<u>Teaching Note</u>

Overview

The Wefunder case, an example of regulatory entrepreneurship, presents multifaceted challenges associated with leading the growth of a new industry. Opposite to pursuing an entrepreneurial opportunity in an established or mature industry, there is far-reaching uncertainty about the regulatory environment in the equity crowdfunding industry and if new regulations, which might support the growth of the industry, will ever emerge. Moreover, Wefunder's existing success and market leadership, have generated an array of pressing operational/bandwidth challenges and business model viability questions.

Topics examined in the case include:

- crowdfunding campaign dynamics
- types of crowdfunding, with an emphasis on equity crowdfunding
- new industry creation
- entrepreneurial finance
- operations and scaling challenges of a new venture

Broadly, the case has value in intermediate and advanced entrepreneurship courses which might examine:

- ambiguity and uncertainty in the face of entrepreneurial action
- the creation (versus discovery) of entrepreneurial opportunities
- challenges educating customers/consumers/users when introducing a new innovation
- engaging in government relations—and at the extreme, regulatory leadership and lobbying—to create and enlarge an entrepreneurial opportunity

The case offers an integrated view of the four types of crowdfunding, painting a broad picture of this relatively new and developing area of entrepreneurial finance. Moreover, the case examines vital relationship-dimensions between entrepreneurs who choose to crowdfund (i.e., Creators) and Backers. Namely, the case analyzes the motivations of backers to support a given entrepreneur, project or cause, and how community is built around a campaign. The case is a multimedia case in that it links to several lively crowdfunding pitch videos and campaigns which animate the topic.

Case Questions

Below are notes to support a discussion and debrief of the five questions presented at the end of the case. Nonetheless, the case discussion can be taken in many directions.

Question 1: In what cases should an entrepreneur consider—and not consider—equity crowdfunding? How should equity crowdfunding be evaluated and compared to other sources of capital?

What should be clear from the case is that both rewards-based crowdfunding and equity crowdfunding are particularly expensive forms of capital in terms of cost and time. The cost of capital on Kickstarter averages 9% of capital raised, where portals such as Wefunder charge approximately 5% of funds raised. More than the direct financial cost, is the time-requirement to build and nurture relationships with backers or investors.

Clearly, crowdfunding is not 'free money from the universe'. Rather, funds come with strings to nurture, and particularly update and inform, an engaged backer community. Most rewards-based campaigns, and many equity campaigns, offer physical rewards to incent backers. The fulfillment of promised rewards, and in some cases production of those rewards, can be very time-consuming and even distract the entrepreneur from the core work of growing his or her venture.

This stated, both reward and equity campaigns, can be a cost-effective way to show *market validation* for an entrepreneurial opportunity, and build an enthusiastic user-community.

Question 2: How are backer motivations similar—and different—when comparing rewards-based crowdfunding versus equity crowdfunding?

On the surface, there appears to be a significant difference between backers of equity crowdfunding campaigns and rewards-based campaigns, where equity investors seek riches, and rewards backers seek only products. The thinking goes that the former crowdfunding type is for the hard-nosed investor, where the latter is for fans and followers, who don't apply an investment lens. Indeed, with equity crowdfunding, the backer is evaluating and investing in a venture, whereas rewards-based crowdfunding is generally limited to a project or product, so the scope of assessment is much narrower.

Research and interviews with those who run equity crowdfunding campaigns, however, show that the differences are exaggerated. More specifically, even equity campaign backers invest for emotional reasons, more akin to rewards-based crowdfunding. For example, they wish to back and support a local business (restaurant or liquor distillery) which one is a fan of – not to accumulate maximum wealth from $200 or $400 invested.

In fact, many equity crowdfunding campaigns offers 'perks', i.e., physical goods or discount coupons, so backers can also get rewards. Additionally, many equity crowdfunding campaigns actually offer debt equity, where backers are paid back as a fixed percentage of business revenues, so any upside is capped. Lastly, as discussed in the case, currently there is no secondary market in which backers may transfer investments made in equity crowdfunding campaigns, so all backers are essentially in a buy-and-hold position when they contribute.

In sum, the labels of equity and rewards-based crowdfunding belie some underlying comparability in the motivations of backers – to support entrepreneurs and products they often know and appreciate.

Question 3: What is regulatory entrepreneurship?

As described in the case, and defined by Pollman and Barry, regulatory entrepreneurship considers that "some companies pursue a line of business that has a legal issue at its core—a significant uncertainty regarding how the law will apply to a main part of the business operation, a need for new regulations in order for products to be feasible or profitable, or a legal restriction that prevents the long-term operation of the business." They continue, "for these entrepreneurs, political activity is generally a major component of their business models. Essentially, these companies are in the business of trying to change or shape the law."[1]

While government relations and lobbying have been a focus of larger corporations with the corresponding means and interests for decades, *regulatory entrepreneurship* is a relatively newer form of entrepreneurship, gaining increasing interest.

Other prominent examples of entrepreneurial ventures engaging in regulatory entrepreneurship include:

- Uber—the ride-hailing app which has aggressively challenged, and many times disregarded, local, regional, and national taxi/driver laws.
- Airbnb—the home-renting service which also has challenged national and local laws on lodging services.
- Lime—the scooter rental app which has forcefully challenged, and in many cases flouted, existing transportation laws.

Arguably, there are ethical questions raised by regulatory entrepreneurship. Namely, is it ethical to act outside of existing regulatory frameworks in an effort to change those frameworks? Clearly, there have been recriminations with this approach -- for example strikes by French and London taxi drivers to protest Uber's policies and expansion--but it is also the

[1] Pollman and Barry, "Regulatory Entrepreneurship," 90 S. Cal. L. Rev. 383, 392 (2017)

case that entrepreneurs may justly choose to challenge entrenched political interests and business models.

Airbnb is arguably an example of regulatory entrepreneurship that has yielded both socially-desirable and socially-undesirable outcomes associated with its business model. On the one hand, Airbnb has driven down the cost of travel, and facilitated cultural connections (e.g. in the coordination to arrange a stay which may be in the actual house/room of the host). On the other hand, the aggressive growth of Airbnb in some cities, and associated speculation in real estate to offer Airbnb lodging, have worsened the affordable housing problem. Analogously, the rise of equity crowdfunding arguably has diluted the protections included in prior law for smaller, unsophisticated investors.

In sum, not all local, regional and national regulations are just, but the entrepreneurial team is pursuing a unique type of growth strategy when lobbying for new regulations is central to the entrepreneurial opportunity.

Question 4: Given that equity crowdfunding industry growth is much lower than anticipated, what should Wefunder's immediate and longer term strategy be? Relatedly, in your view, what competitive actions will separate winners from losers in this new industry?

Clearly, the ability to intake and promote quality campaigns is central to Wefunder's strategy, as growth is driven by generating deal flow, commissions and fees. However, as noted in the case, the desire to cultivate and seize a long-term growth opportunity requires investor education and expectations-management. Namely, Wefunder is aware of inevitable backlash if it markets its platform and campaigns as only a profit-making vehicle without substantial risk.

This suggests that entrepreneurs creating new industries – or in a leadership position in their creation – bear the responsibility to establish initial industry conditions favorable to overall venture success.

The earlier rise of rewards-based crowdfunding suggests strategies to educate backers and manage their expectations. Namely, Yancey Strickler, co-founder of Kickstarter, famously claimed "Kickstarter is not a store!" and aggressively promoted this statement, to educate its users that campaign backers face both transaction and timing risks entirely unlike ordering from Amazon, for example, where a product is assured to arrive two days after order.

Moreover, Kickstarter initially banned photorealistic CAD-renderings of product concepts to guard against fraud, and the seeking of funds in absence of a developed physical prototype. While some fraud exists on Kickstarter and Indiegogo, estimated to be less than 2% of all projects (Mollick, 2014), this reality has not stymied the growth of the overall industry and entrepreneurial opportunity.

Clearly, WeFunder faces some analogous challenges and imperatives:

- Continuing to attract quality deal flow, and evaluating what types of entrepreneur campaigns to emphasize and avoid during scale up, potentially focusing on certain markets and sectors
- Implementing new processes and systems to lower the resource requirements to onboard campaigns
- Comparable to its regulation-creation leadership efforts before, aggressively lobbying to legalize the "Investment Clubs" at the heart of Wefunder's intended business model

In sum, Wefunder, again, finds itself at the bleeding edge of its regulatory entrepreneurship efforts to create and shape its entrepreneurial opportunity. Wefunder's prior experience has shown that policy change takes years – not months – to act. What entrepreneurial lobbying efforts can produce a change and can come in time?

Question 5: How, if at all, will the emergence of crowdfunding impact angels and venture capitalists?

While it is tempting to think that crowdfunding and angel/VC investment are necessarily at odds, in fact, some angels and VC's leverage crowdfunding to raise capital for the ventures they support, seeking *market validation* for an entrepreneurial opportunity.

The Pebble 2.0 watch ("Pebble Time"), which raised over $20 million, was a VC-backed venture which turned to crowdfunding to pre-sell products to a growing customer base (many Pebble 1.0 backers) and offset required investments to scale production. As such, many VC's see successful crowdfunding campaigns as telling data about a target market's interest in an innovation and the potential market size.
Moreover, crowdfunding platforms can help angels and VCs identify potential deals and entrepreneurs needing follow-on investments. In fact, a number of equity crowdfunding campaigns have been accompanied by simultaneous traditional private placements.

Appendix A. Legalities of Equity Crowdfunding for Non-Accredited Investors

Nick's frustration with the inability of small businesses to raise money from numerous small investors was legally justified at the time. The problem stemmed from Section 5 of the Securities Act of 1933 (the "33 Act") which states in part, "Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security…" This language would have the effect of requiring any company desiring to sell any of its securities in interstate commerce to go through the process of creating and filing a registration statement with Securities and Exchange Commission ("SEC"), a process that can take upwards of 6 months and cost over $1 million. Fortunately, the 33 Act contained a number of exceptions to this registration requirement, the most commonly used of which are described below.

First, in recognition that the federal government's regulatory reach does not extend beyond interstate commerce, Section 3(a)(11) exempts from the 33 Act "Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory." At the time of Nick's early involvement in the securities world, the SEC had issued Rule 147, a safe harbor regulation explaining its understanding of this "intrastate exception." Under that Rule, the issuer (if a corporation) had to be incorporated under the laws of the target state and have its principal place of business there. In addition, it must have derived 80% of its revenue from that state, maintained 80% of its assets there, and spent 80% of the proceeds of the offering there. Furthermore, all offerees and purchasers must have been resident in the target state and securities offered pursuant to the Rule could not be resold outside of the state for at least 9 months. Significantly, in the age of the internet where it is difficult if not impossible to control who can access a website, the requirement that all <u>offerees</u> be resident in the target state effectively eliminated the use of the internet if an issuer wished to rely on the intrastate exception. And, significantly, even those few offerings which might be able to comply with Rule 147 would still be subject to the securities regulations of the target state.[2]

Much more useful was the exception contained in Section 4(2) of the 33 Act exempting from the registration requirement "transactions by an issuer not involving any public offering." This welcome exception for so-called "private placements" nonetheless left much to interpretation. Just what exactly is a "transaction…not involving any public offering?" Over the years, courts have relied on a number of factors to distinguish qualifying private offerings from public ones, attempting to differentiate investors who "need the protection of the Act" from others who might have "access to the kind of information which registration would disclose." These factors included the identity of the offerees and their relationship to the issuer and each other, the size of the offering, the number of investment units (shares) offered, the methods of communication and distribution employed, and the length of time the securities were held

[2] Rule 147 has since been amended to make it more internet friendly.

before resale. All of these factors are at least somewhat subjective and given the harsh penalties for being found to have engaged in an unregistered public offering, left anyone relying on Section 4(2) at considerable risk.

In an attempt to mitigate that risk, The SEC had issued another safe harbor, Regulation D, the operative portions of which were denominated as Rules 504, 505 and 506. Under Rule 504, as long as all offers were made in states which imposed their own disclosure regulations, an issuer could raise as much as $1 million by simply filing a one-page notification with the SEC ("Form D"). No further restrictions were imposed.

If an offering raised over $1 million but not more than $5 million, in addition to filing Form D, the number of purchasers were limited to 35 plus an unlimited number of accredited investors. Issuers were prohibited from making general solicitations of offerees and had to take reasonable steps to control resales of securities. And if any non-accredited investors were involved, the issuer also had to provide a disclosure statement, which included financial information which became more extensive depending upon the amount of money to be raised.

Offerings of more than $5 million fell under Rule 506, whose regulations were substantially similar to Rule 505 except that the required disclosures, financial and otherwise, were more extensive than under Rule 505. General solicitation was allowed so long as limited to accredited investors. And the issuer was required to verify that any and all non-accredited investors "ha[ve] such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."

The combination of the need to comply with state regulations in small offerings, the increasingly extensive required disclosures, and the limitations on the number and nature of offerees, generally made Regulation D a non-optimal solution for the type of offerings Nick had in mind.

One more commonly used exception to the registration requirement which was equally if not more inapt derived from the SEC's general exemptive authority contained in Section 3 (b) 1 of the 33 Act:

> The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $5,000,000.

Pursuant to this authority, the SEC had issued Regulation A, which allowed issuers raising up to $5 million to file a "simplified" form of registration statement (an "offering circular"), rather than a full-blown registration. However, it was generally believed that the amount of disclosure still necessary to comply with Regulation A, the cost of creating such an offering circular, and the amount of time it took to create and gain SEC approval for such a document made use of Regulation A impractical, especially in light of the $5 million dollar limitation. [3]

Nick was, therefore, generally correct that there was no practical method under the securities laws as they then existed for a small company to raise a relatively small amount of money from a relatively large number of small unaccredited investors.

[3] Regulation A has since been amended to, among other things, increase the size of eligible offerings to $50,000,000.

Appendix B. The JOBS Act and Wefunder's Participation

All this effort initially paid off in the form of Title III of the Jumpstart Our Business Startups (JOBS) Act, enacted on April 12, 2012. That Act created a crowdfunding exemption from registration under the 33 Act (and from state securities regulation) of offerings of securities which complied with the following limitations:

a) The aggregate amount raised under the crowdfunding exemption by any offeror within any 12 month period cannot exceed $1 million.
b) The amount raised from any individual investor within said 12 month period cannot exceed
    a. The greater of $2000 or 5 percent of the annual income or net worth of the investor if either said net worth or annual income is less than $100,000, or
    b. Ten percent of the annual income or net worth of the investor if either the net worth or annual income of the investor equals or exceeds $100,000, provided the amount raised from such investor within said time period does not exceed $100,000.
c) The transaction is conducted through a registered broker/dealer or the newly created concept known as a "funding portal." Thus, crowdfunding offerings cannot be conducted directly by issuers; third party "intermediaries" are necessary.

The JOBS Act went on to impose the following restrictions on "intermediaries."

a) They are required to register with any applicable self-regulatory organizations, which, in the case of funding portals turned out to be the Financial Industry Regulatory Authority (FINRA)
b) They are further required to ensure that the proceeds of an offering are turned over to the issuer only if and when the stated target amount has been raised;
c) They are prohibited from paying finders fees for obtaining potential investors;
d) Their directors, officers, partners and persons occupying similar roles are prohibited from having any financial interest in any issuer using their services; and
e) They are required to comply with such regulations regarding provision of disclosure information to investors, assuring that investors appreciate their risk of loss, reducing the risk of fraud, protecting investor privacy and enforcing the limits on individual investment as the SEC shall promulgate.

Further, the JOBS Act imposed significant restrictions on crowdfunding issuers.

a) Issuers are required to provide both the potential investors and the SEC with disclosures covering, among other items, the following information:

    a. Names of directors, officers and 20% owners of the issuer
    b. Descriptions of the financial condition of the issuer which can range from tax returns to as much as audited financial statements depending upon the amount to be raised
    c. The target amount to be raised and deadline for raising it
    d. Description of the capital structure of the issuer and of the securities being sold
    e. The price of the offered investment units and the valuation method used in determining said price
    f. The name and address of the issuer, a description of its business, the proposed use of proceeds and the risks of investment; and
    g. Such additional information as the SEC shall, by rule, require

b) Any advertising of the offering must direct potential investors to the relevant intermediary.
c) Any compensation paid in exchange for promoting the offering must comply with rules to be promulgated by the SEC
d) Following a successful offering, issuers must provide annual reports to the investors and SEC including financial statements and other information to be required by the SEC.
e) Issuers must comply with any other rules which the SEC, by rule, may require.

Lastly, the JOBS Act provided that any securities purchased under the crowdfunding exemption could not be resold (with certain limited exceptions) for one year from the date of purchase.

With this major legislative victory, all eyes turned to the SEC, without whose rulemaking, the crowdfunding exemption could not go into effect. Unfortunately for those interested, it turned out to be a long wait. Proposed rules were not released until October 23, 2013, and final rules, providing all the clarifications required by the JOBS Act, were finally promulgated on October 30, 2015, with an effective date of May 16, 2016.

Wefunder actively participated in this rulemaking, in the process providing the SEC with a formal comment letter after the proposed rules were released for comment. The letter praised the SEC for not requiring investors to prove their net worth and annual incomes with tax returns, etc. Such disclosure would be a powerful deterrent in context of such small investment amounts. It also approved of the SEC's position that the $1 million limit on monies raised through crowdfunding would not count against any monies raised by an issuer pursuant to other 33 Act exemptions. It further approved of the SEC's allowance of oversubscriptions to offerings and giving issuers the flexibility to reject subscriptions from individual investors.

However, Wefunder requested that the SEC reconsider its decision not to allow intermediaries to take a financial interest in issuers in exchange for its services, thereby aligning the interests of the intermediaries with that of investors. It further requested the SEC to allow “special purpose entities” to invest in crowdfunding offerings. These would be entities formed by investors for the purpose of investing in an offering, thus avoiding the necessity for issuers to have to deal with multitudes of small individual investors going forward. And Wefunder also requested the SEC to reconsider its stance against allowing intermediaries to “rate” issuers.

Only the request regarding taking a financial interest in the issuer as compensation was granted, conditioned on full disclosure to the investors and SEC. Otherwise, the final regulations largely tracked the proposed rules with some further clarifications. The Equity Crowdfunding industry about to be born!

Appendix C. Key Dates and Milestones

2012 – Congress passes the Jumpstart Our Business Startups (JOBS) Act in response to the 2008 economic crisis. Wefunder is invited to the White House Rose Garden to see Obama sign the bill into law.

2012 – The Wefunder founders raise $530,000 from 60 investors and begin "crowdfunding for rich people"/accredited investors while waiting for new crowdfunding regulations to be developed.

2013 – Nick Tommarello, Nick Belote and Mike Norman participate in the business incubator Y-Combinator in Cambridge, Massachusetts.

2012-2016 – The Wefunder founders offer extensive comments and input to shape the development of regulations meeting with U.S. Congress members.

May 16, 2016 – Forty months after the Congressional deadline, the SEC crowdfunding rules go into effect.

May-July, 2016 – 70,000 investors sign up; 5,000 investors commit over $5 million; 29% of investors put the minimum of $100

October 2016 – Over 77,000 investors are registered with Wefunder; Wefunder has helped raise funds for 134 companies

October 2016 – Wefunder becomes the first equity crowdfunding platform to accept Bitcoin

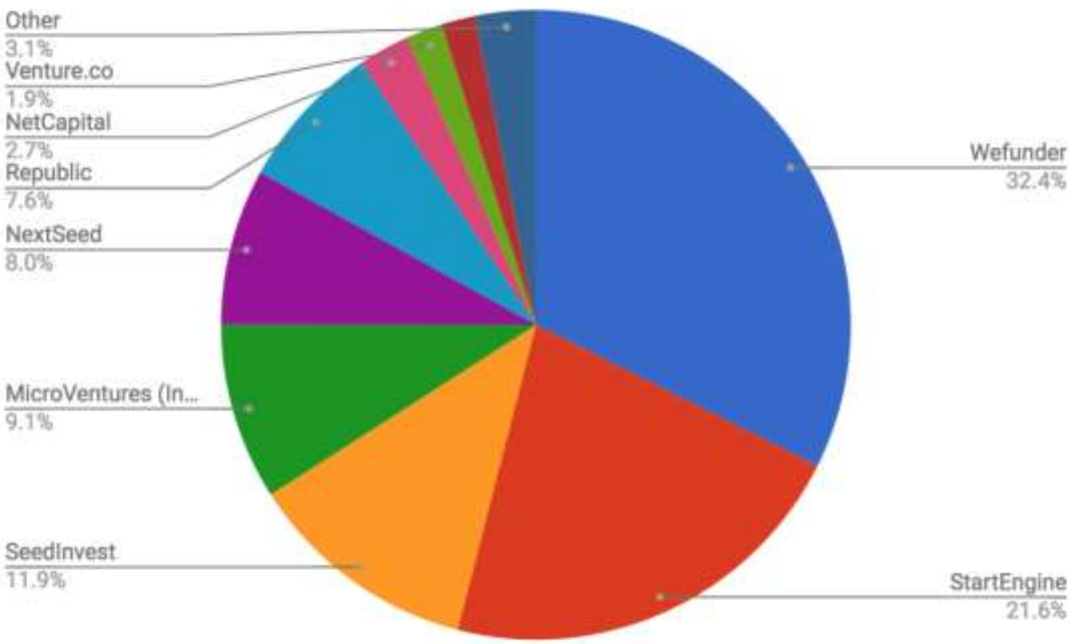
April 2017 – The Wefunder platform accounts for over 80% of all funds raised in the non-accredited equity crowdfunding space.

May 16, 2017 – One year in, 335 companies have filed offerings on all operating portals, 43 percent of which were funded, 30 percent of which had failing campaigns, and the remainder were still fundraising; total capital invested is just above $40 million with the average successful campaign raising $282,000 from about 312 investors, or slightly under $1,000 per contributing investor. Of the 26 portals registered with FINRA, 9 have already closed.

October 2017 – StartEngine and Wefunder are neck-and-neck, each with 40% of total funds raised.

Appendix D. Dollar Volume by Platform

	Through March 31, 2018	
Funding Portal	Amount of Capital Raised (in millions)	% as of total
Wefunder	$33.08	32.4%
StartEngine	$22.05	21.6%
SeedInvest	$12.15	11.9%
MicroVentures	$9.29	9.1%
NextSeed	$8.17	8.0%
Republic	$7.76	7.6%
NetCapital	$2.76	2.7%
Venture.co	$1.94	1.9%
Other	$3.17	3.1%



Source: Startengine.com

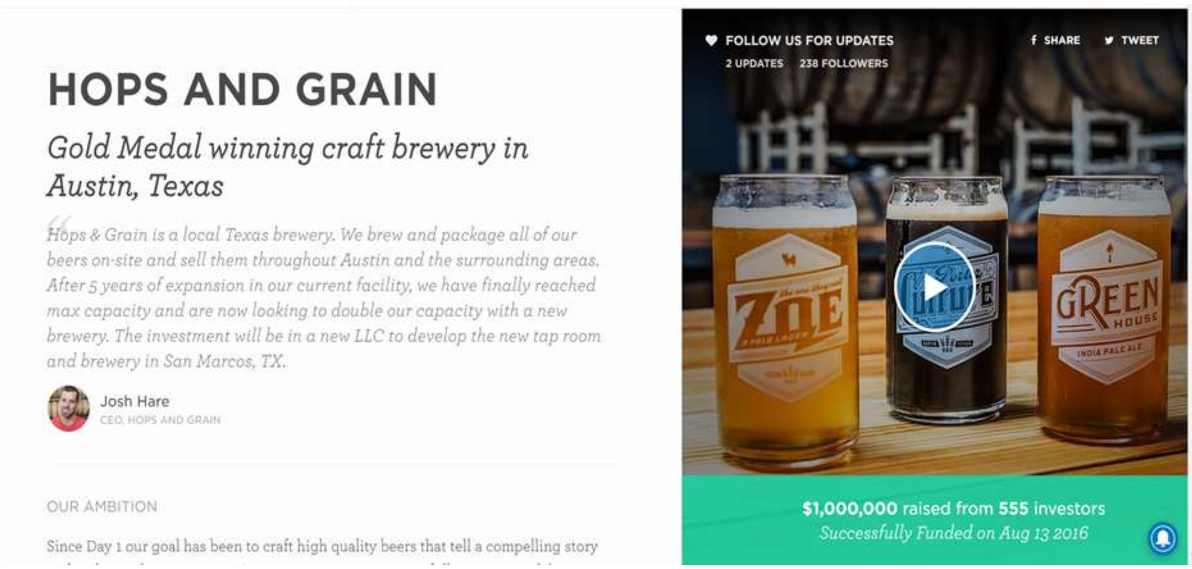
Appendix E. Platforms Listed with FINRA

As of 11/18/18

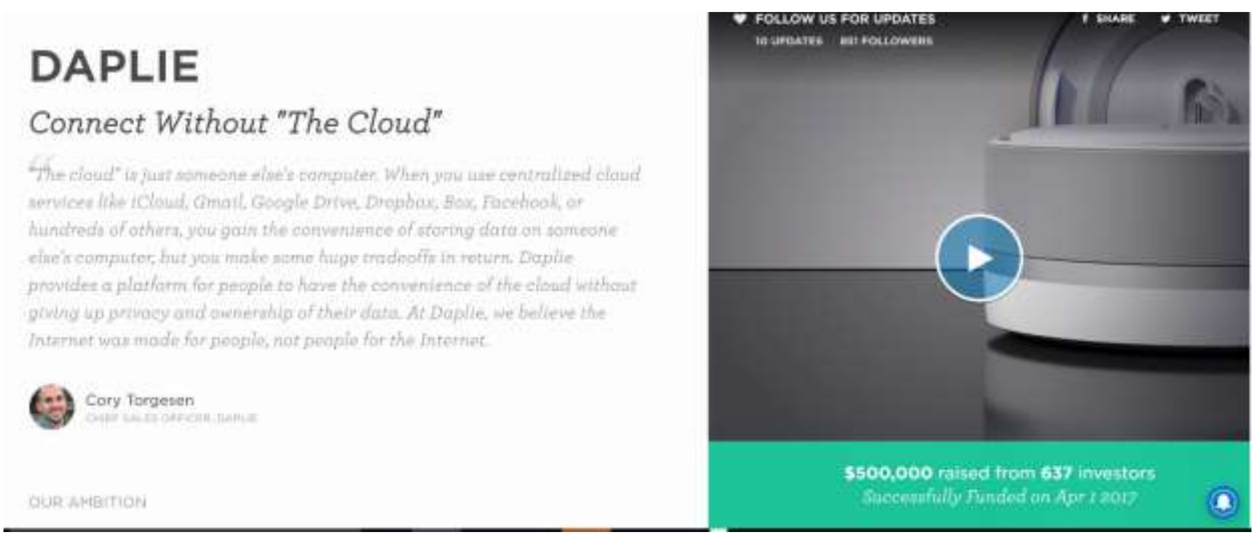
Avonto, LLC
Buy The Block
CollectiveSun, LLC
Crowd Ignition, Inc.
CrowdsourceFunded.com
EnergyFunders Marketplace
Equifund Crowd Funding Portal Inc.
EquityBender LLC
First Democracy VC
FlashFunders Funding Portal, LLC
Funding Wonder Crowd, LLC
Fundme.com, Inc.
Fundpaas Inc
Good Capital Ventures
Gridshare LLC
GrowthFountain Capital, LLC
Honeycomb Portal LLC
Hycrowd LLC
Indie Crowd Funder, LLC.
Jumpstart Micro, Inc
Ksdaq Inc.
Merging Traffic Portal llc
MinnowCFunding LLC
Neighbor Capital
NetCapital Funding Portal Inc.
NextSeed US LLC
NSSC Funding Portal, LLC
OpenDeal Inc.
Razitall, Inc.
SI Portal, LLC
Silicon Prairie Holdings, Inc.
Slice Capital
Sprowtt CrowdFunding, Inc.
StartEngine Capital LLC
StartWise, Inc.
STL Critical Technologies JV I, LLC
Thrivera Ventures Fund I, LLC
title3funds.com
Trucrowd INC
Venture Capital 500, LLC

Wefunder Portal LLC

Appendix Sample Wefunder offerings



Industry: Craft beer
Amount Raised: $1,000,000
Date Closed: August 13, 2016
Number of Investors: 555
Terms: Annual payments of a percentage of gross revenue until twice the invested amount has been repaid.



Industry: Home server (replacing “the cloud”)
Amount Raised: $500,000
Date Closed: April 1, 2017

Number of Investors: 637
Terms: Class A Common Stock