Real Estate Crowdfunding 2.0 – Solving Key Issues

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Introduction: The Financial Crisis Leads to Rise of Alternative Lenders

Capital markets have traditionally been controlled by institutional investors who represent the interests of pension funds, endowments, and closed networks of the wealthiest investors. Every week billions of dollars are exchanged between a few enormous institutions that largely determine the way the financial markets work.

However, the 2008 financial crisis greatly contributed to the growing demand for viable alternatives to the traditional banking system. After the meltdown, the government put several regulations into place mandating that financial institutions hold more cash on their balance sheets, which meant that banks had to severely cut back on lending. As the economic outlook improved, borrowers searched for capital that did not exist.

The shortage of viable funding in tandem with a fundamental shift in consumer willingness to engage in online transactions led to the rise of the peer-to-peer lending space, where individual investors provide financing directly to borrowers. The one-to-one lending model quickly evolved into investment crowdfunding, where individuals pool funds together to make up larger loans.

In the past three years, the maturation of online investment platforms has spread towards the real estate market with the advent of real estate crowdfunding platforms. These platforms increased the ability of companies to leverage the power of the Internet and the crowd to raise capital for development projects.

To be clear, this article does not use the term "crowdfunding" to be limited to securities offerings conducted pursuant to Title III of the Jumpstart Our Business Startups (JOBS) Act, as those rules have not been adopted, and the term "crowdfunding" existed long before the Congress adopted the JOBS Act. Rather, this article uses the term "crowdfunding" to mean the online syndication of investments to a group of investors who did not have access (whether

through regulatory burdens, high investment minimums or other reasons) to such investments in the past.

Funding Models

The regulatory landscape for raising capital online via the crowd is quite limited and restricts who can invest and how funds can be raised. Though a great deal of national attention has been given to the JOBS Act and its potential impact on the world of private fundraising, Regulation Crowdfunding does nott exist and, to date, the bill has had almost zero effect on the industry.

In addition, the costs and restrictions placed by Congress in Title III of the JOBS Act, when viewed against the maximum potential raise of $1 million, virtually ensures that only the most desperate of companies will undertake an offering. The result is that the riskiest investments will be forced into the arena with the least sophisticated and financially stable, and therefore most vulnerable, investors.

Furthermore, while the recently adopted Regulation A+ by ??? holds promise as a result of the higher maximum amounts and preemption of state securities law, it is too early to tell if it will end up being viewed similarly to its predecessor -- too burdensome because of the lengthy and expensive filing and reporting required. There is also some intrastate movement, but the fundraising limits (usually $1M) mean that its utility is extremely limited in real estate development or any other capital-intensive business. In addition, relying on Section 3(a)(11) and Rule 147 of the Securities Act in conducting an intrastate securities offering subjects issuers to great regulatory uncertainty, as the SEC's recent guidance has been inconsistent with past practice at best, and impracticable at worst. Even more worrisome, depending on how the state exemption is written, and how the SEC chooses to interpret Section 3(a)(11), inadvertently allowing even a single non-state resident to invest in an intrastate offering (even if as a result of fraud on the part of such investor) could cause a cascade of securities law violations on both the federal and state level.

The most widespread investment crowdfunding model utilized today is in fact the oldest.The legal underpinnings of almost all investment crowdfunding platforms rely on the federal

exemption contained in Rule 506(b) of the Securities Act, and on the *IPONet* and *Lamp Technologies* no-action letters – both of which are almost 20 years old. It took decades of e-commerce and E*Trade accounts for investors to become comfortable investing in the same manner in which they order books – online.

However, the Rule 506(b) model has its own limitations – namely that it is restricted solely to accredited investors and prohibits general solicitation, thus greatly reducing potential virality.

The only viable tool for building a truly open, online investment platform available to unaccredited investors is to register a marketplace lending prospectus with the SEC. However, since consumer debt platforms Lending Club and Prosper received approval in 2008 and 2009, respectively, the SEC has refused to declare a single, additional marketplace lending prospectus effective, in the consumer debt space or otherwise, thus effectively granting a regulatory monopoly in marketplace lending to these two companies. While there are some interesting theories floating around as to why the SEC has not cleared any other marketplace lending registration statements, the SEC has never spoken publicly on why it has allowed these monopolies to develop.

Problems with Traditional "Crowdfunding"

Though real estate investment crowdfunding has received a lot of attention, particularly from the media, since its wide-scale emergence in 2012, there are a few fundamental problems with the model as it is generally employed.

<u>No Certainty of Closing for Sponsors</u>

Real estate crowdfunding platforms have historically operated according to a "traditional" model, where the amount of funding is unknown and not guaranteed. It is often hard to predict how quickly the crowd will fund a project or whether they will be interested at all. In fact, according to donation-based crowdfunding company Kickstarter, approximately 60% of all of the projects on its platform fail to receive funding.