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Crowdfrauding: Avoiding Ponzi entrepreneurs when investing in new ventures

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Abstract Crowdfunding has gained substantial interest in the U.S., allowing entrepreneurs to raise startup capital in exchange for equity in their ventures. This approach to equity capital can open up new sources of venture finance to legitimate entrepreneurs, but little attention has been given to how it offers new opportunities for illegal entrepreneurs to defraud investors. We adopt a forensic approach to examine entrepreneurs who launch Ponzi ventures—businesses that continually bring in new investors in order to use their money to pay returns to earlier investors—to demonstrate the ease, creativity, and audacity with which these illegal entrepreneurs operate. The provided examples of Ponzi entrepreneurs show how easily they can circumvent the safeguards purported to protect investors: screening by 'the crowd,' transparency and documentation requirements, independent audit reports, and withholding of funds until the venture's financial goal has been met. In this article, we offer possible solutions to help protect investors, legitimate entrepreneurs, and business in general from the damage created by illegal entrepreneurs.

If history teaches us anything, the lesson is that social media technologies increase rather than decrease the potential for fraud.
— Thomas Lee Hazen (2012, p. 1769)

1. New assumptions about entrepreneurs and crowdfunding

Policymakers, government officials, scholars, and much of the media emphasize entrepreneurship as a powerful, positive influence in society because of its role in job creation and innovation (Steyaert & Katz, 2004). This reflects the commonly held assumption that "entrepreneurship should be encouraged because of universal positive effects on employment, wealth creation, and innovation" (Desai, Acs, &

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Weitzel, 2013, p. 21). However, alternative assumptions underlie the arguments presented here. First, entrepreneurship can, at times, represent a negative and destructive, or wealth destroying, force in society (Desai et al., 2013). Some entrepreneurs pursue their own self-interest to an extreme, ignoring their "accountability *to the Other*" (Shearer, 2002, p. 560) or to the broader society. This alternative assumption likely explains why entrepreneurship is sometimes viewed negatively or with suspicion, depicted as "a low-trust form of capitalism, based on a selfish, individualistic and competitive concept of the entrepreneur" (Buckley & Casson, 2001, p. 303).

A second assumption recognizes that entrepreneurs vary widely in terms of how they apply their entrepreneurial talents and how they use the investment and revenues of their ventures (Desai et al., 2013). Ponzi entrepreneurs convince individuals to invest with them and then use the money from later investors to pay returns to early investors (Valentine, 1998); as long as Ponzi entrepreneurs keep bringing in new investors, they can keep the scheme going. This type of illegal entrepreneur often exhibits remarkable creativity and knowledge of business in forming their strategies and business ventures as well as in developing and using social networks, resources, and knowledge; yet they direct their talents toward amassing financial assets, diverting the venture's funds for their personal use, and deceiving large numbers of investors. Ponzi schemes represent entrepreneurial activity, but they clearly do not add value to society. Many investors have lost their life savings, their retirement funds, and their homes when they mistakenly believed they were investing with a legal and ethical entrepreneur who was pursuing wealth creation for the benefit of others as well as for him/herself.

These alternative assumptions do not represent an extreme or anti-entrepreneurship perspective; instead, they lay the foundation for a forensic approach that enables us to better understand and prevent illegal entrepreneurship. The foundation of business and economic activity is trust. Therefore, as business people we have a responsibility to understand how illegal entrepreneurs (i.e., those operating Ponzi ventures) operate so that we can establish effective safeguards to protect business and society from their activities. A *Ponzi venture* is a type of financial fraud in which an entrepreneur continually brings in new investors in order to use their money to pay returns to early investors versus generating profits from the business to pay returns to all investors. Ponzi ventures differ from pyramid schemes in that entrepreneurs operating Ponzi schemes typically expend little of investors' money producing a viable product or service. Furthermore, a Ponzi scheme will always collapse mathematically when the amount of money needed to pay returns to existing investors far outstrips what the entrepreneur can bring in from new investors.

Ponzi entrepreneurs have received more attention in the media in the past few years due to many of their ventures collapsing in the U.S. financial crisis and global economic downturn. In 2008—2013, there were over 500 Ponzi schemes totaling more than $50 billion (Maglich, 2014). These numbers don't include the hundreds of Ponzi schemes that each amassed less than $1 million. The Securities and Exchange Commission (SEC) and other financial and law enforcement agencies are already unable to adequately monitor, investigate, and prosecute Ponzi entrepreneurs, and equity crowdfunding will most certainly make this problem worse simply due to the sheer number of additional funding opportunities.

Crowdfunding—getting large numbers of individuals to each invest small amounts of money—has seen tremendous growth in recent years. Entrepreneurs around the world raised $16.2 billion in 2014, up from $6.1 billion in 2013 (Massolution, 2015). By December 2012, nearly 8,800 domains had been established with crowdfunding in their name; 6,800 were registered after the Jumpstart Our Business Startups (JOBS) Act (Mandelbaum, 2014). In 2012, the JOBS Act made equity crowdfunding legal in the United States. Previously, entrepreneurs could only crowdfund by either providing free products/rewards in exchange for invested funds (reward-based crowdfunding) or by accepting donations (donation-based crowdfunding), wherein providing anything to the investor was not obligatory (Spring, 2013; Stemler, 2013). Reward- and donation-based crowdfunding present few regulatory issues and offer clear benefits to fund providers. However, equity-based crowdfunding requires more regulation because it involves the sale of a security to non-accredited investors (Harrison, 2013).

Equity crowdfunding is viewed as essential in the United States to provide financing for startups in the 'Valley of Death,' or mid-range of $200,000—$2,000,000 (Spring, 2013): Entrepreneurs needing less than that amount can rely on friends, family, and fools while ventures requiring more than $2 million often draw the attention of angel investors and venture capitalists. The JOBS Act allows startup entrepreneurs with emerging growth companies to offer equity in exchange for financing raised through crowdfunding portals (Stocker & Avan, 2012). Raising capital is difficult, and equity-based crowdfunding offers entrepreneurs an alternative way to acquire necessary financing for their ventures. In addition to raising equity capital, crowdfunding helps entrepreneurs demonstrate demand for a