Entrepreneurs Are Not Utilizing Online Equity Crowdfunding

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This is a policy paper discussing online equity crowdfunding for small business entrepreneurs, and analyzes the low success rate of this relatively new financing technique. Created by the JOBS Act, the online equity crowdfunding program was designed to improve access to capital markets for small businesses, and first became available in 2016. The five year success rate is rather limited. Data collected by the SEC on online equity crowdfunding for small business owners shows disappointing rates of utilization. In essence, the concept has not delivered on the promise of increasing capital access for small business owners.

Keywords: equity crowdfunding, entrepreneurs, small business, startup capital

INTRODUCTION

Economists, business owners, and government leaders generally agree that small businesses play an important role in the U.S. economy. Indeed, small business startups have made meaningful contributions to job creation, economic growth, and innovation. Capital access is crucial for new startups and for the expansion of existing small businesses. Unfortunately, many aspiring small business owners have found their access to capital limited by a system that caters primarily to larger companies.

Essentially startup/expansion capital exists in two basic formats: debt (bank and/or family loans) and equity (stock offerings and/or venture capital). Unfortunately both forms of financing have obstacles that limit access for a significant segment of the small business startup market seeking capital. A recently released report by the Kauffman Foundation, (established in the 1960’s by the late entrepreneur and philanthropist Ewing Marion Kauffman), detailed the results of an extensive study of startup capital. Researchers concluded that over 80 percent of entrepreneurs do not access external sources, either venture capital or bank loans, at the time of startup; in fact, 65 percent of entrepreneurial startups rely on personal and family savings, and a sizable share (over 10 percent) use their personal credit cards. (Hwang, Desai, & Baird, 2019).

To help address the problem of limited small business access to capital, Congress passed the Jumpstart Our Business Startups Act (JOBS Act) in 2012, creating a new method by which entrepreneurs can raise capital. (Pub. L. 112–106). Proponents hoped that the new program would improve small business access to capital markets by incentivizing SMBs (small/mid-size businesses) and ECGs (emerging growth companies) to be able to utilize a cheaper and easier way to raise money. (Stanberry & Aven, 2014). However, the reality is that the program has largely not achieved its goals. This paper examines the lack of success of the equity crowdfunding program, reasons for the failure, and recommends changes to improve results.

PROBLEM STATEMENT

As noted above, capital access can be a significant problem for small entrepreneurs because it forestalls or slows down the ability to fund new startups. (Fairlie & Robb, 2010). When the JOBS Act was signed into law, most lawmakers believed it had the potential to significantly disrupt the traditional model of venture capital. The promise of opening up the capital markets had many would-be startups anxiously anticipating the new system. Unfortunately, several years later, small business owners, and the online platform intermediaries that serve them, are still wondering when the expected good times are going to roll. (Hwang, Desai, & Baird, 2019).

Increased capital access also has an ethical component. There have been wide gaps in entrepreneurial opportunity for identifiable subgroups. The latest data available from the preceding twenty-year period (1996-2017) show that men are more likely to start businesses than women, and whites more likely than blacks, primarily due to lack of capital. (Fairlie & Robb, 2010). The access to capital problem has not only financial implications, but socioeconomic and demographic ones as well. (Cumming, Meoli & Vismara, 2019).

Unfortunately, the equity crowdfunding program is not making a big difference according to the most recent SEC report as detailed below. (SEC, 2019). This is especially true for some identifiable groups of entrepreneurs. For example, there was relatively low crowdfunding participation among businesses located in states and/or cities areas that are not technology/finance hubs. (SEC, 2019). The same is true of women-owned businesses; women were significantly underrepresented among equity crowdfunding issuers. (SEC, 2019).

REVIEW OF RECENT STUDIES ON UTILIZATION RATES

The recent data collected by the SEC shows relatively low utilization rates. The number of users is disappointing, and shows little positive change for small business entrepreneurs as a whole, and especially those who are part of underserved ownership groups. In 2016, the first year of full operation of the program, fewer than 300 entrepreneurs utilized this new technique of capital formation. By the end of 2018, the number was fewer than 900. (SEC, 2019).

Additionally, those entrepreneurs who are using the program are raising very modest amounts of capital. The median amount of money raised through the crowdfunding version of an IPO is a little over $100,000. (SEC, 2019). The following data indicates the number of offerings and the dollar size of the offerings. The cumulative results from the official SEC report indicate relatively meager progress. (SEC, 2019).

TABLE 1
NUMBER OF OFFERINGS (SEC 2019)

Year	Number
2018	860
2017	557
2016	292

TABLE 2
SIZE OF OFFERINGS (SEC 2019)

Size	Capital
Median of all offerings	$107,000 raised per offering
Median of largest 500 offerings	$210,000 raised per offering

OVERVIEW OF CROWDFUNDING PROCESS

Donation-based crowdfunding, in which donors contribute money to worthy causes, became popular in the 1990's. Donation-based websites allow willing participants to voluntarily contribute to events, causes, or even small businesses, but donors do not get equity in return, (which the law did not even allow at that time). Around that same time frame, micro-lending or P2P (peer to peer) lending became popular. This type of business financing, accomplished through platforms that allow individuals to lend money outside the boundaries of a traditional bank, fills a unique capital niche but is not the same as equity financing.

Equity Funding Differs From Cause Funding

With easier regulatory burdens on entrepreneurs seeking to raise startup capital for the first time, supporters asserted that equity crowdfunding would follow in the successful footsteps of donation crowdfunding, but that has not been the case. The long-standing federal securities laws were not designed with online equity crowdfunding in mind, and often acted as a barrier to small business access to capital markets. Generally, the law prohibits companies from offering or selling securities unless the offeror registers with the SEC, (or qualifies for one of a limited number of exemptions from registration.)

Since the registration process is very expensive and time-consuming, using a registered IPO offering is almost never a realistic financing option for a typical small startup company trying to raise small amounts of money from a relatively small number of investors. In addition, for companies with the resources to complete the registration process and make a registered IPO offering, these companies then become subject to the reporting requirements of the securities laws, which makes the process even more unattractive because it adds another layer of cost and complexity. A report published by the U.S. Dept. of Commerce found that capital access remains the most important factor limiting the establishment, expansion and growth of small businesses. (Fairlie & Robb, 2010).

Modifications in Rules

The JOBS Act attempts to enhance access to capital primarily by changing three requirements of U.S. securities laws. (Pub. L. 112–106). The first change expands the ability of companies to raise funds through transactions that are exempt from registration under the federal securities laws. The second change eases the regulatory burdens associated with IPOs by phasing in the compliance obligations for public companies that used crowdfunding. The third change raises the dollar thresholds that require privately held companies to register their securities under federal law. This means that fewer small companies are subject to the periodic disclosure requirements applicable to traditional public companies. Taken together, these three changes were intended to act as incentives to use a public offering to finance small startups, making crowdfunding IPO's faster, easier, and cheaper.

Going public through an IPO (initial public offering) sounds exciting at first to many entrepreneurs. In reality, it has not been a realist option for small entrepreneurs raising small amounts of money. It has been a slow and expensive process not appropriate for most entrepreneurs. A readiness assessment for a prospective IPO usually lasts a year or two. (PwC, 2017). Furthermore, based on recent public registration statements of over 300 companies going through an IPO, the companies have incurred an average underwriting fee equal to approximately 5 percent or more of gross proceeds, plus an additional $4 million of offering costs directly attributable to the IPO. (PwC, 2017). Over 80 percent of CFO's estimated expenses of more than $1M on one-time costs. Legal and accounting fees increase significantly for companies that may face additional complexities in preparing for an IPO. (PwC, 2017). There are also significant costs attributable to actually being a public company. Two-thirds of CFO's (67 percent) estimate costs of being public at $1M-2M annually due to increased professional fees paid to accounting and law firms. (PwC, 2017). Obviously, this type of financial burden is not one that most small business startups can handle.

The crowdfunding approach was intended to provide an advantage to SMB's (small and mid-size businesses) and ECGs (emerging growth companies) because it offered a less expensive approach. When an EGC is contemplating going public, it can take advantage of the reduced regulations and scaled-back disclosure requirements for an initial period, including exemptions from certain provisions of the Sarbanes-

Oxley Act and the Dodd-Frank Act, as well as certain audit rules. Generally, small companies are now able to raise capital through online portals after filing a simpler, less expensive forms with the SEC. (Pub. L. 112–106).

The process allows a new startup company to solicit the investment of small amounts of money from a large number of investors, primarily on the Internet through an approved crowdfunding portal or website. In order to facilitate the ability of privately held companies to access capital through crowdfunding, the JOBS Act added a new section that specifically exempts crowdfunding transactions from registration under the Securities Act so long as such transactions comply with certain requirements. (Pub. L. 112–106).

Under the JOBS Act, the only companies eligible to rely on, and to avail themselves of, the Crowdfunding Exemption are those companies that: (a) are domestic entities, (b) are not subject to the reporting requirement of the Exchange Act, and (c) are not investment companies. (Pub. L. 112–106). Additionally, the program limits the total amount of securities an issuer may sell to any one individual investor who purchases securities in a crowdfunding transaction in a given 12-month period. The limitation is one based on the individual investor's annual income or net worth. (Pub. L. 112–106).

Approved Online Funding Portals

Issuers may only utilize online crowdfunding through an approved "funding portal" that has registered with the SEC. (Pub. L. 112–106). A funding portal, defined as an intermediary involving the offer and sale of securities through the Crowdfunding Exemption, is essentially a website that is familiar with the rules and regulations under the JOBS Act. The funding portal or website cannot offer investment advice or recommendations, they are essentially a listing site for investment opportunities, somewhat analogous to the concept of online multiple listing websites in the real estate industry.

Companies that want to engage in a crowdfunding offering under the JOBS Act must furnish some basic information to the SEC and to potential investors. (Pub. L. 112–106). The information disclosed must the names of the issuer's directors, officers, persons holding more than 20 percent of its shares. Additional information includes the issuer's business plan, and some basic financial information on the issuer. (Pub. L. 112–106). The new crowdfunding process requires the issuer to provide some basic level of ongoing financial disclosure on at least an annual basis, although less than a traditional IPO.

DISCUSSION

The U.S. online equity crowdfunding program has been up and running for more than five years, long enough to have produced positive results, but it has not done so. The premise of improving capital access has not been realized. In fact, there are more examples of failure than success. (Won, 2018). There are two or three primary reasons why equity crowdfunding has fallen short of expectations.

First, crowdfunding has not attracted some types of investors. Institutional investors are professional investors. They are actively seeking to put large sums of institutional capital to work. It seems crowdfunding simply is not a very good fit for their interests. (Nead, 2022).

Secondly, crowdfunding carries a relatively high risk. Small business startups with fewer assets represent a much higher risk for would-be investors. (Nead, 2022).

Thirdly, many of the current small business deals offered on funding portals do not meet the quality control and/or due diligence expectations of most professional investors. (Barth, Landsman, & Taylor, 2017)

CONCLUSION AND RECOMMENDATIONS

Crowdfunding could come closer to fulfilling its promise of facilitating capital formation for small businesses by making additional adjustments. To accomplish this, Congress and the SEC must act to make changes in the program. The securities laws, and accompanying regulations, must be amended to more effectively meet the needs of small business owners.

Examples of success exist in jurisdictions such as India, and the UK, where crowdfunding regulations have more significantly reduced regulatory costs and disclosure requirements. (Nead, 2022). This enables small business issuers to raise money in a more cost-effective manner than under the current U.S. program. (SEC, 2019).

Were the U.S. to adopt a more progressive approach to reducing costs and easing disclosure requirements, it is possible that crowdfunding could still realize its' goal of increasing access to capital for the small business sector of the U.S. economy. However, unless additional changes are made, the likelihood of success from the small business perspective remains weak at best.

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