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Additionally, FDIC Call Report data shows that the availability of small loans has steadily decreased as a proportion of the total amount of nonfarm, nonresidential commercial loans by loan balance (Figure 2). As a result, the small loans (often less than $1 million) that startups and small businesses often desire are more difficult to attain.

Equity-based crowdfunding could create an efficient alternative for small businesses and microbusinesses which are unable to attain their desired level of credit in an environment where the amount of small business loans being made available is shrinking. Although the future is impossible to predict, research into potential small business outcomes of equity-based crowdfunding is warranted.

In order to further understand the impacts of the proposed SEC rules and how equity-based crowdfunding may affect entrepreneurs, investors, and the economy, this brief will review current policy, equity-based crowdfunding issues, and two distinct case studies of equity-based crowdfunding platforms.

The Policy: The JOBS Act (2012)

On April 5, 2012, President Barack Obama signed the Jumpstart Our Business Startups (JOBS) Act which encourages investing in small businesses by revising previous securities regulations that fall under the Securities Act of 1933 and the Securities Exchange Act of 1934. The act requires intermediaries to register with the SEC as a broker or funding portal, establish rules against fraud, determine rules for investment limits, and protect the privacy of information collected from investors. It requires issuers, or the firms offering equity, to file with the SEC and provide investors and the broker/funding portal with a variety of information about their respective firms, such as physical address, financial condition of the issuer, and the intended purpose of the funds.

More specifically, the JOBS Act “amends Section 4 of the Securities Act to exempt issuers from requirements of Section 5 of that Act when they offer and sell up to $1 million in securities, provided that individual

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investments do not exceed certain thresholds and the issuer satisfies other conditions in the JOBS Act.” Some of these conditions are still being set by the SEC’s rulemaking process, including parameters for equity-based crowdfunding.

An important piece of the legislation targets funding portals, or online crowdfunding platforms (i.e. Kickstarter, Indiegogo, Patreon, etc.). The JOBS Act exempts these crowdfunding platforms from having to register with the SEC as a traditional broker. However, the platform would need to register with the SEC as a funding portal and would be subject to the SEC’s investigation, enforcement, and rulemaking authority. Funding portals are not permitted to:

- provide investment advice or make recommendations;
- solicit purchases, sales, or offers to buy securities offered or displayed on their respective funding portal;
- pay employees, agents, or other persons for solicitation or based on the sale of securities displayed or reference on its respective website;
- hold, manage, or possess investor funds or securities;
- compensate promoters, finders, or lead generators for providing the funding portal with the personal information of investors; or
- allow its directors, officers, or partners to have a financial interest in any issuer of equity that is using the funding portal.9

Lastly, funding portals are required to become a member of a national securities association that is registered under Section 15A of the Securities Exchange Act.10

**State of the Proposed Rule for Crowdfunding**

The SEC released the notice of proposed rulemaking for Title III of the JOBS Act on November 5, 2013.11 The proposal requested comments on title definitions, investment limits, how income and net worth are calculated for individuals, intermediaries, and many other topics. The comment period closed February 3, 2014 after receiving nearly 500 comments from individuals and organizations.12 The SEC has not finalized the equity-based crowdfunding rule yet, but has set a tentative date of October 2015 to take final action.13 This will provide prospective platforms, investors, and small business entrepreneurs with the assurances they need to go forward in planning for a future with equity-based crowdfunding.

**Possible Small Business Impacts of Equity-based Crowdfunding**

Equity-based crowdfunding could be preferable to traditional methods of debt-based funding for a few important reasons. Equity-based crowdfunding does not require collateral to receive funds, such as a typical bank loan would. It also does not increase one’s chances of experiencing bankruptcy because nothing is initially owed. Instead, payback is ongoing as a share of future revenues.

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12. List of comments can be found via the SEC’s website: [http://www.sec.gov/comments/s7-09-13/s70913.shtml](http://www.sec.gov/comments/s7-09-13/s70913.shtml).
Another benefit of equity crowdfunding is that investments do not need to be repaid if the business fails unlike debt-based funding where bankruptcy may have to be declared in the case of a failed business venture. This may create what economists describe as a “moral hazard” where business owners may be willing to take on too much risk because there will be no threat of bankruptcy. However, taking on additional risks may also allow small business owners to find new ways to innovate their respective products or business models. How this plays out will be determined on a firm-to-firm basis.

In comparison to traditional venture capital (VC) funding, equity-based crowdfunding may be preferable to small businesses because it would allow creators more control over their businesses. Traditional VC funding often allows the venture capitalist to take a board position or advisory role with an active say in the proceedings of the firm whereas equity-based crowdfunding could follow the model of the platform Crowdcube. This platform breaks from the norm of equity-based funding because it offers the option of making investors “B shareholders,” meaning investors do not have a vote in future business decisions. This allows entrepreneurs to maintain majority control of the decision-making processes for their firms.

By having a large group of investors, equity becomes diluted amongst many investors. This may be a preferable option for entrepreneurs who fear an investor or small group of investors may have an outsized impact on the direction of their firm. However, this may not be a guarantee, as funders with heavy investments of capital may demand more of a decision-making stake in the business via voting shares of the firm.

Investor networks can also help businesses create a sense of credibility. Having a team of investors is a signal that the product and/or business strategy could be viable. The larger the number of investors the more likely there is to be herding behavior, or “everyone doing what everyone else is doing, even when their private information suggests doing something quite different.” This means that a cascading effect of funding occurs where the number of investors begets more investors. Investor networks can also provide firm founders with potential connections to other investors thus spurring on the venture capital cycle.

Another interesting aspect of crowdfunding is its innate ability to disburse participation opportunities to various geographic locations. This creates visibility for small firms that may have traditionally been limited by their location. As an example, a previous study showed that the majority of investments were from individuals 3,000 miles away as opposed to traditional venture capital which tends to be within 70 miles of their investment. This means that visibility could create funding from diverse geographic regions, thus increasing the potential investor network for small businesses beyond assumed regional limitations.

As investment grows and interest from investors becomes clear, the possibility for larger investors to provide funding may increase. This could be an effective method for small businesses to break through capital constraints, especially for small businesses in geographic regions where traditional venture capital biases may result in limited investment.

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How Equity-based Crowdfunding May Function: Case Studies of Sellaband and Crowdcube

Once the SEC has released its final rulemaking on crowdfunding, equity-based crowdfunding may have less restrictive boundaries in which to operate. Currently under Section 302 of Title III of the JOBS Act, potential investors have a limited ability to invest in businesses that utilize equity-based crowdfunding:

“(i) the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000.”

The certainty provided by an SEC final rulemaking should quell some of the concerns of prospective equity-based crowdfunding platform creators as well as potential investors. However, the current lack of a functioning model leaves many entrepreneurs guessing as to what equity-based crowdfunding could look like. Reward-based crowdfunding can provide a glimpse, admittedly incomplete, into potential bumps in the road that equity-based crowdfunding could face. It may be insightful to consider current equity-based crowdfunding platforms that exist in countries such as England and Germany which have equity-based crowdfunding regulations in place.

One example is Sellaband, a crowdfunding platform designed as an alternative to traditional financing for the music industry. Sellaband, based in Germany, is a unique case study because it provides a mixture of rewards and equity for funders. To date, Sellaband has raised over $4 million for independent bands.

A second example is Crowdcube, based in England, which focuses strictly on monetary gains via equity, venture funding, and mini-bonds. As of January 2015, Crowdcube has raised $120.2 million and funded $82.6 million worth of businesses.

**Sellaband**

Sellaband has created a form of revenue sharing between the project creator (musical artist), platform provider (Sellaband), and investors (individuals pledging money to a project). This avenue is optional for creators as they can also just provide investors with tangible goods such as an album, merchandise, or autographs, but many artists do offer revenue sharing. Artists are able to set a threshold for a minimum amount of “parts,” or shares, before investors receive a percentage of revenue once the project is complete. Investors will receive a share of revenue that is proportional to the amount of “parts” they have purchased after they meet the minimum parts-owned threshold.

However, some artists decide to allocate parts to investors without a minimum threshold of investment. This creates a unique two-tier system for some projects where some investors receive revenues and tangible goods while others who invest at a lower amount just receive tangible goods. Investors do not receive revenues in perpetuity but instead for the duration of a single tour or five years after the record’s release date depending on the project submitted for investment. This differs from the traditional model of equity where shareholders maintain their shares until they decide to sell them to other prospective shareholders. Sellaband participants experience transactions costs for administration, fraud check, and a fixed fee for his/her bank or credit card company.

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Sellaband reduces transactions cost relative to the amount of funds an investor dedicates to an artist.\textsuperscript{26}

Sellaband’s role in the revenue sharing is to provide the platform and track investments in a project. They are entitled to 15 percent of the budget in exchange for advising the project creator, helping with the execution of the project’s budget, and handling all the financial and administration issues. Investors receive their revenues at the end of each quarter after Sellaband has properly divided the shares amongst investors and artists as well as taken its 15 percent cut of the budget. Sellaband offers to give investors real money via PayPal transfers, maintain the earned funds with the option for investors to use them on other artists (acting as a sort of wallet), or buy various things on the website.\textsuperscript{27}

This illustrates one basic concept of how an equity-based crowdfunding model could function. Equity-based crowdfunding may operate much like the stock market where pieces of firm ownership can be purchased in exchange for funding. The period for these shares could be time-limited, such as Sellaband’s five-year limit on record revenues, or could exist in perpetuity, much as real shares do, until an exit occurs. Unlike funding musicians or bands, businesses would most likely require a system for exits in order to divest the revenues properly. If a business that has a multitude of investors was purchased by another firm, then how revenues are distributed would be paramount to ensuring that investors receive the proper returns. The same process must occur if the business opts for an initial public offering, which also merits an exit strategy for investors.

Sellaband is not a typical model because the reward-only funding option may not exist in conjunction with the equity-based investment option. Sellaband’s model is unique in this fashion whereas Crowdcube more closely resembles traditional equity.

\textbf{Crowdcube}

Crowdcube allows users to invest in startups in three ways: via equity, a venture fund, or a mini-bond. Startups are spread throughout a variety of industries, ranging from Internet and technology to manufacturing and education (Figure 3).

The equity option allows individuals 18 years of age or older who are residents of the United Kingdom, or any other country with a similar related legal structure, to invest in a variety of firms without the supervision of a professional.\textsuperscript{28} The minimum amount required to invest is £10. Similar to Kickstarter, Crowdcube uses an all-or-nothing approach to funding where if a project is not 100 percent funded, the funding will be returned to investors without penalty. Upon registration with Crowdcube, users must categorize themselves as investors and complete a brief questionnaire to assure they understand the risk of investing in startups and early-stage businesses. If the user states they have received independent advice on these risks then they are able to forego the quiz.\textsuperscript{29}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{crowdcube_categories.png}
\caption{Crowdcube Businesses by Category}
\end{figure}

\textsuperscript{26} Id.
\textsuperscript{27} Id.
\textsuperscript{28} To learn about the legal framework in the United Kingdom, see \url{https://www.gov.uk/seed-enterprise-investment-scheme-background}.
Companies at various growth stages that list their firms on Crowdcube (Figure 4) are able to offer investors ordinary shares and B investment shares. Ordinary shares give investors preemption, defined as “potential buyer’s contractual right to have the first opportunity to buy, at a specified price, if the seller chooses to sell within the contractual period,” and voting rights. B investment shareholders are usually not given preemption or voting rights. The firm is allowed to set a threshold for investment before ordinary shares are awarded. Once a firm’s pitch hits its funding target, Crowdcube will complete the legal paperwork, including the “Articles of Association” that form the foundation of the business’s constitution. Crowdcube also runs an anti-money laundering check on investors (which is not the same as a credit check). After seven days, Crowdcube will withdraw funds from the investor’s account and will transfer them to the receiving company. This assures that all transactions within Crowdcube are legal.

A distinctive aspect of Crowdcube is that it allows investors to propose an alternative offer to firm owners. This tool enables potential investors to signal they want to make an investment but that they believe the firm owners’ valuation of their business is inaccurate. The prospective investor then proposes his or her opinion of what the business is worth and the amount he or she is willing to invest (an increase from the minimum £10 investment to a required £2,500 minimum investment is required to use this tool). Crowdcube then recalculates how much equity must then be offered to raise the funds needed and what the investor’s share would be. This creates a collaborative environment where investors and firm owners can negotiate share prices and may allow both parties to garner better information from one another, thus reducing risk. This may be the most interesting facet of the Crowdcube model.

The venture fund option lets investors give their money to a professional fund manager. Crowdcube has partnered with Strathay Ventures, an investment firm specializing in startup and early growth businesses, which will build a portfolio for the individual investor in exchange for a 20 percent portion of profits after a 7 percent rate of return is reached. The minimum investment for this option is substantially higher than the previous option and requires at least £2,500.

The fund manager provides research on the business before the investment. After an investment is made, the fund manager interacts directly with the business and performs annual portfolio valuations for the investor. Managers also negotiate the best available price for investors, cash collection, and cash distribution upon the exit of the business. Managers only make investments if companies are able to raise 33 percent of their desired capital through Crowdcube. If tangible rewards are offered by the firms, the investors will still receive them when using a fund manager. All funds also belong to the investor. Managers tend to create a wide portfolio, usually up to 10 firms, unlike individual investors who tend to invest in just one firm (Figure 5).

When investors using fund managers wish to withdraw their funds, they must provide three months of advanced notice. In regards to voting rights, or ordinary shares, fund managers will abstain or exercise those rights depending on the scenario. This creates another layer of distance between the investor and in what he or

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33. Id.
she is investing. The fund manager option might not be considered under Title III of the JOBS Act, but it could provide a more familiar and comfortable investing option for people that tend to already invest using wealth managers.

Crowdcube’s third option, mini-bonds, are targeted toward institutional investors and allow longer-term investments, averaging four to five years. Investors in mini-bonds lend money to more well-known brands over a set time period in return for interest repayments. This allows investors to earn a regular fixed income of 6 to 8 percent interest per annum. Investors also receive their initial investments as a lump-sum repayment at the end of the investment term.

These three options allow Crowdcube users to select the type of investment they want to make and how much of their money and time they would like to invest.

**Conclusion**

Currently, a gap exists between small businesses’ desired capital and the capital being made available to them. Although the SEC has not yet finalized the rule which would fully permit equity-based crowdfunding, there is already a promising future for this funding model. By looking at current examples, such as Sellaband and Crowdcube, it is possible to begin to construct hypotheses of how platforms may operate in the United States.

Following the examples of these two platforms, it is reasonable to assume that ensuring legality, preventing fraud, and protecting investors as well as business owners will be points of emphasis in the SEC’s final rule-making on equity-based crowdfunding. It could prove to be a beneficial new way for small businesses to buy new equipment, hire employees, or purchase real estate amongst many other possibilities. This new avenue of funding could ultimately shift the way prospective business owners decide to start their firms. It could also provide a new growth option for small businesses that are ready to begin growing, but lack the capital to do so. In essence, equity-based crowdfunding could provide the crucial stream of funding for small business owners and entrepreneurs that is highly sought after.

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