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The Danger of Crowding Out the Crowd in Equity Crowdfunding

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The Danger of Crowding Out the Crowd in Equity Crowdfunding

**Summary**
With regard to equity crowdfunding, too many policymakers and regulators are focusing their attention on the “funding” piece of crowdfunding, overlooking the fact that the true revolutionary power of crowdfunding lies instead in the crowd.

**Keywords**
crowdfunding, kick-starter, indiegogo, rockethub, entrepreneurs, investors, equity

**Disciplines**
Business | Entrepreneurial and Small Business Operations | Public Policy

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With the success of reward-based crowdfunding as an example, in 2012 Congress passed the Jumpstart Our Business Startups Act (The JOBS Act). The JOBS Act makes a number of changes to security laws, and a substantial effect of the legislation, under Title III, is to legalize equity crowdfunding. This allows companies to use crowdfunding to raise money in return for equity, rather than restricting fundraising to a patron model.

While the SEC has yet to finalize regulations on crowdfunding under the JOBS Act, it is not clear that the current draft regulation will do much to make crowdfunding a useful tool to encourage innovation and job growth, as it makes equity crowdfunding too expensive and difficult. For example, CrowdFund Capital Advisors used estimates from the SEC to determine that raising $100,000 under the JOBS Act would result in up to $39,000 in compliance fees, and that raising larger amounts would still require that almost 8% of the proceeds go to fees. Further, even if the regulation changes, I worry that both the SEC and many of the other players in the space are paying too much attention to the “funding” piece of crowdfunding, concentrating on creating a new financial vehicle. My research shows that the true revolutionary power of crowdfunding is instead the “crowd”—and that only by refocusing on the crowd, and understanding its value, will equity crowdfunding lead to improved innovation, more jobs, and better outcomes for investors and entrepreneurs alike.

THE VALUE OF CROWDFUNDING

The true power of crowdfunding is its ability to democratize entrepreneurship. Currently, access to startup capital is tremendously limited. Overwhelmingly, the companies that receive venture capital investment are founded by white males; less than 3 percent of VC-backed companies have female cofounders, and only 1 percent of VC-funded startups are founded by African Americans. Further, VC is highly concentrated, with most investment occurring in just a few locations, particularly the San Francisco, Boston, and New York metropolitan areas. This lack of diversity is problematic on its face, but even more so if you follow the overwhelming evidence that innovation can come from anywhere. Rather than drawing our entrepreneurs from across the nation, the current funding system only truly works for a very small segment of people.

On the other hand, as can be seen in Figure 1, crowdfunding projects are distributed across the country. Further, the typical disadvantage faced by women in raising VC funding is completely reversed in crowdfunding. All other things being equal, women are 13 percent more likely than men to succeed in raising their goal in a crowdfunding campaign because they are helped by other women. This suggests that crowdfunding may truly democratize access to capital, if done correctly.

Further, crowdfunding can lead to the creation of real companies and jobs. A previous survey of design, technology, and video game projects that raised money on Kickstarter before mid-2012 found that non-equity crowdfunding can indeed support more traditional entrepreneurship. A very high percentage (over 90%) of successful projects remained ongoing ventures, 32 percent of which reported yearly revenues of over $100,000 a year after the Kickstarter campaign (10 percent of these represented ongoing companies that already had been making that much). Further, successful projects added an average of 2.2 employees per project—and this does not include outliers like Oculus VR, sold to Facebook for $2 billion, which did not respond to the survey. The survey also suggested that crowdfunding did much more than provide funds, unlocking the ability to reach customers, press, employees, and outside funders. Crowdfunding, then, is more than a theoretical source of opportunity. The research shows that it actually does increase opportunity and helps lead to the estab-

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1 Sherwood Neiss, “It might cost you $30K to crowdfund $100K under the SEC’s new rules,” VentureBeat, January 2, 2014.
6 Ibid.
lishment of real companies, even though
crowdfunding remains limited to giving
away rewards, rather than equity. The SEC
and Congress need to consider the positive
impact of crowdfunding on entrepreneurship
and innovation, which lies in the
relative ease with which individuals, even
unlikely individuals, can raise funding for
good ideas. Focusing purely on crowdfund-
ing as an investment model might lead to
the creation of regulation that reduces the
ability of crowdfunding to democratize
startups, again limiting funding to the well-
connected few. Trusting the crowd in crowd-
funding means not just paying attention to
innovators, but also to the way the crowd
effectively funds legitimate projects in what
is currently a nearly unregulated market.

WHY CROWDFUNDING NEEDS
THE CROWD

One of the big surprises of reward-based
crowdfunding is that, contrary to expecta-
tions, fraudulent projects are rare.\(^5\) Previous
research indicates that the amount of money
pledged to projects that ultimately seem
to have no probability of being delivered
accounts for less than 0.1 percent of all
pledged funds. This is despite the fact that
reward-based crowdfunding sites have few if
any formal controls against fraud beyond an
initial screen by the reward-based portal.

Fraud is so low not because of registra-
tion requirements, but because the com-
munity of investors plays a critical role in
detecting and deterring fraud. On sites like
Kickstarter, investors look for signals of
quality, and are more likely to fund projects
that show signs of the ability to succeed,
as such clear plans for future development,
and appropriate backgrounds, past experi-
ence, and outside endorsements of the
project creators. The crowd can be quite sen-
sitive – a single spelling error decreases the
chance of funding success by 13 percent.\(^6\)
This process works because many individu-
als (with verifiable real-world identities)
weigh in on projects, discussing the merits
and probability of success of each project.
These discussions take place on Kickstarter,
but also on other social media sites, blogs,
and forums. The result is that comments
on potential issuances are made not just by
investors, but also by outside experts, com-
munities of interest, and journalists. These
online communities play several important
roles in improving offerings, preventing
fraud, and making crowdfunding successful.

First, they allow a core-periphery
dynamic to develop, similar to that seen
in other functional online communities,
ranging from Wikipedia to open source
software development. Having many people
examining issuances from the periphery,
even if they may not all be core investors
themselves, greatly increases the chance that
someone will have the expertise and desire
to spot potential issues with a proposal. In
the case of Kickstarter, communities have
successfully detected fraudulent projects,
and had healthy debates over the merits of
other projects that have resulted in proj-
ects improving as a result of the feedback.
Allowing ongoing discussions between
potential investors, community members,
and issuers is a vital aspect of avoiding fraud
and improving proposed projects. Some of
this is already in the draft SEC regulation.

Further, the network effects within
communities enable one interested party to
draw others into the discussion, adding to
the possibility that investors or commenta-
tors with appropriate expertise will find the
relevant projects where their knowledge
would be most useful. Indeed, a decade of
research has shown that vibrant communi-
ties are key to harnessing the best ideas
from a crowd, and to improving exist-
ing ideas, in order to create breakthrough
innovations. Communities can only form,
however, if there are enough quality issuers
to attract high-quality community mem-
bers. Otherwise, there will be little to draw
a community to a portal. I would caution
against too many formal regulatory fil-
ings, as that may actually increase fraud by
discouraging high quality issuers with other
alternative fundraising options. This will
make it hard to gain the interest of com-
munity members to portals, and therefore
reduce the ability of communities to help
detect fraud.

In addition to preventing fraud by
issuers, communities with persistent identi-
ties can prevent future fraud, including
pump-and-dump schemes. If a community
around a particular investment consists of
known members with consistent identities
(something not in the current investment
regulation), it will immediately be obvi-
ous if outside individuals attempt to falsely
promote or denigrate a funded company for
fraudulent purposes. The community will
be able to detect anonymous outsiders, and
community members will have reputational
reasons for avoiding these sorts of schemes,
or their online identities will become associ-
ated with fraud.

Crowds are not just about preventing
fraud, however. They also provide ongo-
ing benefits. An analysis of the long-term
results of reward-based crowdfunded
projects showed that the money raised was
not considered to be the most important
outcome of crowdfunding. Instead, proj-
ect founders were even more interested
in building long-term relationships with
customers, getting information about
markets, and marketing themselves. In a
survey, when people that sought crowdfund-
ing were asked to explain why, the answer
that “the project could not have been funded
without [crowdfunding]” was actually the
fourth most popular reason, not the first
(see Figure 2).\(^7\)

The lessons of reward-based crowd-
funding suggest that the success of equity
crowdfunding will depend on the long-term
interactions between issuers and investors.
These communities over the longer term will
help keep crowdfunded companies account-
able to investors. If investors are going to
be able to provide meaningful feedback
to companies when asked, or be able to
weigh in on potential pivots or changes of
direction, there will need to be an ongo-
ing engagement between investor com-
munities and companies. On Kickstarter,
communities of backers continue to give
feedback on projects long after funding has
closed, providing both a valuable resource
and an important incentive for projects to
deliver. Having issuers connected to per-
sistent online identities, such as LinkedIn,
ensures that founders of projects are held
accountable for their actions and perfor-
mance across many projects, and that their
skills and backgrounds can be adequately
assessed. Something similar will be needed in equity crowdfunding.

Vibrant communities arise when they
have a wide variety of potential investments
to examine and discuss. I would urge the
SEC and Congress to ensure that barri-
ers to entry (financial and regulatory) are
not so high as to drive the best investment
opportunities towards other funding mecha-
nisms. If platforms only attract a few issuers,
communities will not have a chance to
form, resulting in less crowd-based insight
into projects and heightening the chance of
fraud. This, in turn, will damage crowdfund-
ing as a whole, and further drive quality
issuers from the platforms, creating a vicious
cycle. It would be better to err towards
allowing more issuers, with a more vibrant
crowd, than too few, without a crowd but
relying on regulation alone.

**REMEMBER THE CROWD**

Crowdfunding is in its early days, and still
has far to grow. The government can play a
vital role in helping crowdfunding reach its
full potential, but doing so involves taking
some risk on a radically new approach to
funding ventures. The only way it will work
is if the focus remains on crowdfunding as a
community-driven and inherently democ-
ratizing method of raising money, rather
than as simply another investment category.
That means that the crowd needs to have an
active role in sourcing, selecting, and dis-
cussing the potential of new ventures. Even
in reward-based crowdfunding, the early
results are powerful – higher participation
of disadvantaged groups, greater geographic
diversity, and evidence of positive job
growth. I hope that future regulatory efforts
preserve and build on what is right with
crowdfunding, as well as worry about what
might go wrong.
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## ABOUT THE AUTHOR

**Ethan Mollick, PhD**  
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Ethan Mollick is the Edward B. and Shirley R. Shils Assistant Professor of Management at the Wharton School of the University of Pennsylvania. He studies innovation and entrepreneurship, and the ways in which an individual's actions can affect firms and industries. His research includes early-stage entrepreneurship and crowdfunding; the way in which communities of users come together to innovate; and the factors that drive the performance of entrepreneurial companies. Professor Mollick also co-authored Changing the Game, a book on the intersection between video games and business that was named one of the American Library Association's top ten business books of the year, and has studied the way that games can be used to motivate performance and education. He has published papers in leading academic journals, and he was among the 100 most downloaded authors (out of over 230,000) on the Social Science Research Network and was named one of the “40 Most Outstanding Business School Professors Under 40.”

Prior to his academic career, Professor Mollick was co-founder of a company and a management consultant. He has worked with organizations ranging from DARPA to General Mills on innovation and entrepreneurship.

Ethan Mollick received his PhD (2010) and MBA (2004) from MIT’s Sloan School of Management and his bachelor's degree from Harvard University, magna cum laude, in 1997.

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