Regulation Crowdfunding: An Opportunity for New Innovation?

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On my honor as a University Student, I have neither given nor received unauthorized aid on this assignment as defined by the Honor Guidelines for Thesis-Related Assignments

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Introduction

The internet has brought about an age of connected-ness, where individuals around the globe can connect, communicate, and even share resources instantly. One of the many promising sociotechnical systems spawned through this innovation is internet crowdfunding (CF), a financial investment system that allows an entrepreneur to collect money directly from the average person, the "crowd", while bypassing traditional financial systems. While the adoption of crowdfunding was limited at first by the lack of regulations to support the new financial system, over the past 20 years many countries around the world have passed legislation legitimizing this practice. Given the non-traditional nature of crowdfunding investment when compared to practices such as Venture Capital (VC) and Angel Investing (AI), these usually involving one or a few individuals taking on large amounts of risk, there is a question as to whether the differences will encourage CF investment in industries underfunded by VC and AI. Using a five-dimensional framework consisting of the creator, the backers, the campaign, the platform, and the result as detailed by Petruzzelli in 2019, I aim to address the question through analysis of the successes and failures of crowdfunding campaigns in non-traditional industries as the financial technology has matured (Messeni Petruzzelli et al., 2019).

Literature Review

Background on Investment Regulation

For a Venture Capital Firm or Angel Investor investing in a startup, the rules and regulations around how the equity they purchase can be used plays a large role in whether the VC or AI's will invest in the idea. When purchasing equity in a company the Venture Capital firm or AI will, in most cases, receive the equity in a Regulation D security. Unlike public securities and crowdfunding securities, Regulation D securities cannot be sold or traded until they are both registered with the SEC or they have permission from the issuer ("SEC.gov | Rule 506 of Regulation D," n.d.). Rarely will an issuer, the company that was invested in, give permission to their backers to sell the equity since it could harm the public image in a time when confidence is key. Thus when VC's and AI's are making an investment, they are typically taking on a 4 to 7 year, high risk for potentially zero reward bet.

Unlike VC and AI, crowdfunding does not have those limitations. While there are many types of crowdfunding investment such as reward based crowdfunding, donation crowdfunding, and equity crowdfunding, the type that has been legitimized most recently and causing the most disruption is equity crowdfunding. Signed in 2012 and enacted in 2016, the Jumpstart Our Business Startups (JOBS) act streamlined the equity crowdfunding process by creating new rules and regulations to support equity CF (*Regulation Crowdfunding Rules*, 2016). The most important of the changes introduced in this law are the creation of a new type of security called a Regulation Crowd-Funding security, or Regulation CF, and removal of the "accredited investor" requirement. The regulation crowdfunding security is different from Regulation D types because it can be transferred or resold on a secondary platform after one year of ownership. Additionally, these securities can be bought by anyone who meets the minimum asset requirement, not just accredited investors ("SEC.gov | Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers[1]," n.d.). These changes not only open the pool of potential investors by removing the accredited investor requirement but also radically widen the scope of what companies are viable investments. Originally the VC's and Angel Investors would have to wait for the company to be acquired or offer itself on the public market before any return on investment could be seen, but with crowdfunding the equity can be sold, and potential gains realized, in as little as a year.

The Five-Dimensional Framework

The five-dimensional framework for analyzing crowdfunding as presented by Petruzzelli (2019) with the purpose of "analyze the crowdfunding phenomenon" will be largely drawn upon for the purpose of analyzing the question postulated in the introduction. Petruzzelli identified that "the crowdfunding process typically involves the creator, the crowdfunding platform, and the backers" but also that, when analyzing crowdfunding as a whole, details such as length of campaign, fundraising target, how the idea is presented on the platform, and the result of the campaign as a whole are vital (Messeni Petruzzelli et al., 2019). Therefore, a framework consisting of the project creator, the backers, the crowdfunding platform, the campaign itself, and the crowdfunding outcomes was the most applicable when studying the crowdfunding phenomenon.

Each of the dimensions and their relationships have been defined as well. The creator of the campaign is the most influential aspect, being an important relationship builder and maintainer as well as the source of the innovation (Messeni Petruzzelli et al., 2019). A particularly important relationship for the creator is that with the backers of the project. The frequency of updates, transparency with information, and whether the creator is passionate when communicating can all heavily influence a potential backer's perception of the project.

The backers themselves are crucial to the success of the project, both financially as well as being an important advertising mechanism. In particular, "the backers participate and fund a campaign in order to receive material or financial benefits, as well as when they believe that their contribution will make an actual impact for the project success" (Messeni Petruzzelli et al., 2019). Additionally, in majority of cases "the social networks of backers are leveraged to increase the reach of the campaign" (Messeni Petruzzelli et al., 2019). Clearly, then, the interest and excitement of the backers is paramount and further emphasizes the relationship between the backers and the creator.

The project campaign itself acts as the first introduction for a potential backer to the project. Consequently, the choices for how the campaign is represented have a large influence on the backers' perception. Features of the campaign such as the length, readability, presentation, and tone of the description as well as how the creators represent themselves and their credibility have been shown to influence the success of the campaign (Messeni Petruzzelli et al., 2019). The funding goal and duration of the campaign also have influence on the success, although in many cases these choices are less flexible due to financing requirements. The campaign is where the expertise, passion, and trustworthiness of the creator should be on display as to begin building the relationship with the backers.

The crowdfunding platform itself has large influence over all previous dimensions of the framework. The crowdfunding platforms “allow to overcome the constraints of the geographical distance and facilitate the interaction between creators and potential backers”. Additionally, the platforms themselves may support creators by advertising their campaign selectively geographically and by exploiting the referrals of backers (Messeni Petruzzelli et al., 2019). A challenge for platforms is deciding which projects to promote in the limited space on the home page. To promote the most investment, each platform will likely choose projects from domains that most commonly find funding on that platform. Platforms then can influence the success of a campaign if placed on one platform over another.

The outcome dimension for the framework used this paper will differ with respect to Petruzzelli (2019) in that this outcome is related to individual projects where as Petruzzelli defines the outcome with respect to the crowdfunding phenomena as a whole. For the outcome of a campaign in this paper’s framework, each of the dimensions above relates to the outcome of the campaign. While part of the outcome is whether or not the project found funding, the outcome also covers the real-world success of the venture. The outcome will be the analysis of if, and how, the creator turned the success of the campaign both financially and with respect to brand-awareness into a lasting enterprise.

Flaws in Crowdfunding

As discussed by Won (2018) and Hans (2018), the JOBS act was introduced to “enhance innovation and economic growth in the United States by ‘deliver[ing] appropriate forms of capital and liquidity to entrepreneurs at each stage of their growth’” (Won, 2018). To achieve this, the act included the creation of a new framework for equity crowdfunding in the SEC, being finalized as Regulation Crowdfunding. As Won notes, “Regulation CF proponents were optimistic that equity crowdfunding would revolutionize business financing as well as democratize security investments by allowing the middle class to invest in early-stage businesses when equity is cheap”. However, one year after implementation offerings under Regulation CF totaled only $40M versus $1.3 trillion in Regulation D during the same time period. It was clear that small businesses and startups were overwhelmingly avoiding using Regulation CF, turning to traditional routes like banks, VC, and AI (Won, 2018). Both Won (2018) and Hans (2018) agree that the lack of offerings under Regulation CF is in large part due to the fact that "[t]he maximum offering in a twelve-month period is $1.07 million—an insufficient amount to launch a successful offering" (Hans, 2018). Most scholars agree that a successful startup requires between two to five million dollars, an amount that cannot be achieved within a reasonable time frame with regulation CF due to the $1.07 Million annual fundraising cap. Because of these flaws, the number of industries that current Regulation CF can be applied to is limited.

Democratizing Access to Capital

While implementation in the United States is flawed, there exists significant literature on how crowdfunding could open capital investments to a significantly larger pool of socio-economic classes and people than traditional Venture Capital or Angel investment. As Mollick et al. (2016) finds, there is a significant lack of diversity in traditional capital investment with the majority of entrepreneurs and investors being of a similar race, gender, and socio-economic class. This is an issue because "[r]esearch findings from the Center for Talent Innovation… found that having something inherently in common with the funder, decision maker, or investor makes an enormous difference in fundraising success" (Mollick et al., 2016). In particular, the study found that "56 percent of decision makers did not value ideas they didn't personally see a need for, even when evidence suggests it's a good, marketable idea" (Mollick et al., 2016). Understanding this fact with respect to the socio-economic, racial, and gender uniformity in venture capital and angel investment, a clear problem of innovation bias appears. Innovation through traditional investment means is being bottlenecked by ideological differences. However, "crowdfunding offers something other funding mechanisms do not – a way to democratize access to the capital needed to commercialize and distribute innovation" (Mollick et al. et al., 2016). By allowing anyone to invest, the diversity of investors in crowdfunding market can be significantly higher than VC and AI both economically and socially, potentially removing the bottleneck created by limited diversity of VC and AI.

Crowdfunding Patterns in the United States

Crowdfunding in the United States, while limited because of the regulatory flaws, is a quickly growing financial resource. Given the youth of the policy, having only been implemented in 2015, the data on crowdfunding and how it has been used in practice is limited. However, the years following the enactment of regulation have seen a wide array of industries attempt to use the new financial tool. The following sections will detail the crowdfunding investment landscape in the United States as well as analyze the non-traditional industries that have benefitted from the regulation of CF in the U.S. to understand how crowdfunding enabled their success.

The Crowdfunding Investment Landscape

The crowdfunding investment market is still very young in the United States, having only been viable since 2015 when the JOBS act came into effect. Despite this, since 2016 there have been over $340M in equity crowdfunding investment with $130M of that total being invested in 2019 alone (*Crowdfunding Capital Advisors*, n.d.). Unsurprisingly, Application Software has received the largest portion of the total investments with $44.9M in received funding making up 13% of the total funding (*Crowdfunding Capital Advisors*, n.d.). This is similar to the VC funding system in which the software sector receives about 36% of all capital, as detailed in a 2016 report by the Martin Prosperity Institute (Florida & King, 2016). However, while the top industry may be the same, the proportion of total investment of 13% for CF in comparison to the 36% for VC suggests that the capital in the CF system is being spread more evenly across industries.

While the industries receiving the most investment in CF and VC may be similar, the second largest industry quickly breaks that trend. For Venture Capital, the second largest industry is bio-medical technology receiving $5.7B in capital investment, making up another 17.3% of total VC investment. VC firms are concentrating their capital on few industries, with the top two accounting for over 50% of total investment each year and over 75% of funding going to the top 5 (Florida & King, 2016). When comparing this to CF, a clear contrast emerges. According to Crowdfunding Capital Advisors, which has been tracking equity crowdfunding investments in the United States since the beginning of August 2016, the second largest industry is the Beverage industry with $31.6M, or 9.2%, of equity CF capital (*Crowdfunding Capital Advisors*, n.d.). The top two industries in equity CF only account for roughly 22% of all investment and the top 15 industries account for just 80% of all investment. As can be seen by the capital distribution numbers, the diversity of investment is far higher in CF than VC and may reflect the diverse background of investors that make up the backer pool.

In addition to the lower investment concentration, it should be noted that the industries that find successful funding in CF have some major variations from those typical for traditional funding. One of the clearest outliers for equity CF is the beverage industry which receives the second largest portion of CF capital at 9.2% of the total. This is an astronomically large proportion of funds going to an industry such as beverages. In comparison, VC firms invested $1.09B of the total $32B into both the Food and Beverage industries combined, making up just 3.4% of all investment ("2017 U.S. Food & Beverage Startup Investment Report," 2018). Another surprising market receiving the fourth most funds from equity CF is the restaurant industry. Taking in over $26.5M, or 7.8%, of all CF investments, the restaurant industry has seemingly found a promising funding route after being reliant on bank and AI funding for many years (*Crowdfunding Capital Advisors*, n.d.). While the raw capital numbers for VC are significantly higher than those of CF, a factor likely caused both by the youth of equity CF and its regulatory flaws, proportion of investment says a lot about what industries both the backers and the creators feel are viable through crowdfunding. In the following sections I will taking a deeper look at some of these industries and how crowdfunding functions within them to understand how crowdfunding may be enabling the success of these industries and whether this phenomenon can be generalized across a multitude of financial sectors.

The Film Industry

The creative arts such as film have been a strong recipient of all forms of crowdfunding since the inception and popularization of reward-based crowdfunding. Entertainment is one of the largest sectors for both VC and CF investment, enjoying 9.5% and 8.8% of all investment respectively (Florida & King, 2016; *Crowdfunding Capital Advisors*, n.d.). In addition to entertainment funded through equity CF, reward-based crowdfunding financed over 3,800 film and video projects on Kickstarter in 2014, second only to music projects (Gold, 2017). The projects are very diverse as well, with creators from small-time independent filmmakers to big time directors looking to restart a long dead project. One example of this is the *Veronica Mars* movie campaign, which received $5.7M of reward-based crowdfunding to revive the 7 years-past cancelled TV show (Gold, 2017). While the reward-based system has allowed thousands of film projects to find funding, the lack of return on investment (ROI) emphasizes personal connection with the story being told, limiting the backers that are willing to fund the project. With the addition of equity crowdfunding as an option for filmmakers, the option of an ROI will likely greatly expand the donor pool for CF films.

Crowdfunding projects are driven by the vision of the creator, namely the story he or she wants to tell, and the interest of the backers. Given that backers “that identify themselves with the values promoted by the campaign participate more actively” (Messeni Petruzzelli et al., 2019) in conjunction with the expressive nature of film, this relationship is emphasized. Through a CF platform, a filmmaker is able to portray the themes that define the story he/she wants to tell, connect to like-minded people who wish to see the story told, and receive the funds to do it directly. The CF process cuts out the financial and creative studio middle man. Before the financial recession in 2008, independent film producers would normally receive funding through bank loans collateralized by ticket presales from foreign distributors. However, the financial crisis caused many foreign distributers to abandon the acquisition of American films, leaving American independent filmmakers with few options. Reward based CF and later equity CF have grown to fill this gap, and in doing so freed many filmmakers from the creative oversight of largescale studios (Gold, 2017). Adopted out of necessity, crowdfunding has become a tool of creative liberation for an aspiring filmmaker.

For the backers of films, equity crowdfunding is a very risky investment. As the SEC acknowledges in the final rules for EC, “startups and small businesses that … will rely on the crowdfunding exemption are likely to experience a higher failure rate than more seasoned companies”, with projects relating to film adding even more risk due to their nature (Gold, 2017). However, a film that achieves funding through equity crowdfunding will have experience major benefits from their backers in the form of advertisement. In one of equity CF’s major advantages over reward based, equity backers of films and other media will be “devoted advocates of the films in which they choose to invest” (Gold, 2017). A large, devoted backing can “act as a source of credibility to increasingly conservative distributors who can leverage the implicit promotion of a fundraising campaign for all avenues of distribution” (Gold, 2017). In other words, a proven viewer base before the film is even made lends a lot of credibility to an aspiring filmmaker with little previous work, especially to a distributer such as a theatre who’s looking for an ROI on the screen time. Beyond the credibility, the backers provide implicit grassroots marketing that could reduce marketing costs and allow the filmmaker themselves more breathing room within the budget. In the case of film, the existence of the backers in crowdfunding not only fills the needs of the entrepreneur but can seemingly reduce the risk on the investment for the backers themselves through the marketing and demographic data the group provides.

All of these factors will be leveraged towards the overall outcome of the film. Given that independent films with limited releases are often judged by per screen average, the crowdfunding phenomena provides filmmakers with great resources to maximize this outcome. Because of how the crowdfunding platforms are designed, the filmmakers will have access to demographic data of their backers which, in addition to other data they’ve gathered, they could leverage to achieve a higher per screen view through selectively choosing where the film is aired (Gold, 2017). Additionally, the marketing generated by devoted backers will further increase the viewership. Crowdfunding provides a great foundation for an aspiring filmmaker, allowing them to grow their audience with a grassroots campaign made of similar minded, financially invested backers to hopefully deliver a return and provide the credibility needed for bigger budget projects. However, despite all of these benefits, Gold (2017) recommends against using this practice, simply because of the regulatory costs and investment caps that exist in current legislation.

Beverages and Restaurants

One of the more surprising top recipients of Equity Crowdfunding capital is the beverage industry, namely breweries and tap houses. As noted above, the beverage industry is a very large recipient of equity CF investment, taking the second largest proportionally at 9.2% of all capital. The uses of equity crowdfunding in this sector vary, however most use the crowdfunding phenomena for location expansion rather than founding a new brand. One such example is Hops and Grain, an Austin, TX based which raised $1M through the equity crowdfunding platform Wefunder. Founded 5 years before opening the campaign, Hops and Grain wanted to expand to another city after reaching maximum capacity in their initial location (*Invest in Hops and Grain*, n.d.). The company had posted strong revenues and consistent growth over the previous years of operation of their first location, suggesting they likely could have gotten bank funding for their second location. However, as Hops and Grain CEO Josh Hare said in an interview with Wefunder, "[t]he whole reason we chose to go this route with Regulation Crowdfunding is building a deeper base of people who are invested in what we're doing and our story" (Moon, 2017). An important factor when considering crowdfunding, as the financial investment of locals can created devoted, lifelong customers who act as grassroots marketing in a very similar way as film. Hare has emphasized the importance of community in the image of Hops and Grain and used crowdfunding's inherent "community" style fundraising to help achieve that. Considering the consumer facing nature of breweries and restaurants, the investment of community members can make or break a local business such as a brewery.

Discussion

The crowdfunding phenomena itself, outside of policy and implementation, provides entrepreneurs with a unique angle to approach founding a business that is focused on community and engagement. Crowdfunding delivers a resource that traditional funding usually does not: a financially invested and devoted backing. This backing acts as a free marketing tool for the entrepreneur and through these backers, entrepreneurs can connect with communities of people interested in the product as was the case for Hops and Grain. Beyond marketing, a diverse and crowd-based financier has significantly less influence over the creator him or herself by preventing any one individual from having too much control over the enterprise as is the case with film. These factors, among the others presented in sections above, make crowdfunding a power-house for consumer facing industries. CF builds consumer loyalty, creates grassroots marketing, and ensures creative control all while the funds are coming in. For a business that relies on customers choosing their product over a competitor or a consumer facing innovation trying to break into a new industry, it is the individuals who are devoted to a product that will convince their interest-communities to support that product. The crowdfunding phenomena is a promising tool for any entrepreneur trying to create a consumer facing product, however reality tells a different story.

Future Work

While the findings of this paper suggest crowdfunding is a fantastic new tool in the innovation space, the reality of its implementation weaken the practice immensely. Fundraising limits, an overabundance of fees, and limitations on how much a backer can donate are crippling the viability of crowdfunding in the United States (Won, 2018; Hans, 2018; Gold, 2017). Crowdfunding could revolutionize consumer facing industries are formed, creating a new marketplace that is more representative of what innovation exists, but it cannot achieve this until Regulation Crowdfunding is fixed to represent to desires and needs of entrepreneurs.

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