Congressional Testimony

United States House of Representatives

Committee on Small Business

Subcommittee on Investigations, Oversight and Regulations

For the Hearing: "SEC's Crowdfunding Proposal: Will it work for small business?"

Jan 16, 2014

Chairman Schweikert, Ranking Member Clarke and members of the committee, thank you very much for the opportunity to discuss the function that crowdfunding serve in delivering much needed capital to address the funding crisis for small businesses in the United States. I come here today not as a lawyer or government official, but as an entrepreneur who has had my share of both success and failure in starting and building businesses. In addition to sharing that real world perspective, I would like to introduce some new data from the UK and US markets that should shed some light on the magnitude of what is taking place outside the US in crowdfunding to ignite significant opportunities for small businesses to get funding, and the very real risk we run if we overburden issuers, platforms and investors with overly complex regulations. There are still many opportunities to strengthen and improve these draft rules and an opportunity to use new technologies and services to enable better oversight than has ever been available before; but it is up to the SEC to continue working with the public and industry as it finalizes its rules and Congress to determine what are the best actions to accelerate economic growth and create jobs in the United States.

I'd like to begin by thanking the members of this committee and both parties within the House at large, for their bipartisan and overwhelming support for crowdfunding. It was a wonderful example of the ability for both parties to work together in support of small businesses and entrepreneurs, which we all know are America's economic engine. When entrepreneurs have access to capital to grow their organizations, it translates into new American jobs, economic renewal for cities and towns across this county through hard work and American innovation.

As a co-author of the Startup Exemption Framework, the initial proposal for securities-based crowdfunding, and a close collaborator with Rep. Patrick McHenry and Senators Merkley, Bennett and Brown on the passage of the JOBS Act, I was thrilled when Title II draft rules became final and available for use and more recently when the SEC issued Title III draft rules for Regulation Crowdfunding. I want to take a moment in my testimony to give my sincere thanks to Chair White, the Commissioners, Lona Nallengara, David Blass and the rest of the staff that worked on Titles II, III, for their willingness to engage in a robust conversation with the industry while they were drafting their initial rules. While the rule making process did not occur as quickly as I personally may have liked, I want this committee to know that senior staff at the SEC met with myself and other industry leaders over a dozen times, were receptive to our public comments, and were responsive to our information and clarification requests during their rule making process. We hope that the engagement of the industry trade group that I co-founded, Crowdfunding Regulatory Intermediate Advocates (CFIRA), was able to demonstrate that the crowdfunding industry is very focused on creating a stable, orderly market. The industry will only succeed if it can grow and succeed over the long term, and take its place as a new asset class within the private capital market. We as an industry will continue to work with the SEC and the legislative and executive branches of government, to advocate for what we believe will best balance three requirements of good financial regulation: 1) providing cost-effective access to capital for small and medium-sized businesses 2) providing potential investors with protections from bad actors through both proactive education and appropriate regulation and 3) transparency to enable regulators and elected officials with the ability to provide responsible oversight and ongoing regulatory modification.

Ongoing regulatory modification is more important and more possible today than ever because of the access to real time data that will now be available via crowdfunding platforms for both accredited and unaccredited investors. This real time data can enable regulators and legislators to separate fact from guesswork in a more efficient manner than ever before. Online platforms like SeedInvest and OfferBoard are providing issuers and investors with open information and near real time data feeds and indexes from companies like Crowdnetic help to ensure effective information availability, as opposed to the private capital markets of the past where speed and transparency may have been more a wish than a reality. I hope that the SEC can use the JOBS Act, and specifically the online platforms created with Title II and Title III, will deliver better data, more rapidly and more easily to improve investor protection while delivering capital efficiently to small business. As a tech entrepreneur and also now a small business owner, I have real experience in creating products and services, raising capital and creating jobs. That is the perspective that I bring to this conversation. If the proposed regulations are implemented, there are some elements that I think are structured in ways that meet the needs of all three parties (investors, issuers and regulators). Two examples of this are:

- Robust investor education requirements on crowdfunding platforms: Every investor should understand before they invest a single dollar into a small business or entrepreneurial venture that they are inherently high risk and that it is entirely possible they will looks their entire investment. They also should gain access to educational materials that allows them to understand basic due diligence questions and learn online from experts who can provide advice for evaluating these kinds of investments.
- The opportunity to make parallel offerings (Regulation Crowdfunding offerings with other types of private offerings to accredited investors): This enables companies to raise capital from different audiences at the same time and helps companies to efficiently raise more than $1M from accredited investors, if they need to do so (in addition to a crowdfunding round to unaccredited investors).

However there are other elements that I believe must be modified so this market can reach its full potential and we will not loose our leadership position in the new economy.

- The requirements for using CPA audited financials for raises above $500,000.
  - This places an unreasonable burden on entrepreneurs and small businesses and may cause a “soft cap” on raising money above $500,000 due to the cost of capital this regulatory burden imposes. I believe that a “soft cap” that reduces the opportunity by 50% was not within the legislative intent for this act.
  - I understand the goal of this regulation: as the size of the capital raised increases, investors will want increased disclosure and validation of the state of the business. However auditing a business with zero or very little revenue is a waste of time for both the business owner and the accountant.
  - Another potential issue is that it is my understanding that to have a full audit on a corporation usually requires that the company follow accrual accounting process. Most small businesses operate on a cash accounting process. This change also adds to the cost and to the increased level of sophistication required for ongoing use of accrual accounting.
  - Additionally, if I have to spend 30% of what I raise to just comply with legal and accounting requirements, will that significantly reduce the number of legitimate businesses that will use this new funding

> vehicle? At the end of the day, we don't want to create a new way to raise capital that ends up costing business owners more than it would have cost them in credit card interest fees. We must create a better, more efficient way to raise capital for hard working Americans.

I believe it may reduce the positive impact of the JOBS Act but there is still ample opportunity to fix this issue. There must be a new way to harness technology to meet the needs of increased due diligence and transparency while not imposing the significant burden of a full audit. I have confidence that technologies are and will be created to lower the cost of these burdens, but in the meantime, I don't want for these regulations to cause a chilling effect on the industry. How can we make modifications to this regulation so that it does not damage this market before it can get started?

To quote Douglas Ellenoff, the Managing Partner of Ellenoff, Grossman and Schole, a leading securities law firm in New York City, "For the last 80 years, friends and family – those with so called "pre-existing and substantial relationships" with entrepreneurs have invested billions of dollars every year, pursuant to long established securities law exemptions in private financings, without any meaningful disclosures or procedural responsibilities. Now with Title III Crowdfunding, we have designed an online, centralized technology-based process for more efficiently and responsibly managing what has been done in the offline world before – and doing so within full sight of Federal and State Regulators – not merely person to person inconsistent solicitations in kitchens and near water coolers."

I agree with Mr. Ellenoff, and I believe that with crowdfunding, we actually will have better oversight than has ever existed in the private capital markets before.

I would like to use the rest of my testimony to deliver data-driven perspectives about crowdfunding:

1) Where is this market going and how will it develop
2) The UK case study about what does a Light-Touch Regulatory Environment do for crowdfunding: 3 years of data released November, 2013.
3) What happens to companies after they raise money with crowdfunding? New data released January 15, 2014.

Models to understand where the crowdfunding market is going and how will it develop

"The opportunity for regulators is to implement oversight of crowdfunding in a way that is data intensive and prescriptive light" (Bholat, David. 2013. The future of central bank data. Journal of Banking Regulation 14(3): 185-194). In October , 2013 during the First Global Crowdfunding Academic Symposium at University of California, Berkeley's Program on Innovation on Entrepreneurial and Social Finance attended by 100 academics from 15 countries, we were able to learn a great deal about what is going on globally in this new form of modern finance. I think it is a quote worth considering for JOBS Act regulation generally, and regulation crowdfunding in specific.

While some may suggest that the current draft regulation will kill regulation crowdfunding, I would strongly disagree. I believe that the potential of crowdfunding is not about a single company or single crowdfunding platform. It is about a radical evolution of the largely institutional framework for allocating capital (e.g. banks, funds, foundations) to a more individually driven framework that is enabled via both existing and yet-to-be-created technologies. Some of these technologies will also have broader adoption potential throughout the rest of the private capital markets. This is an evolutionary path that is similar to the ways in which other industries in the technology space that have developed over the last 15 years. Below are three examples of similar kinds of radical evolutions in other markets that were driven by innovation that created both new companies and industries.

(1) Online Advertising: Redefining largely offline activities into online activities (e.g. the shift to online advertising and the ability to measure outcomes and improve results)

(2) Social Web: Creating new and unique connections between individuals and brands (e.g. the social Web as a primary communication channel for both individuals and businesses)

(3) Cloud Computing: Transforming the way business can and should be done (e.g. cloud computing – gaining significant scalability and efficiency at radically lower costs)

This thesis also leverages the convergence of these three examples to unlock the opportunity of the JOBS Act to build a new ecosystem in early stage finance and potentially the broader private capital markets. Each of these trends has created new business models, companies and in some cases new industries.

Examples of radical evolutions that have disrupted established markets include:

- Delivery of goods and services / ecommerce: Amazon
- Moving offline tractions to online transactions: EBay
- Facilitating payments: PayPal
- Leveraging social networks to bring offline transactions online with increased scale, transparency, efficiency and with lower friction: Crowdfunding

I believe that the emergence of crowdfunding may offer a similar magnitude of opportunity.

In my opinion, crowdfund investing can be viewed as being analogous to the disruptive innovations created in the social networking, online advertising and online trading industries. Again, this is shifting offline institutional transactions into online personal transactions. Each of these industries faced initial consumer concern arising from the fear of fraud and the comfort with the status quo. Over time, however, the online advertising, online music and online trading industries developed sophisticated analytics, measurement tools, marketplaces, rating systems, provided rapid access to information, and evolved to become both sophisticated and commonplace industries of our daily lives. As shown in the e-commerce and online trading businesses, disruptive technologies can ultimately expand the market for a particular good or service.[1] In the case of e-commerce, the industry was able to achieve a 5% market penetration rate within the first 5 years.[2] When online trading was first introduced in 1991, only about 5% of the U.S. population invested in publicly traded securities. By the mid 1990's, more than 20% of the U.S. population was engaged in the investment of public securities.[3] Similar to e-commerce and online trading, crowdfund investing is disruptive. As shown in the e-commerce and online trading businesses, disruptive technologies can ultimately expand the market for a particular good or service.[4] I anticipate that crowdfund investing will likely have the same impact of expanding the market for participation of private capital in the funding of start-ups and the SME market globally.

The UK case study about what does a Light-Touch Regulatory Environment do for crowdfunding: 3 years of data released November, 2013

The creation of an ecosystem of crowdfunding is occurring globally. Outside of the United States, crowdfunding is legal and being conducted in the United Kingdom, Australia, Italy, Netherlands, Denmark and Estonia. When we look specifically at the UK, where both equity and debt based crowdfunding have been functioning for the last 3 years, we learn a great deal from their experience. The UK government

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[1] *e-business 2.0 – Roadmap for Success*, Dr. Ravi Kalakota,p.2 http://books.google.com/books?hl=en&lr=&id=fkXSp2Me0KAC&oi=fnd&pg=PR15&dq=As+shown+in+the+e-commerce+and+online+trading+businesses,+disruptive+technologies+can+ultimately+expand+the+market+for+a+particular+good+or+service&ots=4BLmzjbyis&sig=E_GpPdmupBQQrxGIaAkYL4FCs0U#v=onepage&q&f=false

[2] ibid p.4

[3] [3]http://www.stock-trading-warrior.com/History-of-Online-Stock-Trading.html

[4] See, footnote 6

has utilized a significantly "lighter touch regulatory environment" and the market has delivered very interesting results. A study released November, 2013 by The University of California, Berkeley, Cambridge University and NESTA provided an excellent map of the industry. I have provided the entire report in Appendix 2 of my testimony and I would encourage the committee members and staff to see the results of a light-touch regulatory environment for this new form of finance. I agree with Julia Groves of the UK Crowdfunding association who said that soon, crowdfinance will not be called "alternative finance" but rather "modern finance".

A few key highlights from this very important study:

- More than 50 crowdfinance companies participated in the study which included every member of the UK crowdfunding association and every member of the UK peer-to-peer lending association.
- The population of the UK is approximately 61M (roughly 20% of the US population)
- The size of the crowdfinance market nearly doubled from 2012 to 2013 from GBP492 to GBP939 ($797M to $1.3B)
- There is clearly a wiliness to engage in this market from both investors/contributors and issuers/project owners
- In 2013, of the above totals,:
    - $314M were individuals lending money to businesses (211% annual growth rate)
    - $45.6M from equity crowdfunding (618% annual growth rate).

    - Equity crowdfunding surpassed rewards-based crowdfunding in 2013 (rewards total $33.4M)
- Collectively in 2013, crowdfinance in the UK contributed $541M in early stage and working capital to over 5,000 start-ups.
- The report makes "cautious predictions" that the crowdfinance market may grow to $2.6B with $1.37B going to provide funding for startups and SMEs

If we extrapolated these numbers to the US, based on our population, crowdfinance would deliver $2.7B in start-up and small business financing to approximately 25,000 businesses across the United States. That equates to 1 successfully crowdfunded company for every 12,800 in state population.

What happens to companies after they raise money with crowdfunding? New data released January 15, 2014

Now, I would like to move on to a survey just released yesterday by my firm, Crowdfund Capital Advisors, that focuses on post-funding activities and what is actually happening to companies after they complete a successful crowdfunding campaign. I believe one of the the benefits of crowdfunding has been that by sourcing money from the crowd, you can enforce structure and transparency on companies, earlier in their lives that can help them to demonstrate a market for their product or service, make potentially more informed decisions, and to help raise them above the noise to find follow-on investors.

In order to learn more about what is going on post-funding in the US, UK and Europe, we surveyed 87 companies that were successful in raising money via crowdfunding campaigns and we looked companies that had used either rewards, debt or equity crowdfunding to ask:

- Does a crowdfunding campaign have any effect on sales (outside of what is raised from the campaign)? To do so we looked at quarter on quarter sales (excluding the value of the crowdfunded round)
    - Among all companies that concluded successful rewards, equity or debt campaigns, quarterly revenues increased by an average of 24% post crowdfunding (not including amounts raised by crowdfunding).
    - Of particular note: When we filtered for equity-based campaigns, we saw a shocking increase of 351% quarterly revenue increase. The results indicate that crowdfunding positively impacts sales and those that run equity-based campaigns see the greatest quarterly increase.
    - Initial research from interviews turns out that the funders see themselves as "active investors" rather than passive investors in large, pubic companies and want to be "loyal to the brand" and "act as an extended sales force" with a "vested interest in the success" of their investment.
    - Crowdfunding acted as a marketing campaign that was able to not only raise money directly, but also raise awareness and drive additional sales.

- Did the company hire any new employees following the crowdfunding round? And if so, how many?

- From our research we uncovered the average company spent 100% of the proceeds within 90 days of the end of the campaign.
- Much of that money went to or was planned to go into hiring people to help the company accomplish the goals of the crowdfunding campaign.
- 39% of companies hired an average of 2.2 new employees per company after crowdfunding.
- An additional 48% of companies said they intended to use crowdfunding proceeds to hire new staff.

- Has there been any activity with angel investors/groups/VC's since you completed the crowdfunding campaign? The resounding answer was yes. It seems that savvy investors are using crowdfunding as a new deal flow engine.
  - Within three months of a crowdfunding campaign:
    - 28% of the companies had closed an angel investor or venture capital round.
    - An additional 43% were in discussions with institutional investors.
    - This means that a total of 71% of companies that were successful with crowdfunding were had already received or were in conversations to accept follow on investors.
  - It provided "Social Proof" to their communities, customers and other investors to demonstrate they were worthy of doing business with.

    - It de-risked follow-on investment because they had demonstrated they were able to both execute and to successfully raise capital before.
    - Investors (be it crowdfunders, private money or public markets) want to invest in companies that have a great story, a great product, a great business model and a great team. These were all characteristics that successful campaigns seemed to demonstrate.

- Were there any other business benefits to completing a crowdfunding round? Respondents said there were indeed benefits other than the cash:
    - Feedback on their product that they were able to incorporate prior to full-scale production.
    - Marketing advice that changed their marketing plans.
    - Investor knowledge and experience that they “would have had to pay hefty advisor fees to receive” but instead got that “in addition to a check” from their investors/contributors.
- Feedback on their product that they were able to incorporate prior to full-scale production.
- Marketing advice that changed their marketing plans.
- Investor knowledge and experience that they “would have had to pay hefty advisor fees to receive” but instead got that “in addition to a check” from their investors/contributors.

Conclusion

My thanks again to the committee for calling holding this important hearing and for its continued focus on seeing that their legislative intent was executed on the JOBS Act. Crowdfunding is delivering on its promise in the UK and other countries because it is leveraging the power of technology, appropriate regulation and the crowd to provide better access to capital for small business and new investment opportunities for their citizens. The question for the United States is: will we put ourselves on a competitive playing field or will we restrict our economic opportunities by over regulating one of the most important new opportunities for small businesses in a generation? I hope that the SEC, in consultation with the Congress and the industry can strike the right balance to help our economy move forward again.

Appendix 1:

Crowdfund Capital Advisors Report: <u>Crowdfund Investing has a Positive Impact on Company Revenue, Investor Interest and Job Creation</u>

Authors: Jason Best, Sherwood Neiss and Richard Swart

While there are dozens of articles and columns speculating whether crowdfunding works or not, the research team at Crowdfund Capital Advisors has recently completed a study of the actual impacts of crowdfunding on companies that raised money using this new form of finance.

Companies in the US, Europe and elsewhere that raised capital via rewards, equity and debt-based crowdfunding were questioned about the marketing benefits, job creation, follow-on investment and the return on investment (ROI). Key questions asked and findings from the survey include:

1. Does crowdfunding have a marketing benefit that translates into sales?
    a. Crowdfunded companies (via rewards, equity or debt) increased quarterly revenues by an average of 24% post crowdfunding (not including amounts raised by crowdfunding).
    b. Equity-based crowdfunding companies increased revenue by 351%.
2. Does crowdfunding create jobs?
    a. 39% of companies hired an average of 2.2 new employees per company after crowdfunding.
    b. An additional 48% of companies said they intended to use crowdfunding proceeds to hire new staff.
3. Does crowdfunding deter follow-on investment?

    a. Within three months of a crowdfunding campaign, 28% of the companies had closed an angel investor or venture capital round.
    b. An additional 43% were in discussions with institutional investors.
4. What was the ROI of a successful crowdfunding campaign?
    a. Every hour invested in a successful crowdfunding campaign returned $813.

Research Methodology

In August 2013, our research team surveyed several hundred companies in the North America, Europe and Africa that had completed successful rewards, debt or equity-based crowdfunding campaigns from June 2012 to June 2013. The team randomly selected companies from major platforms including Kickstarter, Indiegogo. Symbid, Crowdcube, Seedrs, WiSeed and several others. None of the campaigns were for philanthropic causes, meaning that each campaign had to be for a for-profit business to understand the impact crowdfunding has on this type of entity.

We collected data from companies headquartered in the US, Canada, France, Finland, Ireland, the Netherlands, UK, Kenya and Namibia. Each country has its own specific laws regarding crowdfunding. The companies were offered anonymity or could select to disclose their contact information. About 8% completed an online survey (n=87, complete survey replies were gathered from 73 firms). Each company was also offered the opportunity to conduct an in-depth phone interview with our researchers, and 23 of the 73 completed a 30-minute phone interview where the research team discussed their experience with crowdfunding in more detail.

It should be noted that there might be some bias in the data since companies self-selected to participate and hence these findings represent those that had a positive experience with crowdfunding.

Crowdfunding Can Provide Significant Capital in a Rational Manner

- Across all forms of crowdfunding, from rewards to equity, the average amount raised in US dollar equivalents, was $107,810 (the mean was lower, $40,300, with the average skewed by some of the larger equity raises).

- The average equity raised, in US dollar equivalents was $178,790.

- The minimum and maximum amounts raised in US dollar equivalents via debt or equity crowdfunding ranged from $15,600 to $936,000.

- Firms sold between 5% and 50% of their company for an equity round with an average of 15%.

The results show that market participants are acting in a rational manner. Issuers are not seeking more capital than they need and investors are not seeking unreasonable yields. The data also signal that debt campaigns took the place of traditional bank loans since this type of funding has slowed since the global financial crisis of 2008.

There is a Direct Benefit of a Crowdfunding Campaign When Compared to Cost

The average company invested 135 hours of staff time in their campaign, with an average of 45 days engagement. Putting this into return on hours invested, the average crowdfunding campaign returns $813 dollars for every hour invested. The average company spent just over $2,100 on the campaign itself (video, marketing, social media marketing, etc). From this sample, a successful crowdfunding campaign appears to be a very effective marketing and revenue-enhancing use of a firm's time and resources.

Companies also deploy this capital quickly. The average company spent 100% of their crowdfunding raise within 90 days of the end of the campaign. This can be attributed to the tendency of the firms to (a) spend more than anticipated on fulfillment and (b) hiring new employees soon after successfully using crowdfunding.

The most interesting statistic in the study was quarterly revenue growth—defined as quarter over quarter change. This growth was calculated net of the crowdfunding raise. We recognize that running a crowdfunding campaign is time and labor intensive, so we compared revenue figures for the quarter preceding crowdfunding to the quarter after the close of the crowdfunding campaign. The average increase in quarterly revenue across all types of crowdfunding was $12,675. This represents an average increase of 24% quarter over quarter.

While pledge or donation crowdfunding lead to an increase of 24% in revenues, equity-based crowdfunding resulted in a quarterly increase of 351%—not including funds raised via the equity round.

Crowdfunding Campaigns are Used by Smaller Entities but Represent Job Potential

The survey also considered the size of the firms:

- The most common firm using reward-based crowdfunding only had one employee—the founder.
- 15% of the firms had more than two employees, with the largest firm having 15 employees.
- The average company size for debt or equity campaign companies was 2.1 employees.

What was the impact on job creation in these companies?

- Among firms using rewards-based crowdfunding, the median number of new hires was 2.0 with a maximum of 10 new employees hired after crowdfunding success.
- 28% of firms who had had success with pledge and donation-based crowdfunding hired new employees.
- 39% of firms who had success with equity or debt-based crowdfunding hired new employees. These firms hired an average of 2.2 new employees
- In total, 87% of firms either had, or intended to, hire new employees as a direct result of having raised equity or debt financing via crowdfunding.
- The larger the firm size, the more likely the firm would reinvest crowdfunding proceedings into new employee hires.
- Firms with only one employee were extremely unlikely to hire new staff—they reinvested proceeds into product development.

This data indicate that crowdfunding may be a viable form of financing for small teams that would not qualify for institutional financing. It may allow teams to practice fundraising and leverage the proceeds to hire additional resources. It may also signal that companies using rewards campaigns might be testing market validation while equity and debt campaign companies might be looking for growth capital.

Crowdfunding Success Case Study: Microco.sm

Based in London, Microco.sm provides a portal that host's discussion forums, bulletin boards, and communities. CEO David Kitchen describes his portal as the social media platform for the introverted community, turning the notion of Facebook on its head. The company is scheduled to go live in mid-January 2014.

Building on his untraditional past, David's is a true story of "rags to riches" in the making. Years ago, David was homeless, living on the streets of London. Turning his life around, he returned to school and landed jobs programming for Merrill Lynch, the British government and Microsoft.

Microco.sm chose to use the crowdfunding platform Seeders to list its offering.

Unlike other crowdfunding platforms, Seeders acts as a holding company for a group of investors, in turn being treated as a single investor for a given business. The first campaign had a fairly high threshold— £50,000 for 10 percent equity—but was met within 15 hours. About 90 percent of the investors were users of David's prototype.

The second campaign had a threshold of £100,000 for just 5 percent equity—four times the price per share of the first offering—yet was met in a staggering 2.5 hours—again with 90+ percent of investors being users of the prototype. David believes that his ***success can be attributed to the emotional connection of investors*** who believe in him and his portal.

Soon after the first crowdfunding campaign, several angel investors and venture-capital firms approached Microco.sm. David declined their interests and decided to stay on his own for a little longer.

After the second and even more successful campaign, Microco.sm was approached by many of the A-grade venture-capital firms in the UK. Out of these many firms that approached David, only one had a concern with the number of crowdfund investors. That concern was quickly resolved when the firm realized that they would be working with only one other legal shareholder: Seeders.

David attributes crowdfunding as a key part of Microco.sm's success thus far.

Crowdfunding Is Not the Option of Last Resort but Rather the First Choice

One of the main issues in crowdfunding is whether it is a first option for firms with potential or if it is used by firms that have had failures in other capital markets.

The data on pledge and donation-based crowdfunding showed:

- 56% of firms used crowdfunding as their first choice in fundraising.

- 44% of firms had tried—and some with success—to raise funds using other methods.

Among UK and European firms who raised money on equity and debt platforms:

- 52% chose crowdfunding as their first means of fundraising.
- 48% had previously tried other forms of financing.

In this sample, the only form of financing companies had received was personal loans or credit financing—none had been able to raise money from the capital markets.

This may indicate that crowdfunding will be used by small enterprises as the first means of financing. Companies that previously did not qualify for traditional financing may be able to use a crowdfunding success as a reason to qualify for traditional financing later on.

Do Professional Investors Engage with Crowdfunded Companies for Follow-on Investment?

There is a consistent refrain that professional investors will not want to work with companies that have received crowdfunding investments. The data from this study suggest the exact opposite. Within three months of the closing of the crowdfund investing round, 28% of companies had completed a round of investment from either angel groups or venture capital firms. Another 43% reported that they were in discussions with institutional investors. Notwithstanding any limitations from the nature of the survey, this data shows that ***success with crowdfund investing leads to expression of interest from professional investors rapidly after the close of the round***.

Several other firms reported being able to secure business or personal loans on the basis of their success with crowdfund investing. Success with crowdfunding opens the door to traditional forms of investment capital—allowing many firms to establish revenues, customer acceptance and demonstrate the ability to execute—thus gaining trust from established investors. Several founders remarked that they received calls from angel groups that had not even allowed them to pitch, and were receiving term sheets from these same angel groups on the basis of their crowdfunding success. Twenty-seven percent of US-based companies that had successfully used crowdfunding on Kickstarter or Indiegogo had secured angel financing within six months of closing their crowdfunding campaign.

These findings indicate that angels and venture capital groups may look to entrepreneurs to prove their ability to execute and fundraise from the crowd prior to investing. Doing so may de-risk their investment if they can see an entrepreneur has traction from the crowd.

Crowdfunding is More than Money—Product Validation, Market Insight and Strategy

During our interviews we attempted to determine how success with crowdfunding affected business plans, strategy and operations. We used a Likert scale to collect responses from companies on the degree to which crowdfunding success had impacted their marketing plans, business plans and plans for future financing.

The most significant impact of crowdfunding was on marketing planning (mean of 5.6 on 1-10 scale). Firms reported being made aware of new market opportunities, learning which product features resonated with funders, and gaining new insights into competitive products or consumer demand. ***Many firms that had exceeded their funding goals scrapped their marketing plans and created entirely new marketing plans based on their successful crowdfunding round.***

Strategy was nearly as significantly impacted as marketing—with a mean of 4.7 on a scale of 1-to-10. There was a wide variation across firms but responses and interviews suggested that the interaction with the crowd led the founders to re-evaluate their products and go-to-market strategy.

Financing plans shifted dramatically with successful crowdfunding. Given the fact that these firms had either not attempted professional financing, or had been rejected by institutional investors, it is not surprising that many firms had not considered future funding from professional investors. Many of the firms that had raised funds from debt and equity-based platforms reported having less interest in bringing institutional investors on board—essentially an attitude that "I may be able to go it alone", or a plan to fund growth from operations.

Firms with success in pledge- and donation-based crowdfunding often expressed surprise at the degree of interest from angels or venture capital. Opinions and plans varied dramatically but two themes emerged: first, a sense of confidence—these owners believed they could raise money from private investors if they wished; and second, a sense of skepticism, that they were not as motivated to accept the first offer, that their belief in their product/service had been bolstered by their success with crowdfunding and that they felt they had more bargaining power in interactions with investors.

Success Building on Success

While a relatively small survey, this study shows that crowdfunding has significant impacts on strategy, finance, job creation and business finance, and also in how founders perceive themselves and their products. More research is underway to both validate and expand this research. Success with crowdfunding opens the door to new investors and partners, and appears to boost confidence in founders. Contrary to expectation, it also leads to interest and investment activity from angel and venture capital groups. This suggests that institutional investors see success with crowdfunding as a strong indicator of potential success for their early-stage firms.

Equity crowdfunding appears to dramatically accelerate the growth of these early-stage companies suggesting that equity crowdfunding should be considered as one of the main mechanisms for economic development and job growth policy interventions. When a relatively small investment results in several hundred percent growth in revenue and an average of nearly 2.2 new jobs, equity and debt-based crowdfunding deserves the serious attention of policy makers. For more information visit www.theccagroup.com

Appendix 2:

The UK Alternative Finance Benchmarking Report

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Executive Summary

Alternative finance activities such as crowdfunding, peer-to-peer lending and invoice trading have emerged as a significant funding mechanism and source of capital in the United Kingdom in recent years. Meeting the capital needs of both individuals and businesses, facilitating fundraising activities for civic projects and social causes, alternative finance intermediaries have become online marketplaces where individuals, rather than institutions, work collaboratively to form capital. As the alternative finance market continues to grow significantly in the UK and the government looks to regulate the area, this benchmarking report offers a timely snapshot of this fledgling and dynamic sector in order to understand its size, growth and the fluid development of respective segments. In turn, this report aims to inform regulators, brief policymakers, update industrial leaders and educate the wider public about this growing and important industry.

This benchmarking research is a joint project between Nesta, the University of Cambridge and the University of California, Berkeley. It represents the first intensive, comprehensive and empirical country-level study of an alternative finance market anywhere in the world. Primary data gathering was facilitated by a questionnaire-based survey, which was able to capture more than 95% of all UK-based alternative finance activities such as crowdfunding, peer-to-peer lending and invoice trading. Results were obtained from more than 50 alternative finance intermediaries, including almost all members of the United Kingdom Crowdfunding Association (UKCFA) and the Peer-to-Peer Finance Association (P2PFA).

Market size

This benchmarking survey reveals that the UK alternative finance market grew by 91% from £492m in 2012 to £939m in 2013. Accumulatively, the overall market had an average growth rate of 75.1% over the last three years and contributed £1.74b of personal, business and charitable financing to the British economy. While the peer-to-peer charitable fundraising and donation-based crowdfunding still represents the largest segment with £310m in 2013, the vitality and diversity of the alternative market is on full display. This includes peer-to-peer lending, which takes in nearly £287m in 2013, peer-to-business lending achieving a notable £193m, invoice trading platforms recording £97m, equity crowdfunding registering £28m, and reward-based crowdfunding attaining a further £20.5m.

Market growth

Perhaps even more impressive than their already considerable transaction volumes, their accumulative and year-on-year growth rates are high. Equity-based crowdfunding grew 618% from 2012 to 2013, peer-to-business lending grew 211% in the same period, while peer-to-peer grew 126%, reward-based crowdfunding grew 387%, invoice trading grew 167% and debt-based securities grew 170%.

SME finance and future projection

Collectively, the UK alternative finance market provided £463m worth of early-stage, growth and working capital to over 5,000 start-ups and SMEs in the UK during the period 2011-13, of which £332m was accumulated in 2013 alone. Based on the average growth rates of between 2011 and 2013, we can cautiously predict that the UK alternative finance market will grow to £1.6b next year and provide £840m worth of business finance for start-ups and SMEs in 2014.

Introduction: Research Rationale, Objectives and Methodology

The UK alternative finance market has witnessed unprecedented development, unparalleled innovation and unmatched growth in the years since the global financial crisis. As commercial banks restrict business lending and venture capital industries scale back on investment, a new brand of innovative, decentralized and potentially disruptive online financial intermediaries are burgeoning in Britain. From equity-based crowdfunding to peer-to-peer lending, from invoice trading to reward-based crowdfunding, these alternative finance providers are supplying credit to SMEs, providing early-stage investments to start-ups, stimulating regional economies and funding worthwhile causes. The UK Government has actively encouraged the growth of the alternative finance sector by direct capital investment through the Business Finance Partnership, and the Financial Conduct Authority (the FCA) is currently publicly consulting on forthcoming regulation in the area.

However, little information is presently available regarding the overall size of the alternative finance market or the growth of the crowdfunding, peer-to-peer and invoice trading transaction volumes in the UK. While there has been some industry reporting by for-profit organisations on crowdfunding, no independent, reliable and systematic academic research exists to scientifically benchmark the British alternative finance market. It is imperative, particularly at this early stage of the market development, to gather comprehensive information to brief policymakers, inform regulators and update industrial associations and other key stakeholders in alternative finance. It is in this context that UC Berkeley, which has the world's first dedicated research programme for entrepreneurial and social finance, has collaborated with Nesta and Cambridge University to collect and analyse aggregate-level data for the UK alternative finance market and produce this benchmarking report.

Research Strategy and Source of Data

To ensure the consistency, rigour and validity of this benchmarking exercise, this research collected aggregate-level market data directly from alternative finance intermediaries via a secure web-based questionnaire. Leveraging existing research relationships and industry contacts, the benchmarking survey aimed to capture over 95% of all online alternative financing activities in the UK from crowdfunding, peer-to-peer lending to invoice trading. As a country-specific study, we specifically focused on alternative finance intermediaries that are facilitating funding for UK individuals and businesses. Therefore, our survey sample consists of both British intermediaries and some of the international platforms that have significant activity in the UK. The primary data submitted by individual intermediaries were then analysed and aggregated to provide in-depth analysis in order to produce a comprehensive benchmark report. In the very few cases where primary data was not obtainable through survey, secondary data such as public information, annual reports and press releases were utilised to provide the best estimations.

As this benchmarking research is aimed at collecting aggregate-level market data, all individual alternative finance intermediaries were anonymised and all identifying information was stripped from the analytical process. Therefore, no individual or particular survey participants are identified in this final report. The questionnaire-based survey itself was securely hosted on a dedicated account accessible only to the core research team. Commercial exploitation of the data is strictly prohibited.

Research Schedule and Survey Participants

The joint Berkeley-Nesta-Cambridge UK Alternative Finance Benchmarking Survey opened on 25 November and closed on 5 December. Results were obtained from more than 50 alternative finance intermediaries, including almost all members of the United Kingdom Crowdfunding Association (UKCFA) and every member of the Peer-to-Peer Finance Association (P2PFA). Judging by the quality and breadth of the data collected, the research team is confident that more than 95% of all online alternative finance activities in the UK were captured through the benchmarking exercise.

Data Cleaning and Data Analysis

All primary data was exported into an Excel spreadsheet and all intermediary identifying and/or confidential information was stripped from the cleaned data set. Based on the preferences registered by participating intermediaries, a working taxonomy for different segments and models of the alternative finance market was constructed. As a result, donation-based crowdfunding and/or peer-to-peer fundraising are now one category. Peer-to-peer lending and peer-to-business lending are now two separate models to reflect their distinctive lending functions and mechanisms. Invoice trading is classified as a stand-alone model, whilst microfinance and community shares are merged together. The other models of alternative finance are identified as reward-based crowdfunding, revenue/profit sharing crowdfunding, equity-based crowdfunding and debt-based securities, which all have their characteristic mechanisms, dynamics, as well as risk profiles. Hybridised crowdfunding activities, which leverage more than one type of alternative finance model (e.g. reward and equity), were broken down and added separately to the above-mentioned categories.

From the aggregated data of each alternative finance model, the accumulative transaction volumes as well as average yearly growth rates were derived for the last three years. The 2013 figures were predicted by each participating intermediary based on the trading statistics to date, captured during the survey window (25 November-5 December) and the expected volumes for the reminder of the year. The total alternative finance for Small and Medium Enterprises (SMEs) in the UK were obtained by aggregating the empirical data from peer-to-business lending, equity-based crowdfunding, invoice trading, debt-based securities and estimated data (through manual and theoretical sampling) on reward-based crowdfunding. The total number of SMEs that raised alternative finance was derived by the same method, except that figures from reward crowdfunding platforms were excluded to research a conservative, but perhaps statistically more reliable estimation.

The data for the number of total ventures (including all fundraising ventures for personal finance, business finance, social causes and project-based campaigns) and for the number of active investors (including donors, backers or lenders) are gathered directly from the survey entries provided by participating intermediaries. Therefore, these figures are likely to be overestimated and inevitably involve double counting. However, as a snapshot of the UK alternative finance industry, these statistics are still valuable in highlighting the depth of the market and the breadth of people's participation in this important economic sector.

The Size and Growth of the UK Alternative Finance Market

In recent years, the UK alternative finance market has more than tripled from £309m in 2011 to £939m in 2013. Accumulatively, the alternative finance sector has delivered funding of £1.74b to UK individuals and businesses in the last three years. Discounting the donation-based crowdfunding and peer-to-peer fundraising for charitable causes, the UK alternative finance industry still contributed over £955m worth of personal and business finance to the British economy from 2011 to 2013.

In 2013, all sectors of the UK alternative finance market recorded considerable growth and rapid expansion. These market sectors are identified by their alternative finance models, which are summarised and contrasted in the table below. The figures on the right-hand column provide a useful snapshot of the latest market data for these sectors in 2013.

Donation-based crowdfunding/Peer-to-peer online fundraising	No legally binding financial obligation incurred by recipient to donor; no financial or material	**(2013)** £310m

	returns are expected by the donor	
Peer-to-peer lending	Debt-based transactions between individuals; mostly are unsecured personal loans	£287m
Peer-to-business lending	Debt-based transactions between individuals and existing businesses which are mostly SMEs	£193m
Invoice trading	Firms sell their invoices or receivables to a pool of individual or institutional investors	£97m
Equity-based crowdfunding	Sale of registered security by mostly early stage firms to investors	£28m
Reward-based crowdfunding	Donors have an expectation that recipients will provide a tangible (but non-financial) reward or product in exchange for their contribution	£20.5m
Debt securities	Lenders receive a non-collateralised debt obligation typically paid back over an	£2.7m

	extended period of time. Similar in structure to purchasing a bond, but with different rights and obligations	
Revenue/Profit sharing	Issuers incur an obligation to repay lenders, but these payments are variable and a function of the revenues or profits of the firm	£1.5m
Microfinance/Community Shares	Microfinance refers to the lending of small sums to entrepreneurs who are often economically disadvantaged and financially marginalised. There is a debt obligation incurred, but the amounts lent are very small. Community shares refer to the sale of shares in social enterprises serving a community purpose in a particular locality.	£0.8m

The Diversity of the UK Alternative Finance Market

As the diagram below illustrates, perhaps the most encouraging indicator of the UK alternative finance market is its strong and diversified growth in a wide array of models across the board during the period 2011-2013.

The **donation sector**, which consists of donation-based crowdfunding and peer-to-peer online fundraising activities, remains the largest sector in the market with £785m funding raised through it in the last three years. This more established sector has shown a relatively steady growth of about 20% year on year in contrast to some of the other more recent models.

For instance, both **peer-to-peer lending** and **peer-to-business lending** models have developed rapidly in recent years and funded £482m and £276m respectively over the last two years. This sector has significantly outperformed the interest rates available to investors with a relatively low-risk profile. The peer-to-business lending sector is more than doubling each year and the UK is the undisputable world leader of this alternative financing model. The peer-to-business lending intermediaries allow SMEs to receive loans from a pool of online investors in a very short period of time by bypassing the most complicated bank lending processes. For many firms, the speed with which they are able to obtain funding, often in a matter of days, makes this model significantly more attractive than traditional banking.[i] The default rates on peer-to-business loans are also often less than that experienced by commercial banks, demonstrating the ability of a crowd of investors to select and fund quality firms.

Invoice trading is another relatively nascent, but no less innovative, alternative finance model that is burgeoning in the UK. Invoice trading intermediaries enable SMEs to sell their invoices or receivables to many individual or institutional investors and, in turn, effectively drive down the cost of funding. This sector has raised £137m in finance for businesses in the three years from 2011 to 2013 with an annualised growth rate of 487%.

Equity-based crowdfunding grew by more than 600% between 2012 and 2013, from just under £4m in 2012 to slightly over £28m in 2013. This is consistent with the rise of equity-based activities in Western Europe and elsewhere. Data reported in the World Bank report on Crowdfunding shows that, in the past three years, some form of equity crowdfunding has emerged in 27 nations around the world. Given the rapid expansion of crowdfunding markets internationally, particularly in the USA after the recent implementation of Title II of the JOBS Act, it is expected that equity-based crowdfunding will grow significantly over the next few years, depending on the policy decisions and the evolvement of the regulatory framework in the UK. Data reported by Paul Niderer, CEO of the Australia Small Scale Offering Board (ASSOB), shows that, over the past seven years of equity crowdfunding in Australia, 83% of funded firms are still in operation, significantly outperforming comparable firms who were financed using traditional means. Whilst the Australian ASSOB market has structural differences from the UK, it is nonetheless encouraging to see high survival rates among firms raising funds through equity crowdfunding.

Rewards-based crowdfunding is also showing explosive growth, with a growth rate of more than 370% year-on-year and funding £25.6m in the last three years. This sector represents a significant area of growth potential as start-ups and SMEs, rather than just individuals, can leverage this model to conduct early marketing testing and pre-sell inventory, thus shortening product development time, demonstrating market validation and acquiring social proof. Many firms that have utilised reward crowdfunding can go on to approach institutional investors or participate in equity crowdfunding markets once they have demonstrated their capability. **Profit/revenue sharing crowdfunding** totalled £1.6m from 2011 to 2013 and is potentially a high-growth sector, particularly for gaming development, music, books and other forms of entertainment ventures.

Debt-based securities, which is an alternative finance model that offers long-term investment spanning normally 20-25 years, has also recorded an impressive accumulative growth rate of 170% in the last three years, reaching £3.7m. This investment model is often associated with renewable energy projects that offer a very low-risk-profile and make fixed-term interest payments (plus part of the principal) to investors every year. **Microfinance and community shares** financing by individuals or businesses in the UK is still a relatively niche activity. Looking forward, both have demonstrable growth potential to offer hyper-local and community-based alternative funding solutions leveraging people's social and geographical affinities.

The Vitality of the Alternative Finance Market for SMEs in the UK

There is strong evidence to suggest that the alternative finance sector is already a meaningful and effective source of funding for SMEs in the UK. In 201l, online alternative finance intermediaries provided only £26.7m worth of finance to British SMEs. By 2013, from peer-to-business lending to equity-based crowdfunding, from invoice trading to revenue/profit-sharing crowdfunding, the alternative finance market has supplied £332m to SMEs in the UK – a more than 12-fold increase in just three years. By a rather conservative estimation, without including reward crowdfunding, more than 5,000 SMEs have utilised these alternative financing mechanisms in the UK between 2011 and 2013.

On the whole, the alternative financing activities for SMEs have been growing at an average rate of 254% per year total finance raised since 2011. The number of firms participating in these markets has also been growing by an average of 139% in the same period. The difference between these growth rates demonstrates that firms have been able to raise more significant sums of money through alternative financing over time.

This significant growth in alternative finance for SMEs reflects broader national and international socio-economic trends. First, the global financial crisis forced many older adults to start companies in order to protect their retirement accounts or supplement their income. This trend of well-connected, well-networked adults starting firms in mid-life or later is a relatively new development. But, these older entrepreneurs often enjoy significant social networks, which they can leverage to finance new ventures via alternative means, an advantage recent college graduates usually lack. Data from the Global Entrepreneurship Monitor illustrates this trend and identifies a significant increase in entrepreneurial activity in the UK since 2009.[ii]

Second, in many countries, financial reforms have been instituted which, whilst stabilising banking and reducing risk profiles, also had the effect of limiting access to capital for entrepreneurs – many of whom do not have the collateral or credit scores necessary to secure bank financing. Eurostat data indicates that, in the UK, and across Europe more broadly, rejection rates for SMEs applying for loans increased significantly in the wake of the financial crisis.[iii]

Third, there are significant barriers that prevent many entrepreneurs from accessing capital based on gender, race or other non-business factors.[iv] Empirical data demonstrates that investors prefer to invest in companies that match their profiles – in terms of race, gender and socio-economic status. For example, in the United States, investors from elite venture capital firms show a strong preference to invest in companies where the founders graduated from a very small set of elite private universities – usually preferring to invest in fellow alumni. The unintended effect of this homophily is that entrepreneurs who do not enjoy access to these networks of investors based on shared characteristics are often locked out of angel investing and venture capital markets. Alternative finance can be successfully utilised by women, minorities and other financially marginalised entrepreneurs, where its funding mechanisms are often more democratic and less biased. In fact, women entrepreneurs are found to be starting firms in significant numbers on alternative finance intermediaries[v] and they are at least as effective as men at being successful in meeting crowdfunding targets.

Fourth, the widespread application of social media and web-based financial tranasctions has enabled entrepreneurs to seek funding directly and effective from their online communities and through their social relationships. Data from the Wharton Business School[vi] shows that at times 81% of investors or donors in crowdfunding are connected to the founders of the fundraising firm at the first or second degree of separation. Thus, entrepreneurs can essentially monetise their web of relationships, whether from existing customers or social media connections, to raise money directly for growth SMEs or start-ups. This monetisation of social networks could not have occurred without the ubiquitous presence of social media, coupled with the growing trust in online commerce models. The rapid growth of alternative finance for SMEs in the UK is a function of all of these socio-economic trends and an indicator of evolving forms of entrepreneurship and enterprise in the digital era.

The Power of People and the Potential of Alternative Finance

The socio-economic foundation of alternative finance is built upon financial disintermediation, direct interaction and exchange between individuals without the need for orthodox institutions. Therefore, more than purely financial transaction volumes or growth trends, the breadth and depth of individuals and communities' engagement in this sector is fundamental to the health and sustainability of the alternative finance industry.

Number of ventures funded

In 2013, over 647,000 projects, individual or business financing campaigns were fully funded through alternative finance intermediaries. In 2011 and 2012, the figures were just over 448,000 and 503,000 respectively, representing a steady, sustainable and sizable increase of 20.4% per year. Although, in actuality, these figures will tend to be smaller due to potential issues of doubt counting, they still reflect the scale and depth of a vibrant, dynamic and growing alternative finance sector.

Number of new funders

As with most social networking or social-based mechanisms, there are digital divides based on computer literacy, access to the Internet/Mobile technology, and comfort with web-based financial transactions. Despite these well-documented barriers, the UK alternative finance intermediaries have attracted and sustained more than 9.4m active donors, backers and investors on their platforms in 2013. The figures for 2011 and 2012 are 6.35m and 7.69m respectively, realizing a healthy and steady increase of 21.5% per year. Again, these figures will be overestimated in the survey, as many investors, backers and donors will likely be double counted if they contribute funds through more than one alternative finance intermediary in the UK. Nevertheless, the number of people and their level of engagement with alternative finance activities are definitely on the rise in Britain.

According to the benchmarking survey, most of these backers, investors and donors would also have participated in mostly donation and rewards-based crowdfunding and peer-to-peer fundraising activities. However, there is also now a sizable investor community for peer-to-peer, peer-to-business lending, equity-based crowdfunding and other forms of alternative financing activities. Collectively, they represent a major social movement towards an alternative paradigm of funding mechanisms, as well as a significant source of systematic disruption in the evolving financing system.

Growth looking forward

While one cannot make any specific predictions of growth rates based on the early years of a nascent industry propelled by disruptive technology, evidence from the rise of social media, e-commence, mobile technology and the rise of innovative entrepreneurship suggests that alternative finance in the UK will likely grow to be a several billion-pound-a-year market within the next 3-5 years. From the benchmarking data to date and the global growth context, it is almost certain that Britain will continue to experience substantial growth in the number of campaigns, intermediaries, individual borrowers and lenders, and also in the total capital raised to fund businesses through alternative means. Based on the average growth rates of between 2011 and 2013, we can cautiously predict that the UK alternative finance market will grow to £1.6b next year and provide £840m worth of business finance for start-ups and SMEs in 2014.

Endnotes:

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[i] http://www.nesta.org.uk/sites/default/files/banking_on_each_other.pdf
[ii] http://www.gemconsortium.org/visualizations
[iii] http://www.nesta.org.uk/sites/default/files/banking_on_each_other.pdf
[iv] Ola Bengtsson and David H. Hsu, “Ethnic Matching in the U.S. Venture Capital” under 2nd round review at Journal of Business Venturing.
[v] See, e.g., GENDER DYNAMICS IN CROWDFUNDING: EVIDENCE ON ENTREPRENEURS, INVESTORS, AND DEALS FROM KICKSTARTER, Marom, Robb, Sade (2013). http://www.funginstitute.berkeley.edu/sites/default/files/Gender%20Dynamics%20in%20Crowdfunding.pdf)
[vi] The Dynamics of Crowdfunding: An Exploratory Study, Ethan R. Mollick, University of Pennsylvania - Wharton School, June 26, 2013, Journal of Business Venturing, Volume 29, Issue 1, January 2014, Pages 1–16.