The Long-Term Viability of Equity Crowdfunding

By

Emily D. Bosley

A capstone project submitted in partial fulfillment of graduating from the Academic Honors Program at Ashland University

May 2015

Faculty Mentor: Dr. James Falter, Assistant Professor of Finance
Additional Reader: Dr. Charles Bryant, Professional Instructor of Finance
Abstract

Small businesses often have a difficult time obtaining funding. With no credit history and little collateral, obtaining funding can be an insurmountable obstacle for small businesses. Because of this, many entrepreneurs are turning to a newer funding method, crowdfunding. Crowdfunding can broadly be defined as “the financing of a project or a venture by a group of individuals instead of professional parties” (Larralde and Schwienbacher, 2012). Typically, individuals or businesses create a campaign seeking to raise funds on a crowdfunding website. Equity crowdfunding to unaccredited investors was previously inaccessible in the United States due to securities regulations pertaining to equity offerings. The JOBS Act of 2012 made equity crowdfunding legal, and following the passage of this act, the SEC issued several regulations for crowdfunding issuers and “funding portals.” This paper focuses on equity crowdfunding and its practicality in light of these new regulations. Upon examination of the JOBS Act, it seems that the regulation, costs, and risks involved with equity crowdfunding inhibit its long-term potential to be a viable funding method for early stage ventures and also as an investment vehicle for unaccredited investors. While the idea is promising, the burdens put upon the intermediaries and entrepreneurs severely diminish the practicality of equity crowdfunding.
# Table of Contents

Abstract ................................................................................................................................. II

I. Introduction .......................................................................................................................... 1

II. Research Questions .......................................................................................................... 2

III. Literature Review ........................................................................................................... 3
    A. Background .................................................................................................................... 3
    B. Alternate Forms of Funding ......................................................................................... 10
    C. The Jobs Act of 2012 ................................................................................................. 19
    D. Related Articles .......................................................................................................... 25

IV. Analysis of Research Question ....................................................................................... 26
    A. Investment Environment .............................................................................................. 26
    B. Economic Impact of Small Businesses ........................................................................ 27
    C. Crowdfunding sustainability ....................................................................................... 28
        1. Targeted Companies ................................................................................................. 28
        2. Intermediaries .......................................................................................................... 29
        3. Entrepreneurs .......................................................................................................... 34
        4. Investors ................................................................................................................ 37
        5. Overall .................................................................................................................. 39
    D. Other Equity Options ................................................................................................. 41

V. International Perspective ................................................................................................. 42

VI. Summary and Proposition ............................................................................................. 43

VII. Conclusion and Future Directions ............................................................................... 45

VIII. References .................................................................................................................. 49

IX. Biographical Information .............................................................................................. 54
I. Introduction

Small businesses often have a difficult time obtaining funding. With no credit history and little collateral, accessing capital can be difficult for small businesses. Because of this, many entrepreneurs are turning to crowdfunding. Crowdfunding can broadly be defined as “the financing of a project or a venture by a group of individuals instead of professional parties” (Larralde and Schwienbacher, 2012). Typically, individuals or businesses create a campaign seeking to raise funding on a crowdfunding website. This use of the internet allows the business to reach a broad audience and raise money using a large number of funders, with each funder typically contributing a small portion to each campaign.

There are four prevalent methods of crowdfunding: donation, pre-order, debt, and equity. In the donation model, funders merely give money to a person or business. Typically, these campaigns involve philanthropical motives. The donation model provides no economic benefit to the funder, however, aside from appealing to his or her altruism. This means that it is not reliable for funding larger dollar amounts. The pre-order model is often utilized when an entrepreneur wants to fund a product, so he or she charges a discounted price to pre-order a product. This model requires the entrepreneur to sell some of his or her product with lower profit margins, and also does not coincide with raising significant amounts of funding. The debt model behaves essentially as a loan with no “ownership rights.” This is beneficial to the entrepreneur because they are able to retain complete control of his or her business, however, this also means that the entrepreneur is locked into interest payments and therefore has increased default risk. Finally, the equity model, the focus of this paper, is similar to common stock wherein someone invests in the campaign expecting to make a return on his or her investment.

Equity crowdfunding to unaccredited investors was previously inaccessible in the United States due to the regulations surrounding equity offerings set forth in the Securities Act of 1933
and the Securities Act of 1934. Congress passed the JOBS Act of 2012 which made equity crowdfunding legal. Following the passage of this act, the Securities and Exchange Commission (SEC) is expected to issue corresponding regulations for crowdfunding issuers and “funding portals.” This paper will focus on equity crowdfunding and its practicality in light of the limitations. While the idea is certainly a step forward in entrepreneurial funding, the amount of regulation will inhibit young companies and entrepreneurs from being able to take advantage of the opportunity.

II. Research Questions
This paper seeks to answer the following questions:

1. Will SEC regulations affect crowdfunding’s effectiveness as a technique for raising startup capital?

2. In light of the JOBS Act and new SEC regulations, will equity crowdfunding be sustainable as a long-term capital raising technique?

Upon a comprehensive literature review, these questions will be answered. This thesis will discuss the investment environment, the economic impact of small business, the current crowdfunding regulations, and compliance issues. Finally, the thesis will briefly compare prevalent international equity crowdfunding markets, consider the implications of the research, make recommendations moving forward to enhance the utility of equity crowdfunding, and provide direction for future research.
III. Literature Review
   A. Background
Crowdfunding has been increasing in popularity in recent years leading to scholars writing about developments in this evolving field. This literature review will examine background information to establish a foundational understanding, alternate forms of funding to examine the niche that crowdfunding fills, legal articles which align closely with the topic at hand, and other relevant articles which prove pertinent to the topic.

   Agrawal, Catalini, and Goldfard examined the geographic dispersion of investors in crowdfunding campaigns (2011). They noticed that previous research (Tribus 1970, Florida and Kenney 1988, Florida and Smith 1993, Lerner 1995, Sorenson and Stuart 2001, Powell, Koput, Bowie, and Smith-Doerr 2002, Zook 2002, and Mason 2007) indicated that investors in start-up companies tend to be geographically close. This reduces costs in common activities such as providing input and monitoring progress. The authors did a case study of Sellaband which is an Amsterdam-based site focusing on musicians looking for $50,000 in financing to record an album. Their sample included investments made from August, 2006 until September, 2009. From this, they used geographic data from investors and entrepreneurs as well as data on the investment raised for entrepreneurs. They found that the average distance for investors in a crowdfunding campaign is 3,000 miles, thus conflicting with the tendencies of alternate funding methods. The authors found that the likelihood of an investment during a given week increases as more capital is raised. The exception to this is local investors who tend to invest early on in a campaign and are not swayed by the behavior of other investors. This is explained due to the fact that local investors tend to be family and friends. This research ultimately showed that distance is not as much of a barrier in crowdfunding campaigns as it is with alternate funding.
While Agrawal, Catalini, and Goldfard addressed the distance of participants, Miceli, Ordanini, and Pizzetti examined another dynamic of participants, looking specifically at their motivations for participation. Miceli, Ordanini, and Pizzetti (2011) examined three crowdfunding case studies to address mainly why investors participate. They examined Sellaband in the music industry, Trampoline in the financial services industry, and Kapipal in the sector of non-profits. The authors found that participants are motivated by the desire to help others succeed (similar to the “donation” model), the desire to be a social participant, and the monetary payoff that investing in successful ventures can bring in addition to traditional motivations to participate in the service industry. Participants typically have an innovative orientation, a social identification with the project, and a desire to make money from investing in the project. Consumers are able to activate the service process by investing and thus influence the outcome of the crowdfunding process. Understanding the motivations of crowdfunders allows entrepreneurs to better target their campaigns and thus increase their chances of success.

Kitchens and Torrence (2012) move away from participants and focus on the general economy by examining the changing nature of economic development due to crowdfunding. The authors define economic development as “a community or governmental-based group focusing on selling location, natural resources, and labor” (Kitchens & Torrence, 2012). The authors point out that in the past, economic development has been closely managed and controlled, but that will change going forward. Further they posit that companies moving towards “collaboration and crowdfunding” improve the economy. The areas that adapt will succeed, while those that remain stagnant ultimately fail. The JOBS Act aims to open up funding with the intention to create jobs by removing funding barriers. The authors suggest that this regulation makes IPOs (Initial Public Offerings) and funding more simplistic by removing regulatory barriers, such as Dodd-Frank and
Sarbanes-Oxley, put into place. The authors point out the “economic growth is driven by innovation. Innovation is driven by experimentation. Crowdfunding funds experimentation” (Kitchens & Torrence, 2012). They conclude by noting that crowdfunding provides an opportunity for companies through reductions in regulation, but it may also provide communication and administrative challenges. Challenges include a unique and widespread shareholder base. This is important because it demonstrates how crowdfunding could positively affect the economy as a whole.

While many of the previous authors took a look at a specific aspect of crowdfunding, Larralde and Schwienbacher (2012) look at the broader picture by providing an aggregate overview of many aspects of crowdfunding. They begin by establishing the need for crowdfunding stating that many small businesses have trouble obtaining funding for several reasons. A lack of cash flow makes the company risky to funders because they are skeptical of repayment due to the company’s limited funds; there is no historic evidence that they will succeed. They also lack collateral which increases the risk because if a business were to default, there are no tangible assets which the lender may claim to obtain repayment. Finally, information asymmetry heightens the risk because investors are not fully informed about the business itself. This causes them to fund utilizing friends, family, and bootstrapping which the authors define as the “use of trade credit, credit card and other methods, including working capital management” (Larralde and Schwienbacher, 2012). Bootstrapping, however, has a drawback as a funding method as it slows growth. This indicates that there are underserved entrepreneurs in need of the opportunities afforded by equity crowdfunding. According to Kleeman et al. (2008) the main reason that people fund in this manner is to reduce costs. The authors found that for a campaign to be successful it should have certain criteria:
• It should seek to raise a small amount of capital
• It should center on an interesting project
• Entrepreneurs should be willing to take the opinions of participants
• Entrepreneurs should be internet savvy since that is the medium on which this form of funding is based

The authors conclude by offering questions for future research with the most pertinent centering on the intellectual property rights of the entrepreneurs since they must disclose their idea to receive funding. When an entrepreneur explains their idea on the internet, however, they also open themselves up to competitors who may copy the idea. While crowdfunding fills a specific niche, it also includes additional strategic/competitive risks.

Mitra (2012) continues the same line by examining crowdfunding globally from a broader view. The author asserts that crowdfunding essentially combines features of both crowdsourcing and microfinance which the author defines as the concept of “small amounts contributed; no collateral” (Mitra). Crowdfunding is increasing in popularity worldwide with donation and reward-based models currently being the most utilized. Equity platforms, however, are gaining ground with use in Europe and Australia. It is still illegal in Canada due to registration requirements with the provincial securities commission. The United States made equity crowdfunding legal with the JOBS Act which would allow the public solicitation of unaccredited investors, an act that was previously prohibited. The author asserts that the study is useful to entrepreneurs and policy makers as background information on crowdfunding.

Belleflamme, Lambert, and Schwienbacher (2013) examine two specific models of crowdfunding to see which method is the preferred among entrepreneurs: pre-ordering and profit sharing. Their study looked at several variables in both cases including the amount of money
needed to begin production, the baseline quality of goods, the utility from increasing the quality of goods, the number of crowdfunders, and the profits by the entrepreneur. In addition, they looked at specific variables for each type of funding. For pre-ordering these included the community benefits for participation, the price charged to funders, and the price charged to other consumers. They noted that there is an opportunity for price discrimination between these two groups of people. For profit-sharing the variables included again, the community benefits for participation, the share of the profits that would be distributed to participants, and the price that was charged to consumers. In this case, the price would be uniform across all investors. The study found that entrepreneurs prefer to use pre-ordering when the amount of funding needed is relatively small, but they prefer profit sharing when the project requires larger amounts of funding. The study found that entrepreneurs prefer pre-ordering for smaller amounts because they are able to charge different prices to funders and traditional consumers, but as the funding need increases the entrepreneur may need to change the pricing for pre-orders in order to attract investors. This leads to a point where pre-ordering is not financially advantageous thus leading to a preference for profit sharing because even as the number of investors increases, the percentage of profits shared remains unchanged. The authors noted that they limited the study by making each option mutually exclusive. However, it does show important information about the crowdfunding preferences of entrepreneurs.

Consistent with previous research, Burtch, Ghose, and Wateal (2013) examined the behavior of crowdfunders. They wanted to examine social influence on crowdfunding, so they studied 100 online journalism pitches, examining private contributions to a public good. The authors questioned whether to apply a substitution model to explain this contribution or the reinforcement model. Reinforcement models predict that participants contribute out of a desire to
be fair and fit in with peers. The substitution model predicts that people will contribute less when they see greater funding coming into a campaign. They examined antecedents and consequences. For the antecedents they examined contribution, remaining budget, contribution frequency, page views daily, search trends on Google, and posting duration. For consequences they examined read time, funding duration, the amount of time a person spent looking at a pitch, readability, search trends, pitch budget, pitch views and weeks posted. The authors found that the substitution model applied due to “crowding-out.” This indicated that a primary motivation for contribution was the desire to be charitable, a motive essential to the success of donation crowdfunding. This provides a contrast to conventional profit seeking models of investing and gives insight that could be useful to crowdfunders.

The next study begs the same question as Miceli, Ordanini and Pizzetti. Gerber and Hui (2013) sought to answer the question: “What motivates and deters participation in the crowdfunding community?” The authors researched motivations to illuminate opportunities to improve platforms to better recruit and sustain participation. The authors completed 83 interviews of both investors and entrepreneurs to determine motivations and deterrents for participating in a campaign. All participants were U.S. - based, with twenty-one women, and sixty-two men. They found that entrepreneurs were motivated to use crowdfunding because of the need to raise funds, desires to expand awareness about their project or work, maintain control of their project or business, learn a new fundraising skill. Entrepreneurs were deterred from participating because of the lack of ability to attract investors, the fear of public failure, and a lack of commitment to the time and financial resources needed for the campaign. Supporters of campaigns were motivated by the desire to collect financial rewards, the desire to help other people, and the desire to support a cause and be part of a community. Note, that two motives
(helping others and supporting causes) are aligned with the donation model. They were deterred by only one factor: distrust of funding usage. This distrust is ultimately a governance issue and should be mitigated by SEC regulation, but the current lack of regulation surrounding crowdfunding makes this a concern for participants. The authors showed that there are a variety of reasons that people do or do not participate in crowdfunding campaigns and thus gives potential entrepreneurs insight into the crowdfunding industry.

Jegeleviciute and Valanciene return to a basic overview by performing a SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis on crowdfunding (2013). They found that the strengths of crowdfunding included the ability for entrepreneurs to retain decision making power, the access to capital, the ability to test the product or idea in the market before launch and the community benefits such as investment in the area. They found several weaknesses existed, including administrative and accounting difficulties, the lack of advice that entrepreneurs receive from traditional funding options, the lack of protection for an idea, and the potential for fraud. The opportunities include the social networks that can be used, the connectivity that crowdfunding brings, the positive economic effects of investing, and the niche for investing and receiving funding. The threats include legal hurdles with current regulation and the inherent risks present in small business such as the high failure rate among startups as stated by Sigar (2012). The authors conclude by offering areas for future research including the effect of crowdfunding on economies and the benefits and drawbacks to choosing crowdfunding as opposed to alternative funding methods.

Mollick (2014) focuses on the entrepreneurs who realize the benefits of crowdfunding and have chosen it as a funding method. He begins by pointing out that there is a lack of research surrounding the topic of crowdfunding. He examined a dataset of 48,526 projects to determine
factors that predict success or failure of a campaign. Personal network and project quality are both related to success. This means that an entrepreneur who has a wide social network may have an easier time obtaining funding. Furthermore, geography relates to the type of project and success. Of order of significance, first the distribution and success in Kickstarter campaigns is geographically uneven. Second, people are influenced by the culture of their area in what types of projects they pursue. For example, a disproportionate number of projects come from the music city, Nashville, Tennessee, where most of the projects are musically based. The author also found that a majority of entrepreneurs using the reward-based model fulfill their promises to investors, but over 75% are late. The delay can be predicted by the level of funding that a project receives with overfunding being a significant cause. The author suggests that the emphasis on quality shows that crowdfunding participants do assess the potential of entrepreneurial campaigns. The author further asserts that crowdfunding eliminates some geographical constraints that complicate funding.

B. Alternate Forms of Funding

While many scholars are examining what crowdfunding is, many others have examined the merits and shortcomings of alternative types of funding. This is essential to crowdfunding because it establishes the void which crowdfunding attempts to fill in the capital markets.

Berger and Udell (1998) examined the choice of debt versus equity for small business startups. They point out that private markets that tend to fund small businesses are much different than the public markets that fund large businesses because of “information opacity.” While the largest businesses usually are publicly traded and therefore file information with the SEC, small businesses are not required to disclose that same information, thus leading to information asymmetry. The authors compiled existing literature to examine the funding of start-
ups, and found that generally high-risk, high growth start-ups with intangible assets tended to receive equity funding whereas low-growth, low-risk start-ups with tangible assets tended to receive debt funding. This means that higher-risk start-ups that lack tangible assets will likely see more success with the equity model of crowdfunding. The authors also pointed out the significant impact of owner financing in small businesses which does not tend to be prevalent in their larger counterparts. They analyzed nine sources of debt financing and four sources of equity financing and discovered that 70% of financing is provided from the owner, commercial banks, and trade creditors. Financial institutions also play a significant role which is contrary to the assertion that small businesses are unable to obtain funding from financial institutions. Furthermore, there are three main factors of “information opacity” which affect capital structure. Adverse selection, which is a problem associated with “properly identifying the quality of a project” and costly state verification favor debt funding (Peneder, 2012). On the other hand, moral hazard, “the risk resulting from the ability of one party to a contract to take unobserved actions that adversely affect the value of the contract for the other party,” favors equity funding (Stulz & Johnson, 1985). Finally, the authors found that in early stage financing where much information about the business is unavailable, the entrepreneur’s credit-worthiness tends to be scrutinized rather than the business’s credit-worthiness due a lack of credit history for the business. This puts the entrepreneur at risk because he or she is responsible for the loan.

Hsu (2004) looked specifically at a certain type of funding, venture capital, with the hypotheses that:

- “(1) offers made by more reputable VCs [venture capitalists] are more likely to be accepted
- (2) The price that entrepreneurs pay in the market for affiliation is inversely associated with VC reputation.”
The author based this on the assertion that venture capitalists provide more than just monetary assistance with many being utilized for their human capital (professional knowledge) as well as their access to capital. Hsu studied 148 financing offers made to 51 different start-ups. He used models that assessed the probability of acceptance based on the venture capital reputation, the valuation, and controls as well as an equation that measured valuation based on venture capital reputation and controls. Hsu found that an offer from a reputable venture-capitalist is three times more likely to be accepted than offers from alternate venture-capitalists. Furthermore, venture capitalists with favorable reputations typically obtain a 10-14% discount on their capital as compared to venture capitalists with less favorable reputations.

Bettignies and Brander (2007) examined the choice between venture capital and bank financing. They examined several variables including entrepreneurial effort, venture capitalist effort, revenue, opportunity cost of capital, the share owned by the venture capitalist, the entrepreneurial payoff, the venture capitalist payoff, and the marginal value of effort for both the entrepreneur and the venture capitalist. The authors found that entrepreneurs select bank financing (debt) because they retain full control over the business, a key benefit of debt in comparison to an equity model. There is an increased default risk (from bankruptcy) for the banks, however, with early stage firms. With venture capital there is an added bonus of managerial input, but the venture capitalist gets a portion of the business equity thus reducing the entrepreneurial incentive and control. This creates moral hazard for both parties because effort is not measurable in a verifiable way. The study found that without managerial effort, bank finance would always be preferred, but venture capital is preferred in situations where entrepreneurial productivity is low and venture capitalist productivity is high, thus making the managerial input more value-added.
Many of the authors focus on specific types of funding, but Schwienbacher (2007) comes from a different perspective by establishing the types of entrepreneurs and how that relates to the types of funding that they choose to employ. The author examined a variety of variables including:

- Capital requirements
- Values of success
- Time until the investment option expires
- Probability of finding a venture capitalist and of achieving milestones
- Additional effort
- Expected profits
- Options of the entrepreneur
- Bargaining power of the entrepreneur
- Liquidation preference of angel investors
- Fraction of business owned by angel investor
- Present-value of debt
- Fraction of suitable venture capitalist
- The probability that venture capitalist achieves his or her goal

He used this information to discover why an entrepreneur might select a type of funding. The two funding models examined were: waiting until the entrepreneur had sufficient funds or using his or her own funds or angel funds to achieve a milestone and then seek venture capital funding. If a venture is highly profitable, it will likely succeed, there is demand in the venture capital market, and the funding needed is relatively small, then the milestone method is preferred. The author also examined types of entrepreneurs in relation to one another. He examined a profi-
maximizing entrepreneur, a serial entrepreneur who starts businesses in order to sell them and start another business, and a lifestyle entrepreneur who starts a business to actively run the business. A serial entrepreneur is more likely to use the milestone method because he or she are interested in launching a business, selling it, and then moving on. A lifestyle entrepreneur is more likely to wait until funding is achieved because he or she tends to be hesitant to give up ownership to external funders due to their desire to maintain control. The study concludes by suggesting several topics for further research including funding selections in light of poor intellectual property laws and the impact of failure on later opportunities.

Cressy (2012) takes a broad approach by looking at the shortcomings in the overall capital markets rather than studying a specific type of funding. He wrote about funding gaps that exist and inherently disadvantage smaller firms. Cressy points out that most businesses that are small or medium in size, use overdraft lines of credit (debt) to obtain working capital and short term loans. Technology start-ups, however, predominately use equity for funding. Start-up firms are essential for economic growth, but during recessions and economic downturns there is a flight to quality among funding mechanisms that favors large (safer), established businesses thus creating a funding gap. Cressy examines a number of studies citing the Stiglitz Weiss model to show that credit rationing, wherein demand for funding exceeds supply and prices do not adjust accordingly, is likely in capital markets. The Evans and Jovanovic Model (1989) presented research to test the existence of credit rationing. While some studies have supported these findings, other scholars question the representativeness of the data used, the interpretation of the results, and the appropriateness of the model thus causing controversy to surround the study. Cressy additionally examined survey results of businesses that examined the funding
experience. He utilized the survey data to conclude that there is a cyclical nature to funding gaps. He advocates government policy intervention (regulation) to solve this issue.

Another popular form of funding comes to light with DeGennaro (2012) when he examines the funding of Angel Investors. Angel Investments provide an enormous opportunity for return, if chosen successfully, but there is also significant risk since many investments fail. DeGennaro begins by examining the definition of “Angel Investor.” Some scholars include friends and family who invest early in a business while others exclude this group. DeGennaro examines “accredited angels,” eliminating the data on friends and family investments. Typically, accredited angels have expertise to assist a start-up. They look for high growth companies, often in the technology industry, and they usually invest very early on in the lifecycle of a business. The author briefly reviews current articles about Angel Investing and then moves to talk about motivations for investing. Obviously, there are monetary incentives, but often angels want to help people and the community or merely enjoy the beginning stages of starting a business, again a motivation that aligns with the donor model of crowdfunding. The author concludes that the data on returns for these investments is very skewed showing the vast majority being unsuccessful, however, return data is difficult to assess due to a lack of complete information and biased data.

Rather than a particular type of funding, Goldfarb, Kirsch, and Shen examine the financing provided to entirely new industries (2012). They assert that equity is typically a better financing instrument than debt for new industry finance, but equity and debt are complementary to one another. Debt is not as attractive because new industries are typically difficult to understand, so this lack of understanding makes lenders less inclined to invest. Second, lenders often rely on collateral to securitize loans, and new industries are often heavy in intangible assets
thus having a lack of collateral. Third, the high levels of risk would necessitate extremely high interest rates. For these reasons, equity is preferred. Equity is advantageous because it aligns the incentives of entrepreneurs and those that provide financing therefore mitigating information asymmetry. Also complementary, the authors assert, public capital markets provide an avenue for private investors to exit the venture through an IPO if desired. Furthermore, in certain financial climates, the public will finance new industries independently of private markets. The authors support their claims through a series of case studies of new industries including railroad, electricity, automobile, aviation, radio, biotechnology, and the internet. The authors concluded that equity, the public market, and debt are complementary when funding new ventures and new industries.

Peneder (2012), like Hsu, Bettignies, and Brander examines venture capital in his article. The author begins by stating that venture capitalists search for firms with high growth prospects, but this is problematic because firm growth is hard to predict. High growth typically comes when a business is in a phase of transition so it is more likely for young, innovative firms to receive venture capital funding. The author specifically looks at Schumpeterian (radically innovative) entrepreneurs as the target for venture capitalists. Venture capitalists encourage growth through the selection of companies that have prospects for high growth and the value-added function of managerial advice and assistance. The author looks at current growth explanations specifically examining Gibrat’s (1931) Law of Proportional Effect. He found that most firms only achieve modest growth which is why they are not candidates for venture capital funding. Furthermore, venture capital funding is temporary because high growth tends to occur when firms are in transition and cannot be sustained in the long term. Firm growth is driven by three main characteristics:
1. The selection environment or competition for investor dollars which causes venture capital specialization
2. The accumulation regime which causes managerial input to be necessary so that firms can manage a larger company upon accumulating the resources
3. The creation of novelty to achieve the high growth rates

Moving to a more unconventional type of funding, Shadab (2012) discusses hedge funds and particularly the increase in popularity of asset-based lending hedge funds in recent years. The author explains that hedge funds are a popular investment vehicle due to the compensation structure, the organizational form, and the lack of inhibitive governmental regulation. As more people put money into hedge funds the industry grew. The hedge fund industry then began to see strategies being over-utilized, so they sought investments with low correlation to the market and high returns. For these reasons, asset-based lending hedge funds began to rise in popularity. Asset-based lending (ABL) provides loans against assets, and the ABL hedge funds provide loans against (collateralized) assets that might not be accepted from other borrowers. These strategies are attractive because they have a low correlation to traditional investment strategies and other hedge fund strategies. There are drawbacks in that there can be conflicts of interest and the time frame of the loans is longer than hedge funds typically deal with, but the benefits of ABL hedge funds indicates that they will continue to increase in popularity, according to the author, and be a financing factor going forward. This method of funding will be difficult for early stage firms, however, as they have a limited amount of physical assets.

Information asymmetry can be especially prevalent in smaller firms thus making them difficult to finance. Smith (2012) examines financing new firms and begins by pointing out that a lack of funding is often a prevalent problem for entrepreneurs. Entrepreneurship tends to increase
in tandem with personal wealth and access to bank financing. She cites Evans and Jovanovic (1989) who used the National Longitudinal Survey to conclude that entrepreneurs are constrained to only 1.5 times their initial assets. She then moves to examine the Kauffman Firm Survey (Reynolds, 2004) to find that entrepreneurs use a mixture of funding techniques. Start-ups tend to use more debt unless they are in a highly technical field in which case they are equally as likely to utilize equity. She also concluded that the likelihood of bank only financing increased with the presence of physical collateral and the use of equity increased with intangible patents. Overall, Smith found that there was a lack of knowledge on very early stage funding as most of the studies look to more established firms rather than true early-stage startup companies.

Manchanda and Muralidharan (2014) examined the venture capital industry and how it may be affected by crowdfunding. They point out that the typical reason for the failure of a new business is a lack of financing and funding is dependent on its lifecycle stage. The authors focused on obtaining financing at the seed stage which is still conceptual. The authors begin with a meta-analysis of existing crowdfunding literature. They point out that venture capital firms are typically the source of financing during the seed stage, but they have lost trust of entrepreneurs due to investing models, poor performance, low returns, and being blamed for leading companies to premature IPOs. The authors believe that venture capital and crowdfunding are complementary to one another because venture capital is better at identifying success, but crowdfunding is a good way for venture capitalists to value a company.

As evidenced by the aforementioned articles, each funding method has advantages and disadvantages. Debt can be difficult for earlier stage firms due to a lack of tangible assets. Equity is not manageable via an IPO due to the cost structure. Angel investors are very specific in their lending and therefore usually favor certain industries. Venture capitalists also lend to a small
portion of firms. Each funding method while working for some entrepreneurs, does not work universally, and this leaves room for other funding methods. Equity crowdfunding could fill a funding gap for entrepreneurs with innovative ideas but a lack of available funding.

C. The Jobs Act of 2012

Many of the questions surrounding crowdfunding have to do with the legal implications of the JOBS Act and the crowdfunding exemption. Hemingway and Hoffman (2011) write prior to the ratification of the JOBS Act by Congress. They note that most non-bank lenders expect to receive an equity investment when they invest which means that these investments should be registered with the SEC unless there is an exemption. The authors address the issue in several parts. First, they address whether or not a crowdfunding offering should qualify as a security. They use the Howey Test which was established by the Supreme Court to determine “whether or not a financial instrument is an investment contract” (Hemingway and Hoffman, 2011). They used the test to reason that offerings which have an element of profit-sharing are securities and thusly should be registered with the SEC. They move on to discuss whether there should be an exemption and if so, what it should include. They conclude that crowdfunding should be exempted from the Securities Act of 1933. Obtaining an exemption is essential for early stage start-ups because it lowers legal costs, reduces compliance, and makes equity funding more attainable for smaller firms.

Bradford (2012) explained the crowdfunding exemption in his article. Previously, securities crowdfunding was impractical due to high costs associated for entrepreneurs and websites. A provision in the JOBS Act aims to prevent that, but the author asserts that it does not do so properly. To begin, the author points out inherent risks in that the public is not always investment savvy, these investments are illiquid, and there are inherent risks associated with
start-up investments. The new exemption from registration applies to equity crowdfunding campaigns if the total funding sought is under $1 million. The Jobs Act places an investing cap on income and net worth and has websites qualify as “funding portals,” rather than brokers. The Jobs Act fails, however, with vague and ambiguous terminology and restrictive disclosure and reporting requirements. These requirements are cumbersome to the individual entrepreneur, making the exemption impractical.

While many of the scholars applaud the potential of the JOBS Act, Griffin takes a contrarian perspective. Griffin (2012) argues that crowdfunding should not be exempted from the Securities Act of 1933. Specifically, entrepreneurs cannot use crowdfunding for equity offerings because they cannot meet the registration or exemption requirements. Since crowdfunding does not qualify under any of the current exemptions, entrepreneurs would need to register their offering with the SEC, a process which can cost in total in excess of $100,000. Congress proposed to remedy this by allowing crowdfunding to be considered exempt from regulation. The author is opposed to this for several reasons. First, there are many aspects of the internet that are not legally regulated, so it could open investors up to fraud. Griffin cites the “massive amount” of securities fraud in the 1990s as support for this claim. Furthermore, it is difficult to enforce regulations on the internet due to the difficulty of catching cyber-criminals. If cyber-criminals were caught, however, there could be another issue in that the economic amounts might be too small to necessitate a court case. This leaves investors largely unprotected.

Registering securities provides protection for investors because companies must disclose certain facts that are material to investors. If crowdfunding companies do not need to register, however, they are not required to report material information such as managerial or financial information. The only protection the author sees is the cap on the amount invested, but Griffin asserts that this
cap is set at such a high rate that it fails to provide protection to investors. The author’s contrarian perspective argues that while the exemption is beneficial to encourage new business, it will cause far too many problems that the SEC is not equipped to handle.

Gobble (2012) discusses the costs and benefits of legalizing equity crowdfunding. She profiles a campaign for a wristwatch in which the entrepreneur had a prototype and a business plan but was denied venture capital financing. When taken to Kickstarter, however, the entrepreneur raised $8.3 million. While this campaign was successful, it was run on a pre-order basis because of the restrictions placed on crowdfunding that prohibit a stock-based model. The JOBS Act aims to remove this prohibition by exempting crowdfunding from the Securities and Exchange Act of 1933. Those who are opposed to this, say that opening crowdfunding up to allow stock offerings will lead to massive amounts of fraud and removes investor protections. Proponents argue that there is actually very little fraud on the websites, and this will grow the economy and create jobs as more entrepreneurs obtain funding.

Sigar (2012) examines the concerns about fraud with the SEC crowdfunding exemption in his article. The author begins by pointing out how quickly Dodd-Frank (2010) was passed, followed by the JOBS Act, and the crowdfunding exemption. Equity offerings for crowdfunding must meet four criteria:

1. Company seeks to raise a maximum of $1 million
2. Individual investment cannot exceed $2,000 or $100,000 depending on net worth and income levels
3. Deals must be conducted through a registered broker dealer or funding portal
4. The issuer must comply with disclosure and other requirements set forth.
Crowdfunding offerings are considered covered securities so they must be filed only with the SEC and not with the individual states in which it is being offered. The current exemptions to the Securities Acts do not apply because Regulation A, which applies to offerings under $5 million, has extensive compliance costs that make it virtually ineffective in these cases, and Regulation D prohibits general solicitation. The prohibition on general solicitation means that entrepreneurs cannot solicit investment from people with whom they do not have either a previous relationship or an understanding of their financial knowledge. This means that essentially general solicitation prohibits entrepreneurs from asking for investments from anyone except friends and family, and as such Regulation D is inapplicable to crowdfunding. The author finds that concerns about exposing investors to undue fraud risk are not necessary. First, facilitators must register with the SEC. Second, the antifraud components of the Securities Exchange Acts of 1933 and 1934 still apply to exempted offerings. Also the availability of information in today’s society levels the playing field for information between professionals and inexperienced investors. Finally, the monetary caps prevent any significant loss meaning that the risk of fraud is mitigated for a specific issue.

Mashburn (2013) examines the implications of the civil liability provision that was drafted by Congress in relation to the JOBS Act. This provision makes the issuer, directors, and officers liable for misstatements, but the author argues that because crowdfunding will be utilized by early-stage entrepreneurs, many misstatements will be honest mistakes rather than fraudulent activities. Furthermore, because crowdfunding generally involves small monetary values, investors will have a difficult time assuming the legal costs necessary to pursue lawsuits for fraudulent activity. To remedy this issue, Mashburn suggests making knowledge of wrongdoing a prerequisite for liability rather than just punishing mistakes. He further suggests
awarding attorney fees for winning plaintiffs as an incentive to move forward with the monetarily small fraud cases that may arise from equity crowdfunding. He believes that these revisions would align interests of investor and entrepreneurs, while keeping the process affordable.

Some authors are concerned with fraud, but Williamson (2013) says that is not a real concern. The author points out the origin of the JOBS Act suggesting there was a call to tighten regulations after the recession. Also, he suggests there was a call from business owners to loosen constraints on start-up financing. Previously, only accredited investors had an exception that allowed them to invest in Angel investing type situations. The JOBS Act aimed to open the possibility of investing in early ventures to the middle class of investors. The author finds a flaw in a portion of the Jobs Act that prohibits investment companies from participating. Crowdfunding provides a good opportunity for diversification because early stage companies often provide high returns, but with high risks and failures. With the prohibition of investment companies, there cannot be a pooling of funds, similar to a mutual fund. This means that investors will have a very difficult time diversifying their investments in crowdfunding situations and thus be exposed to firm-specific risk. This ban effectively eliminates the benefit for the group of investors that was intended to benefit from the JOBS Act crowdfunding exemption.

Though many of the authors are examining the implications for investors, Deschler (2014) examines the exemption from the perspective of an intermediary. The author offers the question of whether or not the JOBS Act can achieve an effective balance between low compliance costs for intermediaries and investor protection. The JOBS Act creates funding portals, but the author points out that the funding portals face more restrictions than a typical broker-dealer. The ideal intermediary therefore combines the “legal flexibility of a broker-
dealer” and the “technological savvy of a funding portal.” Deschler discusses how intermediaries should address the regulation. The ambitious intermediary, as the author calls it, should use the flexibility to address challenges in an efficient and effective way so that they go above and beyond the requirements of the SEC thus giving them a competitive advantage and attracting more investors and entrepreneurs. If intermediaries fail to behave appropriately, they could see the flexibility lead to restrictive regulation.

Hemingway (2014) echoes major flaws in regulation. She explains that entrepreneurs were previously having success with other forms of crowdfunding, but some wanted to offer equity. She believes that Congress, rather than the SEC, is to blame for the impracticality of equity crowdfunding in its current form. She explains that the reason equity crowdfunding will not succeed is due to inhibitive cost structure associated with regulatory compliance. The disclosure requirements are complicated and expensive, and currently the benefits of this form are less than that of other forms of crowdfunding. She believes that the SEC should draft a new proposal with fewer regulations and less cost. One way to do that is to lower the investment cap which would reduce risk significantly for entrepreneurs.

Hogan (2014) examines the SEC regulation and how it relates to the goals of the JOBS Act. The JOBS Act was intended to allow entrepreneurs access to capital funding and to protect the investors. The current proposals, however, show “onerous regulatory requirements with relatively low maximum capital limits” thus reducing the utility for entrepreneurs (Hogan, 2014). The author explains why crowdfunding qualifies for an exemption and then examines specific proposed regulations. Hogan feels that the investment cap should be reduced to $250 per investor per year. This would make disclosures more simplistic, and it would further protect the investors from loss as the sum of money invested would be significantly smaller. He also feels that while
the SEC proposes the $1 million limit to be per campaign, an aggregate limit of that amount would be more appropriate. His final suggestion is to eliminate the self-certification of finances by investors.

D. Related Articles

Many articles are relevant to the topic of crowdfunding and related topics. Brau (2012) examined several theories to determine why firms go public, including:

- Capital structure optimization
- To overcome borrowing constraints presented by banks
- To establish a market price for the future sale of the business
- To give inside owners liquidity
- To allow ownership dispersion
- To gain publicity for the company
- To use shares in future acquisitions
- To create an analyst following because the timing is advantageous for IPOs
- To create shares for compensation
- To align with industry peers
- As a last resort for funding.

In addition to examining theories he used survey data (Brau and Fawcett 2006b) in order to incorporate private companies as well. He concluded that this question cannot be definitively answered because firms have varied and conflicting rationale for going public. This is important to crowdfunding because equity campaigns are essentially taking a firm public.

All firms need to obtain funding, and one major hurdle that they must overcome is information asymmetry. This is especially problematic for new and small companies. Han and
Zhang examine information asymmetry (2012). They find that information asymmetry is more prevalent in smaller businesses than in larger businesses due to a lack of SEC reporting requirements among smaller, private firms. The authors study two perspectives, the relationship lending perspective and the credit market concentration perspective, using conditional probability (Ueda 2004) (Han et al. 2009 b). The authors found that under the relationship lending hypothesis information asymmetry is reduced because of the incentive to collect private information thus improving the availability of funding the creditworthy firms. In a concentrated credit market, firms may see benefits of more information collected. They may also have to pay above market interest rates and carry more cash than optimal, however, because of the power of banks in a concentrated market. This follows the structure-conduct-performance hypothesis (Berger and Udell, 2006).

The crowdfunding industry, especially the equity portion, is relatively new and relevant information is scarce. The above articles give a nice overview of crowdfunding as well as examining the need for equity crowdfunding as a funding method. Other articles look specifically at the JOBS Act to examine its potential for success as a funding method. Moving forward the paper will utilize this information as base knowledge to examine the JOBS Act and its practicality to ascertain whether or not equity crowdfunding in its current state is sustainable long-term as a funding method.

IV. Analysis of Research Question
   A. Investment Environment
      While many authors in the past have written about different forms of crowdfunding, equity crowdfunding has just recently gained attention with the passage of the Jumpstart Our Business Startups Act in 2012. Title III (known at the Crowdfund Act) titled, “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012,” aims to open up new
funding mechanisms while preventing fraudulent campaigns and protecting investors.

Previously, equity crowdfunding could only attract accredited investors which, in the context of individuals, are only those with a net worth of over $1 million (Legal Information Institute). According to David Mashburn, this is limited to approximately 4 million investors in the United States (Mashburn, 2013). The Crowdfund Act, however, allows unaccredited investors to participate (H.R. 3606, 2012). While allowing unaccredited investors to invest does open up a new pool of participants, the Act itself is somewhat cumbersome for the small businesses that it intends to help and for the intermediaries that facilitate this funding option.

B. Economic Impact of Small Businesses

Small businesses are often in need of funding. According to the Small Business Administration, the lack of funding severely limits the growth of small businesses. A small business is characterized as any company employing up to 499 people (Small Business Administration). According to Forbes the United States has 25 to 27 million small businesses which account for 60 to 80% of jobs within the country (Bagley, 2012). This means that fostering small business growth is essential, and therefore the availability of funding is as well. In 2013 small businesses borrowed roughly $1 trillion, but startup companies typically rely on cash from owners and bank credit (Small Business Administration). This means that entrepreneurs who do not have money to put into the business or who cannot obtain credit, will need alternate ways to obtain funding. Equity crowdfunding has the potential to become instrumental for small businesses and economic growth in the United States.
C. Crowdfunding sustainability
   1. Targeted Companies
The Crowdfund Act helps “emerging growth companies,” defined by the SEC as a company that had under $1 million in revenue in the previous year. A company maintains that classification until such a point that it hits a certain benchmark:
   1. The last day of the year in which the company achieves revenue of $1 million
   2. Five years after the first issuance of equity under this provision
   3. When the issuer has issued over $1 million in non-convertible debt over three years
   4. When the company becomes classified as a “large accelerated filer” (H.R. 3606, 2012)
As seen above, companies that are intended to benefit from equity crowdfunding are small, typically early stage, and in need of financing to grow their business. The five year timespan shows that equity crowdfunding is not intended to be a long-term solution for capital funding such as a line of credit. It is intended that the company receives early stage assistance and then seek other funding sources such as a traditional public offerings or debt financing. Companies with five years of operations generally will have more financial history and collateral that will allow a business to obtain funding from a more traditional venue. Debt restrictions may help with the financial health of a company, but can limit early stage firm access to capital. This causes many early stage companies to have high debt levels which can increase default/bankruptcy risk. This provision attempts to limit the debt and thus the risk of the companies that are able to participate. Finally a “large accelerated filer” is a company that has an equity value of over $700 million and does not meet requirements to report as a smaller company, among other compliance benchmarks (Legal Information Institute). This benchmark does not seem to pose an issue because the majority of companies that have revenues under $1 million are unlikely to have an equity value of that magnitude. While effectively targeting a certain type of company via these
specifications, these restrictions prohibit a more mature company from using equity crowdfunding to finance an expansion, a merger, or a specific project.

2. Intermediaries

The Crowdfund Act has several requirements for intermediaries, issuers, and even investors that beg the question of whether or not the government is over regulating this new funding platform. In order to be an intermediary through which issuers can host campaigns, the website must register with SEC as either a broker or a funding portal. The funding portal provision was added specifically to address the needs of equity crowdfunding. If a company registers as a funding portal the intermediary is prohibited from the following:

1. Offering Investment Recommendations
2. Soliciting purchases of securities on the portal
3. Paying employees based on solicitation of investment
4. Holding or managing investor funds
5. Engaging in other activities that are deemed inappropriate by the SEC

(H.R. 3606, 2012)

The fact that the funding portals are not allowed to give investment advice is a disadvantage for investors. These unaccredited investors may benefit from some professional investment advice.

To avoid these restrictions, a crowdfunding website could choose to register as a broker-dealer. A broker is defined by the SEC as “any person engaged in the business of effecting transactions in securities for the accounts of others” (“Guide to Broker Dealer Registration”, 2008). A dealer is defined as “any person engaged in the business of buying and selling securities for his or her own account” (“Guide to Broker Dealer Registration,” 2008). This is not referring to individual investors necessarily, but rather, it refers to when it is part of regular
business activity. If a company wants to be a broker-dealer then they must complete the following requirements:

1. Fill out the BD (broker-dealer) form
2. Become a member of an SRO (Self-Regulating Organization)
3. Become a member of the SIPC (Securities Investor Protection Corporation)
4. Comply with state requirements
5. Register “associated persons” (“Guide to Broker Dealer Registration”, 2008)

The broker-dealer form contains questions that concern the background of the company requesting broker-dealer status and the people involved. The business must also become a member of a self-regulating organization (SRO) such as FINRA (Financial Industry Regulatory Authority). This requirement is necessary whether the intermediary registers as a funding portal or a broker-dealer. The SRO is used to help the SEC to regulate either the funding portal or the broker-dealer. The SIPC has an annual fee which the broker must pay, and essentially the SIPC acts as insurance so that customers can receive their money back in the event of a liquidation of the broker-dealer. Additionally, broker-dealers have state requirements that are dependent on the states in which they operate. This could become a problem for crowdfunding portals doing business in a large variety of areas/states via the internet. The broker must also file a regulatory form (U-4) concerning each employee who will “effect transactions.” These individuals must also complete the proper certification for example the Series 7 examination. Broker-dealers must comply with anti-fraud provisions and maintain consumer safeguards such as keeping accurate records and staying above minimal capital levels (“Guide to Broker-Dealer Registration,” 2008).

While the intermediary might benefit from being allowed to give investment advice, by registering as a broker-dealer they are also taking on more requirements such as the
aforementioned registration of employees. For simplicity, the majority of intermediaries are more likely to choose the funding portal option. The intermediary, regardless of form, is required to register with appropriate self-regulatory organizations such as FINRA, the Financial Industry Regulatory Authority. The intermediary must also provide disclosures concerning risk, provide investor education materials, and ensure that investors review the educational information, understand it, and can answer questions about his or her level of risk and liquidity (H. R. 3606, 2012). While this requirement intends to protect the investor, the probability of investors reading the disclosures is more than likely remote. This means that while the intermediaries are shoulderung the burden of providing this information, the effort might not be value added to the potential investors who are visiting the website.

The intermediary from that point must, in an attempt to reduce fraudulent activity, obtain background checks and securities enforcement histories for all officers, directors, and equity holders who hold more than 20% of the outstanding equity of the company (H.R. 3606, 2012). This could certainly be a large task depending upon how many campaigns the websites attract. Alone, this compliance activity could result in extraordinary and restrictive expenses. The number of checks per campaign would vary depending on the complexity of company structure. Most small companies do not have a board of directors, and if they do, they are quite small, so the number of checks per campaign might be minimal, but still a cost, nonetheless. This provision is meant to combat the various critics who suggest that offering equity via the internet is an invitation for issuers to defraud unsophisticated investors.

The background checks, while taking a step towards ensuring the authenticity of various campaigns, cannot provide full protection to the investor. Hemingway and Hoffman point out in their study that “investor losses and fraud, as well as inconsistent business practices, may
contribute to perceptions that the crowdfunding market is dishonest or corrupt. Perceptions of market unfairness or distrust may have serious effects on investor confidence and investor behavior” (2011). While the crowdfunding act has provisions against fraud there is a still a high degree of risk associated with investing in equity crowdfunding campaigns. This is similar to the increased risk seen in public equity markets and IPO’s. If investors did lose money frequently they could become risk averse and stop investing in crowdfunding or even the market in general. Griffin points out the parallels between that instance and the JOBS act stating that the SEC revised rule 504 to allow “non-reporting” companies to issue $1 million of securities per year, but this law also allowed general solicitation. This does present some striking similarities in offering amount as well as the platform, but a main difference is the general solicitation section. The Crowdfund Act makes it clear that individual campaigns cannot be advertised, and while unaccredited investors can participate, the Crowdfund Act forces those investors to seek out the campaigns rather than having the worst campaigns advertised to them (H.R. 3606, 2012). This encourages investors to research and seek out winning campaigns which should reduce the potential for fraud.

Another job of the intermediary websites is to ensure that no investors exceed their monetary limit, a point enforced by the SEC. Each investor may only invest a certain portion of money. Any one investor cannot invest more than $2,000 or 5% of their net income or net worth within a year. This applies if their annual income or net worth is under $100,000. If the annual net income or net worth is greater than $100,000 then the investment cannot exceed 10% of an investor's net worth or net income, and the total cannot exceed $100,000 (“SEC Issues Proposal on Crowdfunding,” 2013). This means that websites must not only monitor the issuers, their officers, major shareholders, and directors, but also anyone who invests in a campaign on their
website. The fact that this limit applies for a full year means that investor records must be held for at least that long because it is the responsibility of the website to ensure that investors do not exceed that limit. This could also be complicated because if an investor uses multiple crowdfunding intermediaries the logic of who keeps track of the investment cap is difficult to track and monitor. This would imply that there needs to be a communication channel between the intermediary sites. Alternatively a new business could be formed to facilitate this communication and track information for the websites, but this would represent an additional cost for intermediaries and leads to serious questions on how this information can be tracked and recorded.

The final requirements for the intermediaries involve ensuring privacy, not compensating for providing the intermediary with information about potential investors, and prohibiting directors, officers, and partners from having financial interests in issuers of campaigns (H.R. 3606, 2012). Not providing information on potential investors is intended to protect the individuals from unwanted advertisement. While this provision makes it more difficult to obtain website traffic, it mitigates the risk of fraudulent activity through advertising only risky campaigns. This final prohibition attempts to eliminate potential conflicts of interest, but it also effectively prohibits officers and directors from utilizing their own business. This could create an agency conflict as the interests of the officers of the company are not tied to the investors on the website. Investors on the website would seek high returns since they are undertaking more risk. The officers of the company would seek to make high profits. Higher profits would stem from more investments and more campaigns. While investors seek high quality campaigns, the website would have an interest in having a high number of campaigns. This could incentivize the website to take on subpar campaigns in order to increase the amount of potential investments
offered on the website. To mitigate this risk, the intermediary should align officer and director compensation to campaign success rates. If officers and directors had a vested interest in seeing campaigns succeed, they would be more likely to tighten restrictions and only accept fully suitable campaigns.

3. Entrepreneurs
Aside from the intermediaries, the issuers of the campaign also have burdensome requirements when utilizing equity crowdfunding. Crowdfunding has become exempt from the Securities Act of 1933 as offering do not have to be registered with the SEC (H.R. 3606, 2012). This exception stems from the fact that SEC registration can cost in excess of $100,000 and small companies often cannot afford to undertake those expenses in order to raise funds (Griffin, 2012). Even though the SEC registration is eliminated, however, companies still have requirements that must be met in order to utilize the equity crowdfunding method. The issuers must file several pieces of information with SEC including the following:

- Businesses name
- Legal status
- Business address
- Website
- Names of the directors, officers, and major shareholders
- Business plan
- Business description
- Financial condition of the issuer
- What the money is intended for
- Target amount
• Deadline for investment
• Updates towards the progress
• Pricing method for the offering (H.R. 3606, 2012)

When an entrepreneur has this amount of information available about their business, it implies that he or she has put forth a good deal of effort in preparing for this funding opportunity. This information should also allow potential investors to make an informed decision by utilizing company information, much like a prospectus for a public offering.

The amount of financial information that needs to be disclosed is dependent upon the amount of funding that the entrepreneur is seeking. If a campaign is for $100,000 or less, then the issuer must provide the most recent tax return and financial statements that are certified as accurate by the executive officer of the business. If a campaign seeks between $100,000 and $500,000, then the issuer must file financial statements that are audited and affirmed by a public accountant. If the campaign seeks more than $500,000, the issuer must file audited financial statements (H.R. 3606, 2012). Obtaining audited (by a public-accounting firm) financial statements could become expensive with this fee typically starting at $5,000 and having the potential to be much more (Almerico, 2013). This could present an undue burden for the entrepreneur. The entrepreneur cannot seek to raise more than $1 Million in any one year using equity crowdfunding in order to be considered exempt from SEC registration (H.R. 3606, 2012). This means that costs must be kept at a minimum in order for the entrepreneur to truly obtain a sizable amount of funding. Some proponents of the law argue that these restrictions are still too cumbersome compared to the amount of funding being raised, but still others are concerned about fraud, so there is certainly a balance between protecting the investor and keeping costs low for small businesses.
Detracting from equity crowdfunding’s potential as a viable funding method are prohibitive regulatory costs. Due to the recentness of pertinent legislation, cost figures were obtained via crowdfunding based websites. *Crowdfunding Beat* finds that the cost of an equity crowdfunding campaign will be $12,500-$17,500 for campaigns seeking to raise under $100,000. Campaigns seeking to raise $100,000-$500,000 will pay $39,350-$69,350 in costs. Finally, campaigns raising $500,000 up to the cap of $1 Million could incur $76,200-$151,200 in fees (Eckerle, 2014). This indicates that the host of regulations and fees that make crowdfunding difficult. Based on these figures, anywhere from just over 7% to roughly 30% of the total funding could go to start-up costs and fees. Furthermore, the entrepreneur cannot advertise the campaign except for advertising investors towards the funding portal (H.R. 3606, 2012). This could be challenging for entrepreneurs because they are only funded provided they hit their funding goal. Minimal advertising ability could certainly affect a campaign’s ability to succeed. The entrepreneur cannot compensate anyone for advertising unless it is done through the proper channels. They also must annually file their financial statements with the SEC.

One interesting consideration for an issuer is the fact that the proceeds from the campaign are only provided to the issuer at the point at which the campaign has reached its funding target and the investors have had a chance to cancel their investment (H.R. 3606, 2012). This is problematic for entrepreneurs seeking to raise funding via this method as they will receive no funding if their target is not attained. With this type of policy, there is an incentive to set a lower target. Successful campaigns may raise funding above their target goal and still keep their capital. If they raise less, they receive no funding. Almerico (2013) points out one concern with this model in that there are significant costs associated with readying an equity crowdfunding campaign. With all of the requirements, the entrepreneur is undertaking a significant outlay of
funds with the hope that it will pay off by raising much needed capital. To compound disappointment of potential failure is the fact that the entrepreneur will have spent a considerable amount of money before the campaign began to complete background checks, research financial information, and meet compliance costs. An entrepreneur can also overfund by setting the target artificially low. However, since the information required changes slightly within funding brackets, if a campaign overfunds into the next bracket, they are left without the proper information filed and thus, are not providing adequate information to the investors. The investors also must have an opportunity to cancel their investment. The SEC is currently in the process of finalizing rules for crowdfunding and may propose to give investors up to 48 hours prior to the deadline of the project to cancel their investment (“Crowdfunding”). While this provision attempts to protect the investor, it provides a further complication to equity crowdfunders as this is not an option with a traditional IPO. In a traditional IPO, an investor is not able to back out of their investment unless they sell via secondary markets. With crowdfunding, however, there is more risk involved because investors have the option to withdraw their investment leading to potential underfunding. Furthermore, since there are only 48 hours between the end of the cancellation period and the end of the campaign, entrepreneurs who fall short due to cancellations toward the end of their campaign will find it difficult to gain the necessary additional investments.

4. Investors

Aside from the requirements for the intermediary and the funding portal, there are other restrictions. A company cannot seek to raise more than $1 Million per year using this exemption. This means that entrepreneurs will likely need to seek additionally funding elsewhere in order to grow their businesses. The Crowdfund Act also restricts the unaccredited investor in the amount that they can invest. According to the SEC, an accredited investor must have income greater than
$200,000 in each of the past two years or have a net worth over $1 million. Any person not hitting one of these benchmarks is considered an unaccredited investor (U.S. Securities and Exchange Commission). This restriction is meant protect inexperienced investors. This coupled with the fact that funding portals are not allowed to make investment recommendations, exposes investors to a great deal of risk. Some scholars claim that these limits are set too high as many people cannot afford to lose that much when investing. Bradford (2012) points out that regardless of income or net worth, any investor may pledge $2,000. There is concern that this number is too high as many people cannot afford to lose that much money over the course of one year. Furthermore, since the companies in question are very early stage startup companies, the potential for failure and thus total loss is higher comparatively than with traditional stock investments. This is because the potential for bankruptcy is higher with early stage firms than with mature firms that go through the IPO process. Although some IPOs do not succeed, bankruptcy risk is still more prevalent with smaller companies. While it is important to give the investors freedom and choice in assuming they know their own financial limits, the fact that there is no investment advice, puts the investors further at risk and heightens the stakes for this industry.

Another restriction that could inhibit investors is the fact that securities cannot be transferred within one year except to the issuer, an accredited investor, as part of an offering that is registered with the SEC, or to a family member. This lock-up period severely limits the liquidity of these investments. This restriction could potentially be in place because of concern over who would facilitate the exchange after the offering has expired. These securities would potentially be traded in a similar manner to over the counter investments thus supporting the lack of liquidity. Furthermore, since there is an investment cap, secondary transactions could further
complicate the reporting requirements for intermediaries. Nevertheless, liquidity is an issue because if an investor puts $2,000 into the stock market and unforeseen costs arrive, most stocks traded on the open market have sufficient liquidity to allow investors to obtain money within a reasonable time frame. Equity crowdfunding investments, however, lack liquidity, so if unforeseen expenses arise, the investor may not be able to obtain the capital. This increases the riskiness of these investments and acts as a disincentive for investors. Presumably with the equity model the investor is participating mainly to achieve a return on the investment. Because this investment is illiquid, there will need to be a discount and enormous future potential to attract investors. This compounds the difficulty for funders to reach their funding goals.

5. Overall
According to current regulation, investment companies (mutual funds, etc.) are prohibited from participating in the crowdfunding markets. Williamson (2012) questions the logic behind the ban because it would seem that investment companies could help unaccredited investors to mitigate risks in their crowdfunding investments. Essentially investment companies could pool together many crowdfunding campaigns and make a mutual fund of campaigns. This would have many benefits including allowing the investor to diversify and presumably enhancing the liquidity that would accompany this sort of investment. With such risky investments as early stage companies, there is a high probability of loss. This could be detrimental to some investors, so diversification would surely be a valuable benefit to allowing investment companies to participate. There are also several questions, however, as to how this sort of investment would work if it were structured similar to a mutual fund. At a certain point, the fundraising is over, and after five years, a company can no longer utilize equity crowdfunding as a funding method. This means that a fund manager would continually have to add new funds to ensure that asset levels are maintained. Furthermore, if a fund had an investment in a campaign that did not reach the
funding goal, there would be a complicated monetary situation where presumably invested money was not invested because it had to be returned. Due to the active management, there would be higher investment expenses, and that would bring still another question as to whether the investment limit would include the fee or just the base investment. The investment limitations for individuals would be difficult to maintain. Presumably with diversification, a mutual fund company would pull different campaigns from different sites. But, when an investor uses more than one crowdfunding site, it becomes difficult for the intermediary to ensure that the investor has not reached their maximum investment limit. This would be especially true if an investor chose to invest on their own and in the mutual fund. Again, this calls into question the ability to realistically monitor and enforce regulations.

Compliance and associated costs/fees are a significant burdens associated with this legislation. All of the Crowdfund Act’s requirements must be met, or the exemption to registration is lost. This lack of flexibility affects the issuer, investor, and intermediary. This also increases the risk for all parties involved because there is dependency on other parties and some of the control is placed with third parties. Non-compliance would result in the loss of the exemption thus leaving several consequences for entrepreneurs, intermediaries, and investors. If entrepreneurs lost their exemption they would presumably be required to register their offering with the SEC. If intermediaries lost their exemption they would presumably either go out of business or register as a broker-dealer. It is unclear what the consequences would be for the investor, however, as unaccredited investors have this opportunity via the exemption, their investment could potentially be void.
D. Other Equity Options

Alternatively an entrepreneur could raise equity funds by taking a company public via an initial public offering (IPO). This method, however, has a different set of specifications. The IPO process generally takes preparation up to 12 months in advance in order to transition a company from private to public. Additionally there are several documents that are needed to complete this process:

- Registration statement
- Listing application for the applicable exchange
- Board of directors and current shareholder approval for the IPO
- Post-IPO articles of association
- Underwriting agreements
- Presentation slides that will be used to solicit investment
- Deposit agreements
- Any other pertinent documents (Latham & Watkins, 2008)

Much of the above information is required to list in an equity crowdfunding campaign. According to Price, Waterhouse, Cooper, the underwriting costs alone for an IPO typically range from 5-7% of the placement value, and the average company incurs roughly $3.7 million in costs that are directly associated with the IPO. Public companies on average incur $1.5 million in recurring costs from resulting in being a public company (PwC’s Deals Practice, 2012). While compliance costs for equity crowdfunding would be significant, most companies who utilize equity crowdfunding could not utilize an IPO because it would be cost prohibitive.
V. International Perspective

To assess the viability of equity crowdfunding domestically, it is essential to examine efforts abroad to determine if the United States could be utilizing a successful existing model. While some international countries utilize equity crowdfunding, none of the major crowdfunding countries have a model identical to the United States. The United Kingdom has been utilizing forms of crowdfunding for quite some time as their first crowdfunding campaign was conducted in 1997 (Weinstein, 2013). Its crowdfunding industry is governed by the Financial Services Authority under the Financial Services Markets Act of 2000. Its crowdfunding market, while successful, is different from the proposed atmosphere of the United States. For equity crowdfunding only qualified individuals can participate (Weinstein, 2013). This means that the unaccredited investors that the JOBS Act applies to are not the targets of equity crowdfunding campaigns in the United Kingdom. Its offering amount is much higher at €5,000,000 (roughly $5,250,000), but there is also a 150 person limit on the number of investors per campaign. This means that each individual is contributing a great deal more money. These contribution amounts are well past the investment cap proposed in the United States which further shows the differences between the two models.

Italy’s version of equity crowdfunding is also different than the proposed version in the United States. Weinstein describes it as more of an Angel Investor situation, and the intermediaries merely connect investors with entrepreneurs rather than facilitating actual exchanges. Many of the intermediaries operating now are not governed by the CONSOB (rough equivalent to the SEC) meaning that there is a lack of regulation over Italian equity crowdfunding participants. The Italian authorities are working to propose regulation, so they are at a similar point as the United States, but their market will be different as it will be restricted to “high-tech” business which must be started in the last four years (Weinstein, 2013). Furthermore,
to prevent fraud, these companies must also obtain funding from a sophisticated investor outside
of the crowdfunding campaign. Weinstein describes this necessity as a “co-signing” scenario
(2013). Again, it is evident that Italy is in a similar place with their crowdfunding industry but
has a model that is quite different than the model in the United States.

France has had CIGALES for 20 years which are similar to equity crowdfunding but
without the internet (Weinstein, 2013). CIGALES are investment clubs that pool money to help
small businesses within a community. Rather than expecting a return, however, the reward for
participation in France is a tax deduction. There has been a problem, however, among investors
due to a lack of liquidity of funds invested in this format (Weinstein, 2013). From examination of
these various models, it is evident that the United States is unique in the model that it proposes to
utilize thus meaning that this regulation will set a precedent for the future of (international)
crowdfunding.

VI. Summary and Proposition
1. Will SEC regulations affect crowdfunding’s effectiveness as a technique for raising startup
capital?

This paper has established that there is a definite niche that equity crowdfunding has the
potential to fill. Debt increases default risk for early stage companies and thus is not an attractive
funding option for every firm. Furthermore, not all businesses have the philanthropic ties or
exciting products that will attract funding through a donation or pre-order campaign. Providing
60-80% of jobs in the United States, small businesses are a vital contributor to the United States
economy. This means that easier access to capital funding should be a priority. The JOBS Act
and corresponding SEC regulation fails, however, with requirements that are overly costly and
cumbersome. This is supported by Eckerle who estimates that costs to the entrepreneur could
consume 7-30% of the total funding raised. This means that many entrepreneurs will not be willing to undertake the risks or spend the time to utilize this funding method. Furthermore, they may not have the capacity to undertake the initial costs necessary to begin a campaign.

In order for equity crowdfunding to be a success, websites depend on having a large number of campaigns. Investors will not be enticed to participate without a sufficient number of campaigns from which to choose. Intermediaries are dependent upon the campaigns and the investments in order to generate revenue. This means that both the intermediary and the investor are dependent on mass adoption of this funding method, and the risks and costs saddled on hopeful entrepreneurs indicates that mass adoption is unlikely. This calls into question the real benefits to the entrepreneur and consequently the benefits to anyone planning to enter this industry as an intermediary or an investor. Based on the above research I posit the following:

P1: SEC regulations will affect the potential for crowdfunding and diminish its effectiveness as a funding method for early stage companies.

2. In light of the JOBS Act and new SEC regulations, will equity crowdfunding be sustainable as a long-term capital raising technique?

Equity crowdfunding presents several risks to entrepreneurs, funders, and intermediaries. Entrepreneurs and intermediaries will be burdened by abundant costs and regulations. Further there is a risk of the entrepreneur failing to receive funding if targeted goals are missed. The entrepreneur also has significant liability under the regulation in its current form, and these factors will certainly dissuade entrepreneurs. Intermediaries also face significant regulations that make the process complex. They will shoulder some of the liability for entrepreneur errors which exposes them to further risk. There are also complex compliance issues which could lead to the
loss of the exemption if not dealt with properly. Investors also lack diversification ability and are restricted with the illiquidity of the investment. This lack of diversification and liquidity coupled with a prohibition on investment advice from the funding portals means that entrepreneurs are facing a challenge to attract investors. Investors must be wholly convinced by the campaign to make a one year commitment in an unheard of company to which they may have no connection. This is compounded with the restrictions on advertising individual campaigns. These factors make investor enticement a nearly insurmountable obstacle. These complications for all parties involved means that the legislation in its current form is a disincentive for all potential participants and therefore is not viable. Based on the above research I posit the following:

P2: Equity crowdfunding will not be sustainable as a long-term capital raising technique because the high level of risk creates a disincentive for all involved parties.

VII. Conclusion and Future Directions

Upon thorough examination of the JOBS Act it is clear that the regulation, costs, and risks involved with equity crowdfunding inhibit its potential to be a viable funding method for early stage ventures and also as an investment vehicle for unaccredited investors. While the idea in and of itself is promising, the burdens put upon the intermediaries and entrepreneurs severely diminish the practicality of equity crowdfunding. The legislation clearly misses the mark in several areas.

From the perspective of an entrepreneur, raising money in this manner seems to be a good opportunity there are also significant risk and costs. If they set their funding target too high they could fail to obtain any funding, but if they set it low and overfund, they could find themselves in a different bracket for which they are unprepared. Furthermore, the requirements to start the campaign, while being more simplistic than a traditional IPO, are still cumbersome to
an early stage company. The financial commitment that the entrepreneur is making to bank on receiving the appropriate amount of funding constitutes a large risk that could be detrimental to the firm if plans do not pan out. To help the entrepreneurs, the amount of funding available to be raised with one year should be increased. In order to make the process worthwhile, the process should not be restrained to raising only $1 Million. Because the compliance and disclosure costs are high, increasing this amount would afford more benefits for the entrepreneurs and thus, make it more value-added.

From the perspective of an investor, this method while offering the potential for high returns, is very risky. The investment limits make diversification somewhat difficult. There is a lack of liquidity of the crowdfunding investment meaning that before an investor commits he or she must be sure that the money will not be needed in the near future. Since these are early stage companies, there is a higher risk of total loss, and with funding portal regulations there is no way to obtain advice on the merits of campaigns. To assist the investors, the prohibition on the participation of investment companies should be lifted. This would allow investment companies to create funds using these campaigns which would provide diversification benefits to the entrepreneurs. This would increase the investor protection by allowing the investors the option to mitigate risk. The restriction on selling investments within the first year should also be lifted because the illiquidity of the investment will be a large disincentive for investors. This is echoed by Weinstein’s explanation of crowdfunding in France.

For the intermediaries, disclosures and costs are also cumbersome. The funding portals need to track information on entrepreneurs, directors, officers, and every investor that utilizes the crowdfunding site. There is no room for mistakes because if requirements are not met, the crowdfunding exemption is lost. This is a detrimental situation for the intermediary. To help the
intermediaries and the investors, the individual investment cap should be lowered. The cap should be lowered from $2,000 because this would allow the disclosure requirements to loosen and decrease the cost. The legislation in its current form, necessitates keeping track of every investor as well as the officers and directors of each company involved in each campaign. This is impractical. By lowering the investment cap the risk of loss is further mitigated. It allows disclosure and tracking requirements to be loosened which provides significant benefits to intermediaries and entrepreneurs. Hogan (2014) suggests $250 per person, however, this number seems too low. The funding cap should be lowered to $1,000. While $1,000 is still a good deal of money to potentially lose, $250 is too restrictive. With only $250, investors would only be able to invest in a very small number of campaigns, possibly only one to two depending on investment size. Investors need the potential to diversify, so the funding cap needs to balance the mitigation of loss and the need for diversification. $1,000 is a compromise that sufficiently factors both of these issues.

Going forward, there are many future directions for research that could illuminate aspects of equity crowdfunding. Further research should be conducted on the costs associated with becoming a funding portal as it is unclear how extensive those costs would become. Researchers should study the implications of noncompliance and the effects that this would have on entrepreneurs, intermediaries, and investors. Research could also study investor behavior in relation to the investment cap and how the unaccredited investor would choose investments while restrained in the amount of available investment.

While the idea of equity crowdfunding is promising, the execution through the JOBS Act leaves much to be desired. There are fairly high risks involved for all parties, and the entire process makes the parties interdependent upon one another. Some companies will certainly use
this funding method, but for the majority of the early-stage firms that the act targets, the regulations and costs make the method impractical. The act gives guidance but also leaves many questions that have yet to be answered. Through the examination of this act it is clear that in its current form, it will not provide the relief that many entrepreneurs are seeking and thus proves to be ineffective as a long-term funding method. For the future, the Crowdfund Act still has potential, however, significant revisions as outlined above need to be undertaken to make long-term sustainability a possibility.
VIII. References


IX. Biographical Information
Emily Bosley is a finance and entrepreneurship double major from Wellington, Ohio. At Ashland University Emily is active in the Eagle Entrepreneurs, the math club, and the Eagle Investment Group. Following graduation Emily plans to work at Merrill Lynch in Sandusky, Ohio.