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Crowdfrauding: Avoiding Ponzi entrepreneurs when investing in new ventures

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Abstract Crowdfunding has gained substantial interest in the U.S., allowing entrepreneurs to raise startup capital in exchange for equity in their ventures. This approach to equity capital can open up new sources of venture finance to legitimate entrepreneurs, but little attention has been given to how it offers new opportunities for illegal entrepreneurs to defraud investors. We adopt a forensic approach to examine entrepreneurs who launch Ponzi ventures—businesses that continually bring in new investors in order to use their money to pay returns to earlier investors—to demonstrate the ease, creativity, and audacity with which these illegal entrepreneurs operate. The provided examples of Ponzi entrepreneurs show how easily they can circumvent the safeguards purported to protect investors: screening by 'the crowd,' transparency and documentation requirements, independent audit reports, and withholding of funds until the venture's financial goal has been met. In this article, we offer possible solutions to help protect investors, legitimate entrepreneurs, and business in general from the damage created by illegal entrepreneurs.

If history teaches us anything, the lesson is that social media technologies increase rather than decrease the potential for fraud.
— Thomas Lee Hazen (2012, p. 1769)

1. New assumptions about entrepreneurs and crowdfunding

Policymakers, government officials, scholars, and much of the media emphasize entrepreneurship as a powerful, positive influence in society because of its role in job creation and innovation (Steyaert & Katz, 2004). This reflects the commonly held assumption that "entrepreneurship should be encouraged because of universal positive effects on employment, wealth creation, and innovation" (Desai, Acs, &

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Weitzel, 2013, p. 21). However, alternative assumptions underlie the arguments presented here. First, entrepreneurship can, at times, represent a negative and destructive, or wealth destroying, force in society (Desai et al., 2013). Some entrepreneurs pursue their own self-interest to an extreme, ignoring their "accountability *to the Other*" (Shearer, 2002, p. 560) or to the broader society. This alternative assumption likely explains why entrepreneurship is sometimes viewed negatively or with suspicion, depicted as "a low-trust form of capitalism, based on a selfish, individualistic and competitive concept of the entrepreneur" (Buckley & Casson, 2001, p. 303).

A second assumption recognizes that entrepreneurs vary widely in terms of how they apply their entrepreneurial talents and how they use the investment and revenues of their ventures (Desai et al., 2013). Ponzi entrepreneurs convince individuals to invest with them and then use the money from later investors to pay returns to early investors (Valentine, 1998); as long as Ponzi entrepreneurs keep bringing in new investors, they can keep the scheme going. This type of illegal entrepreneur often exhibits remarkable creativity and knowledge of business in forming their strategies and business ventures as well as in developing and using social networks, resources, and knowledge; yet they direct their talents toward amassing financial assets, diverting the venture's funds for their personal use, and deceiving large numbers of investors. Ponzi schemes represent entrepreneurial activity, but they clearly do not add value to society. Many investors have lost their life savings, their retirement funds, and their homes when they mistakenly believed they were investing with a legal and ethical entrepreneur who was pursuing wealth creation for the benefit of others as well as for him/herself.

These alternative assumptions do not represent an extreme or anti-entrepreneurship perspective; instead, they lay the foundation for a forensic approach that enables us to better understand and prevent illegal entrepreneurship. The foundation of business and economic activity is trust. Therefore, as business people we have a responsibility to understand how illegal entrepreneurs (i.e., those operating Ponzi ventures) operate so that we can establish effective safeguards to protect business and society from their activities. A *Ponzi venture* is a type of financial fraud in which an entrepreneur continually brings in new investors in order to use their money to pay returns to early investors versus generating profits from the business to pay returns to all investors. Ponzi ventures differ from pyramid schemes in that entrepreneurs operating Ponzi schemes typically expend little of investors' money producing a viable product or service. Furthermore, a Ponzi scheme will always collapse mathematically when the amount of money needed to pay returns to existing investors far outstrips what the entrepreneur can bring in from new investors.

Ponzi entrepreneurs have received more attention in the media in the past few years due to many of their ventures collapsing in the U.S. financial crisis and global economic downturn. In 2008—2013, there were over 500 Ponzi schemes totaling more than \$50 billion (Maglich, 2014). These numbers don't include the hundreds of Ponzi schemes that each amassed less than \$1 million. The Securities and Exchange Commission (SEC) and other financial and law enforcement agencies are already unable to adequately monitor, investigate, and prosecute Ponzi entrepreneurs, and equity crowdfunding will most certainly make this problem worse simply due to the sheer number of additional funding opportunities.

Crowdfunding—getting large numbers of individuals to each invest small amounts of money—has seen tremendous growth in recent years. Entrepreneurs around the world raised \$16.2 billion in 2014, up from \$6.1 billion in 2013 (Massolution, 2015). By December 2012, nearly 8,800 domains had been established with crowdfunding in their name; 6,800 were registered after the Jumpstart Our Business Startups (JOBS) Act (Mandelbaum, 2014). In 2012, the JOBS Act made equity crowdfunding legal in the United States. Previously, entrepreneurs could only crowdfund by either providing free products/rewards in exchange for invested funds (reward-based crowdfunding) or by accepting donations (donation-based crowdfunding), wherein providing anything to the investor was not obligatory (Spring, 2013; Stemler, 2013). Reward- and donation-based crowdfunding present few regulatory issues and offer clear benefits to fund providers. However, equity-based crowdfunding requires more regulation because it involves the sale of a security to non-accredited investors (Harrison, 2013).

Equity crowdfunding is viewed as essential in the United States to provide financing for startups in the 'Valley of Death,' or mid-range of \$200,000—\$2,000,000 (Spring, 2013): Entrepreneurs needing less than that amount can rely on friends, family, and fools while ventures requiring more than \$2 million often draw the attention of angel investors and venture capitalists. The JOBS Act allows startup entrepreneurs with emerging growth companies to offer equity in exchange for financing raised through crowdfunding portals (Stocker & Avan, 2012). Raising capital is difficult, and equity-based crowdfunding offers entrepreneurs an alternative way to acquire necessary financing for their ventures. In addition to raising equity capital, crowdfunding helps entrepreneurs demonstrate demand for a proposed project and offers marketing opportunities (Mollick, 2014) as the entrepreneur showcases his or her product to a large global audience or crowd.

Equity-based crowdfunding is not without limitations, however. Equity investors (i.e., accredited investors) often provide advice, governance, and prestige (Hsu, 2004). Instead of the 'smart money' accredited investors are able to provide because of their industry knowledge and contacts that allow them to mentor entrepreneurs, some suggest that the crowd (i.e., non-accredited investors) provides 'dumb money' (Mandelbaum, 2014). It is also unknown whether a future market exists for these securities since they cannot be resold for 1 year after purchase, and whether anyone will want to purchase these securities or equity investments after that time. In addition, it is unclear how the equity's value will be determined. Entrepreneurs may not receive the full investment they need because the true costs associated with this type of equity capital are uncertain, with some speculating that entrepreneurs will be charged up to 17% of the money raised in fees (Mandelbaum, 2014).

Equity crowdfunding has been argued to "assist two groups of people in securing the money and support they need: (1) entrepreneurs trying to turn their ideas into viable businesses, and (2) small business owners trying to keep their businesses afloat or get them to grow" (Stemler, 2013, p. 272). However, a third group can also be assisted by equity crowdfunding: illegal entrepreneurs. Although crowdfunding proponents note the possibility of fraud or illegal behavior by "unscrupulous 'entrepreneurs'" (Stemler, 2013, p. 274), they emphasize that safeguards exist to minimize the risk of fraud; they assume the purpose of crowdfunding is simply to make more funding available to positive, wealth-generating entrepreneurs. The previously discussed alternative assumptions highlight crowdfunding as a new playground with few rules to curb illegal entrepreneurs.

"Fraudsters are already taking advantage of the JOBS Act" to illegally raise money from the crowd (Morsy, 2014, p. 1383). As SEC Commissioner Luis Aguilar (2012) states: "Investors won't return to the IPO market if they don't believe they can trust it." Thus, if members of society cannot trust entrepreneurs and businesses seeking to raise funds, they may resist investing in crowdfunding, encourage government to adopt tighter regulations for all entrepreneurial activities, and adopt negative assumptions about entrepreneurs and business in general.

For this article, we employed a forensic approach involving purposeful sampling to study Ponzi entrepreneurs' operations in order to identify the strategies they use to prevent accurate evaluation of a venture and to manipulate perceptions regarding the venture and the individuals associated with the venture. The examples—some of which occurred prior to legalization of equity crowdfunding—demonstrate how Ponzi entrepreneurs operate, and refute the arguments put forth by equity crowdfunding supporters for why crowdfunding will prevent or seriously limit Ponzi entrepreneurs from pursuing equity crowdfunding. Proponents of equity crowdfunding discount the ease with which Ponzi entrepreneurs can engage in crowdfrauding—that is, raising money for fraudulent ventures using a crowdfunding platform—but these case studies should raise concerns about crowdfrauding aimed at reaching a much larger pool of potential investors. We conclude by offering recommendations for how to reduce the chances of Ponzi entrepreneurs engaging in equity crowdfunding or crowdfrauding.

2. How Ponzi entrepreneurs operate

Ponzi entrepreneurs use strategies to make their ventures appear to be legitimate businesses. These strategies are geared toward preventing accurate evaluation of the venture and manipulating perceptions regarding the venture or the individuals associated with it. The FBI and law enforcement officials describe Ponzi schemes as highly diverse, technologically sophisticated, and imaginative (U.S. Department of Justice, 2012), highlighting Ponzi entrepreneurs' ability to be creative, persuasive, and appear trustworthy. They are quite willing to falsify documents, create a network of companies, and engage in other activities that make it very difficult to track the flow of money or financial performance, thereby preventing accurate evaluation of the venture. Just the act of providing well-prepared documentation adds to the public's and investors' perceptions of the legitimacy of a Ponzi scheme. Michael Kelly utilized this strategy and another often-used strategy: creating a network of companies to pull off the Ponzi scheme.

Michael Kelly incorporated Yucatan Investment Corporation in 1998, a new venture that would purchase and operate hotels in Cancun, Mexico. In the first 18 months of operations, Kelly raised $34 million in 9-month promissory notes to fund his venture. He then launched Resort Holdings International Inc., a successor to Yucatan Investment that sold 9-month promissory notes and universal leases (i.e., timeshares in a specific Mexican hotel). Although investors could use or rent the room themselves, most opted to have an independent *third-party company, World Phantasy Tours Inc., manage and rent the properties in exchange for a guaranteed 11% annual return, whether or not the room was rented. World Phantasy Tours also promised to buy the universal leases at any time for a small discount or at 100% of the purchase price after 2 or 3 years. A network of salespeople solicited investors, provided all-expenses paid trips to Cancun to visit the properties, and reviewed the contracts and documentation with potential investors. Kelly established his company bank account through First Bank of Miami, set up an office in Miami, developed written contracts for investors, created extensive marketing and promotional materials that explained the venture's activities, prepared and distributed regular investor account statements showing interest payments, and provided checks to early investors for their principal and interest. These activities, in conjunction with the endeavor's proffered documentation and apparent transparency, created the appearance of a well-run entrepreneurial venture for 7 years, until thousands of investors discovered in 2005 that Kelly was running a Ponzi scheme: he owned and controlled World Phantasy Tours. By then, Kelly's three ventures had brought in $450 million* (Federal Bureau of Investigation, 2012; SEC, 2008).

Ponzi entrepreneurs also take drastic measures to manipulate perceptions regarding the venture or its leaders. They often capitalize on their close-knit social network in that individuals do not typically perform due diligence because they trust the Ponzi entrepreneur and have seen others in the same social circle profit from investing in the venture (Rampell, 2008). Early investors become strong advocates and act as a salesforce for the venture, encouraging others to invest. Many Ponzi entrepreneurs go so far as to hire others to play a certain role and provide positive evaluations of their ventures, or get confederates to act as 'independent' customers or supporters of the venture. Ponzi entrepreneurs will go to extreme measures to manipulate perceptions of the venture. Consider Thomas Petters.

Between 1995 and 2008, Thomas Petters established Petters Companies Inc. (PCI) and a number of other entities. He assured investors that Ernst and Young had conducted independent audits of his ventures and produced documents making that appear to be true; his firm provided (false) purchase orders for electronics and consumer products from major retailers such as Costco, Sam's Club, and Walmart; and he relied on independent investment managers (who actually worked for Petters' companies) to convince investors that due diligence was conducted on Petters Group operations. Unfortunately, this turned out to be a $3.65 billion Ponzi venture affecting unknown numbers of investors. The money investors put into PCI was used to pay earlier investors, support the operations of businesses in Petters Group Worldwide LLC—including Polaroid Corporation, Fingerhut, and Sun Country—and allow Petters to live a lavish lifestyle (Kurschner, 2012).

Ponzi entrepreneurs often engage in affinity fraud, building trust by demonstrating an affinity with or similarity to their potential investors (Marquet, 2011). Ephren Taylor manipulated perceptions of himself by relying on the language of the Bible, telling stories of growing up with a father who was a minister, packaging his activities as a social venture, and emphasizing that he came from neighborhoods similar to those his venture would support.

Ephren Taylor, who started and funded seven new ventures and received business training from the Kauffman Center for Entrepreneurial Leadership, was named Kansas Entrepreneur of the Year in 2002. He began describing himself as a social capitalist in 2006, offering two investment programs through his newly launched City Capital Corporation (CCC), which was in the business of funding economically disadvantaged businesses and providing financial support to charitable causes. Taylor promoted his ventures through Internet and radio advertisements and in person to socially conservative investors in church congregations. He was introduced to the church members by the ministers, who in some cases touted him as speaking the Word of God. Mr. Taylor quoted scriptures and emphasized that as the son of a Christian minister, he understood the importance of giving back to society. He depicted traditional CDs, mutual funds, and the stock market as foolish and money losers while explaining that the money he raised would be used to support a laundry, juice bar, or gas station in low-income neighborhoods. In addition, he purchased 'sweepstakes machines' that were similar to those in casinos and which were supposed to generate substantial income for investors. After 4 years of operations, Taylor's CCC was shut down as a Ponzi venture that had netted at least $11 million from untold numbers of investors (Wyler, 2014).

Ponzi entrepreneurs such as Taylor excel at spinning a good story and answering questions in ways that break down the resistance and common concerns of investors. Although Kelly, Petters, and Taylor operated their Ponzi schemes prior to passage of the JOBS Act in 2012, their strategies could easily be adapted to equity crowdfunding: they relied on often-used strategies that manipulate potential investors' perceptions of the venture and its viability, as well as the reputation and track record of the entrepreneur, thereby preventing accurate evaluation of the investment by investors. They also capitalized on the support and advocacy of early investors to bring in a continuous flow of money—a strategy that will work well in crowdfunding. Next, we describe how the JOBS Act creates tempting new opportunities for Ponzi entrepreneurs, potentially increasing their numbers.

3. JOBS Act unlocks the door to crowdfrauding

Prior to the JOBS Act of 2012, U.S. Federal Securities Law prevented entrepreneurs from offering equity in their ventures through crowdfunding because it entailed the selling of unregistered securities and illegally soliciting investors (Morsy, 2014). The Securities Act was enacted in response to the Great Depression to ensure full disclosure of truthful information regarding securities offered to the public (Keller, 1988). The SEC has been charged with writing rules and regulations that encourage investment in fledgling ventures while simultaneously protecting investors. However, Crowdfund Intermediary Regulatory Advocates (CFIRA) has engaged in a low-profile battle to protect the interests of crowdfunding portals. For example, although crowdfunding portals are not able to select which companies appear on their website, they can set criteria for the transactions (Mandelbaum, 2014). Developing these criteria complicates the task for crowdfunding portals that hope to offer only legal, ethical startups seeking funding: new ventures have minimal track records and may not have commenced operations, and entrepreneurs must tell a convincing story about what they hope to accomplish in order to raise money.

The JOBS Act and the subsequent rules developed by the SEC have changed, in several significant ways, what entrepreneurs can do to enable equity crowdfunding (Stemler, 2013). Without registration with the SEC, entrepreneurs operating private companies can raise up to $1 million within 12 months from as many as 2,000 investors rather than the prior limit of 500 investors (Hazen, 2012; Simon & Loten, 2014); therefore, entrepreneurs can go after smaller amounts of money from a larger number of people. The JOBS Act also allows entrepreneurs to advertise or solicit investors, but they must offer their securities through a registered broker or online crowdfunding portal. This change to allow solicitation of investors via crowdfunding has already generated almost 900 offerings worth a total of $10 billion (Simon & Loten, 2014).

4. Holes in the safety net of crowdfunding

In order to better understand how Ponzi entrepreneurs may capitalize on crowdfunding, we use our vantage point as researchers who study Ponzi schemes to critique the proposed safety net, which includes (1) self-regulation by 'the crowd,' (2) transparency and documentation requirements, (3) independent auditor reports, and (4) withholding funds until financial goals are reached. These safeguards are supposed to reassure us, but our forensic approach to Ponzi entrepreneurs shows that they can circumvent most forms of investor protection.

4.1. Safeguard #1: Self-regulation by the crowd

Equity crowdfunding proponents argue that fraud will be minimized because the crowd will screen online ventures and identify those that appear questionable or illegal; that is, a large group of interested investors will analyze and evaluate a proposed project or new venture and interact online with the entrepreneur (Neiss & Best, 2012). However, as illustrated in the next example, 1 million investors provided money via the Internet to Paul Burks and his venture, ZeekRewards, without hearing any interested and knowledgeable experts raise questions about the viability of the venture. Some of these investors were also citizens of Paul's hometown, Lexington, North Carolina. One may wonder why local lawyers, accountants, and other sophisticated investors who put their own money into the venture did not notice or warn locals of the dangers.

Paul Burks founded Rex Venture Group LLC in 1997 to operate several Internet-based, multi-level marketing ventures. A penny auction online venture, Zeekler.com, was started in 2010 to allow customers to pay a fee between $.50 and $1 to place incremental penny bids on and purchase items via the website. In January 2011, a related Internet venture, ZeekRewards.com, was launched to drive business to Zeekler.com by encouraging investors to become 'Qualified Affiliates' through the Retail Profit Pool or the Matrix. Investors in the Retail Profit Pool became Qualified Affiliates and shared in the daily profits by paying monthly subscription fees, signing up new penny auction customers, *purchasing and giving away or selling Zeekler.com bids, and providing proof of the daily placement of a free ad for Zeekler.com. Investors became Qualified Affiliates through the Matrix by paying a monthly subscription fee and soliciting other investors who subscribed to the Matrix; the number of subscriptions downline in the pyramid determined an individual investor's returns. The COO of ZeekRewards, Dawn Olivares, helped promote the business through interviews, sales pitches, and speeches at events. "We're a real company" she exclaimed, and emphasized that the firm worked hard to follow the law. However, the government recently indicted Paul Burks for operating an $850 million Ponzi scheme with ZeekRewards that defrauded 1 million investors* (Associated Press, 2014; SEC, 2012; U.S. Attorney's Office, 2014; Weiss, 2013).

Reliance on self-regulation in which the crowd knows what to look for and the right questions to ask—in addition to ensuring that the entrepreneur provides adequate answers—seems to conform with advice offered by experts on Ponzi schemes: Investors should avoid investment fraud by engaging in due diligence, asking for financial records, posing the proper questions, and recognizing that "if it sounds too good to be true, it probably is" (SEC, n.d.). Self-regulation as a safeguard assumes that because crowdfunding accesses a large number of investors, sophisticated investors will catch the fraud by asking the right questions.

Investors drawn to equity crowdfunding have been described as unsophisticated investors (Morsy, 2014; Sullivan & Ma, 2012) who possess very diverse motivations for investing in crowdfunded ventures and belong to vastly different economic classes (Heminway, 2014). Faith Bautista (2013), President and CEO of the National Asian American Coalition, warned the SEC that crowdfunding will enable any startup "to raise $5,000 a year from the 70% of Americans who live from paycheck to paycheck," and that these individuals—particularly new immigrants to the U.S.—tend to be especially attracted to get-rich-quick schemes. Barbara Roper, Director of Investor Protection at the Consumer Federation of America, notes that crowdfunding "has precisely the same place in the average person's investment portfolio that lottery tickets do. . . .They don't consider it part of a well-thought-out investment strategy" (Collins, 2012).

Ponzi entrepreneurs know that once a few individuals—especially prominent ones—decide to invest, herding effects (i.e., the tendency to follow someone assumed to be an authority figure or expert) take over (Heminway, 2014). The 'madness of the crowd' and social proof—relying on evidence that people you trust have already invested—can lead sophisticated investors to make bad decisions along with less knowledgeable investors. Ponzi entrepreneurs create the impression that large numbers of people have screened, approved of, and invested in their ventures; they do this routinely by paying high returns to early investors so these investors actively promote the venture to friends, colleagues, and anyone else who will listen.

Ponzi entrepreneurs further exploit the principle of social proof by creating a perception of exclusivity. Bernie Madoff made potential investors feel privileged by the opportunity to invest; he "shifted investors' fears from the risk that they might lose money to the risk they might lose out on making money" (Zweig, 2008). Creating this perception prevents due diligence because asking questions would insult the person who invited the new investor into the investment opportunity. Won Sok Lee offers another example of how Ponzi entrepreneurs use exclusivity to their advantage. He operated his Ponzi scheme prior to equity crowdfunding, but his venture illustrates that even sophisticated investors can be ensnared.

Won Sok Lee, John Kim, and Yung Kim established KL Group in 2000, a new venture offering a hedge fund advisory business that relied on Lee's proprietary trading system, SmartCharts, to produce as much as 100%—125% annualized returns. Investors were later provided with documents showing 70% and 40% returns in 2003 and 2004, respectively. Investors were impressed by documentation and records provided by KL Group showing amazing returns; new potential investors would often beg Lee to allow them to invest with his firm and become part of KL Group's highly exclusive clientele. When the SEC stepped in and demanded documents in August 2005, it became clear that Lee and Yung Kim—and possibly John Kim, who claimed innocence—had been operating a Ponzi scheme that defrauded many wealthy, elite businesspeople and successful entrepreneurs of $194 million. One expert involved in the case indicated that it was not surprising so many sophisticated investors were part of the 225 people who were scammed: "The guys were slick. They would have given Barnum & Bailey a run for their money. . . .This wasn't just a straight fraud. It was hocus-pocus, smoke and mirrors" (Creswell, 2005).

The sheer number of people involved in crowdfunding does not assure investors that ventures have been properly screened as sound investments.

Certainly there are cases where a bit more due diligence by investors might have uncovered the operations of a Ponzi entrepreneur. For instance, any of the 22,000 investors who provided $6 million to Blake Prater for his various online investment ventures operated under the umbrella firm of Wellspring Capital Group could have performed a search on Google that would likely have shown Prater had prior criminal convictions for fraud and forgery (Malone & Ryan, 2003). Similarly, Thomas Petters' prior convictions should have deterred investors from providing him with $3.5 billion (SEC, 2009b). Yet as many of the examples here illustrate, due diligence can be thwarted by clever Ponzi entrepreneurs.

Although a new Ponzi scheme is uncovered almost weekly and hundreds of Ponzi entrepreneurs get caught every year, it is exceedingly rare for their capture to occur because a savvy potential investor spotted a flaw in the story or the company documents (Olson, 2014). The SEC first investigated Bernie Madoff in 1992 when it conducted an investigation into Avellinos & Bienes, one of Madoff's feeder funds. The investigation was closed when Madoff was able to produce the owed funds and investing records that Frank Avellinos and Michael Bienes could not produce (Bandler & Varchaver, 2009; Henriques, 2011).

In May of 2001, two articles published in prominent outlets raised questions regarding the legitimacy of Madoff's organization. These articles were based on information uncovered by Harry Markopolos, who was hired by Madoff's competitors to uncover any illegal activities. However, the public and the SEC turned a blind eye until 2006 when the SEC finally investigated Madoff again, but found no evidence of fraud (Bandler & Varchaver, 2009; Henriques, 2011). Discovery of a Ponzi venture typically occurs late in the game when investors realize that promised returns have not materialized, they can no longer contact the entrepreneur, or they no longer believe the excuses offered for nonpayment of returns on their investments. Madoff's Ponzi scheme collapsed when the market meltdown of 2008 caused investors to withdraw their funds from Madoff's enterprise to make up for money they were losing in non-Madoff investments (Henriques, 2011).

4.2. Safeguard #2: Transparency and documentation requirements

Equity crowdfunding requires entrepreneurs to disclose certain information to potential investors, such as the new venture's name, the names of the venture's directors, a description of the business in which the venture is engaged, and the venture's business plan (Morsy, 2014). However, "people seeking funds via crowdfunding portals will not have to adhere to the same level of disclosure as normal businesses with a prospectus" (Sullivan & Ma, 2012). The entrepreneur must provide this information to the SEC and to the crowdfunding portal, along with—depending on the amount of money the entrepreneur wishes to raise—financial information on the entrepreneur and company (Mashburn, 2013).

Entrepreneurs choosing to raise $100,000 or less will need to disclose their tax returns and a financial statement for the new venture that has been approved by an owner of the new venture (Stocker & Avan, 2012). When the fundraising goal is between $100,000 and $500,000, entrepreneurs must produce financial statements for their ventures that have been reviewed by a certified public accountant. Audited financial statements are also required for entrepreneurs intending to raise over $500,000 (Stocker & Avan, 2012). Transparency and disclosure requirements for independently reviewed or audited financial statements do not pose significant obstacles for Ponzi entrepreneurs. All of the Ponzi entrepreneurs discussed in this article have lied and distributed misleading financial statements. Edward May ran his Ponzi scheme before crowdfunding was legalized, but his case illustrates that fabricating the documents required in the JOBS Act will be fairly simple.

In 1997, Edward May started a new venture, E-M Management Co. LLC, and another 150 limited liability companies that were all engaged in the business of purchasing telecommunications equipment and using it to provide services to hotels such as the Hilton, MGM Grand, Tropicana Resort Casino, and Sheraton hotels across the U.S. May created a series of 'private offering memoranda' and other documents for investors to reassure them that their money would be used to finance these ventures, and that E-M engaged in a rigorous approval process of every potential new client company. Over 1,200 people relied on these disclosure documents and consequently provided over $250 million to May's venture before learning in 2007 that it was all a giant Ponzi scheme (PR Newswire, 2007; SEC, 2007).

4.3. Safeguard #3: Independent auditor reports

The JOBS Act requires that entrepreneurs raising over $500,000 must provide audited financial statements for their firms. Independent auditors must verify the firm's operations, assets, and any risks related to investments in the crowdfunded venture. Ponzi entrepreneurs can work around this requirement. The Madoff Ponzi scheme represents a fairly common strategy of decentralizing investments through legitimate firms that funnel the money into a Ponzi venture: the legitimate firms employ independent auditors, which gives investors the impression that the Ponzi venture has been properly vetted.

Bernie Madoff, founder of Bernard L. Madoff Investment Securities, operated an investment firm with a very large and diverse clientele for over 30 years. Investors believed that the funds run by Madoff's firm were verified and given clean bills of health by independent accountants working for many of the major accounting firms including PricewaterhouseCoopers, KPMG, BDO Seidman, and McGladrey & Pullen. In reality, Madoff used a very small 3-person accounting firm, Friehling & Horowitz, to perform audits on his company. Investors put money into feeder funds that were set up by outside firms that subsequently gave the money to Madoff to invest; the feeder companies all had regular audits by the major accounting firms. The accounting firms appear to have used the financial statements provided by Madoff and his tiny accounting firm when auditing the feeder funds, and the accounting firms maintain that an audit does not include examining the books of all of the firms that do business with a focal firm. By the time the SEC discovered Madoff's Ponzi scheme, an estimated 2,500—4,000 people had lost somewhere around $65 billion (Henriques, 2011).

Another variation that is commonly used by Ponzi entrepreneurs involves submitting false audit reports. James Ossie, founder of CRE Capital Corporation, claimed that the Robert Half accounting firm had audited CRE. Investors did not realize this was untrue, so they invested $25 million in a Ponzi scheme (SEC, 2009a). Similarly, Michael Wang founded Velocity Investment Group in 2005, offering investments related to residential and commercial real estate loans. Wang provided potential investors with access to audited annual financial statements; however, when the external auditing firm of SingerLewak noted in its 2008 opinion that it could not verify the collectability of Velocity's mortgage loans receivables or nonmarketable equity securities shown in Velocity's books, Wang switched to Kwan & Company, a single-practitioner firm run by a former manager at SingerLewak who agreed to comply and not audit Velocity's financial statements. Since Wang provided falsified financial information to the accounting firm and then posted the resulting financial statements on the firm's website, investors were led to believe the statements had been verified. Over 2,000 individuals invested in Velocity's funds before discovering in 2013 that they had been victims of Wang's $150 million Ponzi scheme (SEC, 2013).

The requirement for entrepreneurs to provide reports from independent auditors has the potential to reassure investors, but it may lure them into thinking that the appearance of audited financial statements equates to safe investments. Ponzi entrepreneurs can work around this requirement, including falsifying the audit reports or simply paying someone to act as a so-called independent auditor for the Ponzi venture.

4.4. Safeguard #4: Withholding funds until financial goals are reached

Another safeguard in the JOBS Act requires that "any funds raised are withheld from the startup until the fundraising target is met; if it is not, the funds are returned to the investors. This makes it difficult to use equity crowdfunding to perpetrate a Ponzi scheme" (Spring, 2013). This provision is intended to ensure that startup capital raised via crowdfunding goes toward startup activities; for example, an entrepreneur cannot raise 25% of her goal and then use those funds for an entirely different venture or purpose. However, as the examples of Ponzi entrepreneurs demonstrate, these individuals will not be deterred by this condition. They can establish and crowdfund multiple ventures (e.g., using different portals, using different names as the entrepreneur) concurrently or sequentially, using the proceeds from the most recent crowdfunded venture to pay investors from prior crowdfunded efforts. Ponzi entrepreneurs can develop business plans, provide essential documentation on the venture, and disclose key details required for crowdfunding.

Ponzi entrepreneurs frequently develop multiple ventures in order to create the illusion of successful businesses, circumvent due diligence by potential investors and regulators, and create a complex labyrinth of companies through which to move money. This approach could easily be used in equity crowdfunding when a Ponzi entrepreneur raises a specific amount of money through an initial venture and then seeks new crowdfunding for a subsequent venture that appears independent and unconnected to his/her other activities. The following example illustrates a strategy that can be readily adapted for crowdfrauding.

Hanif Moledina, majority owner of coffee roasting company Bean East Corporation, convinced 26 investors to provide $8.3 million in financing for his company so he could fulfill contracts to purchase and supply coffee beans to Folgers Coffee Company; however, in actuality there were no contracts with Folgers. Moledina had created the Ponzi scheme to alleviate cash flow problems he experienced after purchasing three companies as part of an expansion strategy. The coffee contract Ponzi scheme did not bring in enough cash, so Moledina falsified financial documents from the company and building leases so he could obtain a mortgage and at least three loans from banks, including BB&T and Washington First Bank. This increased the total amount raised through fraudulent ventures to $16 million (Federal Bureau of Investigation, 2009; Kloppott, 2010).

5. How do we know whom we can trust?

Safeguards that depend on the SEC or other government entities providing more oversight, due diligence, or licensing are unlikely to be effective because these government organizations already lack sufficient personnel and other resources. We also cannot rely on individual investors to identify fraud. Therefore, we offer six safeguards to help reduce crowdfrauding. It should be noted that an effective solution likely requires some combination of these approaches.

5.1. Certified crowdfunding portals: Don't settle for less

The first safeguard for equity crowdfunding involves certifying the crowdfunding portals as legitimate intermediaries. The JOBS Act requires crowdfunding entrepreneurs to use intermediaries such as broker-dealers or crowdfunding portals. These intermediaries must, by law, investigate the officers of the new venture and ensure that potential investors meet the minimum income and maximum investment requirements. However, these portals vary greatly in the level of due diligence in which they engage, who and when they investigate with their due diligence (e.g., entrepreneurial ventures prior to or post crowdfunding), and how carefully they monitor the limits on how much investors are allowed to invest (e.g., investors who earn less than $100,000 per year can only invest a maximum of $2,000 per year; Misterovich, 2013). Thus, crowdfunding portals play a critical role in establishing equity crowdfunding as a legal and ethical investment opportunity.

Crowdfunding portals must register with the SEC and are required to take actions to reduce the likelihood of crowdfrauding, educate their investors about the risks of new ventures, and provide ample information about the entrepreneurs and their new businesses (Misterovich, 2013). However, a recent report indicates that the names of approximately 200 crowdfunding websites look very suspicious, and state officials have taken legal action against a number of online companies that are attempting to engage in fraudulent crowdfunding (Mashburn, 2013).

The extent of due diligence by crowdfunding portals varies widely, and this creates an opportunity for fraudulent portals and fraudulent ventures using the portals. Kickstarter, one of the most popular crowdfunding portals, has been implicated in a series of crowdfunding frauds (Nunez, 2014). This should not be surprising, given the platform's emphasis that "Kickstarter doesn't evaluate a project's claims, resolve disputes, or offer refunds" (Kickstarter, n.d.). While it maintains an Integrity Team that relies on complex algorithms intended to pinpoint suspicious or fraudulent ventures, Kickstarter openly admits that its platform depends on honesty, open communication, and trust to function effectively (i.e., it relies mainly on self-regulation by the crowd to identify fraud). Indiegogo, another popular crowdfunding portal, also depends on the power of the crowd and complex algorithms to detect fraudulent ventures; the weaknesses of this approach were demonstrated in a recent $1.1 million Healbe 'scampaign' for a calorie-counting wristband that Indiegogo founders were unwilling to stop despite numerous complaints from various individuals (Robinson, 2014). Such fraudulent crowdfunding schemes not only damage the specific platform used to raise money, but also raise questions about the entire crowdfunding industry.

Legitimate crowdfunding portals would be well served by developing their own certification processes and perhaps encouraging the creation of an independent organization or industry association to provide certification of portals. The establishment of best practices could be used to reassure investors and form the basis of a certification process. For example, the portals could agree on how best to accomplish the requirement that they ensure crowdfunding investors are educated in the dangers and risks associated with entrepreneurial startups. Some portals may simply ask potential investors to click on a box to confirm that they have read the attached educational materials, similar to websites that currently ask users to agree to a firm's online privacy policies or terms of use. Other portals may recognize that most users do not ever read the documents and rather just click on the required box; these portals may rely on a short quiz covering key points in the educational materials or a one-on-one conversation with a trained investment professional that works for the portal and screens potential investors. If portals adhered to a rigorous certification process, investors could then have some reassurance that the portal is legitimate and operating with investors' interests as a priority.

5.2. Certified entrepreneurs: Due diligence that improves survival

The second safeguard involves certification of entrepreneurs prior to allowing them to crowdfund. It takes a substantial amount of time for crowdfunding portals to fully investigate each new venture and its founders, which explains why Kickstarter and Indiegogo do not provide this level of scrutiny. Each portal would need to employ a team of highly skilled legal and financial experts to conduct due diligence on each project or potential venture, and pass the associated costs on to entrepreneurs, making it more expensive to crowdfund.

A better solution might be to rely on independent organizations to conduct the due diligence. This can be done in several ways. CrowdCheck is an organization that conducts due diligence for at least eight different online crowdfunding platforms or broker-dealer organizations. The platforms that use CrowdCheck's due diligence services add an important layer of security for both entrepreneurs and investors: entrepreneurs with legitimate ventures can crowdfund without having investors' attention and money diverted by fraudulent but impressive sounding ventures, and investors benefit by knowing that the ventures and investment opportunities have been carefully evaluated. The costs of the due diligence service will need to be added into the costs of crowdfunding, making it more costly for entrepreneurs; but the enhanced security and maintenance of trust and honesty in the crowdfunding community will be upheld and the costs can be minimized by relying on specialized due diligence organizations that can achieve efficiencies in their operations.

A second option would involve portals requiring entrepreneurs to gain certification prior to listing their investment opportunities on crowdfunding websites. Due diligence should include extensive background checks on the entrepreneur, verification of his or her résumé, verification of reported startup activities, contracts with suppliers or customers, and an independent audit of the venture. Rather than operating on the belief that the entrepreneur intends to engage in wealth creation and job creation to benefit society, certifying organizations should assume that the entrepreneur may have falsified information or simply provided inaccurate information.

This second form of certification will likely raise objections from advocates of equity crowdfunding because it will increase entrepreneurs' costs to use crowdfunding. However, rather than viewing this solely as an additional cost to the entrepreneur, this due diligence process could take the form of startup assistance as well as certification. The certification process might be used, for example, to help entrepreneurs better forecast their financial statements and cash flows, strengthen their venture's competitive advantage, and develop superior marketing strategies. This approach could result in a lower failure rate among new ventures and possibly create greater interest in equity crowdfunding because the ventures using that investment vehicle have a greater likelihood of success.

Crowdfunding portals are currently responsible for performing due diligence regarding both entrepreneurs and their ventures. This activity is outside the core business of the portals, and likely requires them to hire and retain substantial numbers of employees with sufficient education, training, and experience in conducting due diligence for startup ventures. It also creates a conflict of interest for the portals since they make money by having more entrepreneurial ventures engaged in equity crowdfunding. While they could be hurt by fraudulent or failed ventures, portals could simply argue that no red flags presented at the venture funding stage and any problems must have occurred well after the money was turned over to the entrepreneurs. Organizations that specialize in certifying entrepreneurs and their ventures for equity crowdfunding can build expertise in this area and use the process to help the entrepreneurs refine their venture ideas and operations. They should be able to identify any Ponzi entrepreneurs who attempt to obtain certification by uncovering false documentation, prior convictions for fraud, and misuse of company assets.

The crowdfunding industry is fairly new in the United States and will go through substantial changes in the next few years. However, crowdfunding portals need to become strong advocates for portal certification and certification of entrepreneurs and their ventures. These measures will help to ensure that crowdfunding maintains high standards rather than become a playground for crowdfrauders to capitalize on a popular form of new venture financing.

5.3. Ethical entrepreneurs: Model transparency and trust

One of the dangers of crowdfrauding is that it tarnishes the reputation of entrepreneurs in general and raises questions about whether the public can trust entrepreneurs and other business people. Legitimate entrepreneurs need to distinguish their ventures from those of Ponzi entrepreneurs and other fraudsters, but that can be challenging. Entrepreneurs starting new ventures lack a track record of performance, a market of consumers/users of their products and services, and the infrastructure of their business that can be laid open for inspection. This increases the importance of crowdfunding entrepreneurs ensuring the transparency of their proposed ventures, including sharing the assumptions on which they based their financial estimates; bluntly explaining any possible pitfalls; and using conservative estimates, particularly for when milestones will be reached. The disclosure requirements for crowdfunding should be viewed as minimum requirements; entrepreneurs need to strive for full disclosure. Ethical entrepreneurs can establish trust with crowdfunding investors by engaging in full disclosure, completely answering questions posed by potential investors, and honestly discussing concerns raised by investors on the portal. While some entrepreneurs may worry that full disclosure will reduce the amount raised through equity crowdfunding and require a lengthy timeframe in launching the new venture, they must realize that interested investors could be with them long term, so transparency and trust established early on will likely turn out to be a wise asset.

5.4. Investor certification: Educate for affordable losses

Many argue that it is not possible to strike a balance between increasing entrepreneurs' access to capital while also protecting investors (Mandelbaum, 2014). The SEC rules for implementing the JOBS Act require investors, not the crowdfunding portals, to self-certify their net worth and income (Lingam, 2013). This assumes that investors carefully read and adhere to the guidelines, and that they understand the risks associated with any startup venture.

Expert angel investors acknowledge they often make poor decisions when evaluating proposed startups that include business plans with financial information, venture pitches by the entrepreneurs, and extensive due diligence. For instance, Chris Sacca—a wealthy angel investor—admits that while he successfully picked and invested in Twitter, Kickstarter, Instagram, and Uber, he has misjudged a number of other potential startups (Blumberg, 2014). Fortunately, these individuals can afford to lose thousands of dollars invested in a startup venture whereas investors living paycheck-to-paycheck or hoping to increase their retirement savings cannot. As previously noted, Barbara Roper acknowledged that many investors approach crowdfunding as they do the purchase of lottery tickets: they keep putting money in equity crowdfunding hoping the venture they pick is the next GrubHub, FireEye, or Natural Grocers—three of the fastest growing public companies in the U.S. (Schurenberg, 2015)—without due diligence or knowledge of sound investment practices.

This suggests that investors should be required to obtain certification before being allowed to participate in equity crowdfunding. Certification could involve attending workshops, passing a quiz at the end of an online course, or participating in other educational programs. Investors need to understand that entrepreneurial ventures represent highly risky investments and they should not commit funds they cannot afford to lose. They need education in and knowledge of investment strategies, such as the importance of diversifying one's investments, the ability to evaluate business plans and financial information, and an understanding of how new entrepreneurial ventures differ from larger firms with established track records.

5.5. Local crowdfunding communities: Truly capitalizing on the power of the crowd

Frequent interaction between entrepreneurs and funders may play a key role in preventing fraud (Mollick, 2014). Investors in general, but especially nascent investors, tend to prefer to meet the entrepreneur they are funding (Clifford, 2013). More crowdfunding portals could facilitate this interaction. CROWDFUNDx runs 120-day startup challenges and utilizes leadership boards in 11 U.S. cities that allow the local community to fund winners of pitch competitions (Clifford, 2013). The leadership boards help protect investors by carefully screening the entrepreneurs and ventures prior to crowdfunding, and the entrepreneurs who participate in these competitions likely enhance their chances for success. Crowdfunding portals could form strong ties with certain communities, helping the portals create a competitive advantage and building local entrepreneurs and investor groups.

Crowdfunding portals do not have to certify investors, but they could partner with organizations that would offer investor education and certification in the local crowdfunding community. When nascent investors come to the startup challenges or pitches, they could be directed to individuals in attendance from the education/certification organizations, who would explain to them the importance of informed investing and the potential dangers of crowdfrauding, as well as the possible failure of crowdfunded startups. By embedding crowdfunding in local communities, the portals can assist in establishing positive norms for both screening of entrepreneurial ventures and educating investors.

5.6. Capitalize on the SEC's team: Tipping is not tattling

One of the best safeguards available to each of us involves informing the SEC when we see equity crowdfunding opportunities—or any investments—that appear suspicious or too good to be true. The SEC investigates tips it receives, discretely examining businesses and investments to determine if they appear fraudulent while protecting the anonymity of the person who provided the initial information or raised questions about the venture. If the business appears to be legitimate but is simply poorly managed or lacks a viable product/strategy, the SEC will not take any action; however, if the tip leads to the SEC identifying evidence that a Ponzi venture or other financial fraud is occurring, it will launch a full-scale investigation. Tipping the SEC represents a critical safeguard against crowdfrauding and other types of Ponzi schemes since it allows the SEC to identify Ponzi entrepreneurs before the Ponzi scheme collapses and before investors lose their life savings.

6. Conclusion: Protect the honest and expose the illegal

The central argument of this article is not that entrepreneurs are inherently dishonest or that they should not be allowed to engage in equity crowdfunding. We view ethical entrepreneurs as essential to economic growth and innovation. However, we believe equity crowdfunding—and entrepreneurship in general—needs to be based on an assumption that some entrepreneurs will engage in wealth-destroying and completely self-interested activities that harm society.

The aforementioned cases of Ponzi entrepreneurs demonstrate the ease with which scheming individuals can engage in crowdfrauding, raising money from large numbers of people who can least afford to lose their income or savings. Investors must exercise due diligence and carefully review all available information prior to investing in a crowdfunded venture. Even sophisticated and knowledgeable investors may not be able to spot a Ponzi entrepreneur. Crowdfunding proponents believe that self-regulation of the crowd, transparency and documentation, requiring an independent auditor's report on the venture, and withholding funds until the entrepreneur reaches his/her funding goal will prevent crowdfrauding by Ponzi entrepreneurs, but these preventive measures all rest on faulty assumptions. Ponzi ventures often appear highly viable and likely to provide a reasonable return for investors; in fact, they look very similar to legitimate, ethical ventures.

The goal of providing greater funding opportunities for startup entrepreneurs is a very important one and deserves additional attention. However, loosening the rules on crowdfunding or assuming the current rules will stop Ponzi entrepreneurs seems fraught with danger. Ponzi entrepreneurs harm the fabric of trust on which crowdfunding—and business in general—rests. Each time thousands of investors discover they have lost substantial amounts of money in a Ponzi venture, they become more cynical about entrepreneurial activity, the security of the financial system, and the ability of government to protect citizens from fraud.

"Trust, but verify" was a recommendation emphasized by Ronald Reagan when he was President of the United States. The same recommendation needs to be applied to equity crowdfunding in the form of certification of crowdfunding portals as legitimate organizations that raise money for legal entrepreneurial ventures. This will prevent Ponzi entrepreneurs from starting Ponzi schemes that look like legitimate businesses, and will assure investors that their chosen portal engages in responsible investment practices such as carefully screening and educating investors. Similarly, certification of the entrepreneurs and their new ventures will enable crowdfunding portals and investors to be reassured they are not supporting Ponzi ventures.

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