Nesta...

THE VENTURE CROWD
CROWDFUNDING EQUITY INVESTMENT INTO BUSINESS

Liam Collins and Yannis Pierrakis

July 2012

About Nesta

Nesta is the UK's innovation foundation. We help people and organisations bring great ideas to life. We do this by providing investments and grants and mobilising research, networks and skills.

We are an independent charity and our work is enabled by an endowment from the National Lottery.

Nesta Operating Company is a registered charity in England and Wales with a company number 7706036 and charity number 1144091. Registered as a charity in Scotland number SC042833. Registered office: 1 Plough Place, London, EC4A 1DE

wwww.nesta.org.uk

EXECUTIVE SUMMARY

Crowdfunding is big business. The idea of financing projects or businesses with small contributions from large numbers of people is catching on in a big way and now accounts for significant amounts of money. In 2011 alone, $1.5 billion was raised through crowdfunding for projects and businesses in need of funds. Not only does the model provide finance but also access to a large number of people who can test and market an idea. Crowdfunding takes a number of different forms, the most successful of which has been the reward-based model where participants receive non-financial rewards in exchange for donating to a project. The model effectively harnesses not only the contributors' desire for the reward but also the intrinsic or social motivations to back a project. Other forms of the model are, however, also growing rapidly. The most recent of these is equity crowdfunding, where individuals receive small stakes in a privately owned young business in return for investment.

	Form of contribution	Form of return	Motivation of funder
Donation Crowdfunding	Donation	Intangible benefits	Intrinsic and social motivation.
Reward Crowdfunding	Donation/ Pre-purchase	Rewards but also intangible benefits.	Combination of intrinsic and social motivation and desire for reward.
Crowdfunded Lending	Loan	Repayment of loan with interest. Some socially motivated lending is interest free.	Combination of intrinsic, social and financial motivation.
Equity Crowdfunding	Investment	Return on investment in time if the business does well. Rewards also offered sometimes. Intangible benefits another factor for many investors.	Combination of intrinsic, social and financial motivation.

While equity crowdfunding shares many of the features of the reward model, one significant difference is the combination of both financial and non-financial motives for investing. The model also differs from other forms of equity financing. Crowdfunded businesses do not have to adhere to the strict accounting standards required of public companies and unlike other risk capital providers, crowdfunding investors may have no experience in making such investments.

The process

Investment via equity crowdfunding is facilitated by online platforms, which allow entrepreneurs to connect with potential investors and seek funding from the crowd. Although there is some variation in how platforms operate, the process usually follows the following steps:

- **Application to platform:** Platforms vet submitted applications and decide which businesses to allow on the site.
- **Raising the funds:** Businesses create a pitch with information relevant to the fundraising and have a certain amount of time to raise the capital. They market the campaign through their networks and beyond, and interact with potential investors to address any questions.
- **Fundraising closes:** If the target has been reached by the end of the period they receive the funds following some further vetting by the platform. If they fail to reach the target money is returned to investors.
- **Post-investment:** Investors continue to have the option to interact with the entrepreneur. In some cases they also receive voting rights.

Crowdfunding investment into business

Equity crowdfunding has the potential to be a complementary source of risk capital to the traditional providers in the market, offering finance to many businesses currently struggling to source investment. One such cohort of businesses is those seeking investment in so-called equity gaps where it is difficult to get finance from traditional risk capital providers. Another is businesses that do not fit the high-risk, high-return profile served by the traditional risk finance providers mentioned above, but still face financial constraints. These businesses may not have the potential to deliver the exceptional returns of venture capitalists targets, but they may also be less risky and still provide significant value to the economy.

Some challenges faced by the model

Multiple motives. Managing co-investment between various investors with different motivations for investing is one task that businesses and platforms will need to master. As more evidence becomes available about the mix of factors that drive crowdfunding investment behaviour, it will become clearer how this can be achieved.

Refining the process. During fundraising, it is important that investors make use of all of the information available when assessing business pitches, and are active in interacting with entrepreneurs to find answers to any questions they may have. Being able to use tools to assess the reputation and expertise of entrepreneurs and fellow investors, would be an aid to the evaluation process. Platforms also need to find the best ways of stimulating collaborative evaluation by the crowd to give them every chance of selecting the best ventures. The process will need to continue to iterate in order to find the best ways to vet businesses for fraud, assign fair valuations to businesses and ensure that managing many shareholders does not become a burden.

Getting the right participants. Other challenges include attracting high-calibre businesses and investors to platforms. More experienced investors would be helpful in providing evaluation support for smaller investors and platforms may want to consider how to entice them. Attracting

the right businesses is another important task. Not all businesses will be suited to crowdfunding and as the model develops, evidence needs to be generated to indicate what businesses it works best for. This will include the identification of those ventures that are most successful at harnessing the non–financial contributions from the crowd.

Regulation. One of the main barriers to the growth of the model thus far is regulation, which has hindered the expansion in the number of equity crowdfunding facilitators. As interest in the model grows, there is a greater need for clear legislation in the area and an efficient process for authorising platforms.

This report provides the first account of how the crowdfunding model operates in practice as well as some of the variation in the operating models of the platforms. Drawing on several interviews conducted with key stakeholders, the report looks in detail at the opportunities for equity crowdfunding, the challenges it faces and provides recommendations as to how some of these can be addressed.

ACKNOWLEDGEMENTS

The authors are grateful to the following people for their contributions to the report.

Martijn Arets (Brand Expedition)

Jon Bradford (Springboard)

Albert Bravo-Biosca (Nesta)

Stuart Chapman (DFJ Esprit and BVCA)

Kristof De Buysere (University of Tilburg)

Guillaume Desclee (MyMicroInvest)

Simon Dixon (Banktothefuture)

Ragini Ghosh (CrowdMission)

John Gibson (No 10 Downing Street)

Maurits Groen (WakaWaka)

David Gudgin (Albion Ventures)

Robert Hayes (Investor)

Sebastian Lewis (GetSiteTracked)

Jeff Lynn (Seedrs)

Louise Marston (Nesta)

Matthew Mead (Nesta)

William Reeve (DFJ Esprit)

Ami Shpiro (Investor and Founder of Innovation Warehouse)

Norbert Toepker (Innovestment)

James Watt (Brewdog)

Darren Westlake (Crowdcube)

Stian Westlake (Nesta)

Korstiaan Zandvliet (Symbid)

CONTENTS

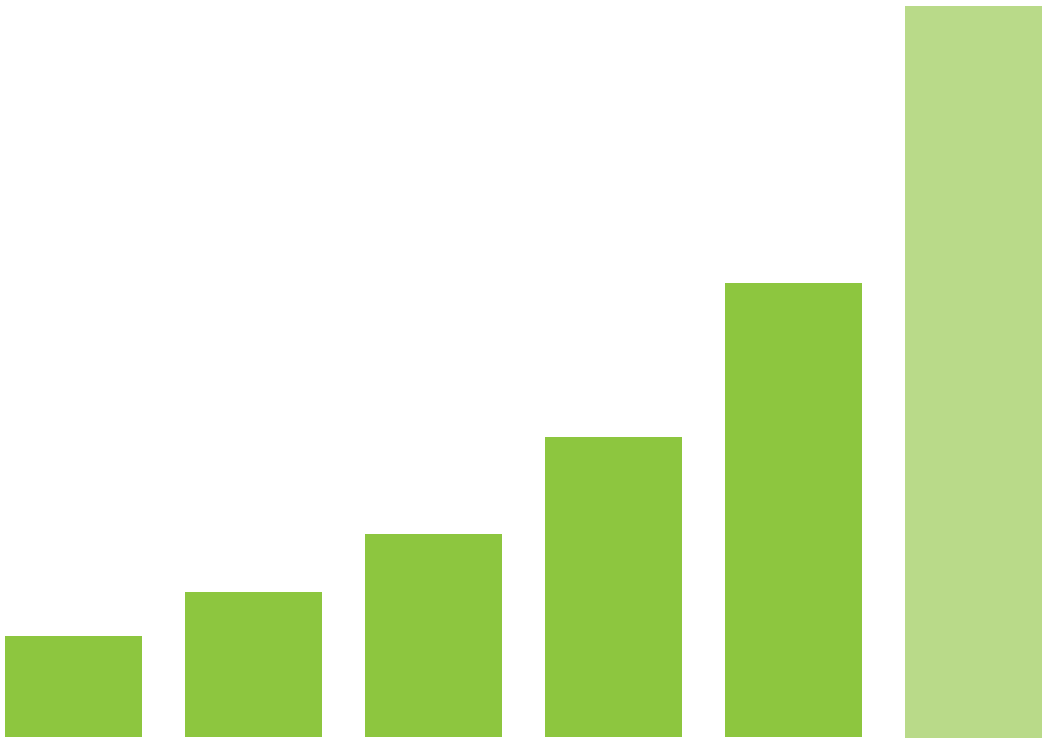
1.

THE RISE OF CROWDFUNDING

On 8 February 2012 Doublefine studios launched a campaign on Kickstarter, a crowdfunding site, to raise $400,000 to finance a new game they hoped to develop in exchange for rewards to donors such as copies of the completed games and lunch with the creators. While Doublefine were permitted 32 days to raise their target, they surpassed the $400,000 in just eight hours. By the end of the 32 days they had raised over $3.3 million from people contributing on average less than $40 each. This fundraise was the highlight in what has been a period of extraordinary growth for crowdfunding.

The concept of crowdfunding finds its root in the broader concept of crowdsourcing, which uses the 'crowd' to obtain ideas, feedback and solutions in order to develop activities. In the case of crowdfunding, the objective is – also – to collect money from the crowd who can often participate in strategic decisions or even have voting rights in a business.[1] As well as permitting entrepreneurs access to a new pool of capital, the model allows them to connect with potential customers or users and test ideas before proceeding with the project. It also gives investors the opportunity to feel part of the project from its very early stages.

Figure 1: Annual growth in the number of crowdfunding platforms worldwide



Source: **www.crowdsourcing.org**

Crowdfunding has been growing rapidly in the past few years as advancements in technology and the growth of social media has made it far easier for entrepreneurs to reach large amounts of people at far less cost. The fundraising itself is usually facilitated by online platforms operated by third parties who manage transactions and vet projects before presenting them to the public. Crowdsourcing.org, an industry website focused on crowdsourcing and crowdfunding, estimates that there were 453 platforms active at the end of 2011 and in that year they raised $1.5 billion in project and business financing.[2] And demand does not look to be slowing. Kickstarter, the market-leading platform, is on track to facilitate the raising of $150 million of project finance for its participants in 2012, more than the National Endowment for the Arts budget in the US.[3] To date, projects with a creative or social focus, where non-financial rewards(e.g. CD, ticket to a play) are offered in return for donations, have been the most successful at raising finance from the crowd.

However, while crowdfunding has been primarily through the reward model, other forms, offering the option for financial return, are also growing fast. Crowdfunded lending to businesses has grown in recent years as an evolution of the more established model of peer-to-peer lending. Platforms give credit scores to businesses seeking loans and lenders can buy loan parts at an interest rate which is often adapted to the market demand. FundingCircle, a London-based provider of crowdfunded loans, has facilitated over £35 million worth of loans to date.

The form of financing that platforms have found it most challenging to facilitate is investment from the crowd for equity stakes in businesses. Unlike the Kickstarter model where donors receive rewards for their contributions, equity crowdfunding allows anyone to take a stake in a young business in the hope of making a financial return if the business does well. However, like the reward model, in many cases investment will also be motivated by non-financial aims as the model taps into the sub-section of the public with an interest in entrepreneurship. The intrinsic motivation to become a part of an entrepreneurial venture or to support a particular individual or business, will play a significant part in many investors' decisions to invest. The extent to which this occurs will determine the level of returns the model is expected to deliver.

While web 2.0 has provided a transformative effect in bringing large numbers of people together, regulation has made it difficult for businesses to tap into these online communities for investment and currently only a few platforms facilitate this process. Legislative changes recently passed in the US have paved the way for growth in the model there, and the interest in the model on this side of the Atlantic will likely increase as a result. However, there are factors other than regulation that have also limited the growth of this model. These include investor worries about how much protection they have against fraud, business concerns about making sensitive information public on platforms and how to manage large numbers of shareholders.

The growing popularity of crowdfunding has increased interest in exploring how the model works but research on equity crowdfunding has, to date, been very limited. Although, as Box 2 on page 16 illustrates, the model is yet to have a significant impact on the market in terms of the amount of investment it has facilitated, it has the potential to deliver a lot more. This report aims to highlight the merits and also the limitations of this new form of financing and its potential to become a significant source of finance for innovative businesses. Interviews with key stakeholders including platform operators, entrepreneurs, and investors have been conducted, in order to identify the challenges faced by the model and what solutions it can adopt to overcome them.

2.

WHAT IS EQUITY CROWDFUNDING?

For the purpose of this report, equity crowdfunding is defined as the offering of securities by a privately held business to the general public, usually through the medium of an online platform. The model permits anyone to acquire a share in privately held businesses, i.e. those that have yet to float on a stock exchange, by allowing a business to offer a certain proportion of its equity for a set amount of capital it is aiming to raise. Investors can then, through the platform, buy small parts of this equity stake. While some may define investment into public companies on stock markets as a form of crowdfunding, the definition used in this report differs from this form of investment in several ways. First, acquiring shares through a stock market is already an established practice where public companies are required to adhere to strict reporting standards. Private companies seeking crowdfunding do not have to adhere to these standards. Second, companies in the stock market are significantly larger and more developed than those seeking finance through equity crowdfunding platforms. And third, unlike stock market investing, crowdfunding platforms offer the opportunity for direct interaction with both the entrepreneurs and other likeminded investors interested in investing in the same company.

Other models that may be deemed as forms of crowdfunding that lie outside of the definition of equity crowdfunding used here, are those that restrict membership of the crowd. Most notably this includes those platforms that only allow accredited investors to participate in investing such as Northern Ireland based Seedups,[5] CircleUp[6] or startup and investor community Angellist[7]. These platforms are a welcome innovation to the field of business angel investing, bringing transparency to what is an opaque process and greater visibility of potential investors for start–ups. They also promote more opportunities for syndication amongst investors, creating a better connected investor ecosystem. While this is a positive development and many businesses have had been very successful in raising capital in this way, unlike crowdfunding, it does not necessarily facilitate the tapping of new pools of capital for investment in innovation. It also doesn't face the barriers equity crowdfunding does when dealing with non–accredited and large numbers of investors.

2.1. The stages of equity crowdfunding[8]

Getting on to a platform

The first step of the crowdfunding process involves a business submitting its proposal to a platform. The platform operators will then look at the plan and perform some level of vetting of the business, looking at factors such as the likelihood the business could be fraudulent, the business's suitability to crowdfunding, the reputation of the entrepreneur(s) and other factors. They then decide whether or not to allow the pitch to go live on the site. Some platforms like Exeter-based Crowdcube do the majority of their vetting beforehand having a 75 per cent rejection[9] rate for applicants. Others favour checking the business later, like Dutch platform Symbid who perform due diligence once the target has been successfully raised but before they release the capital to the business.

Box 1: Case study of 'GetSiteTracked' on Crowdcube

In 2010, GetSiteTracked founder Sebastian Lewis noticed that like many sole traders his father was finding it difficult to adapt to using the internet to source new business. The majority of sole traders, he discovered, didn't have websites for their businesses as most web hosting providers offered services that were overly complex and quite expensive. Out of this realisation came the idea for GetSiteTracked, an online provider of affordable and easy-to-use websites for sole traders. Like most young entrepreneurs, Sebastian needed to raise external capital to get his business off the ground. He was advised not to approach banks as without a sizable asset he would be very unlikely to secure any amount exceeding £10,000, and in his search for alternatives he came across CrowdCube and decided to try raising capital through crowdfunding.

In March 2012, over the course of ten days Sebastian raised £100,000 from 29 investors in exchange for 33 per cent of his business. Recognising the difficulty in setting valuations on seed stage businesses, Sebastian used the feedback from investors to judge what amount of equity investors were willing to accept in return for investment, increasing the amount he was initially intending to offer. According to Sebastian, one of the main benefits of crowdfunding is that once a round is raised it opens doors to other sources of finance.

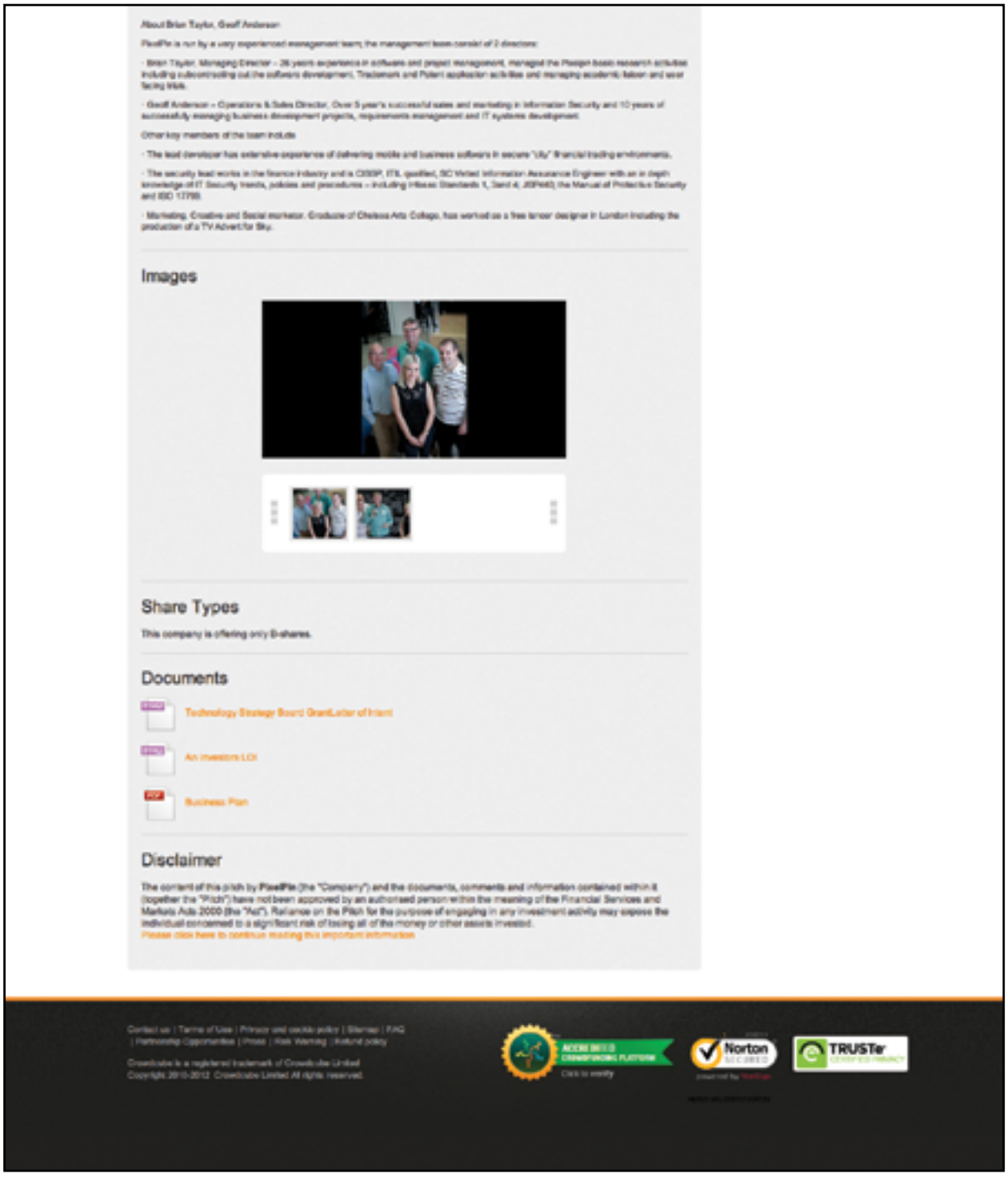
An additional benefit that Sebastian received from the process was the uncovering of a valuable mentor who wanted to get involved in helping the business as well as providing investment. *"While it was not something I expected to attain from the process, Rob's advice has been of enormous value to the business."*

Robert first came across Crowdcube in a local magazine and was intrigued by the prospect of being able to invest directly into a start-up having successfully built a business himself. Through the platform, he reviewed pitches and contacted the entrepreneurs behind some businesses he was interested in. After discussing GetSiteTracked with Sebastian he decided to both invest and to come onboard as a mentor to the business. Getting in touch with the entrepreneurs, he felt was a key part of making the investment decision. Robert also points out that would-be investors should always have an idea of how they expect to make money from their investment i.e. via dividends, trade sale etc., before they invest. While Robert was a heavily involved investor, the majority of Sebastian's investors were quite passive in their approach.

Providing information to investors

Once accepted onto the platform, pitches are uploaded for prospective investors to browse. These are usually in the form of a video or text description explaining the business's model, its roots including some background on the business owners, how much capital it is seeking to raise and

what it needs it for. Another important disclosure is how much equity it is offering, with each investor getting a *pro rata* share depending on the proportion of the target amount they commit. There are a number of ways entrepreneurs can decide on the proportion of equity to offer, occasionally using the help of the platform and investors.



Connecting with investors

While some investors may browse the platform for pitches,[10] the entrepreneur needs to make a conscious effort to market the pitch as widely as possible outside the platform. They need to tap into their network and beyond, to get people interested in the business and in becoming investors. As the campaign advances, it is important that interaction between the entrepreneur and potential investors continues via discussion forums on the platform or via email, phone or even meeting in person to address questions and give updates on the fundraising progress.

The 'all-or-nothing' model

A specific time allowed for the raise or the 'funding window' is also set in advance with platforms usually having either a standard 'funding window' or a limit on the time that can be taken. London-based platform Seedrs, for example, operates a three month standard funding window. As is prevalent in the 'reward' model of crowdfunding, all equity crowdfunding platforms currently in the market operate the 'all-or-nothing' system of funding where the venture has until the end of the funding window to raise its target or else it receives nothing and money is returned to investors. It can also raise no more that its target. The fees charged largely depend on whether funding is successful or not, with platforms usually charging businesses a percentage of the amount raised should they reach their target. Some also charge investor fees as Box 2 illustrates.

After the target is reached

The facilitation of the actual money transfer usually involves an escrow account,[11] [12] independent of both the investor and business, where the investment is held until the total target is reached, or failing that, returned to the investor.

Post-investment practices are also varied depending on the approach taken by a given platform. Seedrs, for example, operates a nominee and management system where it represents the interest of the investors with the business whereas others like Crowdcube and Symbid allow the entrepreneurs to manage their own interests. In the latter approach, investors have the option to be as passive or involved in the business as they choose. As is explored later, there is similar variation across sites in terms of voting rights.

Box 2: Matrix of currently operating equity crowdfunding platforms in the Europe[13]

	Location	Capital raised so far through the platform	Fees	How investment is facilited	Vetting/Due dilligence by platform	Decision on how much equity to offer	Funding window	Post-investment
CrowdCube	UK	£3.7m	For businesses: 5% of amount raised + £1750 legal fees if successful	Both investor and business become members of Crowdcube Ltd for the period of the raise	Vetting done before businesses accepted on platform	Entrepreneur decides. Can increase equity during funding window	60 days as standard	Business decides threshold for voting rights
Symbid	Nether-lands	€<1m	For businesses: €250 up front for existing businesses (start-up ideas can place for free) + 5% of amount raised + legal fees – only payable if successful For investors: 2.5% of investment amount + transaction costs	Investment is via a co-opertaive established in the Netherlands	Perform due diligence once target raised	Entrepreneur decides. Can increase equity during funding window	Maximum of 1 year	Indirect voting rights for all investors via co-operative
MyMicro Invest	Belguim	€500K from professional	For businesses: 12% of amount raised if successful	Investment through an investment vehicle	Board of professional investors do their own due diligence before investing.	Agreement reached after negotiation	1 month as standard	Voting rights for professional investors only
WiSeed	France	€2.5m	For businesses: 10% of amount raised if successful. For investors: 5% of amount invested if successful.	Investment through dedicated investment vehicle for each raise	Perform due diligence before raise	Negotiation between platform and business after due diligence is performed	3 months as standard	Platform manages voting rights
Innovestment	Germany	€0.5m	For businesses: 10% of amount raised if successful.	Investment through dedicated investment vehicle for each raise	Selection process with multiple stages and a board before business allowed on to platform	Uses auction to decide on valuation	30 days as standard	No voting rights for investors
Seedrs	UK	Launching in July 2012	For businesses: 7.5% of amount raised if successful. For investors: 7.5% of profit from investment	Seedrs hold shares on your behalf as a nominee manager	Approve disclosures as financial promotions beforehand and perform legal due diligence once target raised	Entrepreneur sets amount which cannot be altered	3 months as standard	Operate nominee model where they represent the interests of post investment
BankToThe Future	UK	Launching in July 2012	For businesses: 5% of amount raised + £1750 Company Secretarial Fee	Facilitates financial promotion via membership model. Working on next phase with FSA	Vetting performed before business allowed on to platform	Entrepreneur makes decision. BankToTheFuture provides training to assist them	Maximum of 90 days	Investors are collected into private group for updates. Entrepreneur sets minimum investment amount to qualify for voting rights
Crowd Mission	UK	Launching in September 2012	For businesses: 5% of amount raised	Both investor and business become members of CrowdMission for the period of the raise	Initial vetting undertaken before business accepted on to platform. Further vetting done if target is reached	Entrepreneur sets amount which cannot be altered	Still considering options	Still considering options

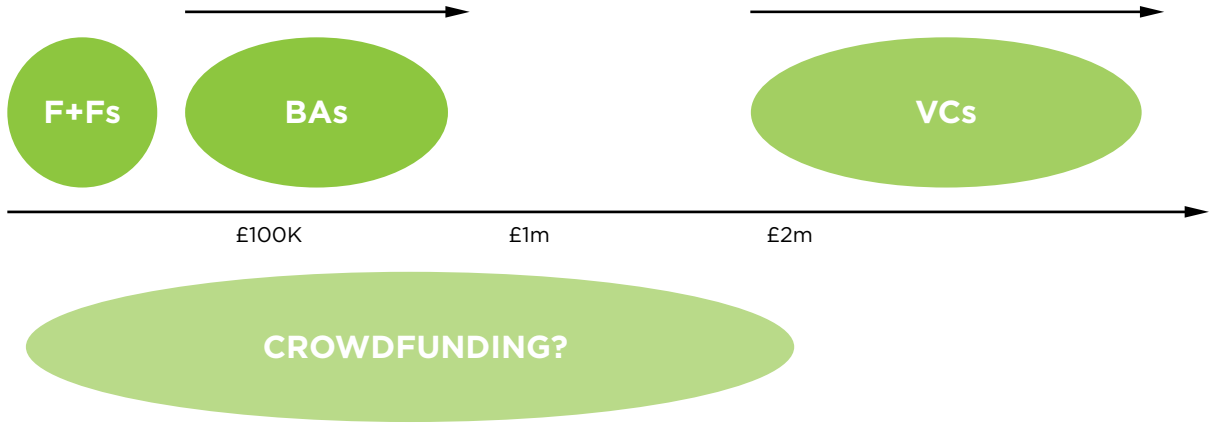
3.

THE MARKET OPPORTUNITY FOR EQUITY CROWDFUNDING

3.1. The equity gap

The demand for accessing risk capital via crowdfunding platforms is potentially extremely large. Quite often, start-up entrepreneurs are unable to access debt financing due to their lack of collateral and the risky nature of their venture. As a result, they tend to be reliant on generating revenue, financial help from friends and family and external sources of equity financing, in order to fund the early stages of their development. As many businesses are not capable of generating revenues in their infancy, friends and family tend to be the first port of call for external finance. Jeff Lynn, founder of crowdfunding platform Seedrs says this has led to something of a class bias in entrepreneurship with only those having access to wealthy friends and family being able to source the capital for their business. In any case, friends and family financing is often an insufficient source of funds and in order to achieve scale, larger sources of risk capital are often required.

Figure 2.



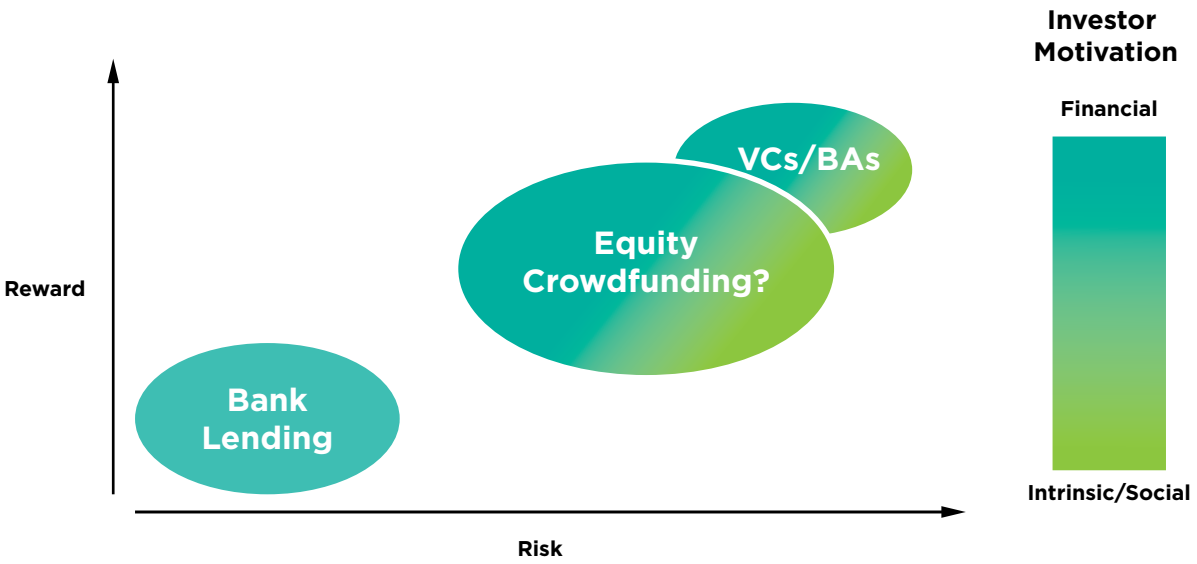
The traditional sources of risk capital, business angels and venture capitalists, have increasingly been moving their investment activity upstream in recent years, making bigger investments into more developed companies.[14] [15]Many angels tend to only consider businesses looking to raise larger amounts with the majority of rounds raised from business angels in 2009/2010 greater than £100,000.[16] Venture capitalists have largely left the seed stage space, with the ratio of transaction costs to investment size for small deals being less and less suited to their business model. One reason this ratio has increased, especially in sectors such as software and internet start-ups, is the decreasing costs of starting a business thanks to innovations such as cloud computing and

greater processing power.[17] This has created two markets[18] where crowdfunding could play a valuable role. One is the initial seed money to start a business, where friends and family finance may be unavailable or insufficient, and amounts required are too small for business angels to get involved. There is also the gap above the level where business angles are usually active, but where the capital required is too small for venture capitalists to get involved. The majority of equity crowdfunding raised thus far, has been in the lower gap but the model may also have the potential to raise large amounts, especially if it can entice larger, more sophisticated investors to participate.

3.2. The risk-reward opportunity

Another issue with traditional risk capital providers is their focus on high-risk, high-return ventures shying away from those that may not have the potential to deliver the exceptional returns they usually seek but also have less risk attached. This is the category that has the potential to achieve significant growth but perhaps not the level of growth that would get a venture capitalist or business angel interested. Whether these businesses can deliver sufficient returns to justify long-term illiquid investment, and how they deliver those returns, are important issues to consider. As discussed in section 3.3, crowdfunding may also have the potential to deliver finance to ventures that have greater levels of risk attached relative to the potential financial gains they can deliver. Non-financial benefits of investment such as rewards and intangible benefits from being part of an entrepreneurial venture may mean some crowdfunding investors will be willing to accept more risk or less return than traditional risk capital investors.

Figure3: Business risk-reward profile where crowdfunding may fit



In previous years, UK governments have intervened in order to increase the flow of seed and early-stage capital with initiatives such as publicly-backed venture capital funds focused on early stage-businesses, co-investment funds and tax-breaks for investors. However, the effectiveness of these schemes has been mixed.[19] [20]Privately-led initiatives such as the growth in start-up accelerators, provide another potential solution to this problem but these are still quite few in number.[21] Another way of increasing the supply of finance to seed and early-stage companies is the facilitation of

purely business angel investments through online platforms, as mentioned earlier. This model, most successfully demonstrated by Angellist in the US, allows for more efficient syndicate investing into start-ups by accredited investors.

Equity crowdfunding may have the potential to offer an alternative or, in some cases, complementary source of finance for businesses in this space, offering risk capital for early-growth or new product development. By design, this financing model is perhaps suited to smaller amounts due to limiting factors related to the size of a crowd a given business can tap into and the amount of capital individual investors can or are willing to contribute. This does, however, depend on the extent to which larger investors participate in the process and there have been some cases where the potential of the model to raise larger amounts has also been shown.[23] Another factor that may make crowdfunding particularly suited to seed and early-stage risk capital, is that it allows investors to commit smaller amounts to many ventures allowing them to effectively spread their risk, in a cost effective way.

3.1. What types of ventures may seek equity crowdfunding?

In time, the primary determinant of the type of businesses that attempt to raise capital via crowdfunding will be the model's success at delivering returns, financial and non-financial, and the benefits businesses get from raising capital through it. Other important factors include:

First, there is the ability of the mechanism to provide follow-on funding to businesses. Some ventures may prefer more conventional providers of risk capital in the hope that they can use the establishment of this relationship to seek further funding in later rounds. The endurance of relationships between venture capitalists may also become a factor when thinking about the quality and experience of the entrepreneur. Research has shown that serial or repeat entrepreneurs tend to have far more success at growing new ventures.[24] These entrepreneurs will often have existing relationships with institutional investors as well as significant personal resources which they may deem preferred alternatives to crowdfunding.

Second, some business models and sectors may be more suited to raising funding through crowdfunding than others. One obvious example of this is consumer-facing businesses. For start-ups in this sector, traction with the potential customer base is an integral part of proving to investors the viability of the proposition. Korstiaan Zandvliet, founder of Symbid, believes that the proof of traction gained by raising a crowdfunded round from investors, who are themselves consumers, will be a significant asset to companies seeking follow-on financing. On the flip side of this are those business models that are based on complex IP or innovations in very high-tech and cutting edge areas. Without in-depth knowledge of the specific area, amateur investors may be hesitant to commit their cash to a venture.

Third, as discussed later, other types of ventures that may be unlikely to seek crowdfunding are those that feel sensitive about making ideas and financial details public on platforms. Those businesses that are particularly capital-intensive in early stages or those that require the types of post-investment support that can only be provided by institutional investors may also not find the crowdfunding model a good fit.

Finally, ventures with a focus on generating social gains as well as profit are one category that could be a good fit for equity crowdfunding. The non-financial motivations for investing, will be stronger in these instances, meaning businesses may not need to deliver as high returns to attract investment. These motivations may also mean investors would be a more effective marketing force for the business in general but especially for getting others involved in the crowdfunding campaign. These businesses could be focused on addressing large international social problems such as in Box 3, or on local issues such as employment in a given area. One investor pointed out that a major opportunity for crowdfunding was allowing people the chance to contribute to businesses starting up in their local area. Karen Darby of CrowdMission, which aims to facilitate the equity crowdfunding of social ventures, says there is a significant population of businesses that would avail of this form of financing.

These factors may determine how similar the cohort of businesses seeking crowdfunding will be to those seeking risk capital in general. By extension, this will impact on how likely crowdfunding returns may mirror those of other risk capital providers.

Box 3: Case study of WakaWaka light – crowdfunding socially focused ventures

1.5 billion of the poorest people on the planet have no access to a safe and affordable source of light. This is the problem Maurits Groen and Camille Van Gestel set out to tackle with their business WakaWaka light. Their product, a highly efficient solar-powered LED light for use in developing countries is designed to be more cost-effective and efficient than other solar-powered alternatives and aims to reduce the use of highly toxic kerosene lamps that are the current norm. Having already committed a significant amount of their own capital to the business, they successfully raised just under €50,000 from reward-based crowdfunding platform Kickstarter. But needing further capital to get production moving they approached Dutch crowdfunding platform Symbid.

In just over two months they successfully raised €75,000 from 320 investors for a 2.5 per cent stake in the business. Investors contributed a wide range of investment amounts from as little as €20. The average investment was €234. Founder Maurits said the main attraction of crowdfunding was that they could access investors that shared their vision of tackling the social problem and were not solely focused on making a profit. As part of their campaign they did not make the IP around the design of the light public but he was not overly concerned about security as solving the wider social problem was more of an aim than capturing market share.

4.

THE CROWDFUNDING MODEL FACES SEVERAL CHALLENGES

4.1. The regulatory environment

Regulation in the area of issuing securities to the public has been the biggest barrier in the growth of crowdfunded equity to date. By its very nature, risk capital investing in young businesses involves the potential that investors may lose part or all of their money. Crucial decisions in relation to due diligence (including vetting for fraud), the setting of valuations, information verification and input to the governance of the venture, often need to be made in the absence of important information that is usually available for more mature ventures. Currently, those engaged in equity investing in young companies such as venture capitalists or business angels, have experience of both management of these types of ventures and knowledge relevant to the specific sectors or technology. The natural worry from a regulatory point of view is that a lack of experience of non-professional investors may lead to investments made into fraudulent businesses or in businesses that, although genuine in their intentions, have little chance of success.

The current regulation relates to equity crowdfunding primarily in two respects. One is the promotion of a share offering and the other is the offering itself.

At present, the regulation states that a company must not promote a share offering to people in order to engage in investment activity unless, either:

(i) they produce a prospectus which is approved by an authorised person; or

(ii) they offer the shares only to exempt persons.[26]

The most common examples of 'exempt persons' mentioned above are high-net-worth individuals/sophisticated investors or investment professionals such as business angels of venture capitalists. There is an exemption to the rule requiring an official prospectus for those raises of less than €5 million[28] but even for these, the promotion needs to be approved by an FSA authorised person[28] who requires it to meet near-prospectus standards and have much of the same costs associated. Darren Westlake, founder of UK platform Crowdcube estimates that meeting the standards for approval can cost anything from £20,000 to £100,000.

The second aspect in relation to the underwriting of the shares is where private companies can only offer shares to individuals who have a 'private concern' in receiving it, loosely meaning that they have some relationship with the business.

Similar legislation is found worldwide and it has forced platforms to operate a variety of different models to facilitate equity crowdfunding. Some, like French platform Wiseed, allow investors to take a stake in a dedicated vehicle that takes an equity share in the business. Crowdcube currently requires both the business and investor to join a limited company for the period of investment. But regulators in the UK are moving to create a framework where funding can be facilitated under their supervision. Seedrs will be launched with oversight by the FSA, but only after a very long authorisation process.

Box 5: Case study of Brewdog's 'Equity for punks'

BrewDog, Scotland's largest independent brewery was one of the very few companies that raised money via the crowdfunding model before online platforms popped up to facilitate the process and reduce the costs. To secure the capital needed to grow their young business, the co-founders decided instead of seeking funds from more traditional sources to leverage the growing fan-base of the brewery and raise money from the crowd. In 2009 and again in 2011 they issued FSA approved share offerings that raised £750,000 and £2.2 million respectively. The second and most ambitious of their 'Equity for Punks' campaigns raised capital from almost 6,000 investors with an average contribution of £372.

It cost Brewdog around £150k to set up the scheme in compliance with FSA regulations. This was spent on auditing accounts, legal verification of prospectus, authorised person under section 21 of the Financial Services Act and a receiving agent. Crowdfunding could, depending on the amount of capital a company is seeking to raise, offer a much more cost effective way of raising funds. While, CEO James Watt likes the model of sourcing capital from fans, he points out that it is extremely important to ensure that crowdfunding raises are FSA compliant.

Barriers also exist in the US but these will, to an extent, be removed once the JOBS act[29] which was passed in April 2012 comes into effect at the beginning of 2013. The change allows for individuals to invest the greater of $100,000 or 10 per cent of their annual income or net worth ($2,000 or 5 per cent for those with net worth of annual income less than $100,000) into privately held businesses. Businesses can raise a maximum of $1 million and must do so through a 'funding portal' which is subject to SEC supervision.

The remainder of this report seeks to identify the potential benefits of, and concerns about, the equity crowdfunding model. It aims to inform entrepreneurs and investors interested in participating in the model and also policymakers considering regulation in the area and incentivising crowdfunding.

4.2. Challenges with operating the model

4.2.1. Setting valuations

As mentioned previously, one of the first stages in the crowdfunding process requires setting a valuation for the company so the entrepreneurs can decide how much equity to offer for the amount of capital they are seeking to raise. This is an important part of the process, as it is necessary to ensure that the entrepreneur gets a fair valuation for their business while ensuring shares are not too expensive. But the difficulty in estimating the value of a company must not be underestimated.[30] Much of the assets held by the business may be in the form of intellectual property and valuations are largely based on risky predictions of future market size, competition, revenue and other variables.

The most common practice on crowdfunding platforms is for entrepreneurs to set the valuations themselves based on what they perceive the business to be worth. However, should they get this valuation wrong it may have a significant, adverse affect on the entire fundraising. A mechanism used by some platforms, that attempts to overcome this valuation problem, is to allow upward flexibility in the amount of equity that is being offered, as the fundraising progresses. In this way the entrepreneur can increase the amount of equity that is being offered if they think the rate of investment to that point is indicating that they may not reach the target before the deadline. Alternatively they may have received feedback from investors that they think the venture is over-valued. Any increase in the equity would also apply to those that had invested before the change with their equity stake increasing too.

Other, more innovative methods of setting valuations are also possible. Innovestment,[31] a German platform, operates a market-driven approach to setting valuation. The entrepreneurs set out the amount of equity and number of shares they are offering and investors bid for the shares with those investors willing to pay the most for the shares getting in on the deal. A reversal of this could also work with investors bidding down the amount of equity they are willing to take at a fixed investment amount, thus avoiding the business raising more capital than it needs. There are some issues with this model also. Auction theory literature[32] indicates that by construction those who win in this dynamic pay more than the larger pool of bidders believe the item, in this case business, is worth and thus may be overpaying.

Another practical move is to ensure entrepreneurs are educated about how to value their businesses. UK platform BankToTheFuture addresses this by offering training to entrepreneurs from ex-investment bankers, fund managers and venture capitalists. Platforms could also explore the potential of allowing entrepreneurs to benchmark their valuations against other similar businesses raising funds on the platform.

Flexibility around setting valuations is essential for very early-stage businesses and allowing the equity stake to be increased or bid for seem sensible approaches. However, just as there are implications for entrepreneurs of offering too little equity, entrepreneurs and investors also need to be aware of the consequences of offering too much equity such as its effect on the business's ability to secure follow-on financing.

4.2.2. Fraud detection, selecting businesses and the wisdom of crowds

One of the main concerns about crowdfunding equity is that funds could be taken from unwitting investors for ventures that have no intention of creating a profitable business. This fear is the one that has been touted most[33] by those arguing against the easing of regulation and promotion of the model. This is an important concern but a closer look reveals that there are a number of safeguards in place to prevent fraud occurring.

The administrators themselves perform some level of vetting of applicants for fraud and as more platforms enter the market the thoroughness of this will become a point of competitiveness. Another protection is the 'all-or-nothing' model operated by platforms where those raising capital only receive the money if their target is reached. One entrepreneur who raised finance through crowdfunding, stated that the 'all-or-nothing' model is crucial as only if a venture has sufficient support from a number of investors does any individual investment become real. The theory here is that the more people that have performed checks for fraud, the more likely a potentially fraudulent proposal will be identified as such. However, this implies that potential investors perform such checks and do not entirely rely on the fraud vetting performed by the platform. This method of crowd vetting also only works when platforms accommodate forum discussions where one can alert others to issues they come across when assessing the quality and validity of a given proposal.

Another protection that could be incorporated would be the introduction of a staggered release of funds linked to milestones. This may encounter regulatory barriers as the platform may be required to hold investors' money for a longer period, and an administrative burden as the platforms would need to check milestones, but it would protect a proportion of the capital from being collected by fraudsters.

In addition to the above, the proliferation of social media is increasing the ability for the online measuring of people's social creditworthiness or trustworthiness, creating tools which will become invaluable in vetting for fraud. These types of recommendation tools[34] will also be extremely useful when trying to assess the competencies and experience of the entrepreneur or the team. As Simon Dixon, founder of platform BankToTheFuture notes, one-seventh of the world has volunteered their data to social networks and this data tells us a lot about the true nature, influence and identity of people. While some level of fraud may be inevitable, it has thus far been negligible. Crowdcube, crowdfunded lender FundingCircle, peer-to-peer lender Prosper and Anglelist all report zero fraud so far.[35] [36] As the model grows, and information becomes more readily available, fraud will become even less of an issue.

Examples of tools being developed that can be used to facilitate the crowdfunding process

The tools mentioned previously for facilitating the assessment of individuals online, also play a part in what might be considered a more important concern, whether crowds will be able to distinguish between good businesses and bad (non-fraudulent) ones. This closely relates to the literature on the ability of crowds to effectively make decisions, and most notably James Surowiecki's *The Wisdom of Crowds.* His theory states that in many cases, the crowd can perform as well as or better than a limited number of the relevant experts in the field. This occurs when individuals from diverse backgrounds, with expertise in different fields, bring various pools of local knowledge together. This assessment of proposals permits all members of the community to benefit from the feedback of the individual.

As well as the tangible information that potential investors get from each other, there is also a signalling effect, where merely the decision of individuals to invest influences the decisions of others to follow. In the ideal scenario, each individual's decision is influenced by his or her own critical assessment of the proposal, based on personal knowledge and the information and signals provided by others. However, the balance between the weights attributed to these factors effecting the investment decision is of great importance. One of the problems with signals is that investors may assign too much weight to them, leading to the potential of a 'cascading' effect or what is termed 'herding'.[37] This occurs when a smaller number of investments made in the early stages of the funding window entice others to invest, whose investments serves as a further incentive to even more potential investors and so on. In this way the likelihood that a venture gets funded is overly reliant on the decisions of those few initial investors and less on the objective analysis of the crowd as a whole. Herding is a problem with any such group-based decision system. Practical measures such as educating investors and compelling them to perform their own evaluation of prospects will minimize the inherit risk of such investment activities.

4.2.3. Investor types and visibility

The ability to view information about other investors could be extremely important with regards to signalling effects. One group of investors are the people that have a personal relationship with an individual or individuals within the business seeking finance. While for all investors there may be some element of a non-financial motive for investing this would be far greater amongst those than have a personal tie to the business. Examples of non-financial motives could be the aspiration to support a local business or entrepreneur, to be involved with an exciting start-up technology or social factors such as the prestige of investing in young businesses. This mix of motivations becomes important when signals are received by the crowd. On the one hand, investments from friends and family, if not identified as such, could be interpreted by other investors as investing primarily based on the perceived financial prospects of the venture. This would lead those receiving the signals to have a positive bias on what the crowd perceives these prospects to be.

On the other hand, however, the presence of funding from friends and family can send a positive signal in respect to the trustworthiness and ability of the entrepreneur(s) and their likelihood to endeavour to make a return for investors. These signals may offer reassurances to 'strange to the entrepreneur' investors who are worried how committed the entrepreneur is to making the business a success. For both reasons it is to the benefit of the model to ensure such investments are transparent, so all investors can accurately judge the signals they receive. These signals are also important for those raising capital who may want to deviate from the traditional strategy of raising money from friends and family before seeking external capital and instead 'save' them for a crowdfunding round.

Evidence from some of the few platforms currently operating in the area indicates that high-net-worth or sophisticated investors also invest via crowdfunding. Symbid says about 30 per cent of their investment comes from accredited investors. Aernoud Dekker, who sourced capital for his business SellAnApp through crowdfunding, raised two-thirds of his target amount from

professional investors. The presence of these investors may have a significant bearing on the ability of the crowd to select the best businesses and also perhaps which types of ventures they may be able to evaluate. Investment received from a professional investor, if identified as such, would serve as a strong signal as to the prospects of the venture.

Recognising the presence of different types of investors can make crowdfunding operate more effectively. A future version of the model may consider having a mechanism that applies weights to the judgement of a given investor, depending on their expertise, experience of making investments, track record on the site etc., while allowing investors to remain anonymous. In this way signals from investors become far more accurate and decisions are less likely to be influenced by investors making poor decisions. The crowd itself can be used to refine the weights assigned to investors by capturing the crowd's rating of an investor's contributions to forums discussing a venture's prospects.[38]

4.2.4. The potential for co-investment with professional investors

Some of the business angels and venture capitalists consulted for the report believe that the participation of experienced investors should be a necessary element of crowdfunding which offers protection for the non-sophisticated investors. This co-investment model between professional and amateur investors (or crowdfunders) is one that is worth exploring further. Professional investors bring expertise across a range of factors that contribute to an investment decision therefore ensuring there are no knowledge gaps in the crowd. However, the challenge for platforms will be to incentivise them to participate in the model.

A business angel and venture capitalist commented that deals tend to find business angels rather than angels seeking out businesses. His assertion that many deals are found via introductions from people in their network highlights that knowing entrepreneurs is of paramount importance and that investing in people who are (at least initially) strangers through a platform may be unappealing. Another investor said he would be unlikely to want to invest through a system that charges a fee when he could do so offline for free. He did, however, think a crowdfunding model might have potential as a source of top-up funding to a round being completed by accredited investors offline. Belgian platform MyMicroInvest[39] offers a similar model to this, in which professional investors invest first with the crowd then having the opportunity to contribute 20–50 per cent of the total round amount afterwards.[40] This allows the angel investors to control the amount of crowd participation and to avoid situations where their investment could be followed by a lot of crowd money.

Any co-investment activity faces additional challenges. One is 'investment terms' as professional investors will likely want to be rewarded for the time they put into evaluating and supporting a venture and may be unwilling to invest on the same terms as the crowd. Another challenge is the ability of syndicate partners to provide follow-on financing. Crowdfunding may not be deemed attractive in this regard unless it has the potential to provide more capital if the business needs it in the future. Platforms tailored specifically for sophisticated investors may also hinder any co-investment as crowdfunding platforms compete with these for investors.

But on the plus side, doing angel rounds can be quite time consuming and expensive on admin and legal costs. Crowdfunding offers a streamlined alternative and the option of an investment process that cuts on transaction costs would be attractive. The non-financial benefits businesses can receive from crowdfunding may also be an attraction for professional investors as they seek to use the crowd to gain traction or feedback for the business.

It should, however, be pointed out that the polarisation of professional and amateur investors used to outline the issues above does not present an accurate composition of the crowd. The sophistication of investors will likely be on more of a spectrum. Jeff Lynn states that Seedrs hope to target the so-called 'mass affluent', those who have significant wealth without being business angels. He refers to people like small business owners or middle managers in large corporations that while not professional investors are far from being naive about the realities of what makes a good or bad business. Not only would these people have a better chance of knowing the difference between good and bad businesses, they may also be better at collaborating and would potentially be seen as more desirable syndicate partners by larger investors.

The participation of professional investors provides significant benefits to the crowd investors. As these investors have the opportunity to invest outside of the crowdfunding mechanism, platforms may need to think of how to incentivise their participation and overcome some of the problems outlined above. Low cost and ease of use should be selling points, using tools such as standardised terms sheets and streamlined due diligence processes that will allow larger investors to take more and smaller bets on businesses if they wish. Platforms also need to convey to large investors the benefits the crowd can give to the business.

4.2.5. Post-investment support and business governance

Research by Sorensen (2007)[41] on venture capital investments showed that post-investment support was almost twice as important as selection when explaining the likelihood that a business becomes successful or not. One venture capitalist identified the provision of corporate governance, an integral element of the support given to businesses, as an area where crowdfunding could face challenges. Again, in theory, the crowd could perform well for some types of post-investment support. Raisers of crowdfunding will have access to many individuals feeding in their opinions on the business and will need to find an effective way of capturing and using these. They also have the opportunity to harness the mass marketing power of the crowd and other benefits of this large network. In practice however, this may only work, or at least work best, for some types of businesses. Those producing consumer facing products and services for example may get significant benefit with investors providing active feedback as users of the product or service. This, however, depends on the extent to which investors engage with businesses and investors' small stakes may mean they chose to remain quite passive.

How much of any potential feedback is actually taken on board may depend on the influence crowd investors will have on the ongoing management of the business. The few platforms currently in operation offer a variety of different ways of managing investor involvement after the investment has taken place. While all investors can contact the entrepreneurs, some platforms also allow for even small shareholders to have a voting share in the business. Crowdcube allows entrepreneurs to set an investment amount above which investors get voting shares. Dutch platform Symbid allows all investors to have a voting share in a co-operative entity that then manages the interests of the group. Another option is the nominee-management model operated by Seedrs, where the platform manages the corporate governance and other post-investment issues for the investors.

There are arguments for and against awarding voting rights to small investors, which one entrepreneur who raised crowdfunding for his business, describes as one of the more difficult aspects in relation to the model. One of the main justifications against issuing voting rights is that the practicalities of managing that many voters would be quite cumbersome and may lead to inertia in the decision making process, especially in cases where the founder does not hold a majority stake in the business. Not giving the small investors voting rights overcomes these issues but may leave the investors vulnerable once their investment is made, for example they may be open to excessive dilution of their equity stake in later rounds of funding.

The nominee approach overcomes this problem but the success of investments is then partially reliant on the abilities of the nominees to manage the investors' interests. One experienced venture capitalist believes building good reputations will be key for crowdfunding platforms if they are hoping to get more sophisticated investors to get involved with them.

There is a lot of room for innovation around how investor interests and interaction with entrepreneurs can be efficiently managed. While it is important to ensure that the burden on entrepreneurs in dealing with investors is not too much and that businesses remain attractive to follow–on investors, small investors' interests need to be protected once the round has closed.

4.2.6 Consequences of openness

For the crowd to make judgements on whether or not to invest in a given venture, they will need to be privy to the full details of the company's financial performance, business plan and other relevant information. How willing entrepreneurs are to open this information to the public could be another limiting factor in the growth of crowdfunding equity. In certain instances, entrepreneurs may fear that their ideas could be copied or that competitors may use the details of their finances and IP to their advantage. Actual evidence to what extent these are real problems and perhaps more importantly to what extent entrepreneurs perceive them as being problems is scarce. However, what is clear is that the risks will vary greatly dependent on how sensitive such information is. One way of overcoming this is to offer entrepreneurs the option to require investors to sign non–disclosure agreements (NDAs).[42] Seedrs offers this option to businesses but founder Jeff Lynn believes the need for NDAs will be quite rare. Only one of the first 20 submissions it has received to date has asked for NDAs to be part of their fundraising. As one entrepreneur we spoke to pointed out, the execution of an idea tends to be far more important than the idea itself.

The platforms themselves may also fall victim to potentially negative consequences of openness. If businesses seeking funding are allowed to upload their plans to the platform without an obligation to accept the financing they raise through the platform, platforms may be susceptible to investors shopping for businesses on their sites and transacting with them offline. In this way they avoid paying the commission charged by the platform. Although currently business angels tend to be sought out rather than seek out deals, as crowdfunding grows this could become an issue.

Finally, investors themselves may be exploited if they feel they are contributing disproportionately to the development of a given venture but not receiving what they believe are suitable rewards for their contributions. This may not be a big issue in the immediate future but more sophisticated iterations may want to create a system where investors can be rewarded and incentivised to contribute above and beyond what would be representative of their financial interest in the venture. A potential reward that entrepreneurs could give to those who contribute significant amounts of time and effort to the business is the option to invest in a later round at a discount.

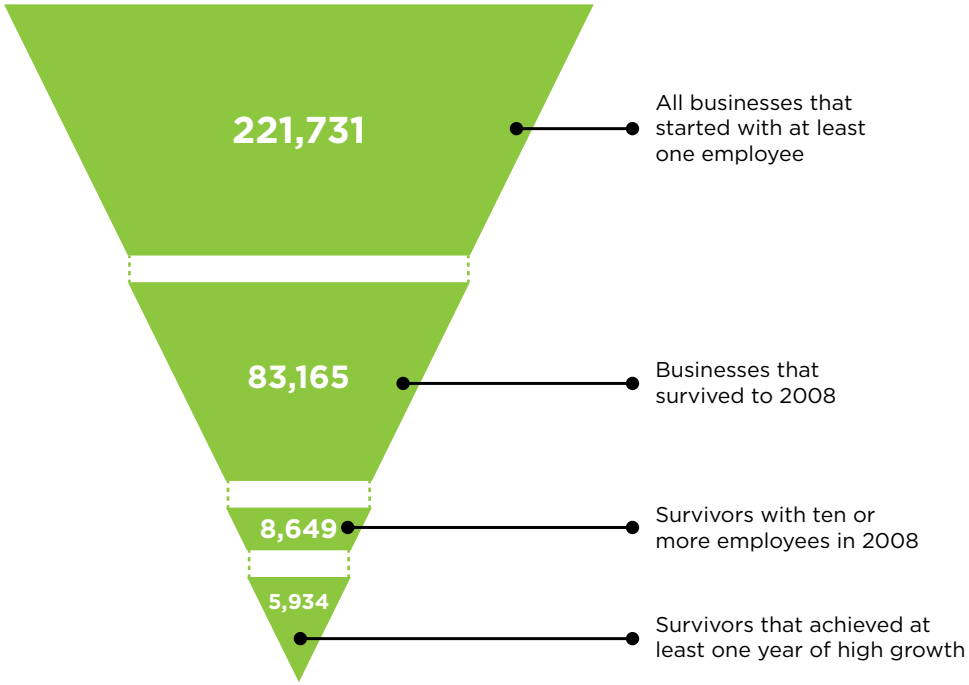
For entrepreneurs the first step is to decide to what extent openness is likely to be a hindrance to participating in crowdfunding. Once established, if this is believed to be a significant worry, efforts need to be made to either protect IP that is made public on platforms or to enable a system where one can seek investment from the public while not sharing excessive amounts of sensitive information. NDAs are one option but will add an extra administrative cost to the model. Co–ordination across platforms will aid the identifying and exclusion of those investors that are using platforms to 'poach' investment opportunities.

4.3. Potential returns from crowdfunding

Equity crowdfunding is a very new model and therefore no data on returns to investors is currently available. However, for crowdfunding to become a viable model, investors will need to make a return large enough to encourage participation in the market and the bearing of the risk inherent with these ventures. This return can be financial or non–financial but given that the non–financial returns that some businesses can offer may be limited, and that many investors, especially larger ones, will likely invest primarily for financial reasons, the potential of the model to deliver financial returns is an important issue.

To put into perspective the level of returns that the model could generate, it is useful to consider other forms of risk capital. Since the dot.com boom, despite top quartile funds performing well, the venture capital market as a whole has generated relatively poor returns.[43] There is some evidence to suggest that business angels have been faring better[44] but unlike VC returns these do not incorporate the cost of the investors' time and effort. Another relevant comparison is with the FTSE AIM index of small and growing businesses, which has lost 25 per cent – including dividends – since inception in 1995.[45] These show that while the potential to make generous returns is present, the risks associated with this type of investment mean that significant losses are also a real possibility. The main source of this risk is the majority of new businesses that fail, and a potential worry with the crowdfunding model is that non–professional investors may not appreciate just how many. Nesta data shows that only 40 per cent of businesses are still alive after their first ten years and less than 10 per cent of these achieve significant growth in employment.[46]

Figure 4.



Source: (2011) 'Vital Growth: the importance of high–growth businesses to the recovery.' London: NESTA.

Schemes currently being run by the Government to incentivise investing into young businesses can bolster the real returns investors can attain. The Enterprise Investment Scheme(EIS)[47] and Seed Enterprise Investment Scheme (SEIS)[48] allow investors to claim tax relief on investments made into qualifying businesses, including those investing through crowdfunding. The latter allow investors to write off 50 per cent of the amount of an investment into a qualifying seed company against their tax liability while the EIS offers a smaller benefit for investments into more developed qualifying businesses. So even if the investors' were to just break even or perhaps even make a small loss on their investment, crowdfunding may still prove an attractive prospect if the business qualified for the scheme. Take up of relief has already started and Crowdcube has facilitated investment into EIS and SEIS qualified businesses. HM Treasury has also made efforts in recent times to simplify the process of claiming such relief.

The ability to provide follow–on investment to businesses may also affect the returns that crowdfunding can deliver. A strategy commonly employed by business angels and venture capitalists is to invest in a few businesses at early stages of their development and use this access to pump more money into the businesses that do well. In many cases these one or two businesses will receive the majority of the investors' contributions and will deliver the bulk of the returns. Equity crowdfunders may not be able to do this, either because they are not aware of the strategy, may not have the knowledge to identify those businesses that are doing well, or not have the opportunity to participate in follow–on rounds.

Equity investing is long–term illiquid investing and potential crowdfunders need to be very aware of this. Unlike the reward model where returns are received quickly, equity investors may have to wait five to ten years for a return. Many operators have expressed the intention of providing investors access to a secondary market in the future to increase liquidity. As independent secondary markets such as Secondmarket[49] and SharesPost[50] grow, they may also facilitate the trading of shares either independently or through partnerships with platforms allowing investors to buy and sell stakes after the round is raised.

Platforms need to ensure that investors are adequately informed of the risks involved in investing in businesses for equity. One experienced venture capital investor noted that over–optimism on the part of amateur investors could be one of the greatest barriers to ensuring the success of equity crowdfunding.

5.

THE FUTURE FOR THE MODEL

As many of the platform operators that were consulted pointed out, the model for facilitating crowdfunding equity will continue to iterate as more information on how it functions in practice becomes available. There is significant scope to incorporate further innovation in what is a fast-growing area. An advantage crowdfunding has over other forms of finance is that the process is facilitated largely, if not entirely, online. This should spur the harnessing of other online tools that can help increase the connectivity of the crowd and make the most of the networks that the model allows entrepreneurs access to.

One direction the model could take is the application of equity crowdfunding to more specialised sectors. Just as the reward model has platforms that target specific niches such as artists raising money for a record release[51] or a game development,[52] equity crowdfunding platforms may decide to focus on software development or consumer goods. Another evolution could be the emergence of hybrid models that incorporate other forms of crowdfunding. BankToTheFuture[53] aims to allow businesses to raise a round combining reward-based crowdfunding and equity finance. It then hopes to use the information gathered from businesses during this process to offer crowdfunded lending once the business starts to generate revenue. Tying crowdfunding closer to other funding innovations such as accelerators is another potential option that should be explored.

This is the first attempt to present the equity crowdfunding model in detail and gives some further food for thought. The success of reward-based crowdfunding offers the hope that the application of the model to equity investing can funnel much-needed capital towards innovative ventures. As illustrated in this report, equity crowdfuding faces many challenges and will need to continue to adapt if it is to prove a viable model for investors and businesses. Some recommendations for consideration by key stakeholders are outlined below.

From investors: Equity crowdfunding offers the opportunity for individuals to be a part of an entrepreneurial venture, an exciting prospect that was up to now reserved for a small population of professional and institutional investors. Those investing largely, or entirely for financial returns need to be aware of the risks involved in equity investing in young businesses and that many businesses will be unsuccessful and fail to make any money for investors. As part of their evaluation of businesses, investors need to make use of all of the tools and knowledge available to them. Interacting with the entrepreneur and fellow investors will assist with the unearthing of all of the necessary information and help in the performing of effective collaborative evaluation of ventures.

For platforms: The success of the model will largely be dependent on platform operators' ability to continually iterate as more information and tools become available to them. They need to innovate to assist business to deliver returns, financial or otherwise, to investors as well as to make sure the model can be an aid to the growth of the businesses it serves. Difficult tasks such as vetting for fraud and assisting investors in choosing the best businesses will need the assistance of other online tools that can help them evaluate entrepreneurs, ideas and markets. As these become more sophisticated, platforms need to incorporate them into their process.

A more developed model could also assist investors with harnessing the knowledge of the crowd to make decisions. Transparency around investors would allow people to accurately interpret

the signals received by investment from other investors which may be important when there are investors with varying levels and types of expertise, and different motivations for investing.

Larger and experienced investors would bring value to the process, especially in the model's early stages, if they could be enticed to participate. Larger investors will also allow the model to deliver larger amounts of funding. Platforms need to demonstrate the value of the model to these investors, highlighting where they provide value such as a streamlined process and the ability to make more and smaller bets. Platform credibility will be another important factor to help attract a good pipeline of businesses seeking finance and to make businesses attractive for follow–on investors.

For businesses: Businesses need to be aware of the benefits and limitations of raising equity crowdfunding when deciding if the model is suitable for them. While there are benefits such as the opportunity to leverage the ability to give rewards to raise finance and the advantage of accessing a large number of advocates, businesses need to consider if these benefits will be significantly important to them.

Interacting with the business through the funding process is of critical importance to investors. Entrepreneurs need to keep investors engaged to ensure they maximise the benefit of having access to the crowd.

For policymakers/regulators: The current regulatory model requires platforms to go through a lengthy process to become authorised by the FSA, such as Seedrs' experience, or alternatively to require platforms to set up administratively cumbersome constructs to facilitate fundraising. Should regulation be eased, following the US example, is one approach but not necessarily the best one. Darren Westlake of Crowdcube points out that the limits in the US legislation on what can be raised and invested are quite small and any UK version should consider increasing them. Seedrs founder Jeff Lynn comments the current UK approach is superior as it ensures that platforms offer greater protection to investors post–investment.

While the protection offered by the UK regulation may be better, the process for allowing platforms to gain accreditation needs to be improved. Once regulators have developed a clearer view on how the model works, guidelines on what the requirements are to gain accreditation should be made public and efforts made to speed up the process. All platform operators consulted in this study, agree that clear and defined supervision of activities in the area will go a long way to improving investor confidence in committing capital to business through the model and will also increase the number of businesses willing to raise this type of finance. As this is quite a new model of finance, it is important that those providing oversight are sufficiently knowledgeable of the nuances of the model and the protections that are required for investors.

Tax incentives are a useful tool to funnel more capital towards innovative business but it is important for policymakers to take account of how these work in crowdfunding. Important considerations include how effective the equity crowdfunding model is at finding the best business and how tax reliefs impact the behaviour of crowd investors as opposed to the sophisticated investors the scheme was set up to incentivise. Another important issue is the practicalities of claiming relief.

As this is a new model with limited data on its operation available to date, many questions still remain unanswered and are potential topics for future research. These include:

- How effective is the crowd at evaluating the potential of young businesses?
- What types of businesses does the model work best for?

- What is the balance between the financial and non-financial motivations of equity crowdfunders and how does this affect the operation of the model?
- What ranges of funding can equity crowdfunding raise for businesses?
- What levels of returns can equity crowdfunding deliver?
- What are the best ways of harnessing the crowd of investors to assist with the businesses development?
- How successful are businesses at raising follow-on capital after crowdfunding?

6.

ENDNOTES

1. Lambert, T. and Schwienbacher, A. (2010) 'An empirical analysis of Crowdfunding.' Louvain–la–Neuve: Louvain School of Management, Catholic University of Louvain.
2. www.crowdsourcing.org
3. Kickstarter Is On Track to Out–Fund the National Endowment for the Arts. http://www.popsci.com/technology/article/2012–02/kickstarter–track–out–fund–national–endowment–arts
4. Accredited investors, also referred to as professional or sophisticated investors in this report, are those that have experience of investing large amounts of capital into unlisted young businesses.
5. http://www.seedups.com
6. http://circleup.com
7. http://Angellist.co
8. This is representative of the most common process. All platforms operate their own variation of the model.
9. Interview with Darren Westlake, Founder, CrowdCube.
10. In many cases contributions largely come from people in your network. Slava Rubin of the world's second largest reward–based platform IndieGoGo states that only 20 per cent of contributions come from complete strangers. See: http://www.readwriteweb.com/start/2012/04/jobs–act–fallout–making–crowdf.php Due to the fact that equity crowdfunding offers the potential for profit it is more likely investors will actively seek out investment opportunities.
11. For more information on the specifics of how the transactions are handled see: De Buysere, K. (2012) 'Venture capital 2.0: Obstacles in using the internet for equity raise campaigns.' Tilburg University (working paper).
12. An escrow is an arrangement made under contractual provisions between transacting parties, whereby an independent trusted third party receives and disburses money and/or documents for the transacting parties, with the timing of such disbursement by the third party dependent on the fulfilment of contractually–agreed conditions by the transacting parties, or an account established by a broker, under the provisions of license law, for the purpose of holding funds on behalf of the broker's principal or some other person until the consummation or termination of a transaction. See: http://www.wikipedia.org
13. The table includes data for the most visible platforms currently active as of May 2012 and those soon to be launching in the UK. For more information, see the respective sites.
14. Venture capital deals, see: (2011) 'BVCA Private Equity and Venture Capital Report on Investment Activity 2011.' London: BVCA. http://admin.bvca.co.uk/library/documents/RIA_2011.pdf
15. BIS (2009) 'Annual report on the business angel market in the United Kingdom.' London: BIS. See: http://www.bis.gov.uk/assets/biscore/enterprise/docs/a/10–994–annual–report–business–angel–market–2008–2009
16. BIS (2010) 'Annual report on the business angel market in the United Kingdom.' London: BIS. See: http://www.bis.gov.uk/assets/biscore/enterprise/docs/a/11–p116–annual–report–business–angel–market–uk–2009–10
17. Miller, P. and Bound, K. (2011) 'The Startup Factories: The rise of accelerator programmes to support new technology ventures.' London: NESTA.
18. Equity gaps will vary by sector. The diagram is a representation of the most common areas where businesses find it difficult to source financing.
19. NESTA, BVCA (2009) 'From funding gaps to thin markets: UK Government support for early–stage venture capital.' London: NESTA.
20. Scottish Enterprise(2008) 'Evaluation of the Scottish Co–Investment Fund: a report to Scottish Enterprise.' Glasgow: Scottish Enterprise. See: http://www.evaluationsonline.org.uk/evaluations/Browse.do?ui=browse&action=show&id=32&taxonomy=INV
21. Miller, P. and Bound, K. (2011) 'The Startup Factories: The rise of accelerator programmes to support new technology ventures.' London: NESTA.
22. Although crowdfunding decreases the cost of raising equity capital, legal fees are still present and can run into the thousands. Martijn Arets who ran the first equity crowdfunding campaign on Symbid says that legal fees make the model impractical for those raising very small amounts.
23. In late 2011 The Rushmore Group raised £1 million pounds through crowdfunding platform Crowdcube. See: http://www.crowdcube.com/investment/the–rushmore–group–ltd–10449
24. Gompers, P., Kovner, A., Lerner, J. and Scharfstein , D. (2010) Performance Persistence in Entrepreneurship. 'Journal of Financial Economics.' 96 pp: 18–32.

25. Zurutskie, R. (2008) The Role of Top Management Team Human Capital in Venture Capital Markets: Evidence from First–Time Funds. 'Journal of Business Venturing.' 25, 155–172.
26. UK Financial Services and Markets Act 2000, c.8 Part II, 21 (Financial Promotion).
27. EU Prospective Directives 2010/73EU and 2003/71/EC.
28. UK Financial Services and Markets Act 2000, c.8 Part II, 21 (Financial Promotion).
29. http://www.gpo.gov/fdsys/pkg/BILLS–112hr3606enr/pdf/BILLS–112hr3606enr.pdf
30. Zacharakis, A., and Meyer, D. (2000) The Potential of Actuarial Decision Models: Can They Improve the Venture Capital Investment Decision? ' Journal of Business Venturing.' 15, pp. 323–346.
31. http://www.innovestment.de
32. Thaler, R. H. (1988) Anomalies: The Winner's Curse. 'Journal of Economic Perspectives.' 2 (1): 191–202.
33. Forbes (2012) 'Crowdfunding,The JOBS Act And Scams In Your Inbox.' See: http://www.forbes.com/sites/johnwasik/2012/03/23/potential–and–obvious–scams/ and JOBS Act becomes law, but questions linger about potential for fraud. http://venturebeat.com/2012/04/05/crowdfunding–bill–becomes–law–but–questions–linger–about–potential–for–fraud/
34. Examples of theses include the recommendation function in LinkedIn, eBay seller ratings, Klout, (for measuring influence) and Kred.
35. Although some of these are different models to equity crowdfunding they are the most similar in the market in regards to susceptibility to fraud.
36. US Senate Committee hearing. See: http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=395de986–77d8–45f6–886d–5da33f1a3593
37. Baddeley, M. (2010) Herding, social influence and economic decision–making: socio–psychological and neuroscientific analyses. 'Phil. Trans. R. Soc.' B 365, 281–290.
38. A similar model was used by the platform VenCorps(ceased operation December 2011) where participants receive rewards for their contribution to investment decisions.
39. http://mymicroinvest.com
40. The crowd votes on pitches to select those businesses that are to be evaluated by the professional investors. The professional investors then select businesses to invest in from these, allowing the crowd to invest also and on the same terms.
41. Sorensen, M. (2007) How Smart Is Smart Money? A Two–Sided Matching Model of Venture Capital. 'The Journal of Finance.' Vol. 62, Issue 6 pp 2725–2762.
42. A non–disclosure agreement (NDA), also known as a confidentiality agreement (CA), confidential disclosure agreement (CDA), proprietary information agreement (PIA), or secrecy agreement, is a legal contract between at least two parties that outlines confidential material, knowledge, or information that the parties wish to share with one another for certain purposes, but wish to restrict access to or by third parties. It is a contract through which the parties agree not to disclose information covered by the agreement. See: http://www.wikipedia.org
43. Lerner, J., Pierrakis, Y., Collins, L. and Bravo–Biosca, A. (2011) 'Atlantic Drift: Venture capital performance in the UK and the US.' London: NESTA.
44. Wiltbank, R.E.(2009) 'Siding with the angels: Business angel investing – promising outcomes and effective strategies.' London: NESTA.
45. Why AIM shares underperform. See: http://www.investorschronicle.co.uk/2011/10/24/comment/chris–dillow/why–aim–shares–underperform–MwHPjC6Q6BboaWY3a8ldtL/article.html
46. NESTA (2011) 'Vital Growth: The importance of high–growth businesses to the recovery.' London: NESTA. It should be noted that this data is for all business start–ups and some of these would unlikely be suited to raising crowdfunded equity e.g. very capital intensive businesses, corner shops. Also, those that were acquired are not included in the count of businesses that survived.
47. For more information see: www.hmrc.gov.uk/eis/
48. For more information see: http://www.hm–treasury.gov.uk/d/seed_enterprise_investment_scheme.pdf
49. http://www.secondmarket.com
50. http://www.sharespost.com
51. http://www.pledgemusic.com
52. http://8bitfunding.com
53. http://www.banktothefuture.com

Nesta...

Nesta

1 Plough Place
London EC4A 1DE

research@nesta.org.uk
www.twitter.com/nesta_uk
www.facebook.com/nesta.uk

www.nesta.org.uk

July 2012

ISBN 978-1-84875-138-5

9 781848 751385