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HOT TOPIC ALERT

Real Estate Crowdfunding

"Crowdfunding" is a term much in vogue recently. Traditional lending sources are bypassed with crowdfunded projects, allowing individual investors to directly evaluate a proposal based on their own criteria or financial interests. The system has populist appeal: in theory, crowdfunding enables those who would otherwise be denied access to capital to move forward with a crowdfunded platform.

The theory may have some validity, crowdfunding is a significant business model in today's economy. Crowdfunding investment solicitations are often directed towards individuals without a high net worth or large disposable income. Those investors are attracted by the low minimum investment, and the low fees charged by intermediaries. Often investors are motivated to invest in projects within their community or products they personally believe will succeed.

What is "crowdfunding?" Merriam-Webster defines the term as "the practice of soliciting financial contributions from a large number of people especially from the online community." The contributions are solicited through a third party, known as a platform, which charges a percentage of the funds collected as a fee. Some of the better known crowdfunding platforms include Kickstarter, IndieGoGo, and MicroVentures. Crowdfunding is popular in artistic communities, with performers, composers, and writers all seeking financial support for their projects. Even independent bookstores have turned to crowdfunding as a way to keep their businesses operating in the face of much bigger competition.

There are four main types of crowdfunding:

1. Donation based, in which donations are solicited without anything offered or expected in return. The popular fund-raising site GoFundMe is an example of this type of crowdfunding.
2. Rewards based, in which a contributor receives a varying level of reward, according to the amount contributed. The reward might be a product that will be produced in the future using crowdfunding capital.
3. Debt based, in which the investments are loans to be repaid with interest. Debt based crowdfunding is used by many start-ups.
4. Equity based, in which the investor receives a stake of the company that is soliciting funds.

Inevitably, crowdfunding grew to encompass real estate finance. The idea spread quickly: one estimate is that the number of real estate crowdfunding platforms went from 10 in 2013 to 75 by January of 2015. Another estimate is that there are over 100 self-described real estate crowdfunding sites (although the author of that piece notes that some crowdfunding sites may be "old-school real estate broker sites in disguise."). Enthusiasts claim that crowdfunding has brought benefits not only for investors but also for real estate companies and for the real estate market as a whole.

Proponents claim that crowdfunding opens up the real estate investment market. Potential investors are able to locate and research multiple investment opportunities on their own. In addition, real estate crowdfunding platforms often require small investments by participants. Many platforms allow participants to put up as little as $1,000. And one platform, Fundrise, started out by requiring a minimum investment of $100, although the company has since increased its minimum. Since late 2015, participation in real estate crowdfunding has been opened to non-accredited investors, defined as individuals who do not have either a net worth of more than $1 million or an annual income of $200,000 (or $300,000 joint income for a married couple) for the past three years.

Some aspects of crowdfunded real estate investment are attractive to investors. Apart from the minimal capital required for participation, many investors appreciate the ability to make their own investment decisions. On the other hand, investors cannot play an active role in managing the investment property. Crowdfunding campaigns are not regulated as closely as other types of investment solicitations, so the information provided to potential investors may not be as extensive as might be wished. Crowdfunding investments are also illiquid, and cannot readily be sold or otherwise converted into cash. An investor who wants out of a crowdfunded investment is basically stuck.

Real estate crowdfunding is a relatively new phenomenon. It has been a part of the real estate market for fewer than five years, and final federal regulations will not be effective until May 2016. While the concept of crowdfunded real estate projects may have enthusiastic proponents, it is too early to tell if it really is a revolutionary development, or just another fad.

SECURITIES? OR NOT?

Crowdfunding campaigns look a lot like public offerings of securities. Shares or other financial instruments are offered for sale to the public in order to raise funds for a company or venture. Public offerings must be registered and approved by the Securities and Exchange Commission (SEC). This raises an important question: Is SEC registration required for a crowdfunding campaign?

The recent development of real estate crowdfunding has its origin in the "Jumpstart Our Business Startups Act," enacted by Congress in 2012. That law, popularly known as the JOBS Act, is an effort to promote small business growth by easing some securities regulations. In particular, Title III of the Act contained provisions designed to encourage crowdfunding by exempting it from some securities laws. While crowdfunding offerings must still be registered with the SEC, the information and paperwork required for such a registration is less than required for a typical registration of a public offering.

Rules adopted by the SEC in 2015, and effective May 16, 2016, provide that crowdfunding campaigns are exempt from the requirement to register as an offering of securities if no more than $1 million is raised in any one year. In addition, aggregate annual investments by individuals are capped at the lesser of:

- $2,000 or 5% of the individual's net income or net worth if the individual has an annual income or net worth less than $100,000, or

- 10% of the individual's annual income or net worth if both income and net worth exceed $100,000.

Crowdfunded investments may be offered only through licensed broker-dealers or registered investment portals or platforms. These portals will be regulated, but the regulations reflect the more limited role the platforms play. Platforms do not provide investment advice, for example.

The SEC regulations also recognize the difficulty of effectively regulating a relatively unknown process. SEC staff will study the regulation and submit a report within three years "on the impact of the regulation on capital formation and investor protection."

States have also moved to exempt crowdfunding solicitations from their securities laws. According to the National Council of State Legislatures, as of January 2016, 20 states have statutes that exempt equity crowdfunding from securities registration requirements. Another eight states and the District of Columbia adopted agency rules to exempt crowdfunding. Now that the federal regulations for exemptions from registration are complete, it is safe to say that more states will be part of the trend to ease the rules.

CROWDFUNDING GOES WAY BACK

Online crowdfunding is a relatively recent phenomenon, but the idea has been around much longer than the word. Public appeals for money for a real estate project have a long history in the United States.

Consider the story of one of America's most iconic landmarks, the Washington Monument. In 1833, a group of prominent citizens, including Chief Justice John Marshall, were frustrated by the government's failure to build a memorial in the capital to President Washington. They formed a private organization, the Washington National Monument Society, to raise funds for the monument. The Society decided on a budget of no less than $1 million ($27 million in 2016 dollars). The Society also determined that it would do this by accepting contributions of no more than $1 per person. To put this figure in perspective, note that the 1830 Census recorded the total population of the United States as 12.8 million people.

This early "crowdfunding" attempt was less than successful. By 1847, when construction started, the Society had raised only $87,000. The Society's fundraising efforts continued for some years, but construction had to be halted for lack of funds. The Monument was not completed until Congress authorized the Army Corps of Engineers to finish it. The Monument was finally completed and opened to the public in 1888. Its lesson about potential crowdfunding pitfalls remains relevant to this day.

LOCALIZED PROJECTS

Crowdfunding is often promoted as a way for smaller investors to participate in the real estate market. These investors are attracted by prospects of "[u]ltra low fees," small minimum investments, and impressive annual returns. But some crowdfunding projects seek investors who have different motives.

Some crowdfunding campaigns focus on financing neighborhood rehabilitation or revitalization. Some of these efforts may be small-scale campaigns directed at saving a favorite local landmark or business. For example, in

Milwaukee, a crowdfunding campaign is raising funds to rehabilitate and reopen a historic restaurant building in the city's Lindsay Heights neighborhood. In addition to a restaurant, the renovated building will include office and studio space. The building is described as "one of several catalytic developments" in the neighborhood. Crowdfunding is also being tapped for larger, more ambitious projects, such as the redevelopment of the Detroit Tigers stadium site.

Other crowdfunding platforms combine the goal of community development or redevelopment with the profit motive. For example, a Pittsburgh-based company called Small Change funds selected real estate development projects that cannot get financing from traditional sources such as banks. Small Change selects projects for possible financing and then rates them according to a proprietary "Change Index." This index measures factors such as mobility (access to transit, walkability, bike lanes, etc.), sustainability, and economic vitality. Potential investors are presented with a project's index number, which they use to evaluate the investment themselves.

As of March 2016, Small Change has invested in only one project, a "tiny house" in the Garfield neighborhood of Pittsburgh. The house, the first of its type to be built in the city, cost $191,000 to build, and was placed on the market for $109,500 (the property is under offer). Small Change raised $100,000 for the project, which was loaned to the builder. The rest of the funds for construction will come from grants from community redevelopment agencies and donations from local business. Investors were advised that the projected return on their investment would be 7.5%.

While there are many non-profit and community groups using crowdfunding for development projects, there are very few for-profit entities that do so. Whether the idea catches on will depend on a number of factors, including whether investors really can do well by doing good.

POTENTIAL PITFALLS OF NON-ACCREDITED INVESTING

There are many reasons an investor might decide they do not want to hold on to a particular investment. For most investments, the solution is to sell. The investor may make a profit or may sustain a loss, but getting rid of the investment is usually just a matter of contacting a broker and instructing him to sell.

If your investment is a share in a crowdfunded real estate project, the exit strategy most likely will not be that simple. The final SEC rules on crowdfunding have limitations on the resale of crowdfunded investment shares. Crowdfunded investment shares may not be sold for one year after purchase, except to the issuer, an accredited investor, as a part of an offering registered with the SEC, or to a member of the investor's family.

The SEC also cautions that resale may be difficult because a seller may have to locate a buyer for the crowdfunded investment him or herself. Unlike traditional securities, crowdfunded investments have no exchange on which they are traded. The new and different character of crowdfunding may make buyers hesitant to repurchase shares at any price, particularly if the seller is selling them because performance has been a disappointment. A willing seller may very well be stuck with an unwanted investment. Therefore, non-accredited investors must understand the potential risks associated with crowdfunding investments.

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White Papers: Comprehensive reports prepared for NAR on issues directly impacting the real estate industry. Examples include: Rental Restrictions, Land Banks, Sales Tax on Services, State and Local Taxation, Building Codes, Hydraulic Fracturing, Foreclosure Property Maintenance, Climate Change, Private Transfer Fees.

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