

# Crowdfunding: Debt, Equity and Social Responsibility

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# The notion of crowdfunding

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- In 1885, Joseph Pulitzer funded the completion of the Statue of Liberty's pedestal by soliciting investments from the readership of his New York World newspaper. The American Committee for the Statue of Liberty could not fund the completion of the project, leading a group of average Americans to contribute about \$1 each, raising over \$100,000 to fund the pedestal's completion.
- In return, all contributors were recognized by Pulitzer, who printed their names in an issue of his newspaper.

# Rewards and donations-based versus Equity-based crowdfunding

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- Internet further eased crowdfunding efforts. Rewards-based crowdfunding included raising seed money online for different projects, ranging from theater and arts to technology.
- Mollick (2016) defines reward-based crowdfunding as efforts to fund entrepreneurial projects by drawing on relatively small contributions from a large crowd of amateur investors without standard financial intermediaries.



Project We Love  
Small Batch  
Minneapolis, MN

**\$8,664** pledged of \$10,000 goal; 183 backers; 10 days to go; [Back this project](#)  
All or nothing. This project will only be funded if it reaches its goal by Sunday, June 10, 2018.







Project we Love  
Little Bear and His Chair - Children's Book  
by Claressa Swensen  
\$2,358 pledged  
94% funded  
23 hours to go  
[Children's Books](#)

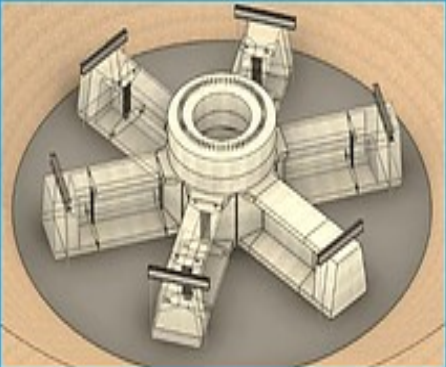
# Securities-based crowdfunding

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- The major differences between rewards-based and securities-based crowdfunding:
  - the use of a professional financial intermediary and
  - the issue of debt or equity instruments to the investor (instead of rewards in a form of products or services)



## The Product



Standard methods in Bridge Engineering applied for first time to Wind Power.  
RUTE has three models sized for varied ground conditions and towers

- Fits the customer workflow
- Manufacturing: 18 beam segments per foundation, 50% concrete and CO2 reduction, less material transport
- Steel tendon kit supplied to Contractor
- Patents: PCT filed in 2016

## Some examples of securities-based crowdfunding

All RUTE Foundations are reclaimable, low material weight, and low cost. RUTE's 30TG design is the outcome of a successful NSF SBIR Phase I structural engineering research. Standard cast-in-place spread foundations have proven reliable, supporting 40,000 turbines nationwide.

Listing Portal: Gridshare LLC; Security type: debt, unit price \$1,000; Target funds: \$100,000; Max offering = \$500,000.  
Progress report is not filed yet.



**Monday Motorbikes** was created by a team of passionate and environmentally conscience motorcycle riders to make getting around the city fun and convenient. By combining old school design with new school technology, Monday Motorbikes provides clean, stylish, and easy to use motorbikes that revolutionize urban transport. The M1 Listing portal: StartEngine Capital, LLC, does not require a license or registration to ride.

Security type: common stock, at \$2 per share;

Total number of shares 25,000;

Max offering amount \$1,000,000;

Target amount \$50,000.

Progress: The amount of securities sold at the close of the offering is 97,556 shares for an amount of

Full Purchase Generation 7 -  
Special Offer  
4,500.00





# Research question

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- This paper investigates the choice between equity and debt instruments that are issued under Securities and Exchange Commission Regulation Crowdfunding.
  - Hypothesis 1: Funding success = function (choice of debt/equity/simple agreement for future equity)
- In addition it offers empirical evidence on how crowdfunding contributes to creation of socially responsible enterprises.
  - Hypothesis 2: Funding success = function (socially responsible mission of a project)



# Legal background and conditions

- Congress passed the JOBS (Jumpstart Our Business Startups) Act in 2012 to make it less expensive for small companies to offer securities. SEC issued its final ruling on May 16, 2016, which amends Section 12(g) of the Securities and Exchange Act of 1934 postulating that the offer and sale of securities must be registered unless it qualifies for an exemption. To qualify for securities-based crowdfunding certain conditions must be met.
- If *either* annual income *or* net worth of a potential crowdfunding investor is less than \$107,000, then during any 12-month period, he can invest up to the greater of either \$2,200 or 5% of the lesser of that annual income or net worth.
- If *both* annual income *and* net worth are equal to or more than \$107,000, then during any 12-month period, you can invest up to 10% of annual income or net worth, whichever is lesser, but not to exceed \$107,000.



# Example of crowdfunding limits

Annual Income	Net Worth	Calculation	12-month Limit
\$30,000	\$105,000	greater of \$2,200 or 5% of \$30,000 (\$1,500)	\$2,200
\$150,000	\$80,000	greater of \$2,200 or 5% of \$80,000 (\$4,000)	\$4,000
\$150,000	\$107,000	10% of \$107,000 (\$10,000)	\$10,700
\$200,000	\$900,000	10% of \$200,000 (\$20,000)	\$20,000
\$1.2 million	\$2 million	10% of \$1.2 million (\$120,000), subject to cap	\$107,000



# Tiered financial disclosure of an issuer

The minimum level of financial disclosure required by the SEC depends on the amount of money being raised or raised by the company in the prior 12 months:

- \$107,000 or less – financial statements and specific line items from income tax returns, both of which are certified by the principal executive officer of the company.
- \$107,000.01 to \$535,000 – financial statements *reviewed* by an independent public accountant and the accountant's review report.
- \$535,000.01 to \$1.07 million – *if* first time crowdfunding, *then* financial statements *reviewed* by an independent public accountant and the accountant's review report, *otherwise* financial statements *audited* by an independent public accountant and the accountant's audit report.



# Types of issuers and securities issued under regulation Crowdfunding

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- According to SEC's Division of Economic and Risk Analysis, the median issuer under Regulation Crowdfunding was incorporated within the last two years and had only three employees, no revenues and around \$5,000 in cash and \$10,000 in debt on its balance sheet. About 60 percent of crowdfunding issuers showed no revenues and 91 percent had yet to earn a profit.
- When the SEC analysts looked at the types of securities that Regulation Crowdfunding issuers chose to offer to prospective investors, they found that common and preferred equity were most frequently offered, accounting for more than a third of the offerings.
- The next most commonly offered security, accounting for just over a quarter of the offerings, was the SAFE.



# Simple Agreement for Future Equity (SAFE)

- A type of deferred equity contract, SAFEs entitle investors to receive a company's equity securities upon certain triggering events. For example, a SAFE may be triggered if the company is acquired by or merged with another company. Other triggers may be an IPO of securities by the company or another round of financing involving equity securities.
- Not all SAFEs are the same. The very important terms governing when investor may get the future equity may vary across the SAFEs being offered in different crowdfunding offerings. Despite its name, a SAFE may not be "simple" or "safe." SEC is concerned about 'so-called SAFE' securities in crowdfunding.
- Unlike their close cousins, convertible notes, SAFEs do not accrue interest while outstanding and have no maturity date. The percentage of the company's equity a SAFE investor may eventually receive upon a subsequent financing is a function of the amount invested and the valuation of the company that is negotiated by the investor. Conversion of the SAFE into equity depends upon that future financing actually coming to fruition.

*Source: SEC Investor Bulletin: Be Cautious of SAFEs in Crowdfunding, **May 9, 2017***



# Convertible notes

- Convertible notes are another type of security that has been offered in crowdfunding opportunities. Account for roughly a third of current issues.
- Convertible notes are essentially debt obligations in which the investor agrees to loan money to the company. In exchange, investor receives a promise of repayment, interest on the loan for a period of time and an ability to convert the outstanding amount into equity of the company at some triggering event.
- Different from SAFEs, convertible notes generally represent a current legal obligation by the company to the investor for the outstanding amount of the note.



# Prior literature: Geographical constraints on fundraising

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- Agarwal, Catalini and Goldfarb (2011) find that crowdfunding relaxes geographical constraints on fundraising that are typical for venture capital. Local funders differ from distant funders in their responsiveness to the investment decisions of others because proximity enables social ties.
- Ivanov and Knyazeva (2017) find some evidence of geographic matching, with issuer characteristics and local availability of listing platforms affecting distance between issuers and platforms.



# Information cascades

- Ivanov and Knyazeva (2017) in their SEC working paper examine how soft and hard information flows and certification of issuer by third parties impacts crowdfunding success. They find that independent auditor and CPA certification of financial statements as well as issuer social media following are positively related to the valuation obtained by issuer.
- Vismara (2016) using data from 2014 UK Crowdcube offerings finds that success of crowdfunding campaigns is predicated upon information cascades: public profile investors increase the appeal of the offer by linking their profile to social networks. Early stages of campaign are important for success: high number of contributors in early stages benefit funding amounts.
- Mohammadi and Shafi (2017) find that female investors are more risk-averse and less likely to invest in young, high-tech startups, yet more likely to invest in projects with a higher proportion of male investors.
- Lei, Yayla and Kahai (2017) provide evidence that social information gathered from reference groups decrease two types of uncertainties: seller opportunism and seller competence.



# Data and variables

Success index (dependent variable)	<u>Funds raised through Reg CF</u> Funds targeted through offering
Independent variables:	
Product	Indicator=1 if issuer develops a product, =0 if it sells a service
Socially responsible business	Indicator=1 if issuer is using green energy, organic and environmental friendly techniques, promotes community development.
Financing	Indicator=1 if crowd funders receive compensation in a form of equity, future revenue, SAFE or profit-share; = 0 if crowd funders receive compensation in a form of debt.
Organizational form of a company	=1 if the initiative is structured as a company; = 0 if it is an individual entrepreneur.
Gender of CEO	1 = female, 0 = male
Prior regulation D listing	1 = yes, 0 = no
<b>Prior rewards-based crowdfunding campaign</b>	<b>1 = yes, 0 = no</b>