Crowdfunding Without the Crowd

Darian M. Ibrahim
William & Mary Law School, dmibrahim@wm.edu
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More from: Darian Ibrahim

Editor's Note: Darian M. Ibrahim is Professor of Law at William & Mary Law School. This post is based on his recent article, forthcoming in the North Carolina Law Review.

My prior article on crowdfunding took a comprehensive look at crowdfunding’s evolution and its place in the entrepreneurial finance landscape. [1] I concluded that while crowdfunding could well turn into a “market for lemons,” in which bad startups seek dumb money as a last resort, this did not have to be the case. I argued that some promising startups—especially very young ones—would have good reasons to crowdfund, and the trick was to be sure investors could distinguish those startups from the many duds that will also populate crowdfunding sites. In particular, I argued that the SEC should make certain changes to the concept and operation of “funding portals”—the new intermediary between startups and investors in the crowdfunding space—before adopting its final rules. Funding portals are the websites that list the startups available for crowdfunding investments, and I argued they should play a larger role as reputational intermediaries between startups and investors.

In Crowdfunding Without the Crowd, I further probe the question at the heart of the funding portal’s role: does crowdfunding need expert intermediation to succeed? Or is crowdfunding, as the name implies, a true “wisdom of the crowds” situation in which expert screening is unnecessary, and perhaps antithetical to achieving the best outcome? The answer to this question will go a long way towards determining Regulation Crowdfunding’s success or failure, and indeed goes to its very nature as an investment option.

In a nutshell, my answer is that crowdfunding does require expert intermediation rather than crowd-based wisdom. For the crowd-based approach to work, there must be: diversity of opinion, independence, decentralization among participants, a method for aggregating their individual solutions, and a well-defined problem having a definitive solution. As my paper explains, none of these are good fits for investing in general, and an even worse fit for startup investing. On the other hand, experts are known to play an important role in investing generally. For example, IPO issuers hire well-known investment banks to rent their reputations to the issuer, thus enticing otherwise wary investors. As applied to startup investing, decades of expert angels and venture capitalists have made entrepreneurship extremely successful.

The most logical expert intermediary for crowdfunding is the funding portal. In a change from the original JOBS Act conception, the SEC’s final crowdfunding rules allow funding portals to screen the startups that wish to list on the site, thus employing the funding portal’s judgment as to which startups are likely to be successful. However, funding portal curation cannot go far enough over fears of becoming a broker-dealer. Thus, for crowdfunding to succeed, expert investors participating in crowdfunding offerings should be active on message boards and investment clubs to guide unsophisticated investors toward the best startups. For example, the WeFunder funding portal (host of half of the first 50 crowdfunding offerings) is home to the “The Wisdom of the Orange Hand” investment club, a self-described “mafia of Y Combinator alumni.” When you “back the club,” you commit to invest a certain amount per deal that the club invests in. In short, you are not even choosing startups at this point, but totally relying on Y Combinator alumni’s expertise in doing so.

However, I argue these experts must walk a fine line between putting their stamp of approval on an offering while also not becoming investment advisors under the Investment Advisors Act of 1940 or statutory sellers under Section 12(a)(2) of the Securities Act of 1933. But on balance, careful curation by funding portals and expert investors will give crowdfunding a better chance of success. This “crowdfunding without the crowd” is a move in the right direction.

The full paper is available here.

Endnotes