Highlights from the First SEC-NYU Dialogue on Securities Crowdfunding[1]

The first SEC-NYU Dialogue on securities crowdfunding was held on February 28, 2017 at the SEC headquarters in Washington, DC. The dialogue brought together practitioners, regulators, and academics to learn, engage, and discuss the state of the nascent U.S. crowdfunding industry and exchange ideas on issues related to investor protection and capital formation. Regulation Crowdfunding, a JOBS Act rulemaking that came into effect on May 16, 2016, allows for an unlimited number of retail investors to be solicited to purchase unregistered securities of private companies.

Highlights from Panel 1: Economic rationale and legal framework for securities-based crowdfunding

Panel 1 focused on the funding needs of small and emerging companies, the impact of Regulation Crowdfunding on companies, investors, and regulators, and the legal requirements for issuers and funding portals.

Prof. Ethan Mollick of the Wharton School, University of Pennsylvania, spoke about lessons relevant to securities-based crowdfunding that could be learned from the reward-based crowdfunding market:

- First, Prof. Mollick argued that crowdfunding leads to the creation of startups. Based on his research using data from Kickstarter, Prof. Mollick found that significant number of crowdfunding projects (about 70%) resulted in the creation of startups. Those startups generate outside revenue beyond crowdfunding and hire additional employees. The average annual revenues, however, are relatively small. The challenge for securities-based crowdfunding is to make it work for such small scale.
- Second, Prof. Mollick noted that crowdfunding appears to democratize access to funding for investors and issuers because there is relatively more access to crowdfunding than to venture capital (VC). Specifically, Prof. Mollick observed that once crowdfunding moves into a geographic area, VC tends to follow. He further cited recent empirical research that suggested minority participation in crowdfunding issuers is high (e.g., 41% of projects on Kickstarter were started by females), and demographic variables such as gender, race, family status, education do not affect the likelihood of success.[2] Democratization, however, requires access, and Prof. Mollick pointed out that many securities crowdfunding sites are heavily curated, which can lead to the same sorts of biases that exist in the wider funding world. If there is enough critical mass

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[1] These Research Notes were prepared by Vladimir Ivanov and Jennifer Juergens, in the SEC's Division of Economic and Risk Analysis. The Research Notes are based on staff observations during the conference and are not a transcript of the event. As such, the Research Notes do not necessarily include the entirety of the panel discussions or the complete views of the panelists. Further, the views expressed by the panelists, and summarized herein, are the panelists' own, and do not necessarily reflect the views of the Commission or Commission staff. To view the webcast of the panel discussions, please visit the website **here.**

[2] See Sorenson, O., V. Assenova, G. Li, J. Boada, and L. Fleming, 2016, Expand innovation finance via crowdfunding, *Science* 354(6319), 1526-1528.

of a minority group, or under-represented group, Prof. Mollick argued, that distribution works to the advantage of entrepreneurs from that group.

- Third, Prof. Mollick explained that crowds are really good at selecting high-quality projects. He noted that failure rates on Kickstarter are relatively low—about 91% of projects end up delivering, and—fraud rates are low, too. But, in order for crowdfunding to work, Prof. Mollick noted, founders need to be identifiable and researchable, communities need to be large and diverse, discussion needs to be public and persistent, and platforms need to be able to act on signals for bad behavior.

Prof. Mollick further emphasized:

- A significant number of investors on Kickstarter derived social benefits from crowdfunding, such as supporting an underrepresented minority group or the ventures of their friends, but it remains to be seen whether this will be the case for securities-based crowdfunding as well.
- The success of crowdfunding campaigns depends on how successful issuers form passionate communities of investors and turn their customers into investors. These communities tend to reduce fraud as well because people are more likely to have expertise in things that they care about [and hence may not be defrauded that easily]. Evidence further suggests that companies take their communities with them as they switch from reward- to securities-based crowdfunding.

Michelle Schimpp from the U.S. Small Business Administration focused her talk on three main points:

- First, Ms. Schimpp explained that there is considerable demand for seed and startup capital – 25% of startups report having no startup capital, while 20% cite lack of access to capital as a primary constraint to their business health and growth. This gap between demand and supply of capital to small firms occurs in both equity and debt financing. Deal sizes from VCs and angel investors are large compared to what seed and startup firms may need. Small business lending has recovered from pre-crisis levels only for the largest deals. Ms. Schimpp argued that securities-based crowdfunding could fill in the funding gap for seed and startups companies who are not close to VCs and angel investors.
- Second, Ms. Schimpp suggested the wisdom of the crowd could "de-risk" the riskiest deals for investors. This would allow more funds to flow into businesses that are not necessarily on VCs' radar. According to Ms. Schimpp, the more funding that startups can raise at the seed stage, the more likely are they to raise series A and first round financing.
- Third, Ms. Schimpp predicted the cost of the transactions will go down as a result of technological innovation associated with debt crowdfunding. For example, compared to traditional banking, debt crowdfunding provides "faster access to loans," and expands loans to companies with lower credit scores and lack of collateral.

Douglas Ellenoff, a securities lawyer at Ellenoff, Grossman, and Schole, LLP, presented an overview of the legal framework of Regulation Crowdfunding. He then made the following observations:

- Over time, VC and other funding deals have increased in size.
- Online financing creates efficiency, and funding portals have to balance the entrepreneur's need for capital with investor protection.
- According to most recent data, the average investment in a company is about $1,000, less than the $2,000 that any investor would be able to invest, regardless of income or net worth.
- The average valuation of a company is approximately $5.3 million, smaller than the average for Regulation A deals.
- The average crowd size in a deal is 330, much larger than the average size of private placement deals Mr. Ellenoff's firm has participated in. Mr. Ellenoff noted that the relatively large average crowd size underscores the importance of access to capital for entrepreneurs.
- There have been low fraud levels in the crowdfunding market so far – only one portal has been closed.

Highlights from Panel 2: Investor protection and capital formation in securities-based crowdfunding

Panel 2 focused on the challenges and tradeoffs of protecting investors in securities-based crowdfunding transactions while facilitating fundraising among small firms and entrepreneurs with limited access to alternative sources of capital.

Paul Laporte, an entrepreneur who used securities-based crowdfunding to raise capital for his company, MF Fire, described his efforts to prepare and execute the offering. The factors that lead to offering success, according to him, were a strong social media network, frequent communication with the crowdfunding community, and efforts to demonstrate that the company is legitimate (e.g., getting an audit).

Sarah Hanks, founder and CEO of Crowdcheck, a company that provides disclosure, due diligence, and compliance services, offered the following points about securities-based crowdfunding:

- "The whole thing about crowdfunding is the crowd." Ms. Hanks emphasized that, no matter how good a product is, if the company does not have a mailing list—a base of fans—potential investors will not be aware of the opportunity for investment.
- Revenue bonds may be useful for companies that have revenues but are not ready for the discipline of fixed income securities. According to Ms. Hanks, these bonds could also be attractive to investors, allowing them to receive payments early compared to equity securities.
- Securities-based crowdfunding platforms appear to be under-resourced. According to Ms. Hanks, the platforms find it difficult to comply with some of the Regulation Crowdfunding rule requirements, such as anti-money laundering (AML) procedures, and with the needs of issuers.
- There is a need for standardization for the terms of the securities offered in the securities-based crowdfunding campaigns, which, Ms. Hanks argues, may improve the investor's ability to compare different securities.

Marc Sharma, Chief Counsel of the SEC's Office of the Investor Advocate, highlighted the following investor protection concerns:

- Mr. Sharma argued that the companies engaging in securities-based crowdfunding are very risky, and the securities involved are highly illiquid.
- He also suggested that there is a lack of professional guidance in crowdfunding investments because angel investors and VCs generally do not participate in crowdfunding deals.
- According to Mr. Sharma, unrealistic valuations and limited disclosure (annually) make it difficult for investors to gauge the risks involved.
- He also noted that the Simple Agreement for Future Equity (SAFE) securities may not be the most appropriate type of investments for securities-based crowdfunding offerings because they depend on a future, uncertain liquidity event.

<u>Highlights from Panel 3: Empirical evidence and data on securities-based crowdfunding</u>

The focus of Panel 3 was the empirical evidence on the current levels of securities-based crowdfunding and a discussion of how future research can help shape the development of this new securities market segment.

Prof. Douglass Cumming from Schulich School of Business, York University, presented his paper on the activities of funding portals using data about activity in Canada. Prof. Douglass presents the following information from his paper:

- Crowdfunding portals engage in a variety of due diligence activities, including background checks, visits to the company, credit checks, cross-checks on social media, account monitoring, and third-party proofs.
- Portals charge a 5% fee on average.
- The likelihood of a portal engaging in due diligence for any given company is higher when (1) fewer projects are listed on the platform; (2) the Portal spends more on due diligence; (3) the Portal has more employees; (4) the Portal engages in equity crowdfunding.
- The likelihood of success of crowdfunding campaigns is greater and the amount of capital raised is higher when the platform applies more due diligence.

Sandy Yu from CrowdBerkeley discussed empirical results from an analysis she and her colleagues at CrowdBerkeley did based on a database of non-securities crowdfunding deals that CrowdBerkeley has assembled. She focused on the following findings from her analysis:

- The number of crowdfunding projects has increased over time. In addition, the composition of those projects has changed; specifically, the fraction of art projects has decreased while the fraction of technology projects has increased.

- Preliminary evidence suggests that crowdfunding lowered the barriers for entry for entrepreneurs.

Vlad Ivanov from DERA discussed empirical results from his recently released white paper on crowdfunding (https://www.sec.gov/dera/staff-papers/white-papers/RegCF_WhitePaper.pdf). Specifically, Vlad noted the following observations from his analysis:

- Although the number of securities-based crowdfunding deals and the dollar volume of those deals are still small, crowdfunding seems to be increasing at a steady pace.
- The issuers that engage in securities-based crowdfunding tend to be small, young, pre-revenue, and non-profitable.
- The majority of securities-based crowdfunding offerings (approximately 36%) use equity securities, with debt and convertible securities also popular with issuers.
- Regarding geographical location of securities-based crowdfunding activity, a significant fraction (approximately 34% of offerings and 38% of aggregate target amounts sought) of securities-based crowdfunding is concentrated in California.
- Empirical evidence suggests that the funding portals industry is very concentrated, with the top 4-5 portals accounting for over 70% of the deal flow.
- The average fee funding portals charge is 5%, which is lower than the fee charged by broker-dealers.