Management Department
The Wharton School
University of Pennsylvania
2000 Steinberg Hall-Dietrich Hall
3620 Locust Walk
Philadelphia, PA 19104.6370
215.898.7722 phone
215.898.0401 fax

To whom it may concern:

As the Edward B. and Shirley R. Shils Assistant Professor of Management within the Entrepreneurship Group at the Wharton School of the University of Pennsylvania, I have conducted research into the determinants of success and failure in crowdfunding sites such as Kickstarter, as well as issues associated with the long-term survival of crowdfunded organizations.

Many other commentators have focused on the costs associated with the crowdfunding, and the relative impact of these costs in encouraging or discouraging equity crowdfunding. While these are valid concerns, I would like to focus on the role of online investor communities, and how it relates to two problems with the current proposed rules: limiting fraud and the advisory role of investors.

First, let us focus on fraud. The rules use formal disclosure and portal oversight to police crowdfunding, which are completely valid (if expensive) approaches, but they ignore the most important part of crowdfunding – the crowd itself. In my peer-reviewed research on crowdfunding[1], I found that fraud is very low in reward-based crowdfunding with the amount of money pledged to projects that ultimately seem to have no intention of delivering promised products accounts for less than 0.1% of all pledged funds in the study. This is despite the fact that reward-based crowdfunding sites have few if any formal controls against fraud beyond an initial screen by the reward-based portal.

The reason fraud is so low is not registration requirements, but that the community of investors plays a critical role in detecting fraud. On sites like Kickstarter, investors look for signals of quality, and are more likely to fund projects that show signs of the ability to succeed – clear plans for future development, appropriate backgrounds, past experience, and outside endorsements. The crowd can be quite sensitive – a single spelling error decreases the chance of success by 13% for a project. This process works because many individuals (with verifiable

[1] Ethan Mollick (2014), **The Dynamics of Crowdfunding: An Exploratory Study**, *Journal of Business Venturing*, 29 (1), 1 - 16

real-world identities) weigh in on projects, discussing the merits and probability of success of each project. These discussions take place on Kickstarter, but also on other social media sites, blogs, and forums. The result is that comments on potential issuances are made not just by investors, but also by outside experts, communities of interest, and journalists. These communities play several important roles in improving offerings, preventing fraud, and making crowdfunding successful.

First, they allow a core-periphery dynamic to develop, similar to that seen in other functional online communities, ranging from Wikipedia to open source software development. Having many people examining issuances from the periphery, while they may not be core investors themselves, will greatly increase the chance that someone will have the expertise and desire to spot potential issues with a proposal. In the case of Kickstarter, communities have successfully detected fraudulent projects, and had healthy debates over the merits of other projects that have resulted in projects improving as a result of feedback. Allowing ongoing discussions between potential investors, community members, and issuers is a vital aspect of avoiding fraud and improving proposed projects. Some of this is already in the draft document.

Further, the network effects within communities ensure that one interested party might draw others into the discussion, adding to the possibility that investors or commentators with appropriate expertise would find the relevant projects where their knowledge would be most useful. Indeed, a decade of research has shown that vibrant communities are a key to harnessing the best ideas from a crowd, and to improving existing ideas, in order to create breakthrough innovation. Communities can only form, however, if there are enough quality issuers to attract high-quality community members, otherwise there will be little to draw a community to a portal. I would urge caution as too many formal regulatory filings will actually increase fraud, as they may discourage high quality issuers with other alternative fundraising options. This will make it hard to gain the interest of community members to portals, and therefore reduce the ability of communities to help detect fraud.

In addition to preventing fraud from issuers, communities with persistent identities can prevent future fraud, including pump-and-dump schemes. If a community around a particular investment consists of known members with consistent identities (something not in the current draft), it will immediately be obvious if outside individuals attempt to falsely promote or denigrate a funded company for fraudulent purposes. The community will be able to detect anonymous outsiders, and community members will have reputational reasons for avoiding these sorts of schemes, or their online identities will become associated with fraud.

Communities are not just about preventing fraud, however. They also provide ongoing benefits. In our study of the long-term results of reward-based crowdfunded projects, the money raised was not considered to be the most important outcome of crowdfunding[2]. Instead, project founders were even more interested in building long term relationships with customers, getting information about markets, and marketing themselves. The answer that "the project could not have been funded without [crowdfunding]" was actually the 4th most popular reason people used crowdfunding, not the first.

As it is, while the proposal has some provisions for allowing dialogue, there is less emphasis on long-term interaction between issuers and investors. These communities over the longer term will help keep crowdfunded companies accountable to investors. If investors are going to be able to provide meaningful feedback to companies when asked, or be able to weigh in on potential pivots or changes of directions, there will need to be an ongoing engagement between investor communities and companies. On Kickstarter, communities of backers continue to give feedback on projects long after funding has closed, providing both a valuable resource and an important incentive for projects to deliver. Having issuers connected to persistent online identities, such as LinkedIn, ensures that founders of projects are held accountable for their actions and performance across many projects, and that their skills and backgrounds can be adequately assessed. Something similar will be needed in equity crowdfunding.

Vibrant communities are attracted by having a wide variety of potential investments to examine and discuss. I would urge the SEC to ensure that barriers to entry (financial and regulatory) are not so high as to drive off the best investment opportunities towards other funding mechanisms. If platforms only attract a few issuers, communities will not have a chance to form, resulting in less crowd-based insight into projects and heightening the chance of fraud. This, in turn, will damage crowdfunding as a whole, and further drive quality issuers from the platforms, creating a vicious cycle. It would be better to err towards allowing more issuers, with a more vibrant crowd, than too few, without a crowd but relying on regulation alone.

With this background, some responses to the requests in the document:

- **General Information about the Issuer, Officers and Directors** This is currently inadequate, in that it only deals with physical identities. Online identities for issuers, commenters, and backers need to be tied to online, as well as physical, identities. LinkedIn, Twitter, and Facebook all provide useful methods of identifying individuals and discovering and verifying expertise. It should be strongly suggested to portals that they use these online methods. Further,

[2] Ethan Mollick, Venkat Kuppuswamy (2014), **After the Campaign: Outcomes of Crowdfunding**. Working paper on SSRN

backers should also be strongly encouraged to have verifiable, real world identities.

- **Description of the Business:** Business plan is a vague term. Based on my research, the crowd actually looks for the following: Plans for implementation, concrete next steps in a business, outside recommendations about the validity of the business, backgrounds of the individuals involved, and prototypes or concept drawings. These should be required elements of the business plan, since investors currently look at these factors as well.

- **Issuer Information/Ongoing Reporting and Amendments.** Portals should remain the central, publically accessible centers for all reports and amendments by issuers. This data should be kept permanently accessible, and cannot be removed or erased. This provides a central location for information about an issuer, and also incentivizes portals to be accountable for issuances on their sites.

- **Communication Channels** I strongly support the requirement to have channels to support ongoing back-and-forth dialogue between potential investors and issuers. I think the rules proposed about registration and identification are appropriate. Portals must either be required to maintain investor communities after funding is complete, or else provide some easy way to move communities, including user identities and comment histories, to a new, permanent online location. Failing to do this will result in a loss of accountability and create an opening for fraud.

By requiring portals and issuers to replicate what has made Kickstarter and other online communities so successful, the SEC can help prevent fraud, strengthen startups, and grow the economy. Please don't hesitate to contact me with any questions.

Sincerely,

Prof. Ethan Mollick