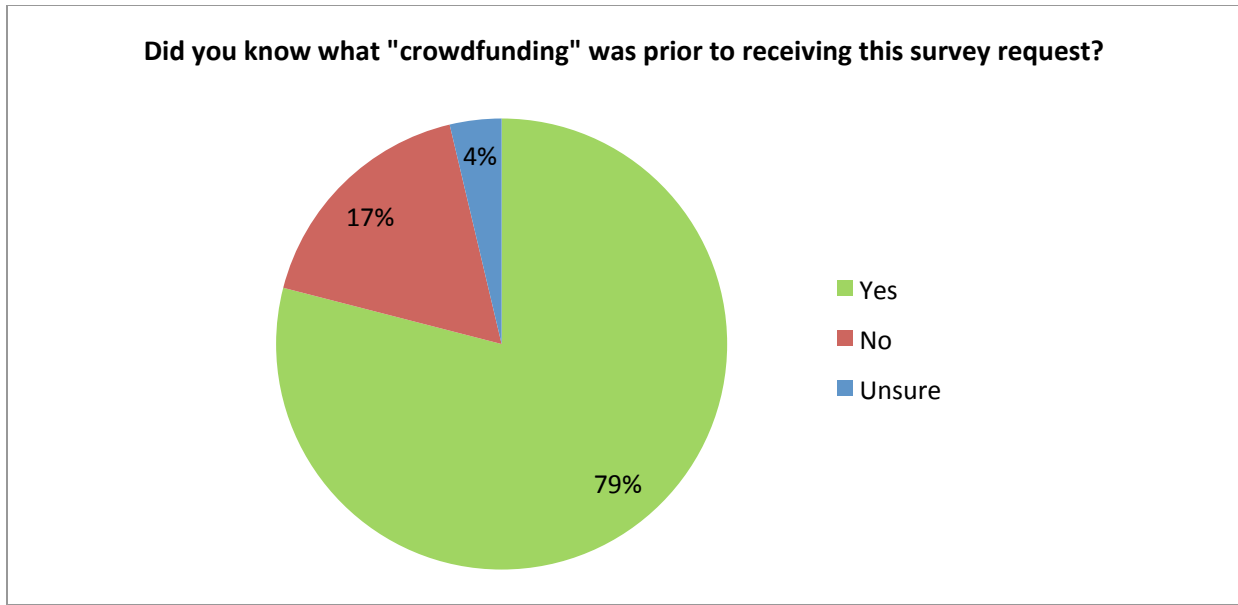


Figure 34: Survey: Chart of Crowdfunding Familiarity

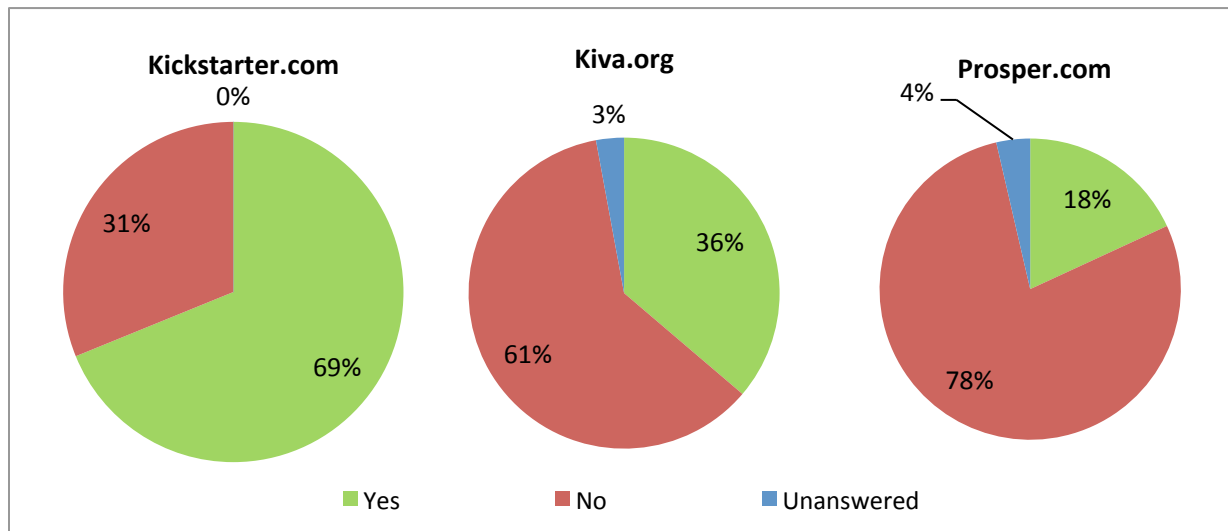


Figure35: Survey: Chart of Kickstarter, Kiva and Prosper Familiarity

In Figure 36 (below), the survey tests the respondent's knowledge of real estate specific crowdfunding sites asking, "Have you heard of these sites?"

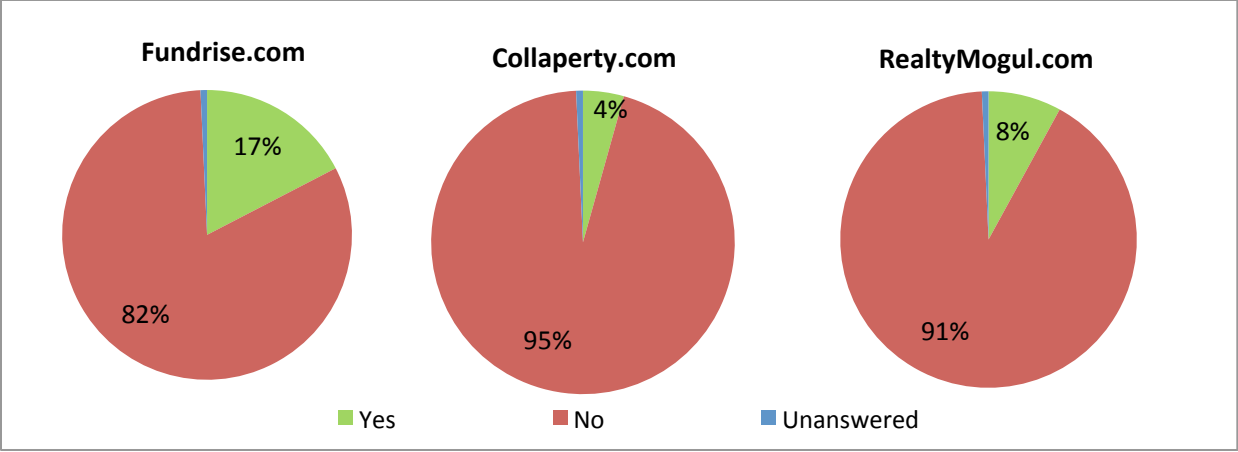


Figure 36: Survey: Chart of Fundrise, Collaperty and RealtyMogul Familiarity

Given that real estate crowdfunding is in its infancy, it is not surprising that few had not heard of these sites. It is notable however that Fundrise had almost the same recognition as Prosper.com; one respondent even knew the RealtyMogul CEO and had invested through the site.

Respondents’ Propensity to Use Crowdfunding for Real Estate in the Future

Interestingly, given that less than 20% of the respondents had heard of at least one of these sites, when asked if they would use a real estate crowdfunding site in the future, 64% said no. To dismiss the use of a real estate site one has not heard of is an unusual response from this sophisticated group. This response could be because of a lack of knowledge or understanding of the sites, lack of need, or fear of something new and perceived as risky.

Figure 37 (below) reflects the responses to two questions asked of the deal sponsor respondents. Deal sponsor participants were asked to rate on a 1 to 10 scale their willingness to raise money on the Internet. The next page in the survey then asked them to rank the importance of crowdfunding site qualities, such as criminal background checks on deal sponsors. They were then asked to re-rate on the same 1-10 scale their willingness to raise money on the Internet with the following question: “Rate your willingness to invest in a private real estate deal that you found on the Internet if the site was a legitimate platform that vetted all deals and sponsors and monitored the deal’s progress.” As expected, the propensity to use this type of site went up by an average of 1.07 spots on a scale, and 60% of the answers changed in the positive direction.

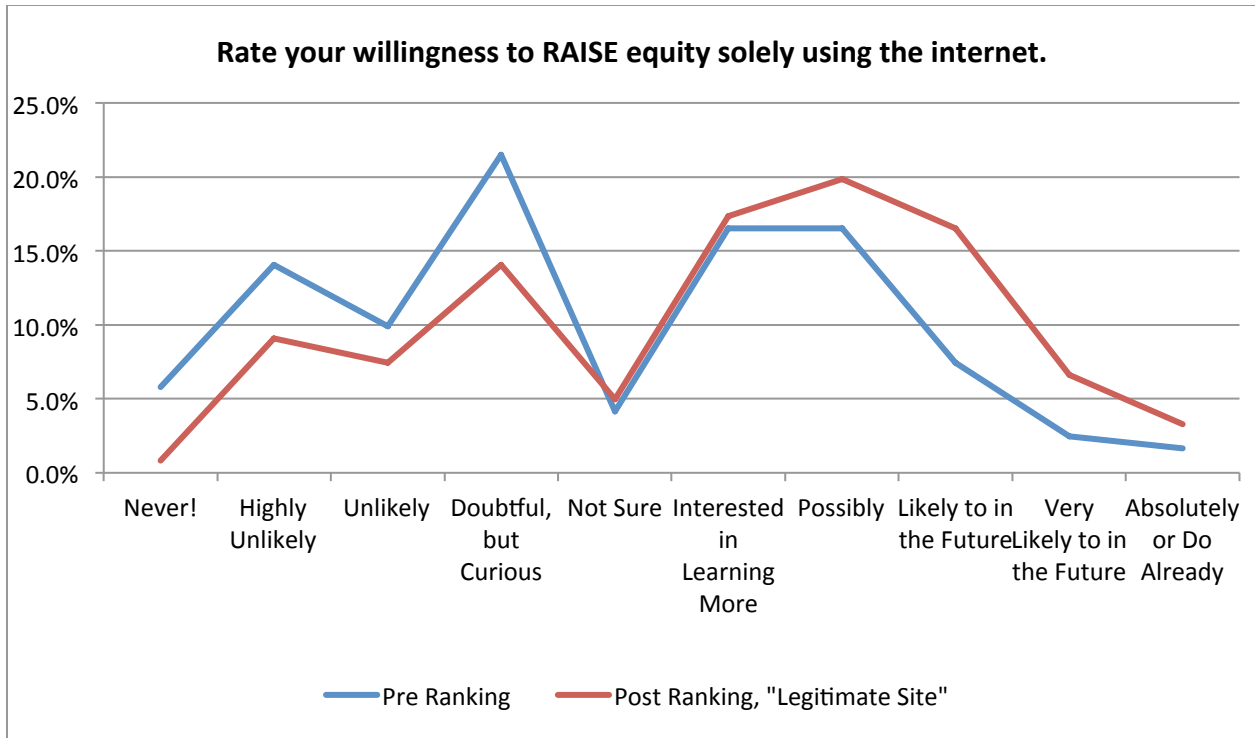


Figure 37: Survey: Graph of Willingness to Raise Equity Using the Internet

In Figure 38 (below) the same methodology and question was repeated for Investor participants and also for those answering “both,” but this time regarding willingness to *invest* over the Internet. Again the answers moved positively by 1.18 spots on the scale, with 58% of the answers moving in a positive direction.

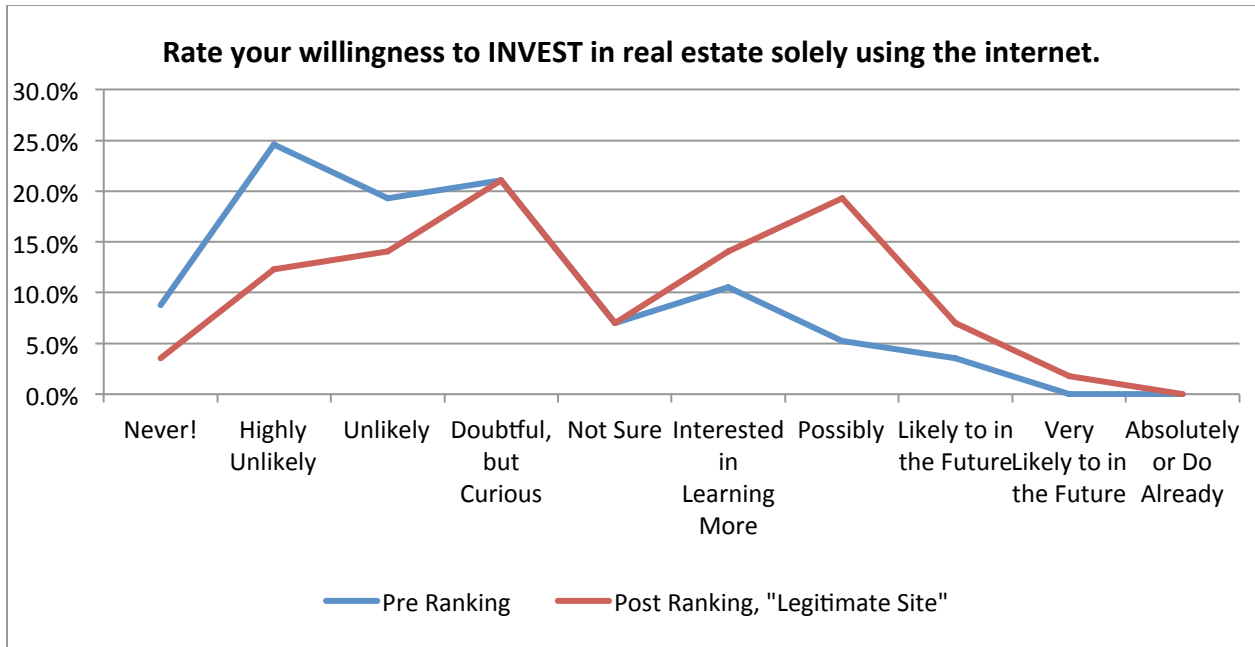


Figure 38: Survey: Graph of Willingness to Invest in Real Estate Using the Internet

It is interesting to note the graphical dip in the middle of both figures above, indicating that most people have a strong opinion one way or the other, or lack of clarity of the response labels. The response also reflects investors as less willing to invest over the Internet, which coincides, with the increased risk they are exposed to. Not a single investor rated their willingness as “absolutely” for either ranking. The pre-ranking response for investors is 1.2 slots lower than sponsors, but the post ranking response is only 1.09 slots lower. This possibly reflects the fact that the site qualities offered helps to mitigate their risk, but also does part of the investor’s due diligence work for them and this may be an attractive feature.

Figure 39 (below) displays how the respondents ranked site qualities, with the most important first:

- | |
|---|
| <ol style="list-style-type: none"> 1) Deal sponsor track record, investor ratings, resume 2) Available site and project information and due diligence 3) Deal sponsor background check (criminal & credit only) 4) Ability to receive money and manage investors online 5) On-going project & sponsor monitoring by website 6) Ease of investing electronically |
|---|

Figure 39: Survey: Table of Ranking Site Qualities

Both sponsors and investors agreed that a sponsor's professional business background is the most important, collective rating track record, ratings from other investors, and resume to be more important than a criminal and credit background check. Not surprisingly, ease of investing electronically came in last, indicating that none of the respondents wants to be easily associated with the wrong sponsor.

Analysis and Conclusions of Both Interviews and Surveys

The survey data analysis was greatly enhanced by the open-ended questions and commentary sections of the survey and from the interviews conducted. These comments provided additional, rich insight into industry professionals' views of the current commercial real estate market as well as on real estate crowdfunding. In addition, both the survey and the interview information point to the same conclusions.

An understanding of the real estate industry and the simple survey data indicates that the real estate industry's use of technology and the Internet lags behind that of other industries. Based on the responses regarding the use of the current offering of commercial real estate websites, the respondents mainly use them to perform due diligence on a deal or project. However, one survey respondent noted that "due diligence is a boots-on-the-ground process, so not sure how an Internet site can vet and report on deals." It is exactly this procedure and non-reliance on technology that leads to the high transaction costs and maintains the barrier to entry to the market. One respondent wrote:

"I think RE Development as well as construction are wavelengths behind other industries in regard to online commerce, fundraising, and general app development. The next decade will harvest many concepts like the ones you have referred to as well as many other topics. I have been interested in online resources to help acquire development sites for quite a while, which I see as an untapped area. I recently met with the CEO of an online platform that utilizes GIS and scrapes public data to assimilate data about sites

all over the US. Software like this as well as fundraising concepts will keep growing stronger over the years. For example, all private developers already have a login page for investors where they have the capability to track the project progress on an open desktop platform.”

Simultaneously, while both sponsors and investors noted the difficulty in the matching process of deals and investors, the majority of respondents' comments focused on how relationship-driven the real estate industry is. The data and the comments support the fact that brokers still play a key role in deal identification as well as sourcing debt and equity instead of the Internet. One person wanted to know “when the Internet is going to replace brokers.”

As a result of the professionals' reliance on relationships, many comments focused on the potential for fraud and the concern over not personally knowing the deal sponsor or investor. One person wrote, “Successful real estate professionals are successful at relationship-building and maintenance. This concept is fertile ground for abuse and fraud.” Conversely, sponsors had concern over their investors, stating, “Real estate deals hardly, if ever, work out according to plan with no bumps along the way. As a deal sponsor, you want to know how your equity will react in tough situations. Relationships are still key even if there are new mediums for a capital raises.” Sponsors also thought that it is “very important that the personality of the investors match the personality of the developer.” In both interviews and comments, sponsors mentioned how difficult dealing with investors was because their concerns and specifically time horizons rarely aligned with that of the developer. Obtaining “patient money” was mentioned in multiple interviews, as was liability concern.

“It is simply not possible to trust an Internet platform under any circumstances. The legal liability questions are profound.” – a project manager who rated he would NEVER invest on the Internet at all.

*“Concerns as a developer: With total strangers and/or less experienced investors investing in my deals, I'd be concerned about risk of litigation or class action suits instigated by opportunistic plaintiffs' attorneys, in the event a deal went wrong. --
Concerns as an investor: Except for trading REIT shares, I have always invested in RE only with people I know personally, very well.”*

Many responses focused on the ability to know the person running the deal:

“Face to face accountability on such a platform with Skype or something like it counteracts legitimate scam artist fears.”

“Cannot imagine an interaction without face to face, or phone dialogue.”

“Since I invest in people, I would need to get to know the people running the deal.”

These survey statements above were further corroborated by an interviewee’s declaration that “it’s all about the track record.” This correlates with the results of the survey data when ranking the qualities investors most highly value in a crowdfund platform: the sponsor’s track record, résumé, and their investor ratings.

One interviewee stated, and many investor survey responses implied, that they look at the person or company first and then the deal or project when evaluating an investment. However, herein lies the chicken and the egg issue related to raising capital and building a track record. How do you build a track record without capital or raise capital without a track record? Comments indicated that there is currently plenty of money out there chasing deals; however, only if they are good deals with good people. The paradox here is the lack of funding options for green developers without personal equity or a track record. One survey respondent wrote, “It is always challenging to raise capital until a track record exists.” Yet, one survey participant noted that if you use crowdfunding, it creates a “perception that you can't raise money using conventional means, so there might be a stigma to this.”

Through interviews and the survey responses, it is evident that private equity or personal funds combined with traditional lending are the dominant capital sources. Most developers interviewed preferred to use personal funds and raise money from friends and family. Consistent with the statements above, they want to know their investors and indicated issues with private equity or institutional investors not suiting their development strategy. Several real estate professionals are beginning to dabble with EB5 financing, evidencing a continual desire for optimal capital sources, but this is unlikely be a mainstream source due to restrictions and requirements.

While deal sourcing is highly localized and fragmented, presenting a low barrier to entry, the capital-raising process still poses the greatest challenge for new entrants. In fact, the survey data highlight the large number of small firms founded by many respondents that actually do a large amount of development, acquisition, or investment volume. There is room and opportunity for individuals and

small firms to participate in the commercial real estate market if they can find the capital. One interviewee needed “seed money” to put a development deal together and attract investors, while another mentioned the difficulty in raising a “blind” fund without a specific deal identified yet so they could quickly move on a prime opportunity when found. Another successful developer revealed that they had started a sister company that loaned money to small, local developers in a neighboring town who needed access to capital. It had been a successful business for the firm as well as for the small developers.

Both the data and responses point to, albeit indirectly, a clear need in the market for a new funding mechanism such as crowdfunding, particularly for smaller, less-established deal sponsors. One survey respondent questioned “whether crowdsourcing will be a capital source for developers with established access to capital from another source, as I believe developers would have to 'give up too much of the deal' and potential profit. However, for young bucks starting out with limited to no capital—but access to a good deal—I believe crowdsourcing may play a much bigger role, as well as for business people (such as the owner of a community store, gym, restaurant, etc.) who want to buy the real estate that houses their business.” This capital access and public tracking of their deal allows them to legitimately build a track record in order to achieve access to the more traditional forms of capital should they choose.

Not only do real estate professionals recognize a need within this particular market segment, but many also foresee the Internet and crowdfunding playing a much larger and more important role in real estate in the future. Although few would disagree that these technological innovations are here to stay and will continue to influence the market, most will approach it with caution. While the response and reception to the survey was very positive, indicating a strong industry interest in this subject, there is also some trepidation. In response to the survey, one MIT alum wrote:

“Congrats on a very well presented and executed survey on a topic of great relevance, particularly to the private, “small cap” sector of the development industry. The ability to provide capital directly to the developers, outside the structured path of traditional bank lending, could probably allow new and innovative development project types to emerge. Determining the risk, and then the appropriate yield requirements, for investors interested in providing small amounts of equity to new development “start-ups”, is going to be a fascinating experiment over the next few years!”

Conversely, from an investor's perspective, there is a definite lack of options to invest in local development or private deals from either a connections standpoint or monetary standpoint. Given the limitations under the securities laws on raising money from non-accredited investors, it was important for this survey to capture the fact that a significant portion of these respondents are actually not accredited or don't know if they are. Almost all, if not all, respondents have at least a graduate degree and hold a professional, white-collar job, but are still unable to attain accreditation status, which supports the need for democratization of investing through crowdfunding. Many private REITs, funds, or private placement options have minimums ranging from \$10,000 to \$50,000 or more, which prevents many would-be investors from participating in this market.

In summary, personal connections and brokers still remain a vital part of the real estate industry and thus keep it from achieving efficiency. Private equity and traditional bank loans continue to prevail as the capital structure for real estate, but many real estate professionals anticipate crowdfunding's impact on certain areas of the real estate market. However, as a result of the current market, small or new developers or real estate firms face capital-raising hurdles despite the breadth of opportunity in the physical market. The need for investment opportunities in real estate with a smaller capital requirement is ever-present and desired by investors seeking to allocate funds to real estate. The interviews, survey data and comments presented in this chapter are succinctly restated in a single survey comment:

"The capital markets are very effective and efficient for quality developers and deals. Capital is quite easy to get. For small investors, the public markets provide numerous choices with great liquidity and oversight. Crowdfunding may make sense for very small deals or some income properties, but I would be very concerned about the possibility of abuses."

Real estate professionals agree there is a need for capital for sub-institutional or start-up firms.

Chapter VIII: The Conclusion - Potential Strategic Implications of Internet Crowdfunding on the Real Estate Market

Six days after President Obama signed the JOBS Act into law on April 5, 2012, an obscure technology company, Pebble Technology, after having lost the traditional investment community's support, turned to Kickstarter.com. In a bid to survive, Pebble sought to raise \$100,000 to manufacture their new invention: a wristwatch capable of integrating with a user's smart-phone. Thirty-seven days later the campaign shattered crowdfunding records: 68,929 people pre-purchased a watch for a combined raise of \$10.26 million.²³⁰

The coincidence of these two events' timing is remarkable. The United States Congress, in a rare show of bipartisan support in passing the JOBS Act, could not have known about the plans for the yet-to-be-created Pebble Watch, nor could Pebble have known the probability of a politically divided Congress actually passing such sweeping legislation. Fast forward a year and a few months later to July 2013: the SEC has started to release the rules implementing the JOBS Act, announcing on July 10th that they are finally implementing part of Title II, lifting the ban on general solicitation of private placement securities. During this same time span, through Kickstarter.com, Pebble Technology Company has sold 85,000 watches in their pre-order phase plus an additional 275,000 through their website.²³¹ On July 7, 2013 Pebble signed a distribution deal with Best Buy; the watches were sold out on the first day.²³²

These parallel developments are both unique and historic, borne out of a capital-deprived financial system still reeling from the effects of a near-fatal financial heart attack in 2008. In recognition of this problem, Congress is trying to revive a small business-driven economy with new legislation, meant to "jumpstart" new business formation. The early travails of Pebble Technology represent thousands (perhaps hundreds of thousands) of good ideas across multiple industries that go wanting for capital.

The commercial real estate industry is certainly one victim, having been severely hobbled by this shortage of capital. While the commercial real estate market has seen a rather dramatic recovery since 2008, it has been an uneven, two-speed recovery. The sector deemed "institutional," dominated by

²³⁰ "Pebble: E-Paper Watch for iPhone and Android by Pebble Technology — Kickstarter."

²³¹ "Pebble Raises Record \$10 Million on KickStarter, Sells 85,000 Watches | BGR."

²³² "Pebble Smart Watch Preorders Hit 275,000 Ahead of Best Buy Debut."

capital-rich REITS, pension funds, and large, private equity firms have almost completely recovered, with capitalization rates close to pre-2008 levels. At the same time, the “sub-institutional” sector, traditionally financed by small local investors borrowing from commercial banks, has been lagging behind.²³³

There is a parallel from the investor perspective. The average investor seeks to create a well-diversified portfolio, which by definition entails an allocation to commercial real estate. This investor is almost always relegated to investing in REITS, ETFs, or through a managed retirement fund. As explored earlier in this paper, these “soft” assets and relegation to institutionally invested real estate has proven a sub-optimal proxy for commercial real estate assets, with REIT shares exhibiting a high correlation to the equity markets, and all these methods chocked full of broker fees and management expenses.

Direct access to this sub-institutional market is equally as difficult; property information is scarce, pricing transparency is opaque, and the market depends on relationships. Scarcity of information and pricing opacity are not inadvertent errors the marketplace wants to correct. The marketplace creates and enforces them to protect its functionaries, a well-paid cadre of commercial real estate brokers, debt brokers, and equity brokers. As a result, the commercial real estate industry has remained somewhat of an exclusionary club.

The collision of crowdfunding with commercial real estate is the central issue of this thesis. Crowdfunding for commercial real estate dis-intermediates the existing traditional real estate investment system as illustrated in Figure 40 below.

²³³ COSTAR, “CCRSI June2013 Press Release Commercial Real Estate Prices Shake Effects of First Quarter Seasonal Slowdown with Strong Showing in April.”

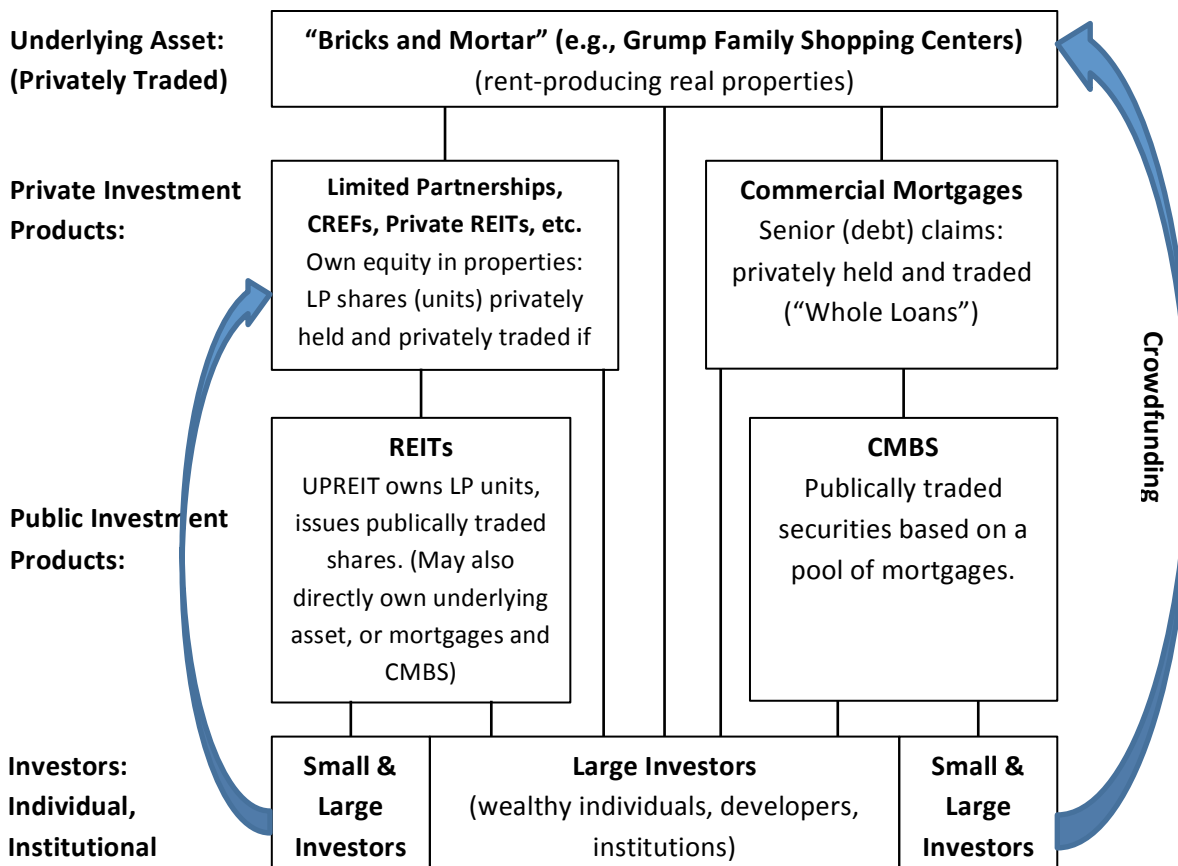


Figure 40: Modified Diagram of the Real Estate Investment System with Crowdfunding (Geltner Miller, Authors)

To further illustrate this argument in a precise and detailed manner, the following example presents the crowdfund ecosystem in action:

Spring 2015. Emily Entrepreneur has run a successful catering business for five years and now needs more room than her current kitchen provides. While thinking about her next location, she ponders the fact that since starting her business, customers and friends have wanted her to open a restaurant. However, in late 2011, she couldn't get a loan to purchase a commercial building because she could not raise equity with her limited network and little knowledge of real estate. Furthermore, she had limited resources to research rental rates or purchase prices to determine the best course of action.

Yet, over the last two years, local businesses have been partnering with developers and real estate professionals on a website, raising capital for their businesses and the real estate needed to house these businesses. Emily Entrepreneur ventures onto the site and reads the success stories. Within a few weeks she partners with a successful, young real estate developer, David Developer, who identifies

several potential locations situated in an up-and-coming neighborhood of Middletown America. Only a few years earlier, David Developer identified this area of town as the next “hot spot.” Despite having a graduate degree in real estate development and a great idea, he could not attract accredited investors because he had no track record, but this crowdfunding website has enabled him to put together several successful projects since then.

Through the crowdsourcing and funding site, investors seem to favor location A. David puts together an official funding campaign and soon several hundred people commit amounts ranging from \$1,000 to \$10,000 of equity to buy this building for Emily Entrepreneur’s restaurant.

Simultaneously, Average Joe, a young professional in the area, sees the investment opportunity for Emily Entrepreneur’s restaurant on the web. He knows the location is in an emerging area of town with lots of growth potential and is eager to invest. He has saved \$1,000 of his \$75,000 annual salary to invest in local real estate and is excited to contribute it toward this restaurant building. A few years earlier, he had wanted to invest in another building in that area, but the local developer had a minimum contribution amount of \$10,000, and furthermore Average Joe wasn’t an accredited investor. Emily Entrepreneur’s restaurant presents an opportunity through crowdfunding for Average Joe to participate in this growing real estate market. Average Joe also likes the idea of helping a local business in his community.

Finally, David Developer’s crowdfund campaign reaches \$750,000 in equity, and he arranges a commercial real estate loan with a local bank for the remaining \$750,000 needed to purchase this building as well as renovate the space and building for the restaurant. At the same time, Emily Entrepreneur signs a lease with the LLC put together by David Developer that will own the building. The individuals that committed the \$750,000 in funds will be limited partners in the LLC. Emily then, on her own, crowdfunds \$50,000 needed for working capital for the restaurant.

Six months later Emily Entrepreneur’s restaurant is open and catering to numerous patrons that have also invested in the building. Average Joe and his friends enjoy eating there and contributing to the success of the building’s tenant.

We predict that this type of scenario will play out repeatedly as the crowdfund phenomenon flourishes under the JOBS Act regulations. The question, though, is just how large of a market this will be?

How much of the commercial real estate markets will be crowdfunded with either equity or debt is a difficult, but not impossible number to estimate. Researchers from the University of California, Berkeley's College of Engineering's Fung Institute, in conjunction with industry professionals, deployed an instructive method, a variant of which will be used here. The team at Berkeley estimated the potential size of the overall crowdfund equity markets, excluding commercial real estate. Their examination focused only on new businesses typically funded by some combination of angel investing, venture capital, and small business loans.

They found estimates of the total amount of capital invested by angel investors and also estimated the total number of new business starts, then estimated both the equity and debt needs. For each of these statistics, they then created two scenarios: in the first, that 1% of these amounts would be that crowdfunded, and in the second, assuming the high adoption rates present in new technology, 2.5% would be crowdfunded. However, these percentages are untested and unproven given the novelty of crowdfunding.²³⁴

We deployed a similar methodology to compute the potential commercial real estate market. Utilizing data from CCRSI, the value of the US commercial real estate market, excluding specialty properties (such as prisons, schools, and churches) was estimated to be \$9.0 trillion. The CCRSI data, further categorized by value between Institutional (77%) and sub-institutional (23%) markets, indicated a value for institutional property at \$6.9 trillion and sub-institutional property at \$2.1 trillion. Given that different commercial real estate data can vary among various providers, a 2011 Prudential Real Estate Investors estimate was also surveyed, indicating the institutional property value in the U.S. was \$6.7 trillion. Since the boundaries between the asset classes are ambiguous, this additional report provided confidence in the CCRSI market values sampled.

The CCRSI index adjusted the 2009 estimates to a 2013 value of \$8.3 trillion for the institutional market, reflecting a 19.6% increase over this time period due to the market recovery; however, the growth rate for the sub-institutional sector was negative possibly due to the impact the 2008 financial crisis had on this market. For purposes of this analysis, a 0% rate was used, resulting in an estimated 2013 total market value of \$10.4 trillion.

²³⁴ Jason Best et al., "How Big Will the Debt and Equity Crowdfunding Investment Market Be? Comparisons, Assumptions and Estimates," 3.

However, crowdfunding for real estate is still in its infancy, and the SEC has yet to issue important rules and regulations allowing companies to put JOB Act legislation into action; therefore, it may be longer before the CRE crowdfunding market begins to enter the mainstream. 2015 might be a better year to examine the market size. With an estimated annual growth rate of 4.3% provided by Prudential for the next ten years for both market sectors, the estimated 2013 total CRE market value is projected to grow to \$11.3 trillion by mid-2015.

Crowdfunding will be used only when purchasing a property or, in certain cases, recapitalizing the current capital stack; therefore, only a percentage of this market value will be searching for capital each year. Transaction volume fluctuates based on market cycles, current economic conditions, and even in reaction to near-term events or time of year, so a simple average percentage was assumed. The industry standard for underwriting commercial property is a ten-year holding period, and commercial real estate loan terms are often only five, seven, or ten years at the most. Furthermore, the average NCREIF property is held for seven years. From these data points, we used a conservative 10% annual turnover rate to calculate the value of properties searching for capital in 2015.

While the sub-institutional market will be the likely sector to immediately benefit from crowdfunding, one could also argue that the institutional sector, not currently in need of equity capital, will use crowdfunding for other, related reasons. Fundrise LLC founder Ben Miller, during a recent Webinar, mentioned his firm's recent partnership on a development project with the large development firm Forrest City. On the call, Miller acknowledged that while Forest City is not in need of crowdfund equity, it values the community relationship and community "buy-in" fostered by local investors owning equity in a project in their backyard. If this phenomenon becomes widespread, large developers may routinely use crowdfunding in all their projects, expanding its use well beyond the borders of the sub-institutional markets described above.

There is an additional "wild-card" argument for the potential impact of crowdfunding on the institutional commercial real estate markets. Given the unpredictable cost of equity provided by the crowd versus the cost of equity provided by the current marketplace, what if the demand from the crowd for institutional equity and/or debt is greater than the demand institutional investors currently provide? Theoretically, this discrepancy could push down the cost of crowdfund equity below institutional equity and/or debt, in effect "crowding out" traditional investors in favor of the crowd. While forecasting the future price action in markets is difficult if not impossible, the data table

presented below allows the user to make their own assumptions and independently assess the potential size of the crowdfund marketplace.

Figure 41 (below) shows the resulting calculations based on this methodology. The matrices show different value amounts based on the annual turnover percentage and percent of the industry-raising capital through crowdfunding. The three matrices show the estimates for the entire commercial real estate industry, the sub-institutional sector, and institutional sector.

In keeping with the methodology used in the UC Berkeley study referenced above, at a 1% crowdfund usage rate assuming a 10% annual turnover of total commercial real estate assets, the crowdfund CRE market would be \$11,268,244,540 and \$28,170,611,349 at a 2.5% usage rate. Segregating out just the non-institutional commercial real estate sector, at a 1% usage rate the market would be \$2,251,847,430 and at 2.5% usage, \$5,629,618,575.

Examining just the institutional segment, at a 1% usage rate the market would be \$9,016,397,110. Since the institutional sector is almost four times larger than the sub-institutional market, any fraction of this institutional sector that might deploy crowdfunding would have a dramatic effect on the \$2.51 billion estimate.

Matrices of the Potential Commercial Real Estate Crowdfund Market in 2015

Total Commercial Real Estate Market						
<i>Estimated Total Commercial Real Estate Market Value in 2015 = \$ 11,268,244,539,720</i>		<i>Percent of Market Participating in Crowdfunding</i>				
		1.00%	1.50%	2.00%	2.50%	3.00%
<i>Annual Turnover Rate</i>	12.00%	\$ 13,521,893,448	\$ 20,282,840,171	\$ 27,043,786,895	\$ 33,804,733,619	\$ 40,565,680,343
	10.00%	\$ 11,268,244,540	\$ 16,902,366,810	\$ 22,536,489,079	\$ 28,170,611,349	\$ 33,804,733,619
	8.00%	\$ 9,014,595,632	\$ 13,521,893,448	\$ 18,029,191,264	\$ 22,536,489,079	\$ 27,043,786,895
Sub-Institutional CRE Market						
<i>Estimated Total Sub-Institutional CRE Market Value in 2015 = \$ 2,251,847,430,000</i>		<i>Percent of Market Participating in Crowdfunding</i>				
		1.00%	1.50%	2.00%	2.50%	3.00%
<i>Annual Turnover Rate</i>	12.00%	\$ 2,702,216,916	\$ 4,053,325,374	\$ 5,404,433,832	\$ 6,755,542,290	\$ 8,106,650,748
	10.00%	\$ 2,251,847,430	\$ 3,377,771,145	\$ 4,503,694,860	\$ 5,629,618,575	\$ 6,755,542,290
	8.00%	\$ 1,801,477,944	\$ 2,702,216,916	\$ 3,602,955,888	\$ 4,503,694,860	\$ 5,404,433,832
Institutional CRE Market						
<i>Estimated Total Institutional CRE Market Value in 2015 = \$ 9,016,397,109,720</i>		<i>Percent of Market Participating in Crowdfunding</i>				
		1.00%	1.50%	2.00%	2.50%	3.00%
<i>Annual Turnover Rate</i>	12.00%	\$ 10,819,676,532	\$ 16,229,514,797	\$ 21,639,353,063	\$ 27,049,191,329	\$ 32,459,029,595
	10.00%	\$ 9,016,397,110	\$ 13,524,595,665	\$ 18,032,794,219	\$ 22,540,992,774	\$ 27,049,191,329
	8.00%	\$ 7,213,117,688	\$ 10,819,676,532	\$ 14,426,235,376	\$ 18,032,794,219	\$ 21,639,353,063

Figure 41: Matrices of Estimated Commercial Real Estate Crowdfunding Market Size in 2015

A clear finding from the interviews, the survey data, and commentaries is that for both developers and investors, the legitimacy of an Internet site and protection against fraudulent and/or

criminal activity is a primary concern and an absolute prerequisite. While accepting the many respondents' view that the Internet can never completely replace the "face-to-face accountability," we circle back to the largest fraud in history mentioned in Chapter 2 accomplished by Bernard Madoff. Madoff did not know how to use email and was technologically challenged. He did not use the Internet to perpetrate his fraud. He used longstanding face-to-face relationships, combined with an opaque "members only" club-like structure that operated successfully for over twenty years. He was considered an upstanding citizen in every other regard, a philanthropist, an active member of his synagogue, a good father, and non-executive chairman of the NASDAQ stock market. The Madoff incident provides a harsh reminder that "face-to-face" interaction and background are not a panacea to protect against fraudulent or criminal activity. Fraud existed before the Internet, and face-to-face interaction was the primary weapon that con men deployed to convince their victims of their legitimacy.

In contrast, while there clearly exist risks of fraud with crowdfunding, "the crowd" can also weed out errant members, including frauds, or even criminals. One recent example occurred on Kickstarter.com. A company called Magnus Fun launched a pre-order campaign entitled "Kobe Red – 100% Beer Fed Kobe Beef Jerky", raising \$120,000 from 3,300 backers. Kickstarter was initially alerted to a potential problem when Magnus did not follow the Kickstarter "best practice" guidelines such as posting their photos on their campaign page. The fraud was detected by a group of filmmakers called Kickstarted who were making a documentary film about Kickstarter, obtaining their funding with a separate Kickstarter campaign. In a blog post Kickstarter staff recounted, "It's a credit to Kickstarter and the collective power of the crowd to identify fraud."

Another, more emotional example occurred after the April 15, 2013 Boston Marathon bombings. The suspects were initially identified in part from photographs taken by "the crowd" and calls with information into police. This led to a series of unfortunate events resulting in an MIT police officer's tragic death and in another police officer's being severely wounded. "The crowd" was then urged to "shelter in place" during the apprehension process, and a fifteen-hour curfew engulfed the entire Boston metropolitan area. While all Boston and Cambridge residents (including the authors) appreciate the brave and successful efforts of law enforcement in apprehending these criminals, one might ask if the process would have been hastened had the crowd been able to move about and assist in locating the evasive bomber. Not until the curfew was lifted was the remaining suspect found when a local citizen noticed a trail of blood to his boat.

This discovery by a member of the crowd leads back to Bernie Madoff. Had “the crowd” had access to Madoff Securities, would “the Madoff incident” be the largest fraud in history or just a footnote in a list of small-time scams, or would he have raised any money at all?

The power of the crowd is undeniable—to self-regulate and to fund—and an important founding characteristic of capitalism. On the eve of the JOBS Act being set into motion as the SEC releases its rules, the impact of crowdfunding on the U.S. commercial real estate market will be profound.

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Appendix A: The JOBS Act



PUBLIC LAW 112-106—APR. 5, 2012

JUMPSTART OUR BUSINESS STARTUPS ACT

Public Law 112–106
112th Congress

An Act

Apr. 5, 2012
[H.R. 3606]

To increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Jumpstart Our
Business
Startups Act.
15 USC 78a note.

SECTION 1. SHORT TITLE.

This Act may be cited as the “Jumpstart Our Business Startups Act”.

SEC. 2. TABLE OF CONTENTS.

The table of contents of this Act is as follows:

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TITLE I—REOPENING AMERICAN CAPITAL MARKETS TO EMERGING
GROWTH COMPANIES

Sec. 101. Definitions.
Sec. 102. Disclosure obligations.
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Sec. 107. Opt-in right for emerging growth companies.
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TITLE II—ACCESS TO CAPITAL FOR JOB CREATORS

Sec. 201. Modification of exemption.

TITLE III—CROWDFUNDING

Sec. 301. Short title.
Sec. 302. Crowdfunding exemption.
Sec. 303. Exclusion of crowdfunding investors from shareholder cap.
Sec. 304. Funding portal regulation.
Sec. 305. Relationship with State law.

TITLE IV—SMALL COMPANY CAPITAL FORMATION

Sec. 401. Authority to exempt certain securities.
Sec. 402. Study on the impact of State Blue Sky laws on Regulation A offerings.

TITLE V—PRIVATE COMPANY FLEXIBILITY AND GROWTH

Sec. 501. Threshold for registration.
Sec. 502. Employees.
Sec. 503. Commission rulemaking.
Sec. 504. Commission study of enforcement authority under Rule 12g5–1.

TITLE VI—CAPITAL EXPANSION

Sec. 601. Shareholder threshold for registration.
Sec. 602. Rulemaking.

TITLE VII—OUTREACH ON CHANGES TO THE LAW

Sec. 701. Outreach by the Commission.

TITLE I—REOPENING AMERICAN CAPITAL MARKETS TO EMERGING GROWTH COMPANIES

SEC. 101. DEFINITIONS.

(a) SECURITIES ACT OF 1933.—Section 2(a) of the Securities Act of 1933 (15 U.S.C. 77b(a)) is amended by adding at the end the following:

“(19) The term ‘emerging growth company’ means an issuer that had total annual gross revenues of less than \$1,000,000,000 (as such amount is indexed for inflation every 5 years by the Commission to reflect the change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics, setting the threshold to the nearest 1,000,000) during its most recently completed fiscal year. An issuer that is an emerging growth company as of the first day of that fiscal year shall continue to be deemed an emerging growth company until the earliest of—

“(A) the last day of the fiscal year of the issuer during which it had total annual gross revenues of \$1,000,000,000 (as such amount is indexed for inflation every 5 years by the Commission to reflect the change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics, setting the threshold to the nearest 1,000,000) or more;

“(B) the last day of the fiscal year of the issuer following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under this title;

“(C) the date on which such issuer has, during the previous 3-year period, issued more than \$1,000,000,000 in non-convertible debt; or

“(D) the date on which such issuer is deemed to be a ‘large accelerated filer’, as defined in section 240.12b-2 of title 17, Code of Federal Regulations, or any successor thereto.”.

(b) SECURITIES EXCHANGE ACT OF 1934.—Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended—

(1) by redesignating paragraph (77), as added by section 941(a) of the Investor Protection and Securities Reform Act of 2010 (Public Law 111-203, 124 Stat. 1890), as paragraph (79); and

(2) by adding at the end the following:

“(80) EMERGING GROWTH COMPANY.—The term ‘emerging growth company’ means an issuer that had total annual gross revenues of less than \$1,000,000,000 (as such amount is indexed for inflation every 5 years by the Commission to reflect the change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics, setting the threshold to the nearest 1,000,000) during its most recently completed fiscal year. An issuer that is an emerging growth company as of the first day of that fiscal year shall continue to be deemed an emerging growth company until the earliest of—

“(A) the last day of the fiscal year of the issuer during which it had total annual gross revenues of \$1,000,000,000 (as such amount is indexed for inflation every 5 years by the Commission to reflect the change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics, setting the threshold to the nearest 1,000,000) or more;

“(B) the last day of the fiscal year of the issuer following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act of 1933;

“(C) the date on which such issuer has, during the previous 3-year period, issued more than \$1,000,000,000 in non-convertible debt; or

“(D) the date on which such issuer is deemed to be a ‘large accelerated filer’, as defined in section 240.12b-2 of title 17, Code of Federal Regulations, or any successor thereto.”.

Applicability.
15 USC 78c note.

(c) OTHER DEFINITIONS.—As used in this title, the following definitions shall apply:

(1) COMMISSION.—The term “Commission” means the Securities and Exchange Commission.

(2) INITIAL PUBLIC OFFERING DATE.—The term “initial public offering date” means the date of the first sale of common equity securities of an issuer pursuant to an effective registration statement under the Securities Act of 1933.

15 USC 77b note.

(d) EFFECTIVE DATE.—Notwithstanding section 2(a)(19) of the Securities Act of 1933 and section 3(a)(80) of the Securities Exchange Act of 1934, an issuer shall not be an emerging growth company for purposes of such Acts if the first sale of common equity securities of such issuer pursuant to an effective registration statement under the Securities Act of 1933 occurred on or before December 8, 2011.

SEC. 102. DISCLOSURE OBLIGATIONS.

(a) EXECUTIVE COMPENSATION.—

(1) EXEMPTION.—Section 14A(e) of the Securities Exchange Act of 1934 (15 U.S.C. 78n-1(e)) is amended—

(A) by striking “The Commission may” and inserting the following:

“(1) IN GENERAL.—The Commission may”;

(B) by striking “an issuer” and inserting “any other issuer”; and

(C) by adding at the end the following:

“(2) TREATMENT OF EMERGING GROWTH COMPANIES.—

“(A) IN GENERAL.—An emerging growth company shall be exempt from the requirements of subsections (a) and (b).

Time period.

“(B) COMPLIANCE AFTER TERMINATION OF EMERGING GROWTH COMPANY TREATMENT.—An issuer that was an emerging growth company but is no longer an emerging growth company shall include the first separate resolution described under subsection (a)(1) not later than the end of—

“(i) in the case of an issuer that was an emerging growth company for less than 2 years after the date

of first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act of 1933, the 3-year period beginning on such date; and

“(ii) in the case of any other issuer, the 1-year period beginning on the date the issuer is no longer an emerging growth company.”.

(2) PROXIES.—Section 14(i) of the Securities Exchange Act of 1934 (15 U.S.C. 78n(i)) is amended by inserting “, for any issuer other than an emerging growth company,” after “including”.

(3) COMPENSATION DISCLOSURES.—Section 953(b)(1) of the Investor Protection and Securities Reform Act of 2010 (Public Law 111-203; 124 Stat. 1904) is amended by inserting “, other than an emerging growth company, as that term is defined in section 3(a) of the Securities Exchange Act of 1934,” after “require each issuer”.

15 USC 78l note.

(b) FINANCIAL DISCLOSURES AND ACCOUNTING PRONOUNCEMENTS.—

(1) SECURITIES ACT OF 1933.—Section 7(a) of the Securities Act of 1933 (15 U.S.C. 77g(a)) is amended—

(A) by striking “(a) The registration” and inserting the following:

“(a) INFORMATION REQUIRED IN REGISTRATION STATEMENT.—“(1) IN GENERAL.—The registration”; and

(B) by adding at the end the following:

“(2) TREATMENT OF EMERGING GROWTH COMPANIES.—An emerging growth company—

“(A) need not present more than 2 years of audited financial statements in order for the registration statement of such emerging growth company with respect to an initial public offering of its common equity securities to be effective, and in any other registration statement to be filed with the Commission, an emerging growth company need not present selected financial data in accordance with section 229.301 of title 17, Code of Federal Regulations, for any period prior to the earliest audited period presented in connection with its initial public offering; and

“(B) may not be required to comply with any new or revised financial accounting standard until such date that a company that is not an issuer (as defined under section 2(a) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201(a))) is required to comply with such new or revised accounting standard, if such standard applies to companies that are not issuers.”.

(2) SECURITIES EXCHANGE ACT OF 1934.—Section 13(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a)) is amended by adding at the end the following: “In any registration statement, periodic report, or other reports to be filed with the Commission, an emerging growth company need not present selected financial data in accordance with section 229.301 of title 17, Code of Federal Regulations, for any period prior to the earliest audited period presented in connection with its first registration statement that became effective under this Act or the Securities Act of 1933 and, with respect to any such statement or reports, an emerging growth company may not be required to comply with any new or revised financial

accounting standard until such date that a company that is not an issuer (as defined under section 2(a) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201(a))) is required to comply with such new or revised accounting standard, if such standard applies to companies that are not issuers.”

15 USC 77g note.

(c) OTHER DISCLOSURES.—An emerging growth company may comply with section 229.303(a) of title 17, Code of Federal Regulations, or any successor thereto, by providing information required by such section with respect to the financial statements of the emerging growth company for each period presented pursuant to section 7(a) of the Securities Act of 1933 (15 U.S.C. 77g(a)). An emerging growth company may comply with section 229.402 of title 17, Code of Federal Regulations, or any successor thereto, by disclosing the same information as any issuer with a market value of outstanding voting and nonvoting common equity held by non-affiliates of less than \$75,000,000.

SEC. 103. INTERNAL CONTROLS AUDIT.

Section 404(b) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7262(b)) is amended by inserting “, other than an issuer that is an emerging growth company (as defined in section 3 of the Securities Exchange Act of 1934),” before “shall attest to”.

SEC. 104. AUDITING STANDARDS.

Section 103(a)(3) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7213(a)(3)) is amended by adding at the end the following:

“(C) TRANSITION PERIOD FOR EMERGING GROWTH COMPANIES.—Any rules of the Board requiring mandatory audit firm rotation or a supplement to the auditor’s report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an emerging growth company, as defined in section 3 of the Securities Exchange Act of 1934. Any additional rules adopted by the Board after the date of enactment of this subparagraph shall not apply to an audit of any emerging growth company, unless the Commission determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation.”

Determination.

SEC. 105. AVAILABILITY OF INFORMATION ABOUT EMERGING GROWTH COMPANIES.

(a) PROVISION OF RESEARCH.—Section 2(a)(3) of the Securities Act of 1933 (15 U.S.C. 77b(a)(3)) is amended by adding at the end the following: “The publication or distribution by a broker or dealer of a research report about an emerging growth company that is the subject of a proposed public offering of the common equity securities of such emerging growth company pursuant to a registration statement that the issuer proposes to file, or has filed, or that is effective shall be deemed for purposes of paragraph (10) of this subsection and section 5(c) not to constitute an offer for sale or offer to sell a security, even if the broker or dealer is participating or will participate in the registered offering of the securities of the issuer. As used in this paragraph, the term ‘research report’ means a written, electronic, or oral communication

Definition.

that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision.”

(b) SECURITIES ANALYST COMMUNICATIONS.—Section 15D of the Securities Exchange Act of 1934 (15 U.S.C. 78o-6) is amended—

- (1) by redesignating subsection (c) as subsection (d); and
- (2) by inserting after subsection (b) the following:

“(c) LIMITATION.—Notwithstanding subsection (a) or any other provision of law, neither the Commission nor any national securities association registered under section 15A may adopt or maintain any rule or regulation in connection with an initial public offering of the common equity of an emerging growth company—

“(1) restricting, based on functional role, which associated persons of a broker, dealer, or member of a national securities association, may arrange for communications between a securities analyst and a potential investor; or

“(2) restricting a securities analyst from participating in any communications with the management of an emerging growth company that is also attended by any other associated person of a broker, dealer, or member of a national securities association whose functional role is other than as a securities analyst.”

(c) EXPANDING PERMISSIBLE COMMUNICATIONS.—Section 5 of the Securities Act of 1933 (15 U.S.C. 77e) is amended—

- (1) by redesignating subsection (d) as subsection (e); and
- (2) by inserting after subsection (c) the following:

“(d) LIMITATION.—Notwithstanding any other provision of this section, an emerging growth company or any person authorized to act on behalf of an emerging growth company may engage in oral or written communications with potential investors that are qualified institutional buyers or institutions that are accredited investors, as such terms are respectively defined in section 230.144A and section 230.501(a) of title 17, Code of Federal Regulations, or any successor thereto, to determine whether such investors might have an interest in a contemplated securities offering, either prior to or following the date of filing of a registration statement with respect to such securities with the Commission, subject to the requirement of subsection (b)(2).”

(d) POST OFFERING COMMUNICATIONS.—Neither the Commission nor any national securities association registered under section 15A of the Securities Exchange Act of 1934 may adopt or maintain any rule or regulation prohibiting any broker, dealer, or member of a national securities association from publishing or distributing any research report or making a public appearance, with respect to the securities of an emerging growth company, either—

- (1) within any prescribed period of time following the initial public offering date of the emerging growth company; or
- (2) within any prescribed period of time prior to the expiration date of any agreement between the broker, dealer, or member of a national securities association and the emerging growth company or its shareholders that restricts or prohibits the sale of securities held by the emerging growth company or its shareholders after the initial public offering date.

15 USC 78o-6
note.

SEC. 106. OTHER MATTERS.

(a) DRAFT REGISTRATION STATEMENTS.—Section 6 of the Securities Act of 1933 (15 U.S.C. 77f) is amended by adding at the end the following:

“(e) EMERGING GROWTH COMPANIES.—

Public
information.
Deadline.

“(1) IN GENERAL.—Any emerging growth company, prior to its initial public offering date, may confidentially submit to the Commission a draft registration statement, for confidential nonpublic review by the staff of the Commission prior to public filing, provided that the initial confidential submission and all amendments thereto shall be publicly filed with the Commission not later than 21 days before the date on which the issuer conducts a road show, as such term is defined in section 230.433(h)(4) of title 17, Code of Federal Regulations, or any successor thereto.

“(2) CONFIDENTIALITY.—Notwithstanding any other provision of this title, the Commission shall not be compelled to disclose any information provided to or obtained by the Commission pursuant to this subsection. For purposes of section 552 of title 5, United States Code, this subsection shall be considered a statute described in subsection (b)(3)(B) of such section 552. Information described in or obtained pursuant to this subsection shall be deemed to constitute confidential information for purposes of section 24(b)(2) of the Securities Exchange Act of 1934.”

(b) TICK SIZE.—Section 11A(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78k-1(c)) is amended by adding at the end the following new paragraph:

“(6) TICK SIZE.—

“(A) STUDY AND REPORT.—The Commission shall conduct a study examining the transition to trading and quoting securities in one penny increments, also known as decimalization. The study shall examine the impact that decimalization has had on the number of initial public offerings since its implementation relative to the period before its implementation. The study shall also examine the impact that this change has had on liquidity for small and middle capitalization company securities and whether there is sufficient economic incentive to support trading operations in these securities in penny increments. Not later than 90 days after the date of enactment of this paragraph, the Commission shall submit to Congress a report on the findings of the study.

Determination.
Deadline.

“(B) DESIGNATION.—If the Commission determines that the securities of emerging growth companies should be quoted and traded using a minimum increment of greater than \$0.01, the Commission may, by rule not later than 180 days after the date of enactment of this paragraph, designate a minimum increment for the securities of emerging growth companies that is greater than \$0.01 but less than \$0.10 for use in all quoting and trading of securities in any exchange or other execution venue.”

15 USC 78c note.

SEC. 107. OPT-IN RIGHT FOR EMERGING GROWTH COMPANIES.

(a) IN GENERAL.—With respect to an exemption provided to emerging growth companies under this title, or an amendment made by this title, an emerging growth company may choose to

forgo such exemption and instead comply with the requirements that apply to an issuer that is not an emerging growth company.

(b) SPECIAL RULE.—Notwithstanding subsection (a), with respect to the extension of time to comply with new or revised financial accounting standards provided under section 7(a)(2)(B) of the Securities Act of 1933 and section 13(a) of the Securities Exchange Act of 1934, as added by section 102(b), if an emerging growth company chooses to comply with such standards to the same extent that a non-emerging growth company is required to comply with such standards, the emerging growth company—

(1) must make such choice at the time the company is first required to file a registration statement, periodic report, or other report with the Commission under section 13 of the Securities Exchange Act of 1934 and notify the Securities and Exchange Commission of such choice; Notification.

(2) may not select some standards to comply with in such manner and not others, but must comply with all such standards to the same extent that a non-emerging growth company is required to comply with such standards; and

(3) must continue to comply with such standards to the same extent that a non-emerging growth company is required to comply with such standards for as long as the company remains an emerging growth company.

SEC. 108. REVIEW OF REGULATION S-K.

(a) REVIEW.—The Securities and Exchange Commission shall conduct a review of its Regulation S-K (17 CFR 229.10 et seq.) to—

(1) comprehensively analyze the current registration requirements of such regulation; and

(2) determine how such requirements can be updated to modernize and simplify the registration process and reduce the costs and other burdens associated with these requirements for issuers who are emerging growth companies.

(b) REPORT.—Not later than 180 days after the date of enactment of this title, the Commission shall transmit to Congress a report of the review conducted under subsection (a). The report shall include the specific recommendations of the Commission on how to streamline the registration process in order to make it more efficient and less burdensome for the Commission and for prospective issuers who are emerging growth companies.

TITLE II—ACCESS TO CAPITAL FOR JOB CREATORS

SEC. 201. MODIFICATION OF EXEMPTION.

(a) MODIFICATION OF RULES.—

(1) Not later than 90 days after the date of the enactment of this Act, the Securities and Exchange Commission shall revise its rules issued in section 230.506 of title 17, Code of Federal Regulations, to provide that the prohibition against general solicitation or general advertising contained in section 230.502(c) of such title shall not apply to offers and sales of securities made pursuant to section 230.506, provided that all purchasers of the securities are accredited investors. Such rules shall require the issuer to take reasonable steps to verify

15 USC 77d note.
Deadlines.

that purchasers of the securities are accredited investors, using such methods as determined by the Commission. Section 230.506 of title 17, Code of Federal Regulations, as revised pursuant to this section, shall continue to be treated as a regulation issued under section 4(2) of the Securities Act of 1933 (15 U.S.C. 77d(2)).

(2) Not later than 90 days after the date of enactment of this Act, the Securities and Exchange Commission shall revise subsection (d)(1) of section 230.144A of title 17, Code of Federal Regulations, to provide that securities sold under such revised exemption may be offered to persons other than qualified institutional buyers, including by means of general solicitation or general advertising, provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer.

(b) CONSISTENCY IN INTERPRETATION.—Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended—

(1) by striking “The provisions of section 5” and inserting

“(a) The provisions of section 5”; and

(2) by adding at the end the following:

“(b) Offers and sales exempt under section 230.506 of title 17, Code of Federal Regulations (as revised pursuant to section 201 of the Jumpstart Our Business Startups Act) shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation.”

(c) EXPLANATION OF EXEMPTION.—Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended—

(1) by striking “The provisions of section 5” and inserting

“(a) The provisions of section 5”; and

(2) by adding at the end the following:

“(b)(1) With respect to securities offered and sold in compliance with Rule 506 of Regulation D under this Act, no person who meets the conditions set forth in paragraph (2) shall be subject to registration as a broker or dealer pursuant to section 15(a)(1) of this title, solely because—

“(A) that person maintains a platform or mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through any other means;

“(B) that person or any person associated with that person co-invests in such securities; or

“(C) that person or any person associated with that person provides ancillary services with respect to such securities.

Applicability.

“(2) The exemption provided in paragraph (1) shall apply to any person described in such paragraph if—

“(A) such person and each person associated with that person receives no compensation in connection with the purchase or sale of such security;

“(B) such person and each person associated with that person does not have possession of customer funds or securities in connection with the purchase or sale of such security; and

“(C) such person is not subject to a statutory disqualification as defined in section 3(a)(39) of this title and does not

have any person associated with that person subject to such a statutory disqualification.

“(3) For the purposes of this subsection, the term ‘ancillary services’ means—

“(A) the provision of due diligence services, in connection with the offer, sale, purchase, or negotiation of such security, so long as such services do not include, for separate compensation, investment advice or recommendations to issuers or investors; and

“(B) the provision of standardized documents to the issuers and investors, so long as such person or entity does not negotiate the terms of the issuance for and on behalf of third parties and issuers are not required to use the standardized documents as a condition of using the service.”.

Definition.

TITLE III—CROWDFUNDING

Capital Raising
Online While
Deterring Fraud
and Unethical
Non-Disclosure
Act of 2012.
15 USC 77a note.

SEC. 301. SHORT TITLE.

This title may be cited as the “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012” or the “CROWDFUND Act”.

SEC. 302. CROWDFUNDING EXEMPTION.

(a) SECURITIES ACT OF 1933.—Section 4 of the Securities Act of 1933 (15 U.S.C. 77d) is amended by adding at the end the following:

“(6) transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that—

“(A) the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, is not more than \$1,000,000;

“(B) the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, does not exceed—

“(i) the greater of \$2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000; and

“(ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000;

“(C) the transaction is conducted through a broker or funding portal that complies with the requirements of section 4A(a); and

“(D) the issuer complies with the requirements of section 4A(b).”.

(b) REQUIREMENTS TO QUALIFY FOR CROWDFUNDING EXEMPTION.—The Securities Act of 1933 (15 U.S.C. 77a et seq.) is amended by inserting after section 4 the following:

15 USC 77d-1.	“SEC. 4A. REQUIREMENTS WITH RESPECT TO CERTAIN SMALL TRANSACTIONS.
Regulations.	<p>“(a) REQUIREMENTS ON INTERMEDIARIES.—A person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others pursuant to section 4(6) shall—</p> <p>“(1) register with the Commission as—</p> <p> “(A) a broker; or</p> <p> “(B) a funding portal (as defined in section 3(a)(80) of the Securities Exchange Act of 1934);</p> <p>“(2) register with any applicable self-regulatory organization (as defined in section 3(a)(26) of the Securities Exchange Act of 1934);</p> <p>“(3) provide such disclosures, including disclosures related to risks and other investor education materials, as the Commission shall, by rule, determine appropriate;</p> <p>“(4) ensure that each investor—</p> <p> “(A) reviews investor-education information, in accordance with standards established by the Commission, by rule;</p> <p> “(B) positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and</p> <p> “(C) answers questions demonstrating—</p> <p> “(i) an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers;</p> <p> “(ii) an understanding of the risk of illiquidity; and</p> <p> “(iii) an understanding of such other matters as the Commission determines appropriate, by rule;</p> <p>“(5) take such measures to reduce the risk of fraud with respect to such transactions, as established by the Commission, by rule, including obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered by such person;</p>
Deadline.	<p>“(6) not later than 21 days prior to the first day on which securities are sold to any investor (or such other period as the Commission may establish), make available to the Commission and to potential investors any information provided by the issuer pursuant to subsection (b);</p> <p>“(7) ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest, as the Commission shall, by rule, determine appropriate;</p>
Time period.	<p>“(8) make such efforts as the Commission determines appropriate, by rule, to ensure that no investor in a 12-month period has purchased securities offered pursuant to section 4(6) that, in the aggregate, from all issuers, exceed the investment limits set forth in section 4(6)(B);</p>
Confidentiality.	<p>“(9) take such steps to protect the privacy of information collected from investors as the Commission shall, by rule, determine appropriate;</p>

“(10) not compensate promoters, finders, or lead generators for providing the broker or funding portal with the personal identifying information of any potential investor;

“(11) prohibit its directors, officers, or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in an issuer using its services; and

“(12) meet such other requirements as the Commission may, by rule, prescribe, for the protection of investors and in the public interest.

“(b) REQUIREMENTS FOR ISSUERS.—For purposes of section 4(6), an issuer who offers or sells securities shall—

“(1) file with the Commission and provide to investors and the relevant broker or funding portal, and make available to potential investors—

“(A) the name, legal status, physical address, and website address of the issuer;

“(B) the names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20 percent of the shares of the issuer;

“(C) a description of the business of the issuer and the anticipated business plan of the issuer;

“(D) a description of the financial condition of the issuer, including, for offerings that, together with all other offerings of the issuer under section 4(6) within the preceding 12-month period, have, in the aggregate, target offering amounts of—

Time period.

“(i) \$100,000 or less—

“(I) the income tax returns filed by the issuer for the most recently completed year (if any); and

“(II) financial statements of the issuer, which shall be certified by the principal executive officer of the issuer to be true and complete in all material respects;

“(ii) more than \$100,000, but not more than \$500,000, financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures for such review or standards and procedures established by the Commission, by rule, for such purpose; and

“(iii) more than \$500,000 (or such other amount as the Commission may establish, by rule), audited financial statements;

“(E) a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount;

“(F) the target offering amount, the deadline to reach the target offering amount, and regular updates regarding the progress of the issuer in meeting the target offering amount;

“(G) the price to the public of the securities or the method for determining the price, provided that, prior to sale, each investor shall be provided in writing the final price and all required disclosures, with a reasonable opportunity to rescind the commitment to purchase the securities;

“(H) a description of the ownership and capital structure of the issuer, including—

“(i) terms of the securities of the issuer being offered and each other class of security of the issuer, including how such terms may be modified, and a summary of the differences between such securities, including how the rights of the securities being offered may be materially limited, diluted, or qualified by the rights of any other class of security of the issuer;

“(ii) a description of how the exercise of the rights held by the principal shareholders of the issuer could negatively impact the purchasers of the securities being offered;

“(iii) the name and ownership level of each existing shareholder who owns more than 20 percent of any class of the securities of the issuer;

“(iv) how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions; and

“(v) the risks to purchasers of the securities relating to minority ownership in the issuer, the risks associated with corporate actions, including additional issuances of shares, a sale of the issuer or of assets of the issuer, or transactions with related parties; and

“(I) such other information as the Commission may, by rule, prescribe, for the protection of investors and in the public interest;

“(2) not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker;

“(3) not compensate or commit to compensate, directly or indirectly, any person to promote its offerings through communication channels provided by a broker or funding portal, without taking such steps as the Commission shall, by rule, require to ensure that such person clearly discloses the receipt, past or prospective, of such compensation, upon each instance of such promotional communication;

“(4) not less than annually, file with the Commission and provide to investors reports of the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate, subject to such exceptions and termination dates as the Commission may establish, by rule; and

“(5) comply with such other requirements as the Commission may, by rule, prescribe, for the protection of investors and in the public interest.

“(c) LIABILITY FOR MATERIAL MISSTATEMENTS AND OMISSIONS.—

“(1) ACTIONS AUTHORIZED.—

“(A) IN GENERAL.—Subject to paragraph (2), a person who purchases a security in a transaction exempted by the provisions of section 4(6) may bring an action against an issuer described in paragraph (2), either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if such person no longer owns the security.

Deadline.
Reports.

“(B) LIABILITY.—An action brought under this paragraph shall be subject to the provisions of section 12(b) and section 13, as if the liability were created under section 12(a)(2).

“(2) APPLICABILITY.—An issuer shall be liable in an action under paragraph (1), if the issuer—

“(A) by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by any means of any written or oral communication, in the offering or sale of a security in a transaction exempted by the provisions of section 4(6), makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, provided that the purchaser did not know of such untruth or omission; and

“(B) does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.

“(3) DEFINITION.—As used in this subsection, the term ‘issuer’ includes any person who is a director or partner of the issuer, and the principal executive officer or officers, principal financial officer, and controller or principal accounting officer of the issuer (and any person occupying a similar status or performing a similar function) that offers or sells a security in a transaction exempted by the provisions of section 4(6), and any person who offers or sells the security in such offering.

“(d) INFORMATION AVAILABLE TO STATES.—The Commission shall make, or shall cause to be made by the relevant broker or funding portal, the information described in subsection (b) and such other information as the Commission, by rule, determines appropriate, available to the securities commission (or any agency or office performing like functions) of each State and territory of the United States and the District of Columbia.

“(e) RESTRICTIONS ON SALES.—Securities issued pursuant to a transaction described in section 4(6)—

“(1) may not be transferred by the purchaser of such securities during the 1-year period beginning on the date of purchase, unless such securities are transferred—

Time period.

“(A) to the issuer of the securities;

“(B) to an accredited investor;

“(C) as part of an offering registered with the Commission; or

“(D) to a member of the family of the purchaser or the equivalent, or in connection with the death or divorce of the purchaser or other similar circumstance, in the discretion of the Commission; and

“(2) shall be subject to such other limitations as the Commission shall, by rule, establish.

“(f) APPLICABILITY.—Section 4(6) shall not apply to transactions involving the offer or sale of securities by any issuer that—

“(1) is not organized under and subject to the laws of a State or territory of the United States or the District of Columbia;

“(2) is subject to the requirement to file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934;

“(3) is an investment company, as defined in section 3 of the Investment Company Act of 1940, or is excluded from the definition of investment company by section 3(b) or section 3(c) of that Act; or

“(4) the Commission, by rule or regulation, determines appropriate.

“(g) RULE OF CONSTRUCTION.—Nothing in this section or section 4(6) shall be construed as preventing an issuer from raising capital through methods not described under section 4(6).

“(h) CERTAIN CALCULATIONS.—

“(1) DOLLAR AMOUNTS.—Dollar amounts in section 4(6) and subsection (b) of this section shall be adjusted by the Commission not less frequently than once every 5 years, by notice published in the Federal Register to reflect any change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics.

“(2) INCOME AND NET WORTH.—The income and net worth of a natural person under section 4(6)(B) shall be calculated in accordance with any rules of the Commission under this title regarding the calculation of the income and net worth, respectively, of an accredited investor.”

(c) RULEMAKING.—Not later than 270 days after the date of enactment of this Act, the Securities and Exchange Commission (in this title referred to as the “Commission”) shall issue such rules as the Commission determines may be necessary or appropriate for the protection of investors to carry out sections 4(6) and section 4A of the Securities Act of 1933, as added by this title. In carrying out this section, the Commission shall consult with any securities commission (or any agency or office performing like functions) of the States, any territory of the United States, and the District of Columbia, which seeks to consult with the Commission, and with any applicable national securities association.

(d) DISQUALIFICATION.—

(1) IN GENERAL.—Not later than 270 days after the date of enactment of this Act, the Commission shall, by rule, establish disqualification provisions under which—

(A) an issuer shall not be eligible to offer securities pursuant to section 4(6) of the Securities Act of 1933, as added by this title; and

(B) a broker or funding portal shall not be eligible to effect or participate in transactions pursuant to that section 4(6).

(2) INCLUSIONS.—Disqualification provisions required by this subsection shall—

(A) be substantially similar to the provisions of section 230.262 of title 17, Code of Federal Regulations (or any successor thereto); and

(B) disqualify any offering or sale of securities by a person that—

(i) is subject to a final order of a State securities commission (or an agency or officer of a State performing like functions), a State authority that supervises or examines banks, savings associations, or credit unions, a State insurance commission (or an agency

Time period.
Notice.
Federal Register,
publication.

Deadline.
15 USC 77d note.

Consultation.

15 USC 77d note.
Deadline.

or officer of a State performing like functions), an appropriate Federal banking agency, or the National Credit Union Administration, that—

(I) bars the person from—

(aa) association with an entity regulated by such commission, authority, agency, or officer;

(bb) engaging in the business of securities, insurance, or banking; or

(cc) engaging in savings association or credit union activities; or

(II) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of the filing of the offer or sale; or

(ii) has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission.

SEC. 303. EXCLUSION OF CROWDFUNDING INVESTORS FROM SHAREHOLDER CAP.

(a) EXEMPTION.—Section 12(g) of the Securities Exchange Act of 1934 (15 U.S.C. 78l(g)) is amended by adding at the end the following:

“(6) EXCLUSION FOR PERSONS HOLDING CERTAIN SECURITIES.—The Commission shall, by rule, exempt, conditionally or unconditionally, securities acquired pursuant to an offering made under section 4(6) of the Securities Act of 1933 from the provisions of this subsection.”

Regulations.

(b) RULEMAKING.—The Commission shall issue a rule to carry out section 12(g)(6) of the Securities Exchange Act of 1934 (15 U.S.C. 78c), as added by this section, not later than 270 days after the date of enactment of this Act.

15 USC 78l note.

SEC. 304. FUNDING PORTAL REGULATION.

(a) EXEMPTION.—

(1) IN GENERAL.—Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c) is amended by adding at the end the following:

“(h) LIMITED EXEMPTION FOR FUNDING PORTALS.—

“(1) IN GENERAL.—The Commission shall, by rule, exempt, conditionally or unconditionally, a registered funding portal from the requirement to register as a broker or dealer under section 15(a)(1), provided that such funding portal—

“(A) remains subject to the examination, enforcement, and other rulemaking authority of the Commission;

“(B) is a member of a national securities association registered under section 15A; and

“(C) is subject to such other requirements under this title as the Commission determines appropriate under such rule.

(2) NATIONAL SECURITIES ASSOCIATION MEMBERSHIP.—For purposes of sections 15(b)(8) and 15A, the term ‘broker or dealer’ includes a funding portal and the term ‘registered broker or dealer’ includes a registered funding portal, except to the extent that the Commission, by rule, determines otherwise,

Definition.

provided that a national securities association shall only examine for and enforce against a registered funding portal rules of such national securities association written specifically for registered funding portals.”

Deadline.
15 USC 78c note.

(2) RULEMAKING.—The Commission shall issue a rule to carry out section 3(h) of the Securities Exchange Act of 1934 (15 U.S.C. 78c), as added by this subsection, not later than 270 days after the date of enactment of this Act.

(b) DEFINITION.—Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end the following:

“(80) FUNDING PORTAL.—The term ‘funding portal’ means any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to section 4(6) of the Securities Act of 1933 (15 U.S.C. 77d(6)), that does not—

- “(A) offer investment advice or recommendations;
- “(B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;
- “(C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
- “(D) hold, manage, possess, or otherwise handle investor funds or securities; or
- “(E) engage in such other activities as the Commission, by rule, determines appropriate.”

SEC. 305. RELATIONSHIP WITH STATE LAW.

(a) IN GENERAL.—Section 18(b)(4) of the Securities Act of 1933 (15 U.S.C. 77r(b)(4)) is amended—

(1) by redesignating subparagraphs (C) and (D) as subparagraphs (D) and (E), respectively; and

(2) by inserting after subparagraph (B) the following:

“(C) section 4(6);”

(b) CLARIFICATION OF THE PRESERVATION OF STATE ENFORCEMENT AUTHORITY.—

15 USC 77r note.

(1) IN GENERAL.—The amendments made by subsection (a) relate solely to State registration, documentation, and offering requirements, as described under section 18(a) of Securities Act of 1933 (15 U.S.C. 77r(a)), and shall have no impact or limitation on other State authority to take enforcement action with regard to an issuer, funding portal, or any other person or entity using the exemption from registration provided by section 4(6) of that Act.

(2) CLARIFICATION OF STATE JURISDICTION OVER UNLAWFUL CONDUCT OF FUNDING PORTALS AND ISSUERS.—Section 18(c)(1) of the Securities Act of 1933 (15 U.S.C. 77r(c)(1)) is amended by striking “with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.” and inserting the following: “, in connection with securities or securities transactions

- “(A) with respect to—
 - “(i) fraud or deceit; or
 - “(ii) unlawful conduct by a broker or dealer; and
- “(B) in connection to a transaction described under section 4(6), with respect to—
 - “(i) fraud or deceit; or

“(ii) unlawful conduct by a broker, dealer, funding portal, or issuer.”

(c) NOTICE FILINGS PERMITTED.—Section 18(c)(2) of the Securities Act of 1933 (15 U.S.C. 77r(c)(2)) is amended by adding at the end the following:

“(F) FEES NOT PERMITTED ON CROWDFUNDED SECURITIES.—Notwithstanding subparagraphs (A), (B), and (C), no filing or fee may be required with respect to any security that is a covered security pursuant to subsection (b)(4)(B), or will be such a covered security upon completion of the transaction, except for the securities commission (or any agency or office performing like functions) of the State of the principal place of business of the issuer, or any State in which purchasers of 50 percent or greater of the aggregate amount of the issue are residents, provided that for purposes of this subparagraph, the term ‘State’ includes the District of Columbia and the territories of the United States.”

Definition.

(d) FUNDING PORTALS.—

(1) STATE EXEMPTIONS AND OVERSIGHT.—Section 15(i) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(i)) is amended—

(A) by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively; and

(B) by inserting after paragraph (1) the following:

“(2) FUNDING PORTALS.—

“(A) LIMITATION ON STATE LAWS.—Except as provided in subparagraph (B), no State or political subdivision thereof may enforce any law, rule, regulation, or other administrative action against a registered funding portal with respect to its business as such.

“(B) EXAMINATION AND ENFORCEMENT AUTHORITY.—Subparagraph (A) does not apply with respect to the examination and enforcement of any law, rule, regulation, or administrative action of a State or political subdivision thereof in which the principal place of business of a registered funding portal is located, provided that such law, rule, regulation, or administrative action is not in addition to or different from the requirements for registered funding portals established by the Commission.

“(C) DEFINITION.—For purposes of this paragraph, the term ‘State’ includes the District of Columbia and the territories of the United States.”

(2) STATE FRAUD AUTHORITY.—Section 18(c)(1) of the Securities Act of 1933 (15 U.S.C. 77r(c)(1)) is amended by striking “or dealer” and inserting “, dealer, or funding portal”.

TITLE IV—SMALL COMPANY CAPITAL FORMATION

SEC. 401. AUTHORITY TO EXEMPT CERTAIN SECURITIES.

(a) IN GENERAL.—Section 3(b) of the Securities Act of 1933 (15 U.S.C. 77c(b)) is amended—

(1) by striking “(b) The Commission” and inserting the following:

“(b) ADDITIONAL EXEMPTIONS.—

	“(1) SMALL ISSUES EXEMPTIVE AUTHORITY.—The Commission”; and
Regulations.	“(2) by adding at the end the following: “(2) ADDITIONAL ISSUES.—The Commission shall by rule or regulation add a class of securities to the securities exempted pursuant to this section in accordance with the following terms and conditions:
Time period.	“(A) The aggregate offering amount of all securities offered and sold within the prior 12-month period in reliance on the exemption added in accordance with this paragraph shall not exceed \$50,000,000. “(B) The securities may be offered and sold publicly. “(C) The securities shall not be restricted securities within the meaning of the Federal securities laws and the regulations promulgated thereunder.
Applicability.	“(D) The civil liability provision in section 12(a)(2) shall apply to any person offering or selling such securities. “(E) The issuer may solicit interest in the offering prior to filing any offering statement, on such terms and conditions as the Commission may prescribe in the public interest or for the protection of investors.
Records.	“(F) The Commission shall require the issuer to file audited financial statements with the Commission annually. “(G) Such other terms, conditions, or requirements as the Commission may determine necessary in the public interest and for the protection of investors, which may include— “(i) a requirement that the issuer prepare and electronically file with the Commission and distribute to prospective investors an offering statement, and any related documents, in such form and with such content as prescribed by the Commission, including audited financial statements, a description of the issuer’s business operations, its financial condition, its corporate governance principles, its use of investor funds, and other appropriate matters; and “(ii) disqualification provisions under which the exemption shall not be available to the issuer or its predecessors, affiliates, officers, directors, underwriters, or other related persons, which shall be substantially similar to the disqualification provisions contained in the regulations adopted in accordance with section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (15 U.S.C. 77d note).
	“(3) LIMITATION.—Only the following types of securities may be exempted under a rule or regulation adopted pursuant to paragraph (2): equity securities, debt securities, and debt securities convertible or exchangeable to equity interests, including any guarantees of such securities.
	“(4) PERIODIC DISCLOSURES.—Upon such terms and conditions as the Commission determines necessary in the public interest and for the protection of investors, the Commission by rule or regulation may require an issuer of a class of securities exempted under paragraph (2) to make available to investors and file with the Commission periodic disclosures regarding the issuer, its business operations, its financial condition, its

corporate governance principles, its use of investor funds, and other appropriate matters, and also may provide for the suspension and termination of such a requirement with respect to that issuer.

“(5) ADJUSTMENT.—Not later than 2 years after the date of enactment of the Small Company Capital Formation Act of 2011 and every 2 years thereafter, the Commission shall review the offering amount limitation described in paragraph (2)(A) and shall increase such amount as the Commission determines appropriate. If the Commission determines not to increase such amount, it shall report to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate on its reasons for not increasing the amount.”

Deadlines.
Review.

(b) TREATMENT AS COVERED SECURITIES FOR PURPOSES OF NSMIA.—Section 18(b)(4) of the Securities Act of 1933 (as amended by section 303) (15 U.S.C. 77r(b)(4)) is further amended by inserting after subparagraph (C) (as added by such section) the following:

“(D) a rule or regulation adopted pursuant to section 3(b)(2) and such security is—

“(i) offered or sold on a national securities exchange; or

“(ii) offered or sold to a qualified purchaser, as defined by the Commission pursuant to paragraph (3) with respect to that purchase or sale.”

(c) CONFORMING AMENDMENT.—Section 4(5) of the Securities Act of 1933 is amended by striking “section 3(b)” and inserting “section 3(b)(1)”. 15 USC 77d.

SEC. 402. STUDY ON THE IMPACT OF STATE BLUE SKY LAWS ON REGULATION A OFFERINGS.

The Comptroller General shall conduct a study on the impact of State laws regulating securities offerings, or “Blue Sky laws”, on offerings made under Regulation A (17 CFR 230.251 et seq.). The Comptroller General shall transmit a report on the findings of the study to the Committee on Financial Services of the House of Representatives, and the Committee on Banking, Housing, and Urban Affairs of the Senate not later than 3 months after the date of enactment of this Act.

Reports.
Deadline.

**TITLE V—PRIVATE COMPANY
FLEXIBILITY AND GROWTH**

SEC. 501. THRESHOLD FOR REGISTRATION.

Section 12(g)(1)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78l(g)(1)(A)) is amended to read as follows:

“(A) within 120 days after the last day of its first fiscal year ended on which the issuer has total assets exceeding \$10,000,000 and a class of equity security (other than an exempted security) held of record by either—

Time period.

“(i) 2,000 persons, or

“(ii) 500 persons who are not accredited investors (as such term is defined by the Commission), and”.

SEC. 502. EMPLOYEES.

Section 12(g)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78l(g)(5)), as amended by section 302, is amended in subparagraph (A) by adding at the end the following: “For purposes of determining whether an issuer is required to register a security with the Commission pursuant to paragraph (1), the definition of ‘held of record’ shall not include securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act of 1933.”.

15 USC 78l note.

SEC. 503. COMMISSION RULEMAKING.

The Securities and Exchange Commission shall revise the definition of “held of record” pursuant to section 12(g)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78l(g)(5)) to implement the amendment made by section 502. The Commission shall also adopt safe harbor provisions that issuers can follow when determining whether holders of their securities received the securities pursuant to an employee compensation plan in transactions that were exempt from the registration requirements of section 5 of the Securities Act of 1933.

SEC. 504. COMMISSION STUDY OF ENFORCEMENT AUTHORITY UNDER RULE 12G5-1.Deadline.
Recommendations.

The Securities and Exchange Commission shall examine its authority to enforce Rule 12g5-1 to determine if new enforcement tools are needed to enforce the anti-evasion provision contained in subsection (b)(3) of the rule, and shall, not later than 120 days after the date of enactment of this Act transmit its recommendations to Congress.

TITLE VI—CAPITAL EXPANSION**SEC. 601. SHAREHOLDER THRESHOLD FOR REGISTRATION.**

(a) AMENDMENTS TO SECTION 12 OF THE SECURITIES EXCHANGE ACT OF 1934.—Section 12(g) of the Securities Exchange Act of 1934 (15 U.S.C. 78l(g)) is further amended—

Deadline.

(1) in paragraph (1), by amending subparagraph (B) to read as follows:

“(B) in the case of an issuer that is a bank or a bank holding company, as such term is defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841), not later than 120 days after the last day of its first fiscal year ended after the effective date of this subsection, on which the issuer has total assets exceeding \$10,000,000 and a class of equity security (other than an exempted security) held of record by 2,000 or more persons;” and

(2) in paragraph (4), by striking “three hundred” and inserting “300 persons, or, in the case of a bank or a bank holding company, as such term is defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841), 1,200 persons”.

(b) AMENDMENTS TO SECTION 15 OF THE SECURITIES EXCHANGE ACT OF 1934.—Section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)) is amended, in the third sentence, by striking “three hundred” and inserting “300 persons, or, in the case of bank or a bank holding company, as such term is defined

in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841), 1,200 persons”.

SEC. 602. RULEMAKING.

Not later than 1 year after the date of enactment of this Act, the Securities and Exchange Commission shall issue final regulations to implement this title and the amendments made by this title.

Deadline.
15 USC 78j note.

TITLE VII—OUTREACH ON CHANGES TO THE LAW

SEC. 701. OUTREACH BY THE COMMISSION.

The Securities and Exchange Commission shall provide online information and conduct outreach to inform small and medium sized businesses, women owned businesses, veteran owned businesses, and minority owned businesses of the changes made by this Act.

Web posting.
Small business.
Women.
Veterans.
Minorities.
15 USC 78d note.

Approved April 5, 2012.

LEGISLATIVE HISTORY—H.R. 3606:

HOUSE REPORTS: No. 112-406 and Pt. 2 (Comm. on Financial Services).

CONGRESSIONAL RECORD, Vol. 158 (2012):

Mar. 7, 8, considered and passed House.

Mar. 15, 19-22, considered and passed Senate, amended.

Mar. 27, House concurred in Senate amendment.

DAILY COMPILATION OF PRESIDENTIAL DOCUMENTS (2012):

Apr. 5, Presidential remarks.



Appendix B: Alexa Tables

TABLE A: Alexa U.S. and Global Rankings (Data observed 7/17/13)

THEISIS RANK (U.S.)	U.S. RANK	WEBSITE NAME	GLOBAL RANK	THEISIS RANK (GLOBAL)	CROWDFUND SECTOR	NOTES
1	358	www.kickstarter.com	834	1	Reward	
2	1,062	www.indiegogo.com	2,562	2	Donation	For Profit
3	1,522	www.gofundme.com	5,479	3	Donation	For Profit
4	2,978	www.lendingclub.com	13,774	6	Lending	Registered Securities
5	5,660	www.prosper.com	23,206	8	Lending	Registered Securities
6	5,884	www.massivemov.com	763,830	54	Reward	
7	6,133	www.youcaring.com	31,023	9	Donation	Not For Profit
8	6,283	www.angel.co	11,833	4	Equity/Venture	
9	7,129	www.giveforward.com	33,254	10	Donation	For Profit
10	7,206	www.quirky.com	17,169	7	Reward	Invention/Sales
11	7,307	www.kiva.org	13,622	5	Donation	Not For Profit
12	12,405	www.crowdrise.com	46,086	11	Donation	For Profit
13	13,713	www.donorschoose.org	62,816	16	Donation	Not For Profit
14	15,753	www.fundrazr.com	59,047	14	Donation	For Profit
15	17,529	www.razoo.com	56,610	13	Donation	For Profit
16	18,509	www.firstgiving.com	60,207	15	Donation	For Profit
17	19,232	www.rockethub.com	66,903	17	Donation	For Profit
18	20,531	www.fundly.com	76,554	19	Donation	For Profit
19	21,566	www.fundanything.com	67,572	18	Donation	For Profit
20	22,086	www.pledgemusic.com	52,841	12	Donation	For Profit
21	26,084	www.fundable.com	89,150	20	Equity	Hybrid, Reward and equity on a subscription basis
22	27,177	www.rally.org	146,862	23	Donation	For Profit
23	30,659	www.crowdfunder.com	101,037	21	Donation	For Profit
24	39,453	www.crowdfunder.com	134,771	22	Equity	JOBS Act Launch
25	40,692	www.fundraise.com	171,093	24	Donation	For Profit
26	50,758	www.gogetfunding.com	304,031	34	Reward	
27	55,648	www.launcht.com	311,212	35	Services	Crowdfunding platform, portals and campaigns
28	68,112	www.circleup.com	219,180	25	Equity	FINRA REG
29	70,470	www.rockthepost.com	269,166	30	Services	Crowdfunding platform, portals and campaigns Career Investments 3% origination fee and 1.5% fee on payments made to backers
30	79,849	www.pave.com	544,211	48	Equity	
31	81,713	www.fracturedatlas.com	396,720	40	Donation	Not For Profit
32	82,521	www.wefunder.com	286,279	31	Equity/Venture	
33	86,907	www.fundageek.com	381,243	38	Reward	
34	90,531	www.seedinvest.com	411,104	41	Equity/Venture	Venture Capital
35	94,986	www.earlyshares.com	551,307	49	Equity	JOBS Act Launch
36	98,105	www.seedandspark.com	475,213	46	Reward	
37	108,409	www.givezooks.com	390,048	39	Donation	For Profit The reward is a predetermined number of apps that the developer creates
38	109,584	www.appbackr.com	240,453	27	Reward	US based site with completed deals and a functional private placement Reg D Rule 506 model
39	111,843	www.realtymogul.com	360,503	36	Equity/Real Estate	
40	112,906	www.crowdit.com	360,560	37	Reward	
41	114,886	www.microventures.com	291,408	32	Equity/Venture	Lending FINRA registered
42	117,875	www.startsomegood.com	220,500	26	Donation	Not For Profit The only entrant in the Regulation A sector, only in Washington and Virginia
43	120,662	www.fundrise.com	251,340	29	Equity/Real Estate	
44	125,560	www.jumpstartcity.com	768,629	55	Reward	
45	128,119	www.icrowd.com	878,611	56	Equity	JOBS Act Launch
46	133,747	www.solarmosaic.com	431,921	44	Lending	Registered Securities
47	135,094	www.pledgie.com	247,949	28	Donation	Not For Profit
48	160,292	www.peerbackers.com	532,620	47	Reward	
49	167,745	www.equitynet.com	592,671	51	Services	Software for startups and investors
50	175,157	www.microryza.com	450,803	45	Donation	For Profit
51	176,683	www.peerform.com	726,658	53	Lending	Unclear if they are operating or not
52	195,409	www.somolend.com	708,198	52	Lending	Broker/Dealer - Gate Securities
53	200,173	www.opportunity.org	416,952	43	Donation	Not For Profit
54	204,341	www.ibankersdirect.com	969,121	58	Equity	FINRA REG
55	221,850	www.growvc.com	299,996	33	Equity/Venture	
56	262,455	www.invested.in	412,646	42	Services	Crowdfunding platform, portals and campaigns
57	290,562	www.give2gether.com	1,091,775	60	Services	Fundraising application service
58	293,044	www.bolstr.com	1,149,156	61	Services	Legal Framework for small business fund raising
59	344,149	www.realtyshares.com	2,284,811	64	Equity/Real Estate	
60	408,753	www.prodigynetwork.com	931,330	57	Equity/Real Estate	Sells Colombian and US property to non-US investors
61	485,910	www.collaperty.com	1,357,346	62	Equity/Real Estate	
62	611,928	www.primarq.com	2,459,377	66	Equity/Real Estate	"Equity sharing"for homebuyers and homeowners
63	999,999	www.crowdmason.com	2,436,628	65	Equity/Real Estate	
64	999,999	www.fsquare.com	6,372,696	68	Equity/Real Estate	Farmland investing on a sale-leaseback model
65	999,999	www.globorex.com	4,809,977	67	Equity/Real Estate	
66	999,999	www.ifunding.com	9,738,948	69	Equity/Real Estate	

TABLE B - Alexa Rankings by Sector (Data observed 7/17/13)

THESIS RANK (U.S.)	U.S. RANK	WEBSITE NAME	GLOBAL RANK	THESIS RANK (GLOBAL)	CROWDFUND SECTOR	NOTES
2	1,062	www.indiegogo.com	2,562	2	Donation	For Profit
3	1,522	www.gofundme.com	5,479	3	Donation	For Profit
9	7,129	www.giveforward.com	33,254	10	Donation	For Profit
12	12,405	www.crowdrise.com	46,086	11	Donation	For Profit
14	15,753	www.fundrazr.com	59,047	14	Donation	For Profit
15	17,529	www.razoo.com	56,610	13	Donation	For Profit
16	18,509	www.firstgiving.com	60,207	15	Donation	For Profit
17	19,232	www.rockethub.com	66,903	17	Donation	For Profit
18	20,531	www.fundly.com	76,554	19	Donation	For Profit
19	21,566	www.fundanything.com	67,572	18	Donation	For Profit
20	22,086	www.pledgemusic.com	52,841	12	Donation	For Profit
22	27,177	www.rally.org	146,862	23	Donation	For Profit
23	30,659	www.crowdtilt.com	101,037	21	Donation	For Profit
25	40,692	www.fundraise.com	171,093	24	Donation	For Profit
37	108,409	www.givezooks.com	390,048	39	Donation	For Profit
50	175,157	www.microriza.com	450,803	45	Donation	For Profit
7	6,133	www.youcaring.com	31,023	9	Donation	Not For Profit
11	7,307	www.kiva.org	13,622	5	Donation	Not For Profit
13	13,713	www.donorschoose.org	62,816	16	Donation	Not For Profit
31	81,713	www.fracturedatlas.com	396,720	40	Donation	Not For Profit
42	117,875	www.startsomegood.com	220,500	26	Donation	Not For Profit
47	135,094	www.pledge.com	247,949	28	Donation	Not For Profit
53	200,173	www.opportunity.org	416,952	43	Donation	Not For Profit
21	26,084	www.fundable.com	89,150	20	Equity	Hybrid, Reward and equity on a subscription basis
24	39,453	www.crowdfunder.com	134,771	22	Equity	JOBS Act Launch
28	68,112	www.circleup.com	219,180	25	Equity	FINRA REG
30	79,849	www.pave.com	544,211	48	Equity	Career Investments 3% origination fee and 1.5% fee on payments made to backers
35	94,986	www.earlyshares.com	551,307	49	Equity	JOBS Act Launch
45	128,119	www.icrowd.com	878,611	56	Equity	JOBS Act Launch
54	204,341	www.ibankersdirect.com	969,121	58	Equity	FINRA REG
39	111,843	www.realtymogul.com	360,503	36	Equity/Real Estate	US based site with completed deals and a functional private placement Reg D Rule 506 model
43	120,662	www.fundrise.com	251,340	29	Equity/Real Estate	The only entrant in the Regulation A sector, only in Washington and Virginia
59	344,149	www.realtyshares.com	2,284,811	64	Equity/Real Estate	
60	408,753	www.prodigynetwork.com	931,330	57	Equity/Real Estate	Sells Colombian and US property to non-US investors
61	485,910	www.collaperty.com	1,357,346	62	Equity/Real Estate	
62	611,928	www.primarq.com	2,459,377	66	Equity/Real Estate	"Equity sharing" for homebuyers and homeowners
63	999,999	www.crowdmason.com	2,436,628	65	Equity/Real Estate	
64	999,999	www.fsquare.com	6,372,696	68	Equity/Real Estate	Farmland investing on a sale-leaseback model
65	999,999	www.globere.com	4,809,977	67	Equity/Real Estate	
66	999,999	www.ifunding.com	9,738,948	69	Equity/Real Estate	
8	6,283	www.angel.co	11,833	4	Equity/Venture	
32	82,521	www.wefunder.com	286,279	31	Equity/Venture	
34	90,531	www.seedinvest.com	411,104	41	Equity/Venture	Venture Capital
41	114,886	www.microventures.com	291,408	32	Equity/Venture	Lending FINRA registered
55	221,850	www.growvc.com	299,996	33	Equity/Venture	
4	2,978	www.lendingclub.com	13,774	6	Lending	Registered Securities
46	133,747	www.solarmosaic.com	431,921	44	Lending	Registered Securities
51	176,683	www.peerform.com	726,658	53	Lending	Unclear if they are operating or not
52	195,409	www.somolend.com	708,198	52	Lending	Broker/Dealer - Gate Securities
5	5,660	www.prosper.com	23,206	8	Lending	Registered Securities
1	358	www.kickstarter.com	834	1	Reward	
6	5,884	www.massivemov.com	763,830	54	Reward	
10	7,206	www.quirky.com	17,169	7	Reward	Invention/Sales
26	50,758	www.gogetfunding.com	304,031	34	Reward	
33	86,907	www.fundageek.com	381,243	38	Reward	
36	98,105	www.seedandspark.com	475,213	46	Reward	
38	109,584	www.appbackr.com	240,453	27	Reward	The reward is a predetermined number of apps that the developer creates
40	112,906	www.crowdit.com	360,560	37	Reward	
44	125,560	www.jumpstartcity.com	768,629	55	Reward	
48	160,292	www.peerbackers.com	532,620	47	Reward	
27	55,648	www.launcht.com	311,212	35	Services	Crowdfunding platform, portals and campaigns
29	70,470	www.rockthepost.com	269,166	30	Services	Crowdfunding platform, portals and campaigns
56	262,455	www.invested.in	412,646	42	Services	Crowdfunding platform, portals and campaigns
57	290,562	www.give2gether.com	1,091,775	60	Services	Fundraising application service
58	293,044	www.bolstr.com	1,149,156	61	Services	Legal Framework for small business fund raising
49	167,745	www.equitynet.com	592,671	51	Services	Software for startups and investors

Appendix C: Survey Questions

The screenshot shows a web browser window displaying the SurveyMonkey interface. The page title is 'Thesis Survey'. At the top, there are three tabs: 'Design Survey', 'Collect Responses', and 'Analyze Results'. Below the tabs, a message states: 'Below is a list of the collectors you are currently using to collect responses. To view the details or change the properties of an existing collector, just click the name. To collect more responses for this survey from a different group of people, click "Add New Collector".' There is a '+ Add Collector' button on the right.

A light green banner with the text: 'NEW Buy a Targeted Audience: Need a specific group of people to take your survey? We can help. Learn more >' is visible.

Collector Name (Method)	Status	Responses	Date Modified	Actions
MIT Faculty (Web Link)	● CLOSED	1 response	July 8, 2013 9:52 AM	Edit Clear Delete
MIT Sloan Real Estate Club (Web Link)	● CLOSED	14 responses	July 8, 2013 9:53 AM	Edit Clear Delete
Twitter (Web Link)	● CLOSED	0 responses	July 8, 2013 9:53 AM	Edit Clear Delete
MSRED Class - Thesis Survey (Web Link)	● CLOSED	4 responses	July 8, 2013 9:53 AM	Edit Clear Delete
Bonnie's Contacts - Thesis Survey (Web Link)	● CLOSED	20 responses	July 8, 2013 9:54 AM	Edit Clear Delete
John's Contacts - Thesis Survey (Web Link)	● CLOSED	0 responses	July 8, 2013 9:54 AM	Edit Clear Delete
Facebook Thesis Survey Link (Web Link)	● CLOSED	10 responses	July 8, 2013 9:54 AM	Edit Clear Delete
LinkedIn Thesis Survey (Web Link)	● CLOSED	6 responses	July 8, 2013 9:54 AM	Edit Clear Delete
MIT Alumni Thesis Survey Web Link (Web Link)	● CLOSED	120 responses	July 8, 2013 9:54 AM	Edit Clear Delete

The Windows taskbar at the bottom shows the system clock as 12:54 PM on 7/8/2013, along with various application icons.

CONSENT STATEMENT

***1. You have been asked to participate in a research study conducted by John McDonald and Bonnie Burgett from the Center for Real Estate at the Massachusetts Institute of Technology (M.I.T.). The purpose of the study is to evaluate the potential impact of the JOBS Act, crowdfunding, and internet platforms on specific real estate asset sectors and investment. The results of this study will be included in Bonnie Burgett and John McDonald's Masters thesis. You were selected as a possible participant in this study because you are a professional in the real estate industry whose opinions and knowledge of this field are deemed to be accretive to writing our thesis. You should read the information below, and ask questions about anything you do not understand, before deciding whether or not to participate.**

- **This survey is voluntary. You have the right not to answer any question, and to stop the survey at any time or for any reason. We expect that the survey will take about 10 minutes.**
- **You will not be compensated for this survey.**
- **The results of this survey will be collected anonymously and kept confidential.**
- **Unless you give us permission to use your name, title, and / or quote you in any publications that may result from this research, the information you tell us will be confidential.**
- **This project will be completed by August 15, 2013. All survey answers will be stored in a secure work space until 1 year after that date. The results will then be destroyed.**

Please contact us with any questions or concerns:

Bonnie Burgett, bburgett@mit.edu, 214-794-0306

John McDonald, jmac57@mit.edu, 646-207-7124

If you feel you have been treated unfairly, or you have questions regarding your rights as a research subject, you may contact the Chairman of the Committee on the Use of Humans as Experimental Subjects, M.I.T., Room E25-143b, 77 Massachusetts Ave., Cambridge, MA 02139, phone 1-617-253-6787.

By selecting "yes" below you acknowledge that you understand the procedures described above, and that all questions have been answered to your satisfaction, and you agree to participate in this study.

Yes

No

Participant Type

2. Please select the appropriate survey to take.

- Developer or Deal Sponsor (i.e. General Partner)
- Investor (i.e. PE Fund that places money with other RE firms)
- Both - Participates in the Real Estate industry in both sponsor and investor capacities

Internet Background - Sponsor

3. Check all that apply. Which social media outlets do you actively use for business purposes (i.e. finding real estate development deals or firms for investment)?

- Facebook
- Myspace
- Blogs
- LinkedIn
- Meetup
- Responding to Direct Email Solicitations
- Twitter
- Weibo
- General Internet Searches
- Google Circle/Google Plus
- Plaxo
- Other (please specify)

4. Rate how important the internet is to providing business connections and information used for real estate investment purposes.

Not Important Minimal Impact Neutral Important Crucial

Internet Background Continued - Sponsor

5. Have you heard of Auction.com?

- Yes
- No

6. If yes, have you (or your firm) purchased property or bid via Auction.com or would you use Auction.com?

- Yes - I have purchased property/notes on Auction.com
- Yes - I have bid on property/notes on Auction.com
- Yes - I am interested in Auction.com for the future
- No - I would not use this site.
- N/A

Crowdfunding Background - Sponsor

7. Did you know what "crowdfunding" was prior to receiving this survey request?

- Yes
- No
- Unsure

8. Have you heard of these sites?

	Yes	No
Kickstarter.com	<input type="radio"/>	<input type="radio"/>
Kiva.org	<input type="radio"/>	<input type="radio"/>
Prosper.com	<input type="radio"/>	<input type="radio"/>

Crowdfunding for Real Estate - Sponsor

9. Have you heard of these sites?

	Yes	No
Fundrise.com	<input type="radio"/>	<input type="radio"/>
Collaperty.com	<input type="radio"/>	<input type="radio"/>
RealtyMogul.com	<input type="radio"/>	<input type="radio"/>

10. If yes, have you (or your firm) used or would you use any of these sites?

- Yes - I have used one of these platforms
- Yes - I plan on using one in the future
- No - I do not plan on using them
- N/A

Real Estate Capital Info. - Sponsor

The information gathered in this section is for the purpose of evaluating the market's need for easier methods of raising capital for real estate development or investment deals.

11. Estimate how many real estate deals you or your firm have lost due to a funding gap or hurdle to raising money.

- None
- Less than 5 deals in last 5 years
- 5 to 10 deals in the last 5 years
- 10 or more deals in the last 5 years

Other Comments (Optional)

12. If, none or less than 5, did you have to raise mezzanine debt to complete the capital stack for deals you were able to complete?

- Yes
- No
- N/A
- Other (please specify)

Real Estate Capital Info. Continued - Sponsor

The information gathered in this section is for the purpose of evaluating the market's need for easier methods of raising capital for real estate development or investment deals.

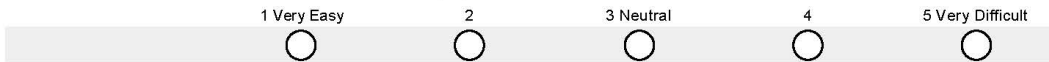
13. Have you used a third party to raise EQUITY in the last 5 years? (ex. HFF)

- Yes
- No
- Other (please specify)

14. Have you used a third party to raise DEBT in the last 5 years? (ex. mortgage broker)

- Yes
- No
- Other (please specify)

15. Rate how difficult it is to find NEW, qualified investors for real estate deals:



Other (please feel free to add any additional comments)

Willingness to Raise Equity Over the Internet - Sponsor

16. Rate your willingness to raise equity solely using the internet.

Never!	Highly Unlikely	Unlikely	Doubtful, but Curious	Not Sure	Interested in Learning More	Possibly	Likely to in the Future	Very Likely to in the Future	Absolutely or Do Already
<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Platform Qualities - Sponsor

17. Rank the importance of these platform qualities and/or attributes that an internet based investment site should have (with 1 as the most important and 5 as the least important).

Note: The answers automatically re-order as you rank them.

<input type="text"/>	a. Deal sponsor background check (criminal & credit only)
<input type="text"/>	b. Online project due diligence for investors
<input type="text"/>	c. Deal sponsor track record, investor ratings, resume
<input type="text"/>	d. Ability to receive money and manage investors online
<input type="text"/>	e. On-going project & sponsor monitoring by website

18. Rate your willingness to raise equity on the internet if the site was a legitimate platform that vetted all deals and sponsors and provided deal sponsor services such as investor funding management.

Never!	Highly Unlikely	Unlikely	Doubtful, but Curious	Not Sure	Interested in Learning More	Possibly	Likely to in the Future	Very Likely to in the Future	Absolutely or Already Do
<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

19. Optional: Please list any additional concerns you would have with using an online capital raising platform or any additional services or qualities you would want this platform to have.

Company/Work Background - Sponsor

The questions on this page and the following investment pages are designed to correlate investor or deal sponsor qualities and investment profiles with knowledge and usage of current real estate internet platforms and view of raising capital over the internet. Survey answers are anonymous.

20. What is the job title for your current position?

21. Is your company public or private?

- Public
- Private

22. About how many employees work at your company?

- 0 - 5
- 6 - 10
- 10 - 25
- 25 - 50
- 50 - 100
- 100 - 200
- 200 - 500
- 500 +

Investing Background - Company - Sponsor

The questions on this page and the following investment pages are designed to correlate investor or deal sponsor qualities and investment profiles with knowledge and usage of current real estate internet platforms and view of raising capital over the internet. Survey answers are anonymous.

23. Which best describes the volume of development or commercial real estate acquisitions your company has made over the last 5 years?

- \$0 to \$1 Million
- \$1 Million to \$5 Million
- \$5 Million to \$10 Million
- \$10 Million to \$20 Million
- \$20 Million +
- Other (please feel free to give more detail if you want)

24. Check all that apply. Which ways do you or your firm fund real estate acquisitions or developments?

- | | |
|---|--|
| <input type="checkbox"/> CMBS Debt Financing | <input type="checkbox"/> RE Private Equity Funds |
| <input type="checkbox"/> Traditional Bank or On-Balance Sheet Lending | <input type="checkbox"/> Personal Equity Funds |
| <input type="checkbox"/> Private Lending | <input type="checkbox"/> EB5 Funds |
| <input type="checkbox"/> REIT Funds | |
| <input type="checkbox"/> Other (please specify) | |

Internet Background - Investor

25. Check all that apply. Which social media outlets do you actively use for business purposes (i.e. finding real estate development deals or firms for investment)?

- | | | |
|--|----------------------------------|---|
| <input type="checkbox"/> Facebook | <input type="checkbox"/> Myspace | <input type="checkbox"/> Blogs |
| <input type="checkbox"/> LinkedIn | <input type="checkbox"/> Meetup | <input type="checkbox"/> Responding to Direct Email Solicitations |
| <input type="checkbox"/> Twitter | <input type="checkbox"/> Weibo | <input type="checkbox"/> General Internet Searches |
| <input type="checkbox"/> Google Circle/Google Plus | <input type="checkbox"/> Plaxo | |
| <input type="checkbox"/> Other (please specify) | | |

26. Rate how important the internet is to providing business connections and information used for real estate investment purposes.

Not Important Minimal Impact Neutral Important Crucial

Internet Background Continued - Investor

27. Have you heard of Auction.com?

- Yes
- No

28. If yes, have you (or your firm) purchased property or bid via Auction.com or would you use Auction.com?

- Yes - I have purchased property/notes on Auction.com
- Yes - I have bid on property/notes on Auction.com
- Yes - I am interested in Auction.com for the future
- No - I would not use this site.
- N/A

Crowdfunding Background - Investor

29. Did you know what "crowdfunding" was prior to receiving this survey request?

- Yes
- No
- Unsure

30. Have you heard of these sites?

	Yes	No
Kickstarter.com	<input type="radio"/>	<input type="radio"/>
Kiva.org	<input type="radio"/>	<input type="radio"/>
Prosper.com	<input type="radio"/>	<input type="radio"/>

Crowdfunding for Real Estate - Investor

31. Have you heard of these sites?

	Yes	No
Fundrise.com	<input type="radio"/>	<input type="radio"/>
Collaperty.com	<input type="radio"/>	<input type="radio"/>
RealtyMogul.com	<input type="radio"/>	<input type="radio"/>

32. If yes, have you (or your firm) used or would you use any of these sites?

- Yes - I have used one of these platforms to invest in a real estate deal
- Yes - I plan on using one of them in the future
- No - I do not plan on using them
- N/A

Real Estate Deal Sourcing - Investor

33. Rate how difficult it is to find new, qualified real estate investment opportunities:

1 Very Easy 2 3 Neutral 4 5 Very Difficult

Other (please feel free to add any additional comments)

Willingness to Invest Equity Over the Internet - Investor

34. Rate your willingness to invest in real estate solely using the internet.

Never! Highly Unlikely Unlikely Doubtful, but Curious Not Sure Interested in Learning More Possibly Likely to in the Future Very Likely to in the Future Absolutely or Do Already

Platform Qualities - Investor

35. Rank the importance of these platform qualities and/or attributes that an internet based investment site should have (with 1 as the most important and 5 as the least important).

Note: The responses automatically re-order as you rank them.

a. Deal sponsor background check (criminal & credit only)

b. Available site and project information and due diligence

c. Deal sponsor track record, ratings, & resume

d. Easy of investing electronically

e. On-going project & sponsor monitoring by website

36. Rate your willingness to invest in a private real estate deal that you found on the internet if the site was a legitimate platform that vetted all deals and sponsors and monitored the deal's progress.

Never! Highly Unlikely Unlikely Doubtful, but Curious Not Sure Interested in Learning More Possibly Likely to in the Future Very Likely to in the Future Absolutely or Already Do

37. Optional: Please list any additional concerns you would have with using an online investment portal or any additional services or qualities you would want this platform to have.

Company/Work Background - Investor

The questions on this page and the following investment pages are designed to correlate investor qualities and investment profiles with knowledge and usage of current real estate platforms as well as opinions on investing over the internet. Survey answers are anonymous.

38. What is the job title for your current position?

39. Is your company public or private?

- Public
 Private

40. About how many employees work at your company?

- 0 - 5
 6 - 10
 10 - 25
 25 - 50
 50 - 100
 100 - 200
 200 - 500
 500 +

Investing Background - Company - Investor

The questions on this page and the following investment pages are designed to correlate investor qualities and investment profiles with knowledge and usage of current real estate platforms as well as opinions on investing over the internet. Survey answers are anonymous.

41. Which category best describes the level of equity has your company invested in private commercial real estate over the last 5 years?

- \$0 to \$1 Million
- \$1 Million to \$5 Million
- \$5 Million to \$10 Million
- \$10 Million to \$20 Million
- \$20 Million +
- Other (please feel free to give more detail if you want)

42. Check all that apply. Which ways do you currently invest in real estate?

- CMBS or RMBS Bond Purchases
- REIT Shares
- RE Private Equity Funds
- Other (please specify)
- Directly – Equity Investment in Joint Venture
- Private Lending

Internet Background - Both

43. Check all that apply. Which social media outlets do you actively use for business purposes (i.e. finding real estate development deals or firms for investment)?

- Facebook
- LinkedIn
- Twitter
- Google Circle/Google Plus
- Myspace
- Meetup
- Weibo
- Plaxo
- Blogs
- Responding to Direct Email Solicitations
- General Internet Searches
- Other (please specify)

44. Rate how important the internet is to providing business connections and information used for real estate investment purposes.

Not Important Minimal Impact Neutral Important Crucial

Internet Background Continued - Both

45. Have you heard of Auction.com?

- Yes
- No

46. If yes, have you (or your firm) purchased property or bid via Auction.com or would you use Auction.com?

- Yes - I have purchased property/notes on Auction.com
- Yes - I have bid on property/notes on Auction.com
- Yes - I am interested in Auction.com for the future
- No - I would not use this site.
- N/A

Crowdfunding Background - Both

47. Did you know what "crowdfunding" was prior to receiving this survey request?

- Yes
- No
- Unsure

48. Have you heard of these sites?

	Yes	No
Kickstarter.com	<input type="radio"/>	<input type="radio"/>
Kiva.org	<input type="radio"/>	<input type="radio"/>
Prosper.com	<input type="radio"/>	<input type="radio"/>

Crowdfunding for Real Estate - Both

49. Have you heard of these sites?

	Yes	No
Fundrise.com	<input type="radio"/>	<input type="radio"/>
Collaperty.com	<input type="radio"/>	<input type="radio"/>
RealtyMogul.com	<input type="radio"/>	<input type="radio"/>

50. If yes, have you (or your firm) used or would you use any of these sites?

- Yes - I have used one of these platforms
- Yes - I plan on using one of them in the future
- No - I do not plan on using them
- N/A

Real Estate Capital Info. - Both

The information gathered in this section is for the purpose of evaluating the market's need for easier methods of raising capital for real estate development or investment deals.

51. Estimate how many real estate deals you or your firm have lost due to a funding gap or hurdle to raising money.

- None
- Less than 5 deals in last 5 years
- 5 to 10 deals in the last 5 years
- 10 or more deals in the last 5 years

Other Comments (Optional)

52. If, none or less than 5, did you have to raise mezzanine debt to complete the capital stack for deals you were able to complete?

- Yes
- No
- N/A
- Other (please specify)

Real Estate Capital Info. Continued - Both

The information gathered in this section is for the purpose of evaluating the market's need for easier methods of raising capital for real estate development or investment deals.

53. Have you used a third party to raise EQUITY in the last 5 years? (ex. HFF)

- Yes
- No
- Other (please specify)

54. Have you used a third party to raise DEBT in the last 5 years? (ex. mortgage broker)

- Yes
- No
- Other (please specify)

55. Rate how difficult it is to find NEW, qualified investors for real estate deals:

1 Very Easy 2 3 Neutral 4 5 Very Difficult

Other (please feel free to add any additional comments)

56. Rate how difficult it is to find new, qualified real estate investment opportunities:

1 Very Easy 2 3 Neutral 4 5 Very Difficult

Other (please feel free to add any additional comments)

Willingness to Raise Equity or Invest Over the Internet - Both

57. Rate your willingness to RAISE equity solely using the internet.

Never! Highly Unlikely Unlikely Doubtful, but Curious Not Sure Interested in Learning More Possibly Likely to in the Future Very Likely to in the Future Absolutely or Do Already

58. Rate your willingness to INVEST equity solely using the internet.

Never! Highly Unlikely Unlikely Doubtful, but Curious Not Sure Interested in Learning More Possibly Likely to in the Future Very Likely to in the Future Absolutely or Do Already

Platform Qualities - Both

59. Rank the importance of these platform qualities and/or attributes that an internet based investment site should have (with 1 as the most important and 5 as the least important).

Note: Answers automatically re-order as you rank them.

<input type="text"/>	a. Deal sponsor background check (criminal & credit only)
<input type="text"/>	b. Online project due diligence for investors
<input type="text"/>	c. Deal sponsor track record, investor ratings, resume
<input type="text"/>	d. Ability to receive money and manage investors online
<input type="text"/>	e. On-going project & sponsor monitoring by website
<input type="text"/>	f. Easy of investing electronically

60. Rate your willingness to RAISE equity on the internet if the site was a legitimate platform that vetted all deals and sponsors, and provided deal sponsor services such as investor funding management.

Never!	Highly Unlikely	Unlikely	Doubtful, but Curious	Not Sure	Interested in Learning More	Possibly	Likely to in the Future	Very Likely to in the Future	Absolutely or Already Do
<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

61. Rate your willingness to INVEST equity on the internet if the site was a legitimate platform that vetted all deals and sponsors, and monitored the deal's progress.

Never!	Highly Unlikely	Unlikely	Doubtful, but Curious	Not Sure	Interested in Learning More	Possibly	Likely to in the Future	Very Likely to in the Future	Absolutely or Already Do
<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

62. Optional: Please list any additional concerns you would have with using an online capital raising platform or any additional services or qualities you would want this platform to have.

Company/Work Background - Both

The questions on this page and the following investment pages are designed to correlate investor or deal sponsor qualities and investment profiles with knowledge and usage of current real estate internet platforms and view of raising capital over the internet. Survey answers are anonymous.

63. What is the job title for your current position?

64. Is your company public or private?

- Public
- Private

65. About how many employees work at your company?

- 0 - 5
- 6 - 10
- 10 - 25
- 25 - 50
- 50 - 100
- 100 - 200
- 200 - 500
- 500 +

Investing Background - Company - Both

The questions on this page and the following investment pages are designed to correlate investor or deal sponsor qualities and investment profiles with knowledge and usage of current real estate internet platforms and view of raising capital over the internet. Survey answers are anonymous.

66. Which best describes the volume of development or commercial real estate investment your company has made over the last 5 years?

- \$0 to \$1 Million
- \$1 Million to \$5 Million
- \$5 Million to \$10 Million
- \$10 Million to \$20 Million
- \$20 Million +
- Other (please feel free to give more detail if you want)

67. Check all that apply. Which ways do you or your firm fund real estate acquisitions or developments?

- | | |
|---|--|
| <input type="checkbox"/> CMBS Debt Financing | <input type="checkbox"/> RE Private Equity Funds |
| <input type="checkbox"/> Traditional Bank or On-Balance Sheet Lending | <input type="checkbox"/> Personal Equity Funds |
| <input type="checkbox"/> Private Lending | <input type="checkbox"/> EB5 |
| <input type="checkbox"/> REIT Funds | |
| <input type="checkbox"/> Other (please specify) | |

68. Check all that apply. Which ways do you currently invest in real estate?

- | | |
|--|--|
| <input type="checkbox"/> CMBS or RMBS Bond Purchases | <input type="checkbox"/> Directly – Equity Investment in Joint Venture |
| <input type="checkbox"/> REIT Shares | <input type="checkbox"/> Private Lending |
| <input type="checkbox"/> RE Private Equity Funds | |
| <input type="checkbox"/> Other (please specify) | |

Investment Criteria - ALL

The questions on this page and the following investment pages are designed to correlate investor or deal sponsor qualities and investment profiles with knowledge and usage of current real estate internet platforms and view of raising capital over the internet. Survey answers are anonymous.

69. Please select all property types that you develop or actively purchase:

- | | |
|--|--|
| <input type="checkbox"/> CBD Office | <input type="checkbox"/> Full Service Hotels |
| <input type="checkbox"/> Suburban Office | <input type="checkbox"/> Residential (single family, multifamily <4 units) |
| <input type="checkbox"/> Retail Shopping Centers | <input type="checkbox"/> Multifamily (>4 units per bldg) |
| <input type="checkbox"/> Malls | <input type="checkbox"/> Industrial |
| <input type="checkbox"/> Limited Service Hotels/Motels | <input type="checkbox"/> Land |
| <input type="checkbox"/> Other (please specify) | |

70. Please select which regions you acquire property in:

- | | |
|---|--|
| <input type="checkbox"/> New England (CT, ME, MA, NH, RI, VT) | <input type="checkbox"/> Southwest (AZ, NM, OK, TX) |
| <input type="checkbox"/> Mideast (DE, DC, MD, NJ, NY, PA) | <input type="checkbox"/> Rocky Mountain (CO, ID, MT, UT, WY) |
| <input type="checkbox"/> Great Lakes (IL, IN, MI, OH, WI) | <input type="checkbox"/> West (AK, CA, HI, NV, OR, WA) |
| <input type="checkbox"/> Plains (IA, KS, MN, MO, NE, ND, SD) | <input type="checkbox"/> Internationally |
| <input type="checkbox"/> Southeast (AL, AR, FL, GA, KY, LA, MS, NC, SC, TN, VA, WV) | |

71. Optional: Give any additional information that would describe the type of real estate development or investment either you or your firm engage in.

Investing Background - Personal - ALL

The questions on this page is designed to correlate investor or deal sponsor qualities and investment profiles with knowledge and usage of current real estate internet platforms and view of raising capital over the internet. Survey answers are anonymous.

72. Are you an accredited investor?

- Yes
 No
 Don't Know

Demographic Info - ALL

Demographics will be used to correlate age and location with current internet usage in the real estate industry and willingness to use the internet to raise equity. Survey answers are anonymous.

73. What city and state do you currently live in?

74. Which category below includes your age?

- 17 or younger
 18-20
 21-29
 30-39
 40-49
 50-59
 60 or older

Thank you!!!

75. Thank you so much for taking this survey. We greatly appreciate your feedback.

We invite you to add any additional information below that may assist us in understanding your development strategy or business. Most importantly, please feel free to add your thoughts on the internet and its impact commercial real estate as well as the crowdfunding phenomenon.

Please feel free to contact us if you have any questions we can answer and/or if you would be open to being interviewed further.

Bonnie Burgett, bburgett@mit.edu, 214-794-0306

or

John McDonald, jmac57@mit.edu, 646-207-7124

Please remember to press DONE below to submit your answers. Thank you!

Appendix D: Example of LinkedIn Usage for Commercial Real Estate

7/23/13

Gmail - [4] discussions on LinkedIn



Bonnie Burgett <bburgett@gmail.com>

[4] discussions on LinkedIn

1 message

Dallas Real Estate Professionals Group Members <group-digests@linkedin.com> Tue, Jul 23, 2013 at 9:05 AM
To: Bonnie Burgett <bburgett@gmail.com>

Dallas Real Estate Professionals



DREP July 23, 2013

New Discussions (4)

Real Estate Investment Property

Started by Nick Battisto, Disposition Associate at New Western Acquisitions

Like · Flag

Are you looking for heavily discounted wholesale properties throughout the DFW AREA. Sign up for our buyers list below. <http://e8.octadyne.net/guest/homewoodproperties>

Started by Randy Quay, President / Owner of Homewood Properties, Inc.

Like · Flag

Are you looking for heavily discounted wholesale properties throughout the DFW AREA. Sign up for our buyers list below. <http://e8.octadyne.net/guest/homewoodproperties>

Started by Randy Quay, President / Owner of Homewood Properties, Inc.

Like · Flag

A "Secret Sentence" you can use to land more job interviews and job offers?

Started by Londa Poche, Manager

Like · Flag

Stop inappropriate content the moment it is posted. [Send me an email for each new discussion](#) »
Do you know anybody that might like this group? [Invite others to join](#) »

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This email was intended for Bonnie Burgett (Real Estate Professional). [Learn why we included this.](#) © 2013, LinkedIn Corporation. 2029 Stierlin Ct. Mountain View, CA 94043, USA

Appendix E: Fquare Landing Page Changes

July 4, 2013 - 11:39 AM EST

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Agricultural Investments

Where **50 and counting** agricultural investors equity crowdfund the purchase of active commercial grain farms.

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3 Year Hold 4% Fixed Yield Plus Capital Appreciation	5 Year Hold 5% Fixed Yield Plus Capital Appreciation	7 Year Hold 6% Fixed Yield Plus Capital Appreciation	Secure Loans 10%-12% Fixed Yields Distressed Debt Loans
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Diversification does not ensure a profit or protect against loss in declining markets.

Past performance is no guarantee of future results.

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July 11, 2013

Agricultural Investments

Where **51 and counting** agricultural investors equity crowdfund the purchase of active commercial grain farms.

[OPEN AN ACCOUNT](#)

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Equity crowdfunding for Agricultural Investors	Up to 6% yields	Diversified investment portfolios	Fixed-life investments
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