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Does Equity Crowdfunding Have Potential in the U.S.?

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ABSTRACT

Numerous crowdfunding platforms have proliferated over the years. Sites like Kickstarter, Kiva, and IndieGoGo have begun to change the ways entrepreneurs are able to seek startup capital. There are five common crowdfunding methods available today, but until the year 2014 one of them, equity crowdfunding, was completely obstructed by Federal laws in the U.S. Recent changes have opened the possibility of an online equity crowdfunding platform, but the risks involved and the laws in place raise many questions regarding how successful an online platform could be. This paper seeks to address the problems involved with the laws and limitations of a platform and determine whether or not such a platform would be feasible.

TABLE OF CONTENTS

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Chapter 1

Crowdsourcing, the Origins of Crowdfunding

The widespread accessibility and use of the Internet has revolutionized most aspects of our lives. Amazon, Zappos, and eBay have changed how we shop; iTunes, Spotify, and illegal downloads have changed how we listen to music; Netflix and Hulu have changed how we watch television and movies. The ubiquity of the Internet has changed how we do many things, but it has also transformed the way we think about the world. The connected, collective nature that is inherent to the Internet has given rise to a new philosophy: crowdsourcing.

Crowdsourcing is the idea that makes websites like Wikipedia possible: a large group of people (i.e. "the crowd") complete big tasks a single person or entity, whether it be out of lack of time, money, or other resources, would not be able to do on its own. In the case of Wikipedia, instead of building an online encyclopedia using a closed system of article writers and editors, the site's founders opened the ability to write and edit entries to everyone on the Internet. This allowed Wikipedia to use its resources to build the site's infrastructure while the crowd, in this case the Wikipedia community, provided the content.

This crowdsourcing philosophy can be found all over the Internet. The website Discogs is a database of music album releases compiled and edited by user submissions; Reddit is an online news and entertainment community whose "front page stories" are determined by member votes. Part of why the Internet is so important to crowdsourcing is because never before has there been a "place" where anyone, regardless of where they are located geographically or their level of income, can come together at the same time for the same thing. In the past, large intermediaries such as stock markets were required to pool and allocate capital. The Internet has disrupted the way we do many things and has recently given rise to a new way for firms to raise capital called crowdfunding.

Crowdfunding is quickly becoming the go-to alternative for newly started companies to generate funding. "The usual sources of business finance – bank lending, venture capital, retained earnings – are not available to small and micro-business" (Bradford). New ventures are often too risky for banks to lend to, not established enough for venture capital to be interested in, and have not made enough money to be self-sustaining. Normally, these entrepreneurs will turn to their network of family, friends, and acquaintances. Unsurprisingly, these sources often have insufficient funds (Bradford). One last option for startups is the angel investor – wealthy individuals who offer both money and advice; but this is a limited market and these investors "tend to focus on larger investments" (Bradford).

In the face of this "small business funding gap," entrepreneurs have begun focusing on the power of the Internet and its ability to generate crowds to find new ways to fund projects (Bradford). Much like traditional financial markets, crowdfunding attempts to pool together money from different sources to fund projects a single entity would not be able to undertake on its own. However, rather than seek money from wealthy individuals or large institutional investors crowdfunding goes straight to the general public, the idea being that the company will raise the necessary funds "through relatively small contributions from a large number of people" (Bradford).

As an incentive to encourage investing, companies utilizing crowdfunding can offer a product or service, a prize or reward, debt, nothing at all, or equity. Startups in the United States have been unable to use equity crowdfunding because, until recently, there have been very strict regulations on the selling and trading of securities. These regulations, namely the Securities Act of 1933 and the Securities Exchange Act of 1934, make registering the sale of stock prohibitively expensive for small startups seeking to raise modest amounts of seed capital – the Acts were created to regulate companies seeking to raise millions or even billions on the IPO market, making regulatory costs relatively negligible. However, the recent passage of the Jumpstart Our Business Startups (JOBS) Act has introduced exemptions to these regulations that have stifled the feasibility and legality of equity crowdfunded projects.

The first part of this paper explores the world of crowdfunding as it currently is. It will explain each type of crowdfunding currently being used and examples of platforms offering specific types. The next section will go deeper into the crowdfunding type of interest to this paper: equity crowdfunding. Here will be a discussion of the current status of equity crowdfunding in the United States – the regulations that have until now prevented it from taking hold, examples of platforms that tried to work within the regulations of the Acts of ’33 and ’34 prior to the JOBS Act, and examine the exemptions contained in the JOBS Act with a focus on Title III, the CROWDFUND Act. Then the risks inherent to the JOBS Act will be examined; how investors, issuers, and a platform can mitigate these risks; and an attempt to synthesize the regulations and risks to determine the ideal characteristics of a potentially successful equity crowdfunding platform in the U.S will be made. Finally, these new regulations, the risks involved with small business investing, the needs of the average startup company and crowdfunding investors, and the apparent characteristics of a viable platform will be taken into account to see if there is a plausible future for equity crowdfunding in the United States of America.

Chapter 2

Introduction to Crowdfunding

The internet's most famously crowdsourced website, Wikipedia, defines crowdfunding as "the collection of finance to sustain an initiative from a large pool of backers – the "crowd" – usually made online by means of a web platform." In other words, the goal of crowdfunding is to raise a relatively large amount of money through many small contributions. Crowdfunding is generally split into five different categories: donations-based, rewards-based, product-based, lending, and equity. The name of each category offers a hint as to what is being offered in return for an investment (e.g., product-based campaigns give their investors the product they are funding.) While the incentive (i.e. return) offered is the defining characteristic of each type of crowdfunding, it is important to note that the category can also limit the scope of how investments will be used (i.e. investing in a product versus investing in a company.) To better understand the current crowdfunding landscape, each type of crowdfunding will be examined with special attention paid to equity-based crowdfunding.

Donations-Based

In a pure donations-based crowdfunding scheme investors receive nothing in return for their investment, whether it be interest, shared profits, or even a return of their principal amount. None of the current leading crowdfunding platforms utilize a donations-based model, making it the most rarely seen of the five categories. Sites that do offer donations-based services tend to focus on charities and non-profit institutions, although the website Kapipal does allow for-profit institutions to post listings (Giudici). Offerings using the donations-based method also tend to raise less money than other kinds of crowdfunding (Giudici); "investors" will not pay a premium for a project that by definition generates no financial return for them.

It is much more common for "unrewarded requests for donations" to appear on sites that primarily offer rewards-based or pre-purchase crowdfunding (Bradford). These sites, however, usually encourage fundraisers to offer some sort of reward. In fact, "one study found that only 22% of all crowdfunding initiatives were requests for donations" (Bradford), although it was not specified whether this figure was a percentage of the offerings seen on rewards-based and pre-purchase sites or the percentage of initiatives of all kinds.

Although rare, examples of donations-based platforms can be found. According to the website's "About Us" page, GlobalGiving "is a charity fundraising web site that gives social entrepreneurs and non-profits from anywhere in the world a chance to raise the money that they need to improve their communities," helping fund projects that "educate children, feed the hungry, build houses," and "train women (and men) with job skills." Since its founding in 2002 the site has raised over $106 million from more than 370,000 donors, helping fund almost 10,000 projects.

The funds generated by campaigns are handled by the GlobalGiving Foundation, a registered non-profit. The Foundation takes a 15% fee from the total amount and "guarantees that the remainder of the donation will reach the project within 60 days" (Bradford). According to GlobalGiving, the 15% fee goes toward covering costs such as "providing training and support to project leaders" and "finding and vetting projects."

Rewards-Based and Pre-Purchase

Rewards-based crowdfunding campaigns (referred to as "patronage crowdfunding" by Edan Burkett) "offer something… in return for the contribution, but not interest or part of the business" (Bradford). This "something" can be almost anything; rewards range from physical things, such as a personally written thank you card, production stills from the filming of a movie, or a company t-shirt, to things that are more abstract, like production credits in a movie or the chance to listen to an album prior to its public release.

One of the most popular rewards given is the actual product a campaign is funding. When this is the case it is referred to as pre-purchase crowdfunding; investors are essentially buying a product before it has been manufactured. To create an even more incentive, companies might decide to offer the product at a discounted or reduced price. Another way to generate interest is to offer an "enhanced experience" (Bradford), such as a special edition CD or a limited edition of the product being funded.

Due to the strong parallels between the two methods, rewards-based and pre-purchase crowdfunding are often lumped together when referenced in articles. In practice virtually all rewards-based platforms allow for products to be offered as the reward, thus "rewards-based crowdfunding" will be used to as a blanket term for both types of crowdfunding for the remainder of this paper. Rewards-based crowdfunding is the most prominent form of crowdfunding in the United State and is best exemplified by Kickstarter, the most popular platform in the U.S.

Kickstarter was launched on April 28, 2009; as of March 2014 it has received over $1 billion pledged to projects. The platform requires projects to provide some sort of reward to investors who pledge money toward their campaign. According to Kickstarter, "rewards vary from project to project, but often include a copy of what is being produced or an experience unique to the project."

Oftentimes campaigns will offer a tiered rewards structure, meaning that different rewards are given for various funding amounts. For example, one of the most successful campaigns Kickstarter has seen, the Pebble: E-Paper Watch for iPhone and Android, offered one Jet Black Pebble watch to the first 200 backers to pledge $99, a watch they intended to retail for $150. Other tiers included the choice of any color watch for a pledge of $125, early access to Pebble's software development kit as well as any color watch for $235, and a custom watchface as well as 5 Color Pebble watches for a pledge of $1,250.

At the outset of a campaign the promoter of the project must choose a funding goal and the amount of time they have to reach that goal, generally between 30 and 90 days. If the goal is not reached within the given time period then Kickstarter takes no fee and returns all pledged funds to their backers, meaning the project receives none of the money they were asking for. However, if a campaign successfully reaches (or exceeds) its funding goal then Kickstarter takes a 5% fee from the total amount raised and gives the rest of the money to the project. This is referred to as an "all-or-nothing" campaign. Apart from the fee, Kickstarter promises that project creators maintain complete ownership of their work.

One other important aspect of Kickstarter campaigns is the disclosure of how funds will be used. Because these campaigns are created on a project-by-project basis, funds generated are normally used for the production and marketing of a specific product line. This project-by-project methodology lends itself well if one is trying to fund a single product, but falls short if trying to raise capital to fund an entire company.

While it is the most popular, Kickstarter is hardly the only platform available to those who seek funding. Another popular rewards-based site in the U.S. is Indiegogo. The platform is similar to Kickstarter in most regards, however it does not require campaigns to offer rewards (what they call "perks"), although they do recommend them. This means Indiegogo allows donations-based crowdfunding. The biggest difference is that Indiegogo campaigns are not funded on an all-or-nothing basis. Unlike Kickstarter campaigns that must fully meet a funding goal to receive the requested funds, Indiegogo project creators can begin using money immediately. If the funding goal of a project is reached, Indiegogo will take a 4% fee from the total amount of money raised. If the project fails to reach its goal within the predetermined amount of time then the site will take 9% of the total funds raised.

Clearly there are multiple ways to structure a rewards-based platform. Still, the most dominant platform has been Kickstarter. Of the more than $1 billion pledged to projects, $876 million of those dollars went towards the more than 58,000 successfully funded projects. Kickstarter boasts a 44% project success rate and has had almost 6 million total backers, 29% of which are repeat customers. These are important customers to have, though, as 60% of total dollars raised come from repeat backers.

63% of successful campaigns have raised between $1,000 and $10,000 dollars. 11% and 13% of projects raise less than $1,000 or between $10,000 and $20,000 dollars, respectively. To compare, 17% of failed campaigns received no funding, while 64% raised between 1% and 20% of their funding goal. There have been 58 (0.1%) successful campaigns that have raised more than $1 million. The aforementioned Pebble watch was one such campaign, raising a total of $10,266,845 of its original funding goal of $100,000 from 68,929 different backers.

There seems to be a threshold for successful campaigns; the February 3, 2014 edition of the Wall Street Journal included a statistic that 80% of projects that raised more than 20% of their funding goal ended up successful. This might be explained as a sort of "herd mentality" of the crowd. If potential backers see that a project has already achieved a large portion of its requested funds they might take this as a signal that the project is a good idea. While not too concerning with rewards-based crowdfunding, this "signaling" issue could become a bigger problem in equity-based crowdfunding. Investors might interpret a campaign with significant funding as having has received collective due diligence by "the crowd," signaling that the collective research believes they have found a winning company. Individual due diligence in any investment is of crucial importance, regardless of the whether or not there is a crowd.

Lending

Lending crowdfunding is also known as peer-to-peer lending and, as the title suggests, involves one party taking on debt while many individuals – the crowd – provide the loan. Peer-to-peer lending takes two forms: interest bearing and non-interesting bearing.

Listings on interest bearing sites do not necessarily ask for business loans. According to Bradford "most of the loans are used to pay off credit cards or for other personal items such as medical expenses." One such site is Prosper.com.

On Prosper, individuals can seek loans between $2,000 and $35,000. The interest rate the borrower must pay on his or her loan is determined by the platform setting a minimum rate and letting each lender bid on a minimum percentage he or she will accept (Bradford). (For comparison, Lending Club, another peer-to-peer lending site, personally evaluates each borrower and sets an interest rate on that loan depending on their determined "loan grade") (Bradford). Rates range from 6.73% to 35.36% APR and include both the interest and a fee paid to the platform.

Even though it is considered "peer-to-peer" lending, the individuals constituting the crowd technically do not lend the individual any money. Rather "all personal loans are made by WeBank, a Utah-chartered Industrial Bank," as stated on Prosper's website. However, "the site is obligated to pay [back the crowd] only if the underlying borrower repays the corresponding loan," meaning the crowd still bears the risk of default (Bradford).

If a website offers lending with no interest, those who extend loans can only receive a return of their original loan amount, known as principal. Kiva, arguably the largest crowdfunding site of any kind in the world, is a prime example of a non-interest bearing peer-to-peer lending platform. The site began in 2005 as an aide to entrepreneurs and business owners in developing countries, helping connect them with lenders to raise amounts as little as $100 or as large as $25,000 or more. Kiva does not lend money directly to the business owners, but rather deposits the money with “field partners” who are local to the entrepreneur’s community. As the borrower repays the principal of the loan to field partners, the partners in turn pay back the original lenders. Any interest collected on the loan goes toward covering the operating expenses of the field partner, not Kiva.

As with any loan, the lender bears the risk of the borrower defaulting on his or her loan. Because Kiva loans are largely made to one individual in a developing country, though, the risk comes from factors not normally seen in the United States’ corporate, federal, and municipal bond market. Health issues are major risk when dealing with an individual, especially in non-developed countries where serious diseases like malaria are still present. Small businesses in developing countries are at a higher risk of experiencing fires and crop failures. The risks inherent in Kiva’s field partner system are bankruptcy, fraud, and operational risks. Lastly, there are increased country risks – economic, political, and infrastructural – as many country’s currencies, governments, and infrastructure are not as stable as that of the U.S. Despite these increased risks, Kiva claims a 98.94% repayment rate on more than $549 million in loans.

Equity

One of the most complete definitions of equity crowdfunding comes from *Signaling in Equity Crowdfunding* by Gerrit Ahlers et al. The paper draws from multiple sources to conclude that equity crowdfunding "is a method of financing whereby an entrepreneur sells equity or equity-like shares in a company to a group of (small) investors through an open call for funding on Internet-based platforms." The equity being sold gives the purchaser (the investor) a percentage of ownership in the company and could also give them voting rights. "Equity-like shares" can mean multiple things, but in most cases refers to profit sharing. Business owners can include rewards or perks, but this is rarely seen (Burkett).

Whereas rewards-based crowdfunding is centered around a product, equity crowdfunding focuses on the company itself. This means investors are placing their money not because they like an idea or product, but because they believe in the ownership and future profitability of the company. In other words, equity crowdfunders must consider the long-term success of a business while rewards-based crowdfunders only need to think about the short-term return of receiving their reward.

The difference in considerations changes the kind of information required to make an informed decision. While rewards-based investors do need to consider the ability of project creators to follow through with production, most of the focus is on the idea or product itself. Equity investors, on the other hand, need much more information to make an informed decision; although an interesting business proposition might attract their attention, a company's ability to have long-term success will garner their investment. To make such a decision, equity crowdfunding investors will need much of the same information other equity investors (e.g., venture capitalists and investors on stock exchanges) use to make educated investments. Material (important to disclose) information includes current financial statements, financial projections, information about current directors and ownership, and how new capital will be spent.

The disclosure of information leads to the most important aspect of equity crowdfunding: government regulation. Not only does a country's government need to determine what information companies in equity crowdfunding should be required to disclose, but they also need to consider other measures such as investing limits, fundraising limits, and the flow of information between the crowd and a company. Such measures protect investors and offer guidance to companies and crowdfunding platforms. Consequently, the government can directly affect how crowdfunding portals are structured structured depending on what regulations a platform must meet.

Equity crowdfunding is available in several countries across Europe, Asia, and Australia, but due to government regulations regarding the sale and transfer of securities the practice has essentially been illegal in the United States. In 2012, however, Congress passed a bill creating exemptions to the regulations that had until then stifled any equity crowdfunding opportunities. President Obama signed the bill into law, but it is still subject to Securities and Exchange Commission (SEC) input. These regulations and exemptions are discussed in much greater detail in subsequent chapters.

The OECD, an international organization committed to promoting “policies that will improve the economic and social well-being of people around the world,” currently has 34 member countries from across the globe, including the United States (“About the OECD”). Of those 34 countries only 6 permit equity crowdfunding: the U.K., Ireland, France, the Netherlands, Switzerland, and Australia (Ahlers). Germany, another OECD country, allows something called “silent partnerships.” Websites Seedmatch and Innovestment facilitate such partnerships, which are “equity like share[s] in a company that give investors a predefined share of profits but no voting rights” (Ahlers).

Due to the aforementioned legal landscape, there are no examples of equity crowdfunding platforms in the United States. However, one of the best global examples of a currently operating equity crowdfunding platform is the ASSOB, which stands for Australian Small Scale Offerings Board.

ASSOB offers a very robust crowdfunding platform that caters to almost all issuer and investor needs through direct and indirect methods. First, the platform provides a “marketing and distribution channel” that allows entrepreneurs to disperse information regarding their company. ASSOB itself adds value to campaigns by conducting due diligence, offering their guidance and expertise to help fundraising efforts gain momentum, and attending and sponsoring community events and seminars.

The platform also hosts “Australia’s only facility for ‘secondary’ sales of unlisted issued securities,” which is essentially an illiquid stock exchange (when compared to exchanges like the NYSE.) Only companies profiled on the ASSOB platform can be traded over the exchange, so the Board created “compliance listings” that allow private companies who haven’t raised capital through ASSOB’s platform to register with the site, letting them list their securities on the secondary sale platform. To protect investors, the “exchange” prohibits founders of companies from transferring, selling, or otherwise disposing of more than 10% of any founder’s equity for a 12-month period beginning the date the company last obtained new investors from a small scale offer. When investors or company owners wish to sell shares, ASSOB only displays “the asking price of shares being offered;” due to its illiquid nature ASSOB’s secondary exchange cannot quote live share prices (“ASSOB”).

One other interesting service ASSOB offers is called “Executive Equity.” Many of the companies raising funds on the platform are startups that might lack experienced directors or board members. A self-described “matching service,” Executive Equity provides a listing of “executives and seasoned entrepreneurs” from which companies can fill open positions and bring in the experienced guidance they need (“ASSOB”). According to the site this service is different from other recruitment websites because the executives advertising on Executive Equity are willing to be compensated almost entirely in equity.

ASSOB's campaign requirements also indirectly provide aid to companies. As outlined in ASSOB's website, any company "wanting to undertake a capital raising campaign through [the Platform is] required to engage an approved 'Partner.'" Partners, who are "professional business advisors" (e.g., accountants, business consultants, brokers, lawyers), assist companies with ASSOB's admission process and act as an ongoing aide, helping companies comply with platform and governmental rules throughout the campaign process. Every campaign must employ the help of an accredited ASSOB Partner, a title obtained through "specific ASSOB Partner training" ("ASSOB").

The platform has also established disclosure rules beyond annual reports to help create a stronger flow of information for investors. Listings actively seeking investments as well as compliance listings must publish "quarterly activity statements" on their profile page. These reports must confirm the company's solvency, summarize how and why funds were spent, summarize progress made toward company milestones, and disclose any changes, news, or events that have affected the company ("ASSOB"). Profile pages must be maintained with relevant updates made within 48 hours of the event occurrence. True and fair disclosure is expected at all times, though the Australian Securities & Investment Commission would likely handle such a violation.

Companies raising funds are required to keep all funds in an external trust account until certain conditions of the fundraising offer have been met. For example, a campaign must reach a predetermined "minimum subscription amount" within four months of the start of a campaign. Once reached, the company can withdraw funds from the trust account, but if the minimum amount is not met then investors will be refunded their full investment. This is similar to the all-or-nothing funding method used by Kickstarter. ("ASSOB")

ASSOB clearly does many things, but their website also makes a point of noting what they do not do. The Board does not personally give companies capital or take an equity stake in a company. They do not market investment opportunities publicly, keeping all promotion on the platform. Many pages, sometimes multiple times on the same page, remind investors that ASSOB does not offer any sort of financial advice. ASSOB goes to great lengths to remind investors the platform does nothing more than publish offers made by various companies, leaving investors to read the information provided and conduct individual due diligence regarding the industry and market, encouraging them to seek independent advice. The site does this to protect itself from potential lawsuits – if they provided advice and an investment failed they could potentially be held liable for the loss, especially as an unaccredited advisor.

Relative to their minimum fundraising amount ASSOB's fees are not very high. They charge an upfront application fee of $990 and an additional $3,960 fee to all companies who gain approval for admission to the Platform. Companies must pay a fee of $458 for each month of their capital raising campaign, an amount calculated to be the average value of ASSOB's work over the campaign period. Finally, the platform deducts 2.5% of funds before they are dispersed to a company in what they consider a transaction fee. ("ASSOB")

ASSOB is not the only cost to consider when listing on their platform. The Partner required by the Platform is estimated to work "around 100 hours" and "usually earns very little from the preparatory work they do" for a capital raising campaign. Because of this, Partners generally charge a service fee of 5-8% for successfully funded campaigns. Lastly, ASSOB estimates the trust account required to store campaign funds as well as other registration fees to cost a company an additional $1,250 ("ASSOB"). In total a company can expect a successful campaign on the ASSOB Platform to cost around $8,000 as well as 7.5-10.5% of total funds raised. To date, ASSOB has raised $138 million in funds.

One other notable equity crowdfunding platform is Startup Crowdfunding, formerly Grow VC. Rather than allow investors to hold their money until they find a campaign they want to invest in, Startup Crowdfunding charges investors a monthly subscription fee, aggregating these fees into one large investment pool. Subscribers can allocate a percentage of the investment pool to campaigns they think have the most potential for return. Once a project is successfully funded Startup Crowdfunding will conduct its own evaluation of the company, only distributing funds if satisfied. After receiving its funds, the company is paired with a partner not affiliated with the Platform who will provide guidance to the company in the coming years.

Due to the lack of equity crowdfunding platforms there is not much reliable data regarding their performance. The statistics available should therefore be considered rough figures. Giudici et al. pegged the total equity crowdfunding volume for 2011 at $88 million, 67% of which was conducted on ASSOB ($19 million) or SeedUps ($40 million), with the "other major players [being] GrowVC, Buzz Entrepreneur, and Crowdcube." Crowdsourcing.org placed the 2011 total at $112 million and offered statistics on individual platforms. For example, the site claims ASSOB, as of May 2012, had funded 176 companies while Crowdcube, a U.K.-based platform, had funded 11 projects with an approximate total of £2.5 million raised. The same report claimed a compound annual growth rate of 114% for equity crowdfunded companies in Australia. Finally, a 2012 survey by Crowdsourcing LLC determined that 21% of equity-based campaigns raise more than $250,000 while 6% collect less than $10,000. These numbers are most likely affected by the minimum fundraising amounts permitted on the two platforms that over 50% of all equity crowdfunding had taken place over.

Crowdcube recently released their statistics for 2013, offering a look into the performance of one of the smaller equity-based platforms. The site managed to successfully fund 54 businesses with more than €12.2 million ($16.8 million), what they claim is 562% funding growth from 2012. One of their campaigns "broke the equity crowdfunding world record" by raising €1.9 million ($2.6 million). The average investment amount was €2,687 ($3,500), but a single investment of €250,000 ($343,500), their largest of 2013, was made. Crowdcube forecasts 1,072 new jobs will be "created over the next three years by funded companies."

Chapter 3

Equity Crowdfunding in the United States

Until the passage of the JOBS Act in 2012, equity crowdfunding in the United States was almost entirely blocked by two monumental pieces of financial legislation: the Securities Act of 1933 and the Securities Exchange Act of 1934. This was not on purpose – lawmakers in the 1930s could not have foreseen the technological and social changes that eventually led to crowdfunding. The provisions set up to regulate the stock market simply did not translate well to equity offerings of much smaller amounts. There were attempts to create platforms that operated within the Acts of ’33 and ’34, but none managed long-term success. Realizing the need to address this problem, Congress developed a series of exemptions to the Acts of ’33 and ’34 that eventually became the basis for the JOBS Act. In this chapter, the original language and intent of the Securities Act of 1933 and the Securities Exchange Act of 1934 will be examined, a brief overview of U.S.-based platforms that tried to operate within the confines of the law prior to the passage of the JOBS Act will be offered, and a summary of the JOBS Act with particular attention to Title III will be given.

The Securities Act of 1933 and the Securities Exchange Act of 1934

The United States’ economic condition at the beginning of the 1930s was dire at best. Still dealing with what we now refer to as the Great Depression, Congress decided to take action and put laws into place that might prevent a similar financial disaster from happening again. As a result, two major pieces of financial legislation were passed in consecutive years, the Securities Act of 1933 and the Securities Exchange Act of 1934.

The Securities Act of 1933 addressed problems regarding primary market offerings. Congress wanted to confront companies purposely misleading investors by providing fraudulent information, a practice believed to have in part caused the Depression. As a result, the Securities Act's overarching goals were to ensure "issuers selling securities" publicly "disclose material information to investors," that no securities transactions be based on fraudulent information or practices, and to guarantee that investors would be provided accurate information, allowing them to make informed investment decisions (Sarkar).

The Securities Act achieved these objectives by creating a mandatory registration process for the sale of securities and explicitly defining exactly what information is considered material. In its simplest form, the Act of '33 calls for issuers to first submit information that forms the basis of a prospectus and to later submit additional information that is not included in a prospectus but is still accessible to the public. Although the Securities and Exchange Commission (SEC) didn't exist at the time the Act was originally passed, the SEC's responsibilities eventually expanded to give it explicit authority over terms in the Securities Act. This gave it control over exactly what information a company needs to disclose prior to a public offering.

To best provide details relevant to an IPO, most of the required information deals with the issuer and the terms of the securities being offered. This information usually includes "descriptions of the issuer's business, past business performance, information about the issuer's officers and managers, audited financial statements…, executive compensation, risks of the business, tax and legal status, and the terms and information about the securities issued" (Sarkar). The SEC reviews these statements to ensure all required disclosures have been made and, barring any "glaring deficiencies or omissions, the registration statement" is approved (Sarkar). Should it see the need, however, the Act gives the SEC authority to "suggest" changes to disclosures, effectively giving it the power to shape disclosures to best fit investor needs (Sarkar).

The Act enforces truth in these disclosures by explicitly creating liability for issuers should there be "any material misstatements or omissions in the prospectus or registration statement" (Sarkar). It was later amended to give the SEC the power to prosecute those who sell unregistered securities, seek injunctions in the case of a violation or imminent violation of the Securities Act, bar officers and directors caught in violation of the Act's anti-fraud provisions, and seek civil penalties if any party violates the Securities Act, SEC rules, or cease and desist orders issued by the SEC (Sarkar). Although the Act of '33 does not allow the SEC to prosecute companies on behalf of individual investors, it does create provisions that allow such investors to bring civil actions against issuers that make false statements or sell non-exempt, unregistered securities.

While the Securities Act works well when a company is filing for an IPO, it creates barriers for smaller companies wanting to raise capital through an equity sale. The largest barrier is the cost of going through the registration process. The process requires the production of audited financial statements – statements a company must hire an external auditing firm to make. In normal IPOs the external auditor is the second highest expense (legal expenses being the largest), costing firms between $500,000 and $1.5 million depending upon the size of the offering (PricewaterhouseCoopers). This is not a problem when the equity sale will raise $100 million or more, but it is easy to see how such costs become prohibitively expensive if the offering would only raise $1 million or less. Add in other expenses like the SEC's registration and filing costs and one can easily see how the Securities Act unintentionally prohibited small-scale equity offerings before they even had a chance to exist.

The second financial regulation passed, the Securities Exchange Act of 1934, addressed the issue of securities after their initial sale. After the original transaction between company and investor, securities are traded between investors on the secondary market. Secondary market transactions can occur over-the-counter, meaning an investor purchases shares directly from a broker, but more commonly will take place through exchanges like the New York Stock Exchange (NYSE) or NASDAQ.

Like the Securities Act, one of the major issues the Securities Exchange Act addressed was the dispersion of fraudulent information (or the withholding of material information.) Thus the Act of 1934 created a mandatory disclosure process to make material information public. It went a step further, however, and established the Securities and Exchange Commission to directly regulate market exchanges and their participants, namely industry associations, brokers, and issuers (Sarkar). Originally created only to enforce the Securities Exchange Act that created it, the SEC's responsibilities have expanded over the years to include the Securities Act and eventually Sarbanes-Oxley, as well as other financial regulations.

The responsibilities handed to the SEC were (and still are) far reaching. First and foremost the Commission must "ensure [reporting] companies meet the Exchange Act's disclosure requirements" through periodic filings with the SEC. Firms considered "reporting companies" are publicly held companies that have more than $10 million in assets and more than 500 shareholders. Most information is disclosed through annual reports (called 10Ks) and quarterly updates (10Qs). These annual and quarterly reports include information about officers and directors, the line of business the company is currently in, and audited financial statements. If an unexpected event occurs or numbers in a previous report must be amended in between 10Qs, reporting companies must file an 8K, thus disclosing to the public the material information in a timely manner.

The SEC was given a wide range of tools to use to enforce the Securities Exchange Act. The Commission has the power to sanction, fine, and "alternatively discipline" market participants who violate securities laws. It is responsible for establishing rules of conduct for market participants and governs disclosures during proxy contests. Finally, exchanges must register with the SEC.

Aside from the SEC, the Securities Exchange Act created regulations intended to protect investors from market manipulation by traders that partially spurred the crash of 1929 (Sarkar). In addition to the increased reporting that made information more readily available, the ’34 Act also explicitly prohibits insider trading and requires “tender offers,” purchases of 5% or more of a company, be filed with the SEC and made public.

Where the SEC regulates the secondary market on a macro level, the Securities Exchange Act also necessitates the creation of Self-Regulatory Organization (SROs) to develop rules and standards of good practice at the micro level. SROs provide joint supervision to ensure companies and employees “are sufficiently qualified to meet minimal levels of training, and that firms keep accurate, truthful records” (Sarkar). For example, the Financial Industry Regulatory Authority (FINRA) oversees broker-dealer firms and the brokers employed by them. These organizations can hold hearings and take disciplinary action against firms and employees who violate the SRO’s established standards.

Attempts to Work Within Regulations Prior to JOBS Act

The Securities Acts and SEC rules, aside from creating prohibitively high costs, outlaw certain practices inherent to what one would consider “pure” equity crowdfunding (pure in the sense that any individual, regardless of their relation to an issuer, may invest his or her money with a company.) Marketing the sale of securities is one of these practices. While listing equity crowdfunding campaigns on a platform would not violate this rule, an issuer going outside of the platform to direct potential investors to their campaign would.

The other major issue is accredited investors. Investing in small, non-public companies is very risky – they are illiquid and likely to fail. Thus only “accredited investors,” individuals with a net worth exceeding $1 million or annual income exceeding $200,000 each of the past two years, are permitted to invest in such ventures, the idea being their wealth allows them to absorb the loss should the risky venture fail. This measure prevents the general public from investing in such ventures, effectively prohibiting pure equity crowdfunding. The funding platform Seedups, based in Ireland, operates in the United States but only allows accredited investors to participate in campaigns.

There is a pre-JOBS Act exception that allows family, regardless of their income or net worth, to invest in small ventures. Profounder was a U.S.-based equity crowdfunding website that took advantage of this loophole. The platform essentially provided a tool through which entrepreneurs could accept investments from “friends, family members and existing acquaintances” in campaigns they called “Private Raises” (Bradford). Each private campaign cost entrepreneurs $1,000, had 30 days to raise the funds needed, and, like Kickstarter and ASSOB, would only transfer money to a company if the funding goal was met. In return for funds investors would receive a percentage (predetermined by the entrepreneur) of the gross revenues of the business. Although clever in its use of an existing exemption Profounder ceased equity distribution in June of 2011.

The JOBS Act

Similar to how the Securities Acts of 1933 and ’34 followed a major financial crisis, the Jumpstart Our Business Startups Act (JOBS Act) came in the wake of 2008’s so-called Great Recession. According to a legislative summary written by House Republicans the JOBS Act is “intended to improve small business’ access to capital. Specifically, many pieces of the legislation would improve capital formation by expanding equity financing options.”

Of the seven Titles included in the Act, six have little to no relevance to equity crowdfunding. Title I, “Reopening American Capital Markets to Emerging Growth Companies,” creates a new category of issuer called an emerging growth company (ECG). A company is considered an ECG if its gross revenues total less than $1 billion. The ECG title offers relief to companies by "slowly phasing in those regulations that impose higher costs on issuers" ("Digest for H.R. 3606"). This is intended to promote job creation by giving ECGs access to capital markets without the same cost burden undertaken by larger companies.

Title II, "Access to Capital for Job Creators," lifts the ban on the solicitation of unregistered securities, allowing companies to reach larger pool of investors. This Title addresses the problem of marketing equity crowdfunding campaigns previously explained.

"Small Company Capital Formation," Title IV, raises the offering threshold for companies exempted from SEC registration from $5 million to $50 million.

Title V, "Private Company Flexibility and Growth," addresses SEC rules that state that any company with total assets in excess of $10 million and 500 or more shareholders must register with the SEC. As private companies use private equity offerings instead of going public to raise money and offer employees stock as compensation, this 500-person limit can be reached very quickly. Title V allows companies to continue to grow privately and use equity to raise capital.

Title VI, simply referred to as "Capital Expansion," enables "banks to better deploy their capital to make loans and create jobs" by amending the Securities Exchange Act "to increase the number of shareholders permitted to invest in a community bank from 500 to 2,000" ("Digest for H.R. 3606").

Most relevant to the discussion of equity crowdfunding is Title III of the JOBS Act, appropriately named the CROWDFUND Act, which stands for the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act. The CROWDFUND Act "amends Section 4 of the Securities Act to create a new exemption for "crowdfunding" to raise up to $1 million over a 12-month period from small investments from a large pool of investors" ("Jobs Act

Changes...”). Because the investors funding equity crowdfunding campaigns are likely unaccredited, Title III also sets limits for an individual’s purchase of crowdfunded securities. Individuals with an annual income or net worth less than $100,000 may invest $2,000 or 5% of their annual income, whichever amount is greater. All other investors may invest “the lesser of $100,000 or 10%” of their annual income (“Jobs Act Changes...”). Beyond these amounts an investor would be considered accredited and exempt from investing regulations.

A key feature of the CROWDFUND Act creates the requirement that all crowdfunding transactions take place through an intermediary, which can either be a registered broker or an SEC registered “funding portal.” According to the Library of Congress’ Summary of the JOBS Act, a funding portal is defined as “any person acting as an intermediary in a transaction involving the offer or sale of securities… that does not” offer investment advice or recommendations; solicit the purchases, sales, or offers to buy securities offered or displayed on its website or portal; compensate employees, agents, or other people with securities offered on its website or portal; hold, manage, possess, or otherwise handle investor funds or securities; and does not engage in other activities yet to be determined by the SEC. As long as they meet this definition, the Act protects registered intermediaries from legislative and administrative action by state governments. In addition to registering with the SEC, brokers or funding portals must also register with “any applicable self regulatory organization” (“‘JOBS Act’ Signed...”).

Title III also addresses requirements for issuers raising capital through equity crowdfunding. One such obligation is a responsibility to “file financial statements with varying levels of review depending on offering size” (“Jobs Act Changes...”). Issuer information required will be similar to the information provided when registering with the SEC, such as a description of the issuer’s business, an anticipated business plan, financial condition, and, if raising more than $500,000 in a 12-month period, audited financial statements (though that threshold amount is yet to be determined by the SEC) (“‘JOBS Act’ Signed...”). Information regarding the campaign (e.g., the target offering amount, deadline to reach the target amount, price of each share, use of proceeds, company risks) will also be required. Information received from issuers must be given to the SEC at least 21 days before securities are set to go on sale. Lastly, issuers must annually provide investors and the SEC financial statements and reports regarding operation results. ("'JOBS Act' Signed...")

Similar to Title II, the CROWDFUND Act also addresses the marketing of securities. While issuers may direct investors to a certain crowdfunding intermediary, they are prohibited from advertising the terms of their campaign.

Lastly, the Act comments on issues regarding investors. Intermediaries must provide disclosures "and other investor education material" (yet to be determined by the SEC) regarding the risks involved with investing in startup and small companies ("'JOBS Act' Signed..."). Platforms need to ensure investors have reviewed these disclosures by making them answer a series of questions regarding risky investments and affirm their knowledge of the risk of loss ("'JOBS Act' Signed..."). Title III restricts the sale or transfer of securities for one year unless the security is "resold to the issuer, an accredited investor, as part of a registered offering (i.e. an IPO) or to a family member of the purchaser under limited circumstances" ("'JOBS Act' Signed..."). To protect investors, a civil liability provision is established for companies who commit material misstatements or omissions in documents or oral communications involved with the offering or sale of securities. Further requirements have been called for but not yet determined by the SEC. These include what measures an intermediary must take to reduce risk (e.g., background and regulatory checks on directors, officers, and significant shareholders) and how intermediaries can ensure that unaccredited investors do not exceed their investing limitations.

Chapter 4

Current Potential for an Equity Crowdfunding Platform in the United States

President Barack Obama signed the JOBS Act into law on April 5, 2012, but the President signing the bill did not allow it to immediately take effect. The SEC still needs to finalize many of the requirements and has already missed several of the deadlines. Even after the SEC creates its requirements, however, no equity crowdfunding will exist until someone creates a platform to host such activity. Not only will a platform need to operate within the requirements of the JOBS Act, to be successful a platform must also address the needs of issuers and investors as well as take steps to mitigate the risks involved with equity crowdfunding. This chapter will discuss the risks that inherently exist with equity crowdfunding and compile features that best lend themselves to a platform in the United States.

Risks Involved in a Crowdfunding Platform

Any investment inherently bears risk – as saying goes, "no risk, no reward" – but some investments are riskier than others. The JOBS Act's $1 million limit for equity crowdfunding makes it an attractive funding method for smaller companies. Relative to larger, more established businesses, a small company carries a large amount of risk. Any company, regardless of past success, runs the risk of going out of business; this particular risk is amplified in small businesses. When it comes to startup companies a quick Google search will provide failure rates anywhere from 70% to 90%, but the basic idea is conveyed: building a successful business is hard and more than half who try will fail. While there are many risks for equity crowdfunding investors, this risk of company failure is the most important to consider. It is so important that the

JOBS Act explicitly requires platforms to ensure participants are aware of the increased risks involved with investing in small companies; however, this increased chance of failure is hardly the only risk to consider.

Fraud is also an important factor. Even though the JOBS Act does generate disclosure requirements, they fall far short of the requirements of publicly traded companies. To partially bridge this shortcoming, portals will need to provide some form of communication between issuers and investors. Communication channels could be exploited to distribute false information that would be hard to disprove given the lack of publicly available knowledge. Still, there will be less information available to crowdfunding investors and the lack of an underwriter makes it hard to confirm the accuracy of disclosures. The Act does a good job of discouraging fraud, but the fact that these problems still surface even with publicly traded companies should provoke extra caution in equity crowdfunding investors when reviewing a firm.

At the moment there is not really a secondary market for crowdfunded securities, meaning owners of those securities cannot easily sell or trade their shares. This makes the securities very illiquid, a feature modern stock exchanges have managed to all but eliminate.

All of the aforementioned risks are amplified by the fact that many of the individuals partaking in equity crowdfunding will probably be unsophisticated investors. In other words, the investors do not possess the same skills, assets, or knowledge normally owned by investors. They are more likely to confuse or misunderstand financial terms and concepts. Even if they do educate themselves they will probably lack the experience that helps more savvy investors interpret information to uncover good business prospects.

Aside from investors, equity crowdfunding platforms also bear a large amount of risk. They are expected to act as a gatekeeper for both investors and issuers (Brown); before an investor or issuer may partake in crowdfunding activities the portal must first approve of them, most likely through a formal registration process. This creates a potential liability for platforms should they approve a fraudulent company or investor. An added problem comes in the protection of investor data. While issuer information is understandably made public, investors expect their information to remain private.

The topic of unsophisticated investors once again arises with a platform's registration process. For example, an individual calculating his or her net worth or annual income might not know that net worth excludes one's principal residence and annual income excludes unrealized appreciation (Brown). This problem would be compounded should any mistakes, such as math errors or typos, be made. Unsophisticated investors also might not realize that they are cash poor despite meeting net worth requirements; having illiquid assets worth $100,000 is not the same as having $100,000 in the bank. This would become a problem if an investment failed and they did not appropriately budget their cash on hand.

Tracking investor activity will be very difficult without some sort of central investor data repository. Investors could potentially register with multiple platforms; without some sort of communication between platforms or a single place where all crowdfunding investor information is stored, registering with multiple platforms would allow investors to exceed the investing limit specified in the JOBS Act. A government proposal has already concluded that because equity crowdfunding is nascent it does not yet justify the cost to provide such a federal service. One possible solution would be for an SRO to create a database and require that each platform contribute money to fund its upkeep.

The biggest risk currently plaguing equity crowdfunding is the lack of input from the SEC. The JOBS Act leaves many numbers and informational requirements left to be determined by the Commission who have already missed several deadlines outlined in the Act. This risk alone can single handedly prevent platforms from forming. Without knowing exactly what information is needed or what certain limitations are it is impossible to know exactly how to structure a platform. If someone were to start one anyway they could potentially be violating SEC regulations once decisions are finalized or be forced to restructure their established business. Even when the SEC finally distributes the official figures, the Act includes language that would require the Commission to update those figures every five years. So, every five years a platform would need to consider the new numbers and restructure their services accordingly.

Finally, without knowing requirements it would be difficult for a platform to know how to best charge their customers. Issuers in equity crowdfunding schemes will be very sensitive to compliance costs; these companies are turning to equity crowdfunding because they do not have other places to turn to for capital and, by the nature of the $1 million fundraising limit, will not have much wiggle room even after they raise the funds they seek. To attract issuers to their platform, funding portals will need to charge a reasonable price that takes the costs of JOBS Act's requirements into account. None of this can be achieved until the SEC comes to a decision.

Potential Structure for a U.S.-Based Platform

The passage of the JOBS Act made one thing certain: equity crowdfunding will not exist in the United States unless an intermediary also exists. Even though an intermediary can be either a broker or funding portal, brokers are unlikely to participate in equity crowdfunding. This is because the liability taken on by a broker will probably not be offset by commission fees, a problem compounded by the lack of a secondary market (Cohn). Funding portals are more likely to be the intermediary of choice and will probably take the form of an online website whose primary purpose is to host equity crowdfunding campaigns. A successful funding portal will have to efficiently balance issuer and investor needs, government regulations, risks, and costs.

The first thing a platform will need is campaigns to list on their site. In order to make the campaign onboarding process as easy as possible a website needs to provide a clear, straightforward outline of exactly what information the SEC requires them to disclose. The site should also remind issuers of the liabilities (e.g., material misstatements, restriction from marketing the terms of their campaign) placed on them in the JOBS Act. Managing costs for the issuer and the platform during the disclosure process will be crucial. With this in mind companies should be given a fair amount of autonomy in creating their statements and meeting SEC requirements. This information will need to be sent to the SEC.

One of the most crucial aspects of any campaign will be the funding goal and percentage of company being offered, effectively valuating the company. An issuer should provide their best calculation of this at the start of their campaign, but to best stay true to the "crowd" in crowdfunding a process similar to Dutch auction IPOs could be used. This would allow each investor to "bid" on each campaign by providing how much they would like to invest and what percentage of the company they want for that investment. Campaigns would have a "hard" funding limit, meaning it cannot raise more than the amount initially asked for; however, after the goal is reached investors would be allowed to continue bidding on the company until the campaign's predetermined timeframe (probably around three to six months) concluded. At the end of the campaign the final valuation could be determined by taking a median offer or by the platform evaluating the offers on a campaign-by-campaign basis. Investors who offered the most favorable terms would be offered the equity at the determined company valuation until the funding goal is met. Both investors and issuers would need to be given a set time period to accept or reject the offer.

Another important part of an equity crowdfunding campaign will be the communication between issuer and investors. This communication is meant to, in part, supplement the lack of an underwriter and publicly available information about the company. A funding portal would need to have communication centralized on its platform. This helps avoid multiple crowds, providing all information in one place for investors (Brown). Investors should be encouraged to ask questions and issuers should be encouraged to preemptively distribute additional information.

One way to do this is for issuers to create “webinars,” online video seminars. These would help investors better know the company, its team, and what they do.

A platform can go beyond simply hosting campaigns by offering additional services. Something that would add value to campaigns and the companies involved would be to provide guidance following a successful campaign. This could be achieved by partnering with a small business incubator or venture capital firm, essentially letting those individuals use the platform as a search tool. Hosting a secondary market on the portal could also add value by making crowdfunded securities slightly more liquid. Because funding portals by definition are prohibited from holding, managing, possessing, or otherwise handling investor securities the market would have to be carefully set up. The most likely “secondary market” would take the form of a matching service where individuals looking to sell securities could post what they would be willing to sell their shares for. Deals would probably have to be executed outside of the funding portal.

Aside from campaigns, a portal will also need investors to provide capital to companies. The investor onboarding process, like the process for campaigns, will need to be clear and straightforward. Keeping in mind the investors are likely unsophisticated, definitions of terms and how to calculate certain numbers (e.g., net worth, annual income) would probably need to be provided. In the absence of a centralized government repository, investor information would be best stored and communicated between platforms through the sponsoring of an industry central repository. To ensure investors are who they say they are and are providing accurate information some sort of assurance will need to be done on the part of the platform.

All of the risks involved in equity crowdfunding would need to be explicitly displayed in a manner that forced investors to read them. This could take the form of questions that investors need to answer to affirm they understand the risk. Throughout the entire onboarding process a platform would need to take caution to avoid offering any sort of investment advice or recommendations (e.g., how to read or interpret financial statements, how to valuate a company.)

The fees charged by a funding portal would need to be small enough to entice entrepreneurs to utilize their platform and to encourage investors to commit their time and money to campaigns, but large enough to ensure the platform profits as well. There should only be a fee charged to campaigns should that campaign be successful, especially if the platform only conducts due diligence on successful campaigns. No listing fee up front should encourage companies who already have tight budgets to list on that platform. The rate could adjust depending on the size of the campaign; bigger companies seeking larger funding amounts would presumably require more time and attention by the platform. Because investors are already spending so much in the form of the time they take to conduct their own due diligence no fee should be directly charged to them. If anything, a small sign up fee could be asked that would help cover the cost of assuring each investor is who they say they are, but this could be to the detriment of encouraging investors to join a platform.

Chapter 5

Conclusion

Due to the extreme uncertainty created by the SEC's lack of response to the JOBS Act it is impossible at this point in time to confidently say whether or not equity crowdfunding will be successful in the United States. What is certain, however, is that the passage of the JOBS Act has created serious potential where there was previously no chance. Whether or not equity crowdfunding will take hold entirely depends on whether or not funding portals are able to figure out ways to successfully operate.

Looking at the matter strictly from a business viewpoint one might say that if there is a market for something then there will inevitably be a business to fulfill the market's needs. The limited capital that entrepreneurs can obtain from friends and family compared to the expectations and investment conditions of venture capital firms and angel investors has created a funding gap for small companies – a gap that equity crowdfunding would at least partially fill. Despite the risks and challenges involved with creating and running an equity crowdfunding portal there is an apparent market need waiting to be addressed. With this in mind, it is reasonable to assume that someone will find a way to make it all work and meet this need. Platforms, equity or otherwise, that already exist in and outside the U.S. are in an advantageous position. They already have the infrastructure in place, which should allow them to start up at a lower cost. Now the question becomes who will do it first, how will they do it, and will it be successful?

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