HOW CROWDFUNDING Can Save Silicon Valley from Hairbrained Investors

By Vivek Wadhwa

There are fears that another Ice Age is about to hit Silicon Valley because of the implosion of its unicorns: start-ups valued at more than one billion dollars. By one estimate at VentureBeat, there were 229 such companies in January of this year. Their valuations are dropping precipitously because they were overpriced and overhyped. The fear is that venture capital (VC) will dry up and hurt the innovation ecosystem.

Previously, such a setback to venture capitalists would surely have had a chilling effect on the innovation ecosystem because startups were dependent on their funding. But in today's era of exponential technologies, there will hardly be a blip.

To start with, the cost of building new technologies has dropped so significantly that inventors no longer need VC. The desktop computers, server farms, racks of hard disks, and enterprise software that were needed would cost hundreds of thousands, sometimes millions, of dollars.

Today, there is on-demand computing and cloud storage that can be purchased for almost nothing from companies such as Amazon, Google, and Microsoft. Plus, tools such as sensors and 3D printers, which are needed for building sophisticated medical devices and robots, are inexpensive. What costs the most in Silicon Valley is rent and food, but you can share an apartment and live on pizza and ramen noodles.

And instead of begging venture capitalists, angel investors, or friends for the $50,000-100,000 that it typically costs to start a technology company, founders can go directly to the people they are building their products for. They can post a video of a heart-felt pitch and demonstrate a prototype of their ideas on sites such as Indiegogo, Kickstarter, and Plum Alley. If they get funded, they'll know they have a good idea; if they don't, they'll know it is time to go back to the drawing board and come up with something better.

The crowd makes better decisions than venture capitalists do. With crowdfunding, there is direct feedback from the market and a strong connection between the inventor and the funder. The community of funders feels a sense of ownership for the product and helps spread the word. And there is no filter such as a venture capitalist who has his own race and gender biases and only invests in the same trendy technologies as other VC firms.

The failure rate of crowdfunded projects is remarkably low. A recent article in the *Wall Street Journal* estimates that three quarters of VC investments fail to return investor capital, yet only nine percent of crowdfunded projects fail to deliver on what they promised, according to Ethan Mollick, researcher at the University of Pennsylvania, who researched 47,188 Kickstarter projects.

> **The failure rate of crowdfunded projects is REMARKABLY LOW.**

When entrepreneurs take money from venture capitalists, they know that this is coming from deep pockets and is just a financial investment. When dealing directly with customers, it is personal, so entrepreneurs put in extraordinary effort and spend their own money to fulfill their promises. This is what leads to better outcomes.

One of the best examples of a technology that would not have seen the light of day without crowdfunding is virtual reality. As Mollick explained, this was largely ignored by traditional funders after it failed to gain traction in the 1990s. In 2012, 19-year-old Palmer Luckey, who had built a prototype of a virtual reality headset in his parent's garage, launched a Kickstarter campaign for a commercial product. His goal was to raise $250,000, but there was so much demand, that he ended up getting $2.4 million in orders. The product he later developed, Oculus Rift, was acquired by Facebook in 2014 for $2 billion. This set off a frenzy of funding by venture capitalists and greatly accelerated the progress of a world-changing technology.

So far, there have been limits to what start-ups could offer the crowd. They could only pre-sell their product and offer perks such as T-shirts and badges. This is about to change. In May of this year, the Securities and Exchange Commission has rolled out a new program that will allow private companies to use crowdfunding to sell securities—up to $1 million over a 12-month period. This was a provision of the 2012 Jumpstart Our Business Startups Act (or JOBS Act) to assist small companies with capital formation.

But one thing is certain: **THE BALANCE OF POWER** is rapidly shifting from venture capitalists to entrepreneurs. This is a good thing because it will **LEAD TO A GREATER DIVERSITY OF START-UPS.**

Individual investors with less than $100,000 of net worth will be allowed to invest the lesser of $2,000 or five percent of their annual income or net worth. Wealthier individuals can invest up to 10 percent. The investment must, however, be through an authorized funding portal. These portals are required to vet the companies and let investors shop among offerings and discuss them online. They can't offer investment advice, make recommendations, or solicit purchases.

One of the first funding portals, Crowdfunder, didn't waste time in taking advantage of the new rules. It recently announced a VC Index Fund that offers an investment in a portfolio of hundreds of venture-capital backed startups. Crowdfunder chief executive Chance Barrett said his goal was to "allow everyday people to invest online alongside the world's leading venture capitalists, while targeting a fund 10 times more diverse in the number of investments, than a traditional VC." In other words, the public can become "super VCs."

It remains to be seen if equity crowdfunding achieves the same success as product crowdfunding. The stakes are now higher, and the risks of fraud are much greater. But one thing is certain: the balance of power is rapidly shifting from venture capitalists to entrepreneurs. This is a good thing because it will lead to a greater diversity of start-ups. And with a bit of luck, there will also be fewer over-priced unicorns and less wastage of investment capital because the venture capitalists will follow the crowd. **N**

Vivek Wadhwa is an entrepreneur turned academic. He is a visiting scholar at UC-Berkeley, Director of Research for the Center for Entrepreneurship and Research Commercialization at Duke University, and Senior Research Associate for the Labor and Worklife Program at Harvard Law School.