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9B17M039

STARTUPVALLEY: Platform Strategy in Equity Crowdfunding

Yanli Zhang, Ross A. Malaga, and Enrique Nunez wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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In May 2016, Daryl Bryant sat in his luxurious office space in New Jersey, contemplating the future of his company, Hudson Integrated, and of his newest venture, StartupValley. He was proud that Hudson Integrated had been able to thrive for more than 10 years in the hypercompetitive environment of web agencies, where many others failed. But now he felt he was at a crossroad taking a great risk with this new initiative, an equity-based crowdfunding platform named StartupValley. Bryant was confident about the imminent success of his venture, but he also knew he would be facing challenges ahead. The crowdfunding business was a completely new industry to Bryant, with many unclear aspects. Finalizing all relevant regulations for this new industry had taken three years, and during that time the competition had become intense. Bryant worked hard to bring his partner on board, who had been initially skeptical of the initiative. The new business required considerable investments of time and money, which could affect the existing company and the personal lives of the two partners. Bryant had a family and young children to consider, so he wanted to make sure that the new venture was headed in the right direction. Lost in his thoughts about where he had come from and where the future would lead, Bryant gazed out of his office window.

Bryant’s Entrepreneurial Journey

Bryant described himself as always having had an entrepreneurial spirit. In fifth grade, he used his father’s computer to print NFL (National Football League) football helmet stickers and sell them to his classmates for 10 cents each, earning a few dollars per week. By age 16, he was selling Cutco knives so he could afford to take his girlfriend out on dates. However, Bryant’s entrepreneurial spirit really blossomed while attending college and studying computer science and mathematics.

As a student at Montclair State University, Bryant discovered that many restaurants had to pay to dispose of their empty liquor bottles. Sensing an opportunity, Bryant arranged to pick up bottles and make lamps out of them, eventually selling them to fellow students and local restaurants. Using online and word-of-mouth marketing, he started a successful business called Liquor Lamps, until a major liquor supplier who objected to the use of the bottles sent a cease-and-desist letter. Reluctant to engage in a legal fight with a major corporation, Bryant learned a valuable lesson on running a business and decided to refocus his efforts.

Bryant graduated in 2000 and took a job as a software developer in New York City. He quickly rose in the company’s ranks to become the chief executive officer’s right-hand person, although the company folded during the 2002 Internet bubble and Bryant lost his job. After working at a local restaurant, he reflected on his life ambitions, realizing that he had always been an entrepreneur at heart, and decided to start his own business.

Bryant met a fellow Montclair State University alumnus, an accounting major and self-taught programmer, who was also working in a restaurant until the right opportunity arose. Being two prospective entrepreneurs, they decided to work together and started a web development agency called Hudson Horizons. The two partners kept their restaurant jobs while building their new business. The accountant who incorporated the new business referred his brother-in-law as the first customer for the design of a website, which was completed with assistance from Bryant’s girlfriend at the time. Bryant and his partner worked well together to grow the business. Each partner focused on his strengths, although they both had a good understanding of the technical and financial aspects of the business, and strong communication skills in relations with each other and with clients.

Hudson Horizons grew steadily and more than tripled in size in its first 10 years. The company offered various related services including website design, custom website development, search engine optimization, paid search management, and social media marketing for small, mid-sized, and Fortune 500 companies. Bryant emphasized the importance of maintaining a position on the forefront of the most cutting-edge technological innovations.

With growth also came challenges. After 10 years, it was time to slow down and consider the company’s mission and goals to pursue. The industry had become fiercely competitive. Many firms were able to undercut competitors by outsourcing programming operations overseas, so Bryant decided to shift the company’s business model away from web development to an integrated web agency, focusing more time and effort on growing the marketing side of the business. This change was accompanied by a new company name: Hudson Integrated. The new business was scaled back from a high of 25 employees, becoming more selective in its recruitment efforts to ensure that successful applicants suited the company’s culture and core values.

The Birth of StartupValley

One day in 2012, during one of Bryant’s usual routines to keep a close tab on the technology world, he read an article on Crain’s New York Business news feed about the new *Jumpstart Our Business Startups (JOBS) Act*. The *JOBS Act* would make it easier to launch and support start-ups through the use of equity-based crowdfunding. Bryant immediately saw the potential that this initiative provided to ease access to capital. As a business owner, Bryant was well aware of the difficulties involved in raising capital. But this new initiative potentially allowed entrepreneurs to publicize their business ideas and receive funding from anyone who might be interested.

The *JOBS Act* contained two major provisions that were important to start-ups looking to raise capital. The first provision, Title II, enabled start-ups to publicly solicit funding. However, under Title II, start-ups could accept funds only from accredited investors. To qualify as an accredited investor, the individual needed to have a net worth of at least US$1 million[[1]](#footnote-1) or have earned an annual income of at least $200,000 in the previous two years. Therefore, although the Title II provision offered great help to start-ups, smaller investors were not considered. However, the second provision of the *JOBS Act*, Title III, provided the ability for non-accredited individuals to invest small amounts of capital in start-up companies.

Bryant read further to learn more about the key investor protection mechanism of Title III, which was the requirement that equity crowdfunding transactions take place through an intermediary registered with the Securities Exchange Commission (SEC), either a broker–dealer or an approved funding portal. With over 10 years of experience running a multimillion-dollar web agency, Bryant was very familiar with building online portals, having been developing them for his clients. He had been waiting for the “next big thing”—and here it was. He was excited by the idea of helping companies raise capital, while tapping into the resources and capabilities he had built over the years. Bryant’s “aha moment” soon followed, when he envisioned StartupValley, an equity crowdfunding portal to allow start-ups to raise capital.

Bryant’s business partner was reluctant at first, but he was eventually convinced about the idea of StartupValley. Bryant gained new insights by reading the *JOBS Act*, the rules and proposals, and the financial aspects of the platform. Many complexities were involved in running a crowdfunding platform, including conducting due diligence and background checks, and ensuring the legitimacy of the companies raising capital. Bryant anticipated that a great amount of effort would be required to build a team with the relevant expertise, master the financial operations, recruit legal counsel, leverage third-party broker–dealers, and build partnerships. He also devoted time and effort to build various strategic alliances as a co-founder of the Crowdfunding Professional Association and board member of the Crowdfunding Intermediary Regulatory Advocates, among others. These efforts paid off. Bryant had transformed himself into a thought leader in the crowdfunding community. In 2014, he was invited to the White House, along with other industry executives, to discuss developments in the industry.

the Emerging Equity Crowdfunding Industry

Crowdfunding was a way for businesses or other organizations to raise money from multiple individuals. As an extension of traditional financing by friends and family, crowdfunding used communities (often online) to pool money to fund members with business ideas.[[2]](#footnote-2) The history of crowdfunding could be traced as far back as the 18th century, when some writers and artists, such as Mozart, used a subscription model to raise funds for their planned publications or performances.[[3]](#footnote-3) In 1885, renowned publisher Joseph Pulitzer launched a fundraising campaign in his newspaper the *New York World* to raise money from the public to build the pedestal for the Statue of Liberty that had just arrived from France. For $1, a backer would receive a six-inch statuette of Lady Liberty, and for $5, a 12-inch one. In just months, more than 120,000 people from around the world pledged $102,006 to the project, which enabled the pedestal to be built.[[4]](#footnote-4)

For centuries, artists and patrons had used the crowdfunding model to fund projects, so the concept of crowdfunding was certainly not new. The biggest difference between earlier versions of crowdfunding and its contemporary counterparts, however, was that the Internet made the model exponentially more accessible to all. Generally, the industry currently observed four types of crowdfunding: (1) reward-based, where investors received a tangible item or service in return for their funds; (2) donation-based, where contributions went toward a charitable cause; (3) lending-based, where investors were repaid for their investment over a period of time; and (4) equity-based, where investors received a stake in the company.

StartupValley was focused on equity-based crowdfunding. Traditionally, equity funding for start-up companies came from two sources: angel investors, namely affluent individuals who provided capital, usually in exchange for convertible debt or ownership equity; and venture capitalists, typically a dense social network of interconnected companies and players. Angel investors and venture capitalists primarily operated through network connections and direct contacts with entrepreneurs. Bryant was excited by the promise of crowdfunding to level the playing field, or promote fair access, and equalize the funding process by making capital more accessible to a broader set of entrepreneurs. However, with hundreds of crowdfunding websites already available, how would StartupValley stand out from its competitors?

Strategy and Competition in Equity Crowdfunding Platforms

Bryant realized that Internet platforms such as StartupValley were subject to a powerful network effect. Crowdfunding platforms such as StartupValley facilitated a two-sided market, whereby the parties involved—investors and start-ups seeking capital—came together to negotiate funding agreements that were mutually beneficial. As Bryant learned from Facebook’s example, the value of an Internet platform depended on whether it could leverage and exploit the network effect, attract enough quality members from each side of the platform, and create a vibrant ecosystem to match their demands. StartupValley realized that attracting investors required relevant and quality deal flows. However, attracting quality start-ups required an assurance of having quality investors. Bryant deliberated on what strategies he should adopt to create the network effect and increase the value of StartupValley. While considering different strategies, he decided to research how other industry competitors were dealing with these issues.

Which Side to Subsidize and Which Side to Charge?

One of the first questions Bryant needed to resolve was which of the two parties in the transaction to subsidize and which to charge. The decision could be critical to the future of the platform. The value of one party would grow with the popularity of the other party, and eventually both parties would became mutually reinforcing. For example, many Internet platforms provided free access to attract a critical mass of users on one side of the platform, which would then make the platform attractive to the other side. The most prominent example of this strategy was Google, which subsidized its service side by allowing users to search the Internet for free, thereby attracting a vast user base. The platform was thus very attractive to advertisers, who were willing to pay for access to the vast user base. A more traditional example was the practice of some bars offering free entrance and drinks to female customers to attract more male customers who were willing to pay for their own entrance and drinks. Therefore, Bryant realized that determining which party to subsidize and which to charge was critical to the future success of StartupValley.

One common practice in the industry seemed to be to charge investors for access to companies listed on the platform, a practice that was already followed by some of StartupValley’s competitors. For example, start-ups had free access to [AngelList](https://www.quora.com/topic/AngelList) to raise capital. AngelList in turn charged investors 5 per cent carried interest on profits returned to investors participating through the platform. An additional 15–20 per cent carried interest (as specified by a lead investor) would be paid by the investors to the creator of the syndicate or the lead investor to confirm the deal. A small portion of the capital would also be used to cover out-of-pocket expenses for setting up and administering each fund over its lifetime. Each individual investment’s out-of-pocket expenses were covered pro rata by the investors.

Another common practice was to offer companies the service of listing their funding projects for free on the StartupValley platform and charge a placement fee if funding was secured. This practice seemed to be the approach that most crowdfunding equity platforms were following. One example of this approach was SeedInvest. Investors on SeedInvest were not charged a fee or percentage. They received the full amount of their investments in the companies’ securities. However, companies wishing to list on the SeedInvest platform were charged a placement fee contingent on the value of the fundraising amount, upon the successful completion of their offering. The companies also needed to pay for due diligence, escrow, marketing, and legal expense reimbursements.

StartupValley needed to determine whether to charge investors for access to the companies listed on the platform or instead charge companies a listing fee or expense fees, or both. Which strategy would be more conducive to greater growth and value? Bryant felt that he needed more research into the underlying mechanics of this new industry to determine the costs involved in running the platform, the sensitivity of users to price and quality, and other issues relating to the networking details for either party.

Facilitating Trust and Reducing Transaction Cost

A successful equity crowdfunding platform would manage large amounts of money. Therefore, gaining trust and reducing transaction costs were of paramount importance. Investing in early stage businesses was inherently risky. Many of the companies already listed on equity crowdfunding platforms were susceptible to a variety of factors that could affect the company’s value or even lead to its demise. Either of those outcomes would mean a great loss for the company and the investors. Even without loss, the investors’ funds could be held for long periods with limited liquidity to sell their interests. Therefore, trust was essential for the platform’s ability to attract investors and start-ups alike. The SEC required the platforms to conduct a minimum level of scrutiny of the listed companies. Beyond that requirement, the vetting of firms tended to be left to the platform’s discretion.

The European equity crowdfunding site Seedrs conducted a minimal amount of vetting of start-ups wishing to raise capital on its platform. It reviewed all of the information that each start-up provided, requiring evidence to support statements made by the company. The site listed only companies that it believed would be of interest to its members, after concluding that the information provided by the company was “fair, clear, and not misleading.”

AngelList, a U.S. crowdfunding platform, used syndicates to vet interested companies. The platform allowed investors to form syndicates, enabling them to co-invest with other notable investors. Users who chose this approach, referred to as backers, were charged a fee to invest in a prominent investor’s future deals. In return, the backers received access to the investor’s deals and benefited from the investor’s experience in choosing and managing prudent investments.

EarlyShares, a U.S. real estate crowdfunding platform, took a different approach, by leveraging the expertise of outside partners GSV Capital, Brutten Global, and First Key. These partners were institutional investors that invested primarily in the equity securities of emerging private companies that were both rapidly growing and backed by venture capital. EarlyShares was thus able to leverage the vast industry expertise of institutional investors to conduct a rigorous screening process for listed companies.

SeedInvest, a U.S. equity crowdfunding platform, performed a thorough scrutiny of potential listed companies, staking out a high-end position in the industry to cater to select investors. SeedInvest featured only highly vetted investment opportunities that adhered to strict requirements, rather than acting as a simple listing service. Companies listed as having been vetted had undergone a comprehensive due diligence process that included various services. An outside firm had performed legal and confirmatory due diligence. An outside legal counsel had reviewed the company’s transaction documents. An independent broker–dealer registered with the SEC had conducted research and due diligence on each company to determine its viability as an investment opportunity and any risks associated with that opportunity. An investment committee comprising senior executives of the independent broker–dealer then reviewed each company before it could begin accepting investments online.

Bryant felt that a highly vetted platform such as SeedInvest would add value and attract investors. However, it could also be costly and create a bottleneck, or congestion, in the fast-growing plans of the platform. StartupValley would need to determine which level of scrutiny was best: a minimal amount, such as Seedrs; an investor-led syndicate, such as AngelList; or one that leveraged the expertise of broker–dealers or institutional investors, such as EarlyShares or SeedInvest.

How to Attract a Great Number of Customers

After some research, Bryant found that industry competitors generally used two major ways to attract users. One was to encourage access to the platform to a greater number and variety of users. For example, AngelList provided developers with an application programming interface to access its database. EquityNet implemented a sophisticated licensing and affiliate program that allowed investors, government entities, business incubators, and other members of the entrepreneurial community to analyze and capitalize on privately held businesses. EquityNet licensed its data for benchmarking, analysis, and research purposes.

Another way was to provide innovative products and services as incentives for using the platform. For example, Crowdcube, an equity-based U.K. crowdfunding platform, offered traditional equity financing as well as a “mini-bond” products, whereby investors did not own a stake in the business, but instead received regular interest payments from the company, and eventually were returned their initial investment at the end of the mini-bond’s term. EarlyShares offered a convertible debt product, which was often used as bridge financing by the firms. This product essentially enabled investors to provide a loan to a business, which could be turned into equity at some point in the future or paid back to the investor with interest. The loan accrued interest until the principal was converted or paid. Upon conversion, accrued but unpaid interest due to investors was also converted into shares.

Many equity crowdfunding platforms also allowed users to invest in a variety of fund investments. For example, AngelList allowed users to invest in a fund that was invested in a diverse portfolio of AngelList start-ups. Funds returned capital to users when any of its investments had a liquidation event. EarlyShares worked with prominent financial firms to host fund investments, thus allowing qualified investors access to a class of hedge fund and private equity investments that were typically restricted to institutions and extremely high-net-worth investors. Wefunder took a different approach to fund investments. Most of the start-ups that listed publicly on Wefunder raised funds using a WeFund, a product that pooled capital from investors to invest in one specific start-up. Users investing through a WeFund held an interest in the fund instead of holding the company's securities directly. WeFunds were managed by a dedicated affiliate investment advisor.

Bryant pondered the many ways he could employ to attract users to his platform and which incentives to provide. Traditional brokerages and investment banks seemed to have significant advantages, including relationships with investors and experience in bringing deals to market, vetting companies, and conducting valuations. Forging strategic partnerships with brokerages and investment bankers to provide a complete range of services could be an important advantage for Bryant to consider.

StartupValley’s Challenge

After the *JOBS Act* was passed in 2012, Bryant awaited the finalization of the rules for Title III, which took three years. Focused on being second to market, rather than first to market, Bryant envisioned StartupValley to become the only platform truly focused on the Title III investors, which consisted of smaller investors. StartupValley operated in a pre-launch, or beta, status while waiting for the Title III regulations to be finalized by the SEC and the Financial Industry Regulatory Authority. Many of StartupValley’s competitors had launched their solutions with accredited investors under Title II, which enabled them to test their portals and work out any bugs before opening the system to the masses. Bryant’s strategy was to learn valuable lessons from his competitors and determine what worked and what did not.

On October 30, 2015, the SEC finally passed its regulations permitting companies to offer and sell securities through crowdfunding under Title III of the *JOBS Act*. On May 2016, the rules became effective. Title III carried a lower limit on investment amounts and more stringent regulations than Title II had with accredited investors. New crowdfunding regulations were established to limit the amount that companies could raise and individual investors could invest. Under these rules, a firm could raise up to $1 million over a 12-month period. Individuals with an annual income or net worth of less than $100,000 were permitted to invest up to $2,000, whereas investors with an annual income or net worth greater than $100,000 could invest up to 10 percent of their annual income or net worth.[[5]](#footnote-5)

Despite these strict rules, the race for Title III equity crowdfunding business had begun. The equity crowdfunding industry was set to continue its exponential growth over the next few years, riding above the wave of the existing market for accredited investors. The equity-based crowdfunding business was expected by many people in the industry to surpass venture capital funding at some point in the future.

During the long and often frustrating time awaiting the SEC finalization of the Title III rules, Bryant needed to deal with the challenge of dividing time and resources between the new venture StartupValley and his existing business at Hudson Integrated. Increasingly, he found that StartupValley was demanding more and more of his time and resources, which was straining the existing business. To ensure that his current business continued to run smoothly, and to avoid jeopardizing cash flow, Bryant turned his attention back to Hudson Integrated. Clearly, StartupValley was pursuing a different path from his current business, which followed the straightforward model of providing web, mobile, or integrated marketing services to clients in return for payment. However, Hudson Integrated’s business model of good cash flow and low risk was difficult to grow above a limited potential. On the other hand, StartupValley followed a high-risk and high-return business model, requiring much higher investment of time and effort at the start, but with the promise of gaining great momentum and exponential growth. Bryant worried that many of his competitors were deeply funded by venture capitalists and held a great advantage over StartupValley in the race to gain market share.

“The biggest failure in life is not taking risk on something that you believe in,” thought Bryant. “I don’t want to say ‘What if?’ I would rather take the opportunity and learn from it.” Bryant decided to focus on the positive and focus on his upcoming meeting with a venture capitalist about the prospect of supporting StartupValley. However, various questions persisted. Should he continue to pursue his dream of making StartupValley a major force in the equity crowdfunding market? Did he have the resources to successfully run both an equity crowdfunding platform and an integrated web agency? What strategies should he adopt for StartupValley to stand out among the intense competition of the equity crowdfunding industry?

1. All currency amounts are in US$. [↑](#footnote-ref-1)
2. Information for Development Program (*info*Dev)/The World Bank, “Crowdfunding’s Potential for the Developing World,” 2013, accessed January 5, 2017, http://documents.worldbank.org/curated/en/409841468327411701/pdf/840000WP0Box380crowdfunding0study00.pdf. [↑](#footnote-ref-2)
3. Justin Kazmark, “Kickstarter before Kickstarter,” The Kickstarter Blog, July 18, 2013, www.kickstarter.com/blog/kickstarter-before-kickstarter. [↑](#footnote-ref-3)
4. “The Statue of Liberty and America’s Crowdfunding Pioneer,” *BBC News Service Magazine,* April 24, 2013, accessed January 5, 2017, www.bbc.com/news/magazine-21932675. [↑](#footnote-ref-4)
5. “SEC Adopts Rules to Permit Crowdfunding,” U.S. Securities and Exchange Commission, October 30, 2015, accessed January 5, 2017, www.sec.gov/news/pressrelease/2015-249.html. [↑](#footnote-ref-5)