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Crowdfunding: How the Web and Social Media are Changing the Face of Real Estate Investment

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Crowdfunding is a new financing model through which providers and consumers of equity or debt capital can come together and finance specific investments or investment entities. Although still in its infancy, crowdfunding has the potential to redefine the way sponsors and investors access the real estate capital markets. It is important that real estate developers, owners, sponsors and other consumers of investment capital familiarize themselves with this new model for raising capital.

What is Crowdfunding?

Stated simply, crowdfunding involves the use of the internet and social media to raise equity or debt capital, typically from a large number of investors, each of whom is able to choose to invest only a relatively small amount. Crowdfunding comes primarily in two iterations:

- *Private crowdfunding*, through which private entities or sponsors seek to raise capital from high net worth individuals who qualify as "accredited investors" under regulations of the Securities and Exchange Commission ("SEC"), and
- *Public crowdfunding*, through which public offerings registered with the SEC are marketed primarily to retail investors.

In the real estate context, private crowdfunding enables sponsors of "sub-institutional" property investments or small real estate investment pools to seek equity or debt capital while by-passing traditional intermediaries, such as equity funds, investment banks or commercial lenders. It thereby potentially enables investment capital to be accessed more cheaply and for a broader selection of investments than was previously possible. Public crowdfunding, which is still in its infancy, could significantly enhance the capital-raising capabilities of companies that rely on retail capital, such as public non-traded REITs.

How is Crowdfunding Different?

Previously, private equity capital could not be raised through the use of public advertising or solicitation. Real estate sponsors seeking to raise private equity capital were therefore limited to small "friends and family" offerings or were forced to make use of placement agents who were licensed broker-dealers and had access to institutional capital or large "books" of prospective high net worth investors. Prospective investors, on the other hand, did not have ready access to deal flow (unless somehow connected to a market intermediary, such as a broker-dealer or financial advisor) and were therefore effectively excluded from this segment of the capital markets.

Today, this landscape is changing as a result of the Jumpstart our Business Startups (JOBS) Act of 2012. Among other things, the JOBS Act directed the SEC to remove the existing prohibition on general solicitation and advertising in private placements as long as all purchasers qualify as "accredited investors". The SEC responded by adopting new Rule 506(c) of Regulation D under the Securities Act of 1933.

These changes, coupled with the growth of the internet and social media and the SEC's no-action position with respect to certain aspects of federal broker-dealer regulation, have given rise to a growing number of online crowdfunding platforms that use sophisticated internet technologies to enable sponsors to raise private capital from high net worth investors. Typically, these platforms:

- post and publicize their hosted sponsors' investment offerings,
- sign up prospective investors who qualify as "accredited investors" under SEC regulations,
- make available the sponsors' offering documentation, due diligence materials and subscription documentation,
- provide a mechanism for these investors to subscribe for their selected investments online, and
- provide their hosted sponsors with the equivalent of back-office logistical support with respect to their capital-raising efforts.

Accredited investors seeking to invest in real estate can now scroll through these platforms' internet sites, identify their investments of choice, and subscribe to invest amounts that can range from as little as $10,000 in any single investment. Platforms that are not registered as broker-dealers with the SEC are paid through "back-end" participations in the profits from their hosted investments (coupled, in some cases, with management fees that are calculated to reimburse the platforms' actual costs in performing their services) or in some cases through up front service fees from the hosted sponsors. In some cases, these platforms act as "quasi-sponsors," raising capital for an investment vehicle created by the platform to invest alongside a sponsor's other equity investors. Platforms that are registered as broker-dealers charge brokerage commissions that depend upon the amount of capital raised through the platform.

These private crowdfunding platforms potentially enable a much larger universe of sponsors and investments to access the private capital markets than was previously possible. Specifically, smaller first-time funds, or single asset investments, are common offerings among the private real estate crowdfunding platforms. On the flip side, these platforms have not yet proven themselves capable of raising truly large amounts of capital for individual investments, although one such platform claims to have raised some $17 million in crowdfunding for a NYC office building. There are also concerns over the inability to police the quality of offerings in which no registered broker dealers or investment advisors are involved; simple crowdfunding platforms do not guaranty either the accuracy of their hosted sponsors' offering materials or the results of an investment made over their site. However, private investment offerings are likely to increase in size as specific crowdfunding platforms become better-known, proper quality controls are implemented and high net worth individuals become more comfortable with the notion of investing online.

Public crowdfunding platforms are also beginning to appear. For example, American Realty Capital's Nick Schorsch is setting up a public crowdfunding platform through his RCS Capital affiliate, a registered broker-dealer. For now, that platform seems dedicated to ARC-affiliated offerings. We suspect, however, that other large sponsors of public non-traded REITs are likely to follow suit. These platforms could enable public non-traded REIT "wholesalers" to by-pass their traditional retail private broker-dealer sales forces and access the retail investors directly. It remains to be seen whether traditional brokerage firms will also establish crowdfunding platforms to allow for their customers to invest online.

More Changes are Coming

The SEC has also proposed but not yet adopted a public crowdfunding regulation that would allow for retail capital to be raised via crowdfunding platforms by non-public sponsors; however, given the many limitations on the use of this model, including a $1 million limitation on the amount of capital permitted to be raised over a 12-month period and the associated post-offering compliance costs, we do not think that it will have much application for real estate investments. There are other provisions under the JOBS Act for which regulations will be forthcoming which could also potentially impact the way capital is raised for real estate investments.

At Goulston & Storrs, we continue to monitor developments in the real estate capital markets industry and to report them to our clients and relationships. If you have any questions about crowdfunding and how it may be applicable to you or your company, please feel free to call Timothy B. Bancroft at 617-574-3511, David L. Coombs at 617-574-3563 or Yaacov M. Gross at 212-878-5127.

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