By 2012, more money was flowing to the arts through Kickstarter than the National Endowment of the Arts. By mid-2014, $1.2 billion had been distributed to over 64,668 projects on Kickstarter alone, supported by well over six million people, and other sites, ranging from Indiegogo to RocketHub, also have been expanding quickly. The result has been the rapid growth of a powerful new tool to fund creative and for-profit endeavors, from films to technology startups.

To date, almost all of these funds have been given either as donations or in return for some future reward. This approach, commonly called reward-based crowdfunding, treats backers as patrons, rather than investors, of the projects they fund. In return for their donation, backers get a reward from the project creators. This can include being credited in a movie, having creative input into a product under development, or receiving the opportunity to meet the creators of a project. Alternatively, reward-based crowdfunding treats funders as early customers, allowing them privileged access to the products produced by funded projects at an earlier date, better price, or with some other special benefit. The “pre-selling” of products to early customers is a common feature of those crowdfunding projects that more traditionally resemble entrepreneurial ventures.

During the last four years, Kickstarter, the world’s largest crowdfunding platform, has grown quickly, rising from obscurity to become a verb: “I am kickstarting my project!”

THE DANGER OF CROWDING OUT THE CROWD IN EQUITY CROWDFUNDING

BY ETHAN MOLLICK

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.”

The lessons of reward-based crowdfunding suggest that the success of equity crowdfunding will depend on fostering long-term online interactions between project issuers and potential investors in the crowd. Online communities make funding available to a wider range of entrepreneurs than traditional funding models and play important roles in reviewing and improving project offerings and preventing fraud.

Research shows that such vibrant online communities arise when they have a wide variety of potential investments to examine and discuss. So the SEC and Congress would do well to ensure that financial and regulatory barriers to entry for crowdfunding are not so high as to drive the best investment opportunities toward other funding mechanisms.

Only by refocusing on the crowd will equity crowdfunding bring the greatest benefit to investors, entrepreneurs, and the overall economy.
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.¹ 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.² 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.³ 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.⁴ 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-
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 crowdfunding 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 crowdfunding 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 expectations, fraudulent projects are rare. 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 registration requirements, but because the community 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, such as clear plans for future development, and appropriate backgrounds, past experience, and outside endorsements of the project creators. The crowd can be quite sensitive—a single spelling error decreases the chance of funding success by 13 percent. This process works because many individuals (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, communities 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 projects 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 commentators with appropriate expertise will find the relevant projects where their knowledge would be most useful. Indeed, a decade of research has shown that vibrant communities are key to harnessing the best ideas from a crowd, and to improving existing ideas, in order to create breakthrough innovations. Communities can only form, however, if there are enough quality issuers to attract high-quality community members. Otherwise, there will be little to draw a community to a portal. I would caution against too many formal regulatory filings, 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 community members to portals, and therefore reduce the ability of communities to help detect fraud.

In addition to preventing fraud by issuers, communities with persistent identities 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 consists of something not in the current SEC draft regulation), it will immediately be obvious 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 associated with fraud.

Crowds are not just about preventing fraud, however. They also provide ongoing 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, project founders were more interested in building long-term relationships with customers, getting information about markets, and marketing themselves. In a survey, when people that sought crowdfunding 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).

The lessons of reward-based crowdfunding 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 accountable 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

“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.”
direction, there will need to be an ongoing engagement between investor communities 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 persistent online identities, such as LinkedIn, ensures that founders of projects are held accountable for their actions and performance 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 barriers to entry (financial and regulatory) are not so high as to drive the best investment opportunities towards other funding mechanisms. 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 crowdfunding 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 democratizing 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 discussing 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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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.

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