Understanding the Basics of Crowdfunding

How CPAs Can Add Value to Companies and Investors

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For hundreds of years, businesses have raised equity and debt to grow and expand. The process begins when an entrepreneur has an idea that requires capital (or debt-based) investment. The entrepreneur solicits this investment from the public, which thus has the right to a certain return on investment and dividends from the enterprise. Regulations and rules have been enacted to regulate the solicitation and procurement of funds, the launch of an enterprise and its activities, and the return on investment and the payment of dividends.

Crowdfunding is the most recent iteration of investment vehicles. (The sidebar, *Forms of Crowdfunding*, reviews two current types of crowdfunding.) Whereas raising equity and debt for capital investment has traditionally been limited to larger investors, crowdfunding expands investing to a wider investing public; it primarily differs from traditional investment mechanisms because funds are solicited in ever-thinner slices geared toward smaller and more diverse investors. In addition, the enterprise seeking the investment capital has changed. These enterprises are relatively small, ranging from several thousand dollars up to $1 million in net assets, per enterprise.

The communication vehicle that enables enterprises to solicit and investors to invest is the "platform"—that is, websites that allow for an exchange of ideas and money and facilitate solicitation and investment. Platforms enable enterprises to advertise themselves as investment opportunities and help the public find such opportunities and remit funds.

The ensuing discussion explores this innovative method of securing funding for enterprises, especially small companies, and the role of CPAs in this new marketplace. It also addresses the need for Statement of Standards of Attestation Engagements (SSAE) 16, *Reporting on Controls at a Service Organization* [formerly Statement on Auditing Standards (SAS) 70, *Service Organizations*], and service organization control reports (SOC). Given the newly emerging needs of market players, CPAs can use the many tools at their disposal to understand the risks and add value for companies or investors interested in crowdfunding.

Regulating the New Investment Model

Under the crowdfunding business model, the solicitation of funds applies to any enterprise; its purpose is to raise equity or debt financing from the investing public. Yet, new crowdfunding investing vehicles require federal regulation. In response, Congress enacted the Jumpstart Our Business Startups (JOBS) Act of 2012 and tasked the SEC with proposing and implementing regulations.

The SEC proposed regulations aimed at striking a balance between 1) the risk that unscrupulous large investor groups and enterprise operators would prey on the broader investing public, and 2) the regulatory and operational costs of launching an investment solicitation for a small enterprise. The limit, under the SEC proposed rules, is $1 million in net assets per enterprise, and there are regulations designed to stop a controlled group from spinning off multiple instances of related enterprises and raising funds from the investing public in excess of this limit. The SEC regulations do not restrict the type of investment or debt vehicle used by an enterprise, however; for example, convertible debt, secured notes, and equity options are all permitted. The issuers—that is, the enterprises raising money from crowdfunding investors—are expected to assess the investment risks and features that they wish to introduce to the public.

The proposed SEC regulations depict the platform as an intermediary agent that col-

lects its own fees for servicing an enterprise. The platform is responsible for presenting investment shares to new investors, registering investors, and clearing the payments made to issuers. It is clear from the proposed regulations that the platform operators are not allowed to hold the investors' money while a funding campaign is ongoing. There are two ways to comply with these restrictions:

- If the platform is a broker/dealer, it is possible to establish escrow accounts for the invested pools in the name of the issuer. The escrow accounts would be opened and managed under the "best effort" doctrine.
- A custodian clearinghouse could serve as the agency that collects the funds from the investors, based on the platform's records. The clearinghouse would remit the investors' funds to the issuer and pay the platform's fees. In a recent focus group study, platforms reported plans to charge fees between 5% and 17%, a significant amount.

Numerous stakeholders, including the NYSSCPA, have responded to the SEC's proposed rules for investment-based crowdfunding. (See http://www.nysscpa.org/commentletter/sec14.pdf for the Society's complete comment letter.)

The Risks of Crowdfunding

Operational. Aside from the risk of crowdfunding being controlled by a single person or a controlling group, crowdfunding risks are mainly operational and fall into two categories: 1) the enterprise's own operations (e.g., a new drilling site for gas exploration), and 2) the individual or company managing the money-raising operations. The proposed SEC regulations require certain types of disclosures and audits designed to mitigate these risks. In other words, an operator of a new gas exploration drilling site would have to disclose, ahead of solicitation of equity or debt using a crowdfunding method, 1) the nature of the operations and 2) the identities of various individuals and entities associated with the enterprise's investment-solicitation effort. It should be emphasized that because crowdfunding enterprises are currently limited to $1 million in net assets per enterprise, a gas exploration company, for example, would represent a comparatively small operation and not part of an established, multinational, publicly traded corporation.

Crowdfunding platforms present another significant risk to the soliciting enterprise. These platform websites, which "launch" a company's attempt to raise money, carry their own operational risks. Their internal controls might not be suited to providing confidence to the investing public (in comparison with the controls that are in place when a bank or a broker takes trade orders from a person).

Recordkeeping. The platform operator is responsible for matching issuers' offerings—for example, of common shares—with the funds remitted by investors. Whether the funds are maintained in escrow by the platform or by a custodian agent, there is a risk of the investors' records being mismatched to the funds remitted. Furthermore, because there are multiparty transactions involved—including the cancellation of investors' orders, which must take place within a certain time period before the end of the offering period—platforms face both an operational risk that the order will not be fulfilled properly and a compliance risk of failure to comply with the proposed regulations.

Compliance. Platforms will be required to perform the appropriate due diligence on the parties involved; the proposed SEC regulations call for platforms to vet the key persons at the issuers' enterprise, obtain disclosures and proposed intended use, and perform all the required due diligence for the issuers, as well as the required due diligence for investors. For example, if an issuer plans to have a crowdfunding offering for accredited investors, the responsibility for accreditation and vetting falls on the platform operator.

Fraud. Under the proposed rules, the website platform entity will be responsible for assessing fraud risks before and during a crowdfunding campaign. Multiple agents pose fraud risks: issuers, investors, money launderers, and others. Although issuers have to provide certain disclosures, it is mostly the platform's responsibility to assess, manage, and mitigate risks due to fraudulent activity of both issuers and investors. Of course, the risk of fraud by the platform's operations is also present.

Delivering Value

The operational risk of website platforms is that their environment, risk assessment processes, internal controls, communications and information technologies, and monitoring activities will not align with the expectations of the investing public and, by extension, the regulators like the SEC. This level of expectations for platforms resembles that of other trading agents, such as broker/dealers or banks. To address these risks, some have proposed that accountants deliver a public service in the form of SOC 1 reports, primarily promulgated under SSAE 16 (Comment letter by Grassi & Company, https://www.sec.gov/comments/s7-09-13/s70913-128.pdf). SOC 1 reports under SSAE 16 contain several features that align with the objectives of users of crowdfunding platforms.

SOC 1 reports can be of two types: Type I and Type II. In a Type I report, the service organization's auditor—in this discussion, the crowdfunding platform is the "service organization" and the issuers (and perhaps others) are the "user organizations"—renders an opinion about the design and implementation of internal controls, but not about their effectiveness in achieving any objectives. A Type II report contains all the elements of a Type I report, but the service auditor also renders an opinion about the effectiveness of the internal controls in achieving certain objectives.

How does a SOC 1 report deliver value? A platform operator makes its profit by delivering high-volume, high-frequency solicitation from enterprises. Instead of having each enterprise undergo an operational audit, the platform operator would "stand in the shoes" as the agent for the investment manager and "broker" of investments from the general public. By doing so, a single SOC 1 Type II report would serve hundreds of enterprises and thousands of users.

Designing a complete SOC 1 Type II report. In a Type II report, the stated objectives are specified by the service organization and may or may not be the entire compliment of objectives that are important to the investing public. For example, a set of objectives in a SOC 1 Type II report may include proper allocation of dividend reinvestments paid by the enterprise and allocable to the shareholders who invested in equity; however, what might be lacking is an objective that addresses trading confidentiality and protection of personal information. Although the latter objective might have been attained, the

SOC 1 Type II report objectives that had been specified by the platform's management might have omitted this objective; as a result, the SOC 1 report might only partially address a shareholder's concerns and interests.

According to SSAE 16 (para. A34), in a SOC 1 Type II report, service auditors are required to—

> Evaluate whether the control objectives stated in management's description of the service organization's system are reasonable in the circumstances. Considering the following questions may assist the service auditor in this evaluation: … Are the control objectives stated in the description and specified by the service organization complete?

Accordingly, the service auditor must assess the completeness of the control objectives and how users of the report will receive them; however, even the most seasoned auditors might not be able to predict or provide for a full complement of such objectives. In "traditional" SOC 1 Type II report situations, a service organization may solicit or even request approval of the full complement of control objectives, but this would be impractical when a crowdfunding enterprise solicits funds from potentially thousands of investors, and each investment "slice" can be as small as a $100 per person.

How should auditors address this possible unseen need? There are two scenarios that could emerge. In the first scenario, platforms will simply solicit and aggregate feedback from their users to adjust the set of control objectives. Some smart websites provide very sophisticated aggregation mechanisms, and companies could implement a streamlined process for addressing any unanswered control objectives flagged by the investing public. In the second scenario, the operators may request that regulators, such as the SEC and the AICPA, or broker/dealer associations, such as the Financial Industry Regulatory Authority (FINRA), provide feedback as to the completeness of their stated control objectives. Such a process will enable the oversight of control objectives by a third party that does not stand to gain or lose due to the inclusion or exclusion of certain control objectives.

Shifting responsibility to issuers. Another sensitive area for platforms that would undergo testing under SOC 1 reports is the requirement known as "user control consideration," which shifts the responsibility from the service organization to its user entities (i.e., from the platform to the issuers). The responsibilities often include proper and timely authorization for access, proper inputs, and proper review of outputs. For example, a common consideration that shifts the responsibility from the platform operator to the issuer would be as follows: "Persons or software that access the service organization's system are authorized to do so by the user." Another example relates to reports or information produced by the platform: "The user is responsible for reviewing, understanding, accepting, and approving the investment activity reports provided by the platform." Shifting responsibility from the service organization to the user entities requires issuers to accept certain responsibilities to ensure that the platform is performing as intended.

This also represents a legal shift away from the auditor who opines on the service organization's control objectives: if the user organizations don't do their part in ensuring authorized access, for example, how can anyone expect the service organization to work properly? By extension, the service auditor is not responsible for any operational difficulties.

A Call for Transparency

The purpose of the JOBS Act is to create investing opportunities for small investors and to create domestic enterprise funding for small, entrepreneurial companies. At the end of the day, the objective is to increase economic activity and create jobs. Crowdfunding is here to stay as an investment mechanism that enables the matching of enterprises with funds from the general investing public.

Increased transparency is key to the success of this innovative approach and to achieving the act's objectives. The transparency of the process can be economically achieved by relying on the crowd-

FORMS OF CROWDFUNDING

Crowdfunding enterprises are not new. There are currently two unregulated business models for crowdfunding: the reward-based model and the charity-based model.

In the reward-based model, the public is solicited to remit funds; in exchange, the enterprise provides a reward. For example, a young producer who wishes to solicit fund for a documentary movie about global warming might advertise the idea with the aid of social networks, such as Facebook or Twitter. The young producer enables the people who are interested in the movie to crowdfund it by sending money in small denominations. For example, each "investor" receives, for every $10 invested, a ticket to the movie showing or a T-shirt with the movie's name on it. Reward-based crowdfunding often offers an advanced subscription to an enterprise that has not yet launched, though it can also be used for a mature, ongoing enterprise.

Charity-based crowdfunding is a business model that simply solicits money from the public for a particular cause. There is sometimes a nominal reward, such as a pin or a pen with a de minimis value or even a mention on the not-for-profit's website. Of course, if the not-for-profit enterprise is a recognized charitable organization under Internal Revenue Code (IRC) section 501(c), the payment could qualify as a charitable donation, less the value of any goods or services provided (in the example above, the value of the pin or pen received).

funding platforms' operation through SOC 1 reports. Auditors and accountants are in an excellent position to advise companies or investors on this new process and to increase the transparency and efficiency of these capital markets. ❑

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