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Feature article

# Success factors in Title III equity crowdfunding in the United States

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ABSTRACT

The financial industry is seeing rapid introduction of new technologies and new business models that are challenging established practices. Recent changes in financial regulation in the United States have spurred evolution of equity crowdfunding as a potential alternative to traditional sources of venture capital. To address the relative lack of knowledge about success factors, we focus on Title III equity crowdfunding platforms in the United States that are open to non-accredited investors. We draw on traditional venture finance research and we examine the effects of market, execution and agency risks in equity crowdfunding under Title III. We collect data on 133 ventures that attracted more than $11 million in funding commitments across sixteen Title III equity crowdfunding platforms. We find that all three types of risks can affect the likelihood of successful fundraising under Title III. We discuss the implications of these findings for entrepreneurs, investors, crowdfunding platforms and policy makers.



## 1. introduction

Continuous evolution of technology provides innovation opportunities across different sectors of the economy (Kauffman et al., 2017). The finance industry has often been at the forefront of introducing new technologies to reduce friction in commercial transactions and generate new business opportunities. For example, introduction of cashless payment methods in developing economies has been shown to promote the volume of transactions (Runnemark et al., 2015). The Internet has become an effective platform to support innovation in different types of traditional banking activities. For example, Internet-mediated peer-to-peer lending has rapidly grown into a multibillion dollar industry globally (Chen et al., 2016) and Internet-based cryptocurrencies are promising to offer a decentralized alternative to traditional value store systems (Alabi, 2017). In this study, we focus on the innovation in entrepreneurial venture fundraising in the United States. More specifically, we examine the success factors associated with venture fundraising via equity crowdfunding under Title III of the JOBS Act in the United States.

*Equity crowdfunding* refers to the process of raising funds for entrepreneurial ventures, typically via Internet-based platforms, whereby investors receive equity in exchange for capital (SEC, 2016). Equity crowdfunding is distinct from reward-based crowdfunding. In reward-based crowdfunding, project backers provide funds to early stage entrepreneurial projects, typically in exchange for a discount on the planned product, but receive no equity in the project. For example, Oculus Rift raised over $2.4 million on Kickstarter (Gleasure and Feller, 2016), a reward-based crowdfunding platform, through pre-orders for the virtual reality headset, but the individual backers received no equity in the company and they did not benefit from the $2.3 billion acquisition of the company by Facebook (Constine, 2014).

Equity crowdfunding was explicitly prohibited in the United States prior to the passage of the JOBS Act in 2012 (SEC, 2015a). The JOBS Act sought to make it easier for entrepreneurs to raise funding and it contains several provisions. Title II of the JOBS Act became effective in 2013 and it relaxed the rules concerning public investment solicitation from accredited investors (SEC, 2015b). Accredited investors are individuals who either have income exceeding $200,000 per year or have at least $1 million in assets, excluding the primary residence (SEC, 2013). Preliminary research on Title II equity crowdfunding shows that over $1.26 billion have been committed by accredited investors to Title II projects (Mamonov et al., 2017), however, much less is known about Title III.

Title III of the JOBS Act expanded permissible equity crowdfunding to include the general public (Ivanov and Knyazeva, 2017). Title III allows companies to raise up to $1 million from accredited and non-accredited investors over a 12-month period. It allows individual non-accredited investors to commit up to $2,000 a year to equity crowdfunded projects if the person's income is less than $100,000 a year and up to $10,000 if the person's income is above $100,000 (Ivanov and Knyazeva, 2017).

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Investor participation in early-stage venture financing exposes the investors to many risks (Siegel, 2013). Concerns about individual non-accredited investor protections delayed the implementation of Title III provisions until May 2016 (Ivanov and Knyazeva, 2017). A theoretical evaluation of Title III legislation suggested that Title III would likely fail due to information asymmetry and adverse selection problems (Catalini et al., 2016), yet little is known about the actual state of affairs across Title III equity crowdfunding platforms. This is the research gap that we begin to address in the present study.

Title III equity crowdfunding is open to both accredited and non-accredited investors. Prior research on crowdfunding has shown that less experienced investors often follow the lead of more experienced professional investors (Kim and Viswanathan, 2014). We draw on prior research on factors that are commonly considered by accredited investors in potential offline investment opportunity evaluation (Carpentier and Suret, 2015) and we examine the effects of market, execution and agency risks on venture fundraising success in Title III equity crowdfunding. We analyze 133 projects across sixteen Title III equity crowdfunding platforms that sought to raise funding in the period between May 2016 and February 2017. In addition to providing empirical evidence that entrepreneurial ventures can be successful in raising funds under Title III, our results reveal that all three types of risks can affect the success of fundraising in Title III platforms.

The remainder of the manuscript is structured as follows. First, we provide an overview of prior research on equity crowdfunding. Next, we draw on research in risk capital investments and we develop the research framework in our study. We then describe the data and our analytical methodology, and we present the results. We conclude with a discussion of emergent insights and implications of our findings for entrepreneurs, investors, crowdfunding platforms and policy makers.

## 2. Equity crowdfunding literature review

*Equity crowdfunding* is distinct from other types of crowdfunding that exist, in that it allows backers to receive an equity stake in the company. Generally, four types of crowdfunding are recognized: *reward-based*, *equity-based*, *loan-based*, and *donation-based*. Reward-based crowdfunding allows entrepreneurs to raise funding by enabling project backers to pre-order a product or service that is being developed (Kim et al., 2017). Reward-based crowdfunding has always been legal in the United States. Joseph Pulitzer, the publisher of *New York World*, led a crowdfunding campaign to build the pedestal for the Statue of Liberty, and successfully raised funding from 160,000 contributors in 1885 (National Park Service, 2016). Because the campaign initiated by Joseph Pulitzer offered tangible rewards to the participants – the Statue of Liberty would be available for viewing and the top contributions were incentivized by the inclusion of the contributors' names on the memorial plaque on the pedestal, this campaign is generally discussed as an early example of reward-based crowdfunding.

IndieGogo and KickStarter were among the first platforms to leverage the Internet to expand the reach of reward-based crowdfunding, and they have brokered over $3 billion in funding commitments since launch (KickStarter, 2017). There is an active stream of research exploring factors that affect the success of projects hosted on the reward-based platforms (Kim et al., 2017; Mollick, 2014; Mollick and Nanda, 2016; Ryu and Kim, 2016). However, these studies do not necessarily yield useful insights for equity-based crowdfunding, because investor motivations for participation in equity-based crowdfunding platforms are very different from backers in reward-based crowdfunding (Belleflamme et al., 2014). Equity investors are typically motivated by the expected gains in the value of their investments, as opposed to receiving a product or service from a reward-based project.

*Loan-based lending*, also known as *peer-to-peer* (P2P) *lending* is the third type of crowdfunding (Zhang and Chen, 2017). Platforms that facilitate P2P lending, such as LendingClub, typically perform credit risk assessment on the requests for unsecured personal loans and they connect borrowers with potential lenders (Chen et al., 2016). The key difference between loan-based and equity-based crowdfunding is the risk/reward profile of the participating investors. P2P lending typically involves relatively short-term loans (6–36 months), with a clearly defined interest rate that is set at the time of loan origination. Equity-based crowdfunding exposes the investors to much greater uncertainty in terms of both the time horizon for realizing a return on the investment, as well the likelihood of earning a financial return. Research on early-stage venture investments suggests that it commonly takes 5–8 years for the investors in early-stage entrepreneurial ventures to achieve liquidity and more than half of the investments in early-stage ventures result in a loss of the invested capital (Mason and Harrison, 2008).

Whereas the participation in equity, rewards, and loan-based crowdfunding is typically motivated by self-interest (Belleflamme et al., 2014), there are also crowdfunding platforms, such as Kiva.org, that facilitate philanthropic activities. Donors on the Kiva platform provide funds to support entrepreneurs in developing countries. This activity is primarily altruistic – the donors have no financial incentives to participate on the platform (Gleasure and Feller, 2016). Table 1 summarizes the key differences between different types of crowdfunding.

While equity crowdfunding is a relatively recent phenomenon in the United States, a number of other countries have had a head start. Equity crowdfunding has always been legal in Australia and the Australian Small Scale Offering Board (ASSOB) has helped entrepreneurs raise over $146 million since its launch in 2005 (ASSOB, 2017). Ahlers et al. (2015) examined factors that influence equity crowdfunding success on ASSOB. The authors found that provision of financial projections by the entrepreneurs and a greater share of equity being retained by the entrepreneurs were positively associated with crowdfunding success.

Equity crowdfunding regulation has advanced rapidly in Europe and each country in the European Union has at least one equity crowdfunding platform (CrowdfundingHub, 2016). Several studies have explored factors that can affect the success of equity crowdfunding on the European platforms. Lukkarinen et al. (2016) examined an equity crowdfunding platform in Finland and found that the size of the entrepreneurs' social networks had a positive effect on the likelihood of successful fundraising, while the minimum investment amount required from each potential investor had a negative effect on the likelihood of success. Vismara (2016a, 2016b) explored success factors on Crowdcube, an equity crowdfunding platform based in the United Kingdom, and found that social connections, equity retention and engagement of professional investors were positively associated with successful campaigns. Professional investor involvement was also identified as an important factor by Ralcheva and Roosenboom (2016) who also studied Crowdcube.

Focusing on equity crowdfunding in the United States, Agrawal et al. (2013) presented a theoretical analysis highlighting the potential for the crowdfunding platforms to amplify information asymmetries that commonly exist in early-stage ventures. Entrepreneurs typically know more about the prospects of a business venture than the potential investors and the information asymmetry presents a challenge in the evaluation of investment opportunities. However, in a subsequent study, the authors found that angel investors often pool their resources and form syndicates, wherein a well-known investor takes the lead role in performing the due