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Crowdfunding Signals

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 the Tazewell Taylor Research Professor of Law at William & Mary Law School. This post is based on his recent **paper**.

Crowdfunding is the hot new method by which new companies raise their first capital. Selling unregistered securities over the Internet was prohibited in the past because it constituted a "general solicitation" of investors. Then came the JOBS Act of 2012, which initially only allowed general solicitation of accredited investors (Title II offerings). [1] It was not until October 2015 that the Securities and Exchange Commission (SEC) passed the final rules implementing Title III, dubbed "Regulation Crowdfunding" (Regulation CF), which allowed general solicitation—and thus Internet sales—to unaccredited investors. [2]

While companies will primarily crowdfund to raise capital, this paper reveals that a crowdfunding campaign serves important, ancillary purposes too. Just as patents primarily allocate rights and rents while secondarily sending *signals* about firm quality and productivity, [3] crowdfunding campaigns serve the same dual functions for new companies. Signals serve to inform potential investors about a company's quality when that quality is otherwise difficult to observe. [4] Despite early commentary that crowdfunding is an option of last resort for entrepreneurs, this paper argues that a successful crowdfunding campaign can actually send a *positive* signal to follow-on investors, namely angels and venture capitalists (VCs), about firm quality.

This **paper** applies the economic literature on signaling to crowdfunding and reveals that an entrepreneur's decision to crowdfund—if that crowdfunding campaign is successful—can send a better signal of firm quality to angels and VCs than pre-crowdfunding signals did. Entrepreneurs have traditionally signaled firm quality through prior investors, investment contract provisions, and patenting activity, but each has its deficiencies, particularly when applied to very early-stage companies.

Crowdfunding, on the other hand, can signal an entrepreneur's savviness by not risking social awkwardness in seeking friends-and-family money and by delaying equity dilution through the issuance of SAFE securities. Crowdfunding also does more than perhaps any other move an early-stage company can make to signal real-world demand for its product or service. A successful crowdfunding campaign shows follow-on investors that the company has a real customer base, and potential brand advocates. Further, conducting a crowdfunding campaign can force an entrepreneur to "professionalize" the company. The entrepreneur must put together disclosure, deal terms, and other information in a professional format—which is not typically required under Regulation D (pre-crowdfunding) sales by early-stage companies.

Two important ramifications follow from recognizing the positive signaling function of crowdfunding. First, entrepreneurs without wealth or connections who depend on crowdfunding to raise initial capital should not be at a disadvantage when raising additional funds. This helps fulfill crowdfunding's promise to democratize entrepreneurship. Second, if signaling works, then the SEC could scale back the required crowdfunding disclosures, thus making the process more affordable to entrepreneurs.

The full paper is available **here**.

Endnotes

[1] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313 (2012) (codified as amended at 15 U.S.C. § 77d) (instructing the SEC to remove the "prohibition against general solicitation or general advertising" under Rule 506 for sales to accredited investors).
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[2] Jumpstart Our Business Startups Act, §§ 301-05, 126 Stat. at 315-23 (codified as amended in scattered sections of 15 U.S.C.); *see also* 15 U.S.C. § 77d(a)(6) (2012) (investors making less than $ 100,000 annually can invest up to $ 2,000, or 5% of annual income or net worth; investors making over $100,000 annually can invest up to 10% of annual income or net worth).
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[3] Clarisa Long, *Patent Signals*, 69 U. Chi. L. Rev. 625, 637 (2002) (arguing that viewing patents as a tradeoff between rents and rights likewise "presents an incomplete picture of the value and function of patents"); *id*. (exploring "the value of patents as informational mechanisms").
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[4] The seminal work on signaling is M. Spence, *Job Market Signaling*, 87 Q.J. Econ. 355 (1973).
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