The Road to Crowdfunding Hell

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Crowdfunding of equity capital for startups is one of a handful of jewels in the crown of the JOBS Act that swept through the House and Senate in a rare and refreshing show of bipartisanship, and was signed into law by President Obama April 5, 2012. *But the crowdfunding jewel is fool's gold*, and is inherently incapable of harnessing "people-to-people power" and the "wisdom of crowds" to "democratize access to capital for entrepreneurs" in order to "create wealth and make things happen," as crowdfunding sites publicly proclaim. As a savvy tech entrepreneur told me the other day, "I love crowdfunding: it is cheap money for me. I know it is not good for the investors." That is the problem: crowdfunding will at best be good only for the entrepreneurs and middlemen, paid for by unwitting consumers who simply cannot know enough about the highly risky ventures or the highly complex venture investing process to make informed investment decisions.

I am referring only to equity crowdfunding. Crowdfunding of charitable donations, artistic projects, or cool product development in exchange for samples or royalties, can work and has worked. Crowdfunding of debt can work. But crowdfunding equity stock purchases for risky startups—the target of the JOBS act—cannot work for four main reasons:

1. It is based on **inappropriate extrapolations** from other similar-appearing activities, such as donation crowdfunding.
2. Purchasing equity (stock) in early stage ventures is **too innately complex to standardize**.
3. The conduct of due diligence in the ventures raising money will **render crowdfunding prohibitively expensive** and thus impractical.
4. **Crowds are stupid** as often as not, or worse.

Let me say more about each of these problems.

Extrapolations from other successes are inappropriate. The illusion that equity crowdfunding can work is understandable because superficially it looks like: (1) eBay and other successful online markets; (2) donation crowdfunding, such as Kickstarter; (3) angel investing in the startup world, which is prevalent (even if not necessarily successful for the average investor).

Unfortunately, none of these extrapolations is actually valid with regard to equity crowdfunding.

Online market places, such as eBay, facilitate discrete transactions in which consumers and sellers know almost immediately if something is wrong, and they can act to redress their grievances. For its part, donation crowdfunding works precisely because the donordoesn't really care much about getting a product or making personal gain: Most of the donors immediately write off their donation—either financially or psychologically, or both. Expectations of return are minimal at best.

Not so with equity crowdfunding. Purchasers of equity expect a return, and the piece of paper they get for their investment gives them a near-permanent claim against value that is created in the venture. My grandchildren's grandchildren who inherit my stock in crowdfundeddream.com have a legal claim against a small piece of that company's assets, but they would only find out about problems with those assets years or decades or centuries later. And chances are tangible that value will have unfairly leaked out by then—intentionally or otherwise—into the pockets of founders, through executive compensation, and the use of intellectual property by entrepreneurs in subsequent ventures, just for example.

Angel investing has indeed become (and in fact always has been) a very prominent element in the venture world. Unfortunately, as Scott Shane and others have shown, there is a big gap between the public perception and the private reality of angel investing—the highly touted successes ring in our ears, but the much more prevalent private failures disappear quietly with nary a whisper. I myself have made over twenty angel investments, and I have decades of experience as well as access to some of the brightest and most talented entrepreneurs. From experience I can tell you that making angel investments in promising startups is hard enough: Making money at it is many times harder.

Investment complexity precludes standardization. Purchasing the equities of early stage companies, often before they have products or revenues or even employees, is intrinsically complicated by the fact that *investors and entrepreneurs have inherently misaligned interests in the short run*, and aligned interests only in the very long run. In other words, when the investment deal is being done, what is good for entrepreneurs, as my friend said, is bad for investors, and *vice versa*. There are numerous detailed and highly technical mechanisms for more-or-less straightening out this misalignment (the use of convertible preferred stock, for example). This alignment process usually protects investors and their money in the short run, yet creates a win-win situation if and when the venture is extremely successful, often years later if at all. The process is typically painful for the entrepreneur who is forced to bet almost everything on delivering a low likelihood, highly lucrative outcome. As a result, first time entrepreneurs frequently feel that they have been taken to the cleaners by venture capitalists. This exemplifies the famous golden rule of venture capital: "Whoever has the gold sets the rules." Venture capitalists rightfully play the unpopular role of aligning those long term interests and maintaining as many short term protections for the investor as possible.

This investment process is just too complex to standardize in a way that would be understandable and useful for consumers, and still retain legitimacy. Many of the key concepts -- such as implied valuation, liquidation preferences, minority protections, information rights, tagalong provisions, first refusal rights, anti-liquidation, reverse vesting, to name just a few – take years to grasp, let alone learn how to use. Furthermore, the final outcome of this alignment process (a signed term sheet and then definitive legal agreements) is frequently influenced by what areas of investment are considered hot at any given moment, and this can vary from month to month and even week to week, making standardization even more elusive.

Due diligence is too expensive. If investment complexity makes crowdfunding untenable, then the need for due diligence makes it too expensive. When I was a venture capitalist over a decade ago, for each investment (including those we did not follow through on) we spent about $50,000 just in legal fees, and sometimes hundreds of hours studying the ventures' markets, engaged in business model discussions, talking to prospective customers, interviewing industry experts, studying the technology and intellectual property, and talking to each founder's references, sometimes ten or more per founder. The process of due diligence is absolutely essential to make sense of what may sound like a farfetched idea at first and to take as much uncertainty out of the investment decision as possible before taking that ultimate leap of faith. We could justify the huge expense of due diligence because we were investing millions of dollars, and committing to a long term working relationship (and further investment later on) to help the venture grow and generate extraordinarily high value. But crowdfunding is about raising small amounts of money for dozens, hundreds, and thousands of ventures, rendering the due diligence process financially prohibitive, as well as impractical.

Crowds are frequently stupid. Given the complexity and expense of the investment process, the crowdfunding solution purports to allow potential investors to watch whether the "crowd" invests in a given venture, and then jump in as well before it is too late. "So many people who have decided to invest their hundreds and thousands or more *cannot possibly be wrong*, *can they*?"

Yes they can. In fact, they probably are wrong. The problem is, in equity crowdfunding, no one will find out about the mistakes for many years. I did my Ph.D. degree in social psychology studying the behavior of groups, and group irrationality is well-documented—crowds are "wise" only in a very limited set of circumstances. As often as not crowds bring us tulip crazes, subprime meltdowns, the Kitty Genovese scandal, Salem witch trials, and other tragedies. Crowdfunding advocates claim that social media will self-correct the madness of crowds, but this seems to me highly suspect.

In 1980 I published a scientific paper on the commonplace phenomenon of "pluralistic ignorance" in which groups systematically pool their members' ignorance into mutually unhappy outcomes. I also studied cognitive psychology in the 1970s and 1980s when behavioral economists were just beginning to describe and explain the systematic errors that individuals make in evaluating information and making decisions. Stupidity is rampant and some of it (my own as well) is probably hardwired into our brains.

I have talked to crowdfunding proponents in the venture community and the US government. I have reviewed many of the more talked-about equity crowdfunding sites, including some that are operative in the UK and Europe. I have actually made one investment to see how it works. I have so far found misleading statements and/or deep flaws in all of them. One of them claims, for example, to screen ventures using the "same criteria as venture capitalists." I am, to say the least, deeply skeptical.

Equity crowdfunding, to my mind, will effectively tax well-intentioned consumers to the benefit of well-intentioned entrepreneurs and well-intentioned crowdfunding sites, supported by our well-intentioned government. But we all know where a road paved with good intentions can lead.

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