# Crowdfunding – a regional policy assessment

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Abstract:

The entrepreneurial finance literature argues that investors prefer to invest in close proximity to investee firms to facilitate better information exchange, due diligence and investment decisions, and post-investment monitoring. However, crowdfunding has different geographies than e.g. venture capital. Actors are often anonymous, as on stock markets, and geographical proximity seems irrelevant. Contrary, research indicates that also on-line platform-investors prefer close proximity in investments. However, previous research studies large markets such as the U.S., Australia, U.K., Italy, possibly affecting the extent to which there is an investment ‘home bias’. The first of two interrelated research questions in this paper asks whether, and to which extent, there are geographical effects on direct financing mechanisms like crowdfunding. Affirmative answers to this question provide a rationale to embark on a regional policy discussion.

New modes of financing and new actors argueably smoothens the financial system and could potentially alleviate some of the regional financing gap, which is said to hinder development of regional innovation and entrepreneurial ventures. Following this reasoning, bottom-up driven, private crowdfunding initiatives should be given room for unfolding opportunities for groups at the financial markets (nacent entrepreneurs) who are potentially otherwise marginalised and rationed. Contrary, it could be argued that a more extensive regulation of crowdfunding, as pursued at other parts of financial markets, is expedient and that crowdfunding de-couples finance and competences, contrary to what has been strived for in recent capital market policies. Therefore, the second research question is: which problem areas can be identified in crowdfunding, and how should the upsurge of crowdfunding be perceived from a regional innovation policy perspective?

## Introduction

Recent discussions in entrepreneurial finance focuses on development of new modes of financing, in particular how microfinance, peer-to-peer lending and crowdfunding has entered and changed the financing landscape (Wright et al., 2016, Assenova et al., 2017, Bruton et al., 2015, Block et al., 2018). Potentially, these new ways of financing could alleviate some of the regional financing gap, which is said to hinder development of entrepreneurial ventures and innovation. Moreover, they appeared as part of the entrepreneurial finance landscape driven by market forces without much interference by government. Assessed at face value, financing mechanisms that smoothens the financial system and are grown bottom-up should be given room as they contribute to unfolding opportunities for groups at the financial markets (nacent entrepreneurs) who are potentially otherwise marginalised and rationed. Indeed, there has been entutiasm around especially crowdfunding.

While crowdfunding has generally been praised as positively impacting early stage funding options (e.g. Mollick, 2014) the potential negative aspects have been ignored or downplayed amongst policy makers and researchers alike. The academic literature on crowdfunding has virtually exploded since 2011 (Cumming and Johan, 2017, Martinez-Climent et al., 2018)[[1]](#footnote-1), but almost all papers either implicitly assumes, or explicitly express, positive attitudes to the growth of crowdfunding[[2]](#footnote-2). This is perhaps no wonder – how can anyone have troubles with new funding opportunities for very early start-ups emerging, apparently even without imposing a burden on tax payers? A natural evolution of financial systems should include the upsurge of new actors and funding mechanisms?

This paper takes a different perspective. Based upon literature studies and interviews with key actors in the entrepreneurial financing eco-system it provides a more explicit normative assessment of crowdfunding with a view to clarify potential problems in crowdfunding. It is argued that solving, or at least being aware of and alleviating these problems, is a pre-requisite for a positive further public support of crowd-funding mechanisms.

Some of the literature in the regional entrepreneurial financing field argue that whereas existing theories in the field establish that investors prefer to invest in close proximity to investee in order to facilitate better information exchange, due diligence and investment decisions, and post-investment monitoring, then crowd-funding has different geographies. Actors are often anonymous, much in the same manner as on stock markets, and geographical proximity seem to have little impact. Thus, Agrawal et al. (2011) found an average distance between proposer and investor of 3,000 miles. The geographical effect found in the data showed out to stem from family and friends investing in the proposals.

Whereas a regional dimension seem to have little relevance, then on the other hand, research also indicate that even when investment takes place via on-line platforms (e.g. ebay, (Hortacsu, 2009)), investors have preferences for close proximity and a home bias (among others, see e.g. Lin and Viswanathan, 2016, Giudici et al., 2018, Yu et al.,2017). The discussion on possible geographies of crowdfunding is unfolded in section 2.

Therefore, the research questions in this paper are two-fold. First, it is discussed what existing literature point to regarding

 *Whether there are geographical effects even on direct financing mechanisms like crowdfunding?*

Secondly, contrasting the widespread entutiasm around crowdfunding,

 *which problems are associated with the further development of crowdfunding, and building on the analysis of these two questions, what is a regional innovation policy assessment of crowdfunding?*

The paper offers three contributions to the existing knowledge in the field. Firstly, it discusses potential geographical aspects of crowdfunding hence tries to establish the existing knowledge on crowdfunding geographies. Secondly, and most importantly, six potential problem areas of crowdfunding are pointed out, contributing to a more nuanced perspective on crowdfunding and contributing to some areas of attention that need to be dealt with before we join the excessively optimistic and positive attitude to crowdfunding. This is essentially providing a research agenda for crowdfunding studies that address potential problems. Finally, the paper concludes by contributing to a normative perspective on crowdfunding in a regional innovation policy context.

After a short introduction to the context and approach of the research, the paper is structured around these three contributions. Even if crowdfunding encompasses four distinct types (Guenther, C. et al., 2018), equity crowdfunding is the main focus, although many of the arguments also apply to crowdfunding of rewards, donations, lending.

### Context, approach and data

Crowdfunding is a relatively new phenomenon in general and in Denmark. In 2012 there were very sparse activities and only from 2015 onwards there are substantial activities in the market. There is only one source of information on the aggregate crowdfunding activity in Denmark (Det danske crowdfunding marked anno 2016, Vækstfonden og Dansk Crowdfunding Forening, 2017[[3]](#footnote-3)). The conclusions from these mappings are that Danish firms and entrepreneurs raised more than 15 million Euro in 2016 through crowdfunding (including both Danish and foreign platforms). The development of crowdfunding in Denmark has on the aggregate followed the growth in the global market although in Denmark there is a relatively small share of activities within equity crowdfunding with only one platform opened in October 2016. One reason for this is that legislation has not been in place for this type of crowdfunding. Loan funding from Danish platforms amounted to Euro 8 million in 2016, it doubled from 2015.

The approach adopted in this work is two-fold, following the basic research questions. First, it is established whether and to which extent there is a regional dimension to crowdfunding. This is done through reviewing established academic literature in the field. Secondly, in order to obtain a nuanced picture of potential problem areas of crowdfunding interviews with key actors in the financial system is performed, especially among those actors that are expected to be a likely next step on the financing ladder after crowdfunding. Relevant public authories are included in who is interviewed.

Resumes of each interview are made and presented to informants. The Information from Danish Crowdfunding Association is supplemented with data from the Kickstarter platform. Policy documents, business angels associations, and regional business development agencies inform the policy discussion.

## The (potential?) geography of crowdfunding

### Why geography matter to entrepreneurial finance

The entrepreneurial finance literature argues that investors prefer to invest in close proximity to investee firms to facilitate better information exchange, due diligence and investment decisions, and post-investment monitoring. EXPAND – FIN GEO

However, crowdfunding has different geographies than e.g. venture capital. Actors are often anonymous, as on stock markets, and geographical proximity seems irrelevant when investors and potential investee firms ‘meet’ at an electronic platform, hence need not have physical interactions and meetings. In principle, investments are geographically unrestricted, and proposals in the periphery may not suffer from funding gaps as has otherwise been argued is usually the case.

This may justify certain optimism among regional policy makers who may expect that crowdfunding alleviate regional funding gaps because they are not subject to the same geographical skewness that characterise other parts of the entrepreneurial finance landscape, such as venture capital (Guenther et al., 2018). A similar argument was the point of departure for a study on business angels in Sweden (Avdeitchova, 2009). The title of a paper from this study ( 'False expectations: reconsidering the role of informal venture capital in closing the regional equity gap') referred to that there have been similar hopes among regional policy makers for business angel financing. Because business angels are much more dispersed throughout countries and because they are said to prefer investing in close proximity of their home or office, business angels where seen as contributing to closing regional funding gaps. The study showed, however, that the Swedish business angels had surprisingly strong tendensies to invest in metropolitan and/or university regions, a substantial proportion even internationally, regardless their geographically dispersed location. The contribution to closing regional funding gaps where, therefore, relatively small. This accentuates that in order to assess crowdfunding in a regional innovation policy frame, we also need to know more of whether crowdfunding is footloose or geographically bounded (Mollick, 2014).

### The geographical aspects of crowdfunding and implications for intermediation – existing knowledge

Contrary to what one might expect, research indicates geographical effects, that also on-line platform-investors prefer close proximity in investments[[4]](#footnote-4), but some studies maintain that geography has a marginal influence on crowdfunding (e.g. Armour and Enriques, 2018). Agrawal et al. (2011, 2014) did found preferences among backers on crowdfunding platform sellaband.com to support local bands. However, the majority of the geographical effect was shown to originate from investments from family and friends, who naturally have preferences for close geographical proximity.

Hence, there are conflicting conclusions about whether there are specific crowdfunding geographies. Below these contradictions in the literature are elaborated with a view to identify arguments for possible geographic effects.

A study by Guenther et al. (2018) found that overseas crowdfunding investors were not sensitive to distance when investing, but within country investors were. Mollick (2014) study data from 48,500 Kickstarter crowdfunding projects and point out that investments are essentially socially and regionally embedded but also that there is a strong geographic effect even in crowdfunding investments. He finds that crowdfunding success is associated with a large number of friends and connections on social media, an indicator of individual social capital (also Lin and Viswanathan, 2013), and presence of a large proportion of creative people in the region. The crowdfunding activity is generally unevenly distributed, but with large variation among types of projects. Related, the geographic effect is related to the fact that investment proposals reflect the region-typical products and services rather than reflecting investor preferences for close proximity, examples include country music in Nashville, film production in Los Angeles, and technology, games, design in San Francisco.

Similar conclusions, that the geographical area where investors reside impact propensity to fund crowdfunding projects are found in Giudici et al. (2018) and Colombo et al. (2015). The former argue that the social capital in the area increase fundraising success and ascribe this to the social relations among proposers and funders, whereas their compliance with local social norms had no effect. Along the same lines Masciarelli et al. (2019) find that geography and cultural profiles of investors proxied by religiosity impact funding propensities locally and cross-regional. Guenther et al. (2018) found no effect of social capital.

## Specific problem areas

### Problem area 1: Investor protection and other regulation

The first problem area that needs further clarification and awareness has to do with the regulation of crowdfunding activities. The financial system is genereally heavily regulated but the pace of installing regulation of crowdfunding has differed substantially between countries. Public authorities may not need to get money out of the pockets directly but crowdfunding is nonetheless not particularly popular among public authorities due to their general obligations to ensure investor protection and other complicated regulation. There are several aspects of this, and it is handled differently in different countries (Dushnitsky et al., 2016, Armour and Enriques, 2018), generally it is unclear what the implications are if fraud occurs, if crowdfunded businesses fail, or if crowdfunding platforms fail.

The different types of crowdfunding are governed under different regulations and laws. Sticking to equity crowdfunding, this is essentially issuing securities to investors and is consequently part of the securities law. Actors, firms, operating under this law are usually required to disclose all information according to Prospective Directives of the individual countries. For the majority of small firms complying with this involves prohibitive costs. Therefore, some countries imposed an exemption from these obligations. There are also requirements to the legal form of firms. The crowdfunding platforms need approval from the authorities supervising financial market regulations, the tax authorities and are supervised regarding risk of ‘money laundrying’. Investors are under regulation of investor protection, which involves tests of investors etc., however, there are in most countries’ regulation an exemption from this at crowdfunding platforms as it is only necessary to answer a few questions on-line.

### Dumb money?

It is generally difficult to convey competence building to small, entrepreneurial businesses. Therefore, venture capital and business angel financing has been praised for their combination of supply of capital and competencies. These value adding activities help entrepreneurs and businesses upgrade their strategies, execution and management capabilities, and entrepreneurs can leverage the networks that venture capital firms and business angels bring into the development of the venture. In contrast, when businesses are large enough to go public, they are less reliant upon external sparring and can obtain finance from anonymous investors on the stock markets.

Crowdfunding, however, entails many of the same characteristics as market based funding without the entrepreneurs’ skill set being developed at all at the stage of development where the majority of entrepreneurs are seeking crowdfunding. The judgements of the crowd can be questioned as well. Many investors do not have any business background, rather could be characterized as consumers (Armour and Enriques, 2018), and are attracted to the particular investment for a host of reasons, some of which are unrelated to the pure financial sustainability of the businesses proposed (Lin and Viswanathan, 2016). Consequently, project owners report that they had to deal with many different queries around the business as funders had poor understanding of the proposal (Brown et al., 2017).

In addition to poor quality of investors, the signals provided to guide competent crowdfunding investments are poor. In many cases investments are guided by herding behavior, which means that investments are allocated to projects that early adopters found attractive (ibid.). Additionally, early adopters are known to have a large proportion of family and friends who are not valuable for guiding investments (Ordanini et al., 2011). Moreover, investors have no information on who and how many considered a proposal but did not invest, only the time an investment proposal has been open compared to the number of investors who signed up may indicate if it is a valuable signal of whether it is an investment worth pursuing. In this sense, crowdfunding is a step back regarding the simultaneous development of capital and competence among entrepreneurs, and the crowdfunding process may actually distort rather than guide the allocation of capital.

An aspect of this is whether crowdfunding generally is a complement or substitute for alternative funding such as business angels, something we currently know very little on (Block et al., 2018) even if Yu et al. (2017) did find correlation between Kickstarter projects and increased business angel activity in regions. A further aspect is the way geography impact these arguments. Generally, geographical proximity enhances possibilities for alleviating asymmetric information during the pre-investment screening phase and it facilitates smoothened post-investment monitoring and sparring activities (geo references). Crowdfunding has, even if there are geographies associated with it, none of these effects.

### Coordination and dilution – the many stakeholders

It follows from the definition of crowdfunding (‘*Crowdfunding is a method for obtaining project funding, by soliciting contributions from a large group of people, and especially from an online community’,* Wikipedia) that many stakeholders becomes involved, that is become owners. In equity crowdfunding a large number of people are forming the group of owners, in many cases anonymously and without any possibilities to coordinate. The coordination problem is present also on the side of the project owner who in a study of Brown et al. (2017) report that they spend excessively many hours having to deal with many small investors each with different interests and business knowledge.

As crowdfunding is only a first step on the financing ladder later stage financiers will have to consider entering a business with a large number of owners that are difficult to coordinate and are likely to be vastly different than other early stage financiers. Business angels, for example, could therefore be reluctant to engage in firms who are crowdfunding backed.

There are counter arguments on this. As discussed later business angels and other investors may regard the crowdfunders as signaling that the market is ready to adopt the idea. Moreover, it is easier for business angels to get a controlling share for a minimal investment amount. Existing (crowd-) shareholders each have a small share and has no coordination and risks therefore both dilution and loose of any of the (otherwise small) control they may have had. They are therefore more exposed to the risk of agency costs compared to hands-on investors like venture capitalists. The risk of dilution is also present if project owners issue more shares to themselves rather than spending the proceeds from the campaign on relevant investments (Guenther et al., 2018).

### Promoting innovation?

The projects proposed at crowdfunding platforms are vastly heterogeneous. Research needs to establish whether they on average are innovative or not, but inherently there is a need for simple, non-technical messages when the proposal is presented on the platform, therefore one could presume that crowdfunded projects have relatively low innovation hight. Some research do, though, indicate that project owners were often creative and innovative(Brown et al., 2017), and it is a hypothesis for future research if crowdfunded entrepreneurs rely more on effectual than causal logic.

In crowdfunding, the IP is not easily protected, in fact it is part of the core idea that information of the idea is dissiminated. Therefore, crowdfunding entrepreneurs face an inherent innovation sales dilemma between on the one hand publicing as much information as possible in order to make the investment attractive, and on the other hand disclosing information to prevent the idea to be copied. There have been several examples of copying ideas from crowdfunding campaigns.

### Adverse selection?

Research has so far not been able to determine to what extent the firms on crowdfunding platforms have a history of being rejected elsewhere. It that is the case, then that could be for a reason. The financial institutions are important as selection mechanisms in the financial system. All proposals should not be funded, it would be societally inexpedient to have a large number of wannabe entrepreneurs pursuing prospectless projects. The only screening mechanisms imposed by crowdfunding platforms are the initial requirements and that full funding should be obtained from the crowd if projects are to be granted funding.

Specifically, recent research (Brown et al., 2017) suggests that small firms and entrepreneurs demanding crowd-funding equity finance are to a large extent classical discouraged borrowers (Bruton et al., 2015). From other research we know that demand for finance in general, and discouraged borrowers in particular, are unevenly dispersed geographically (Lee et al., 2017). It is an open question if crowdfunding provides possibilities for these (self-) excluded groups to enter the financial markets and if the crowd then in reality is choosing among projects that even before being presented to the crowd to a large extent have been subject to a classical adverse selection mechanism.

The fact that project owners may have been rejected elsewhere can impact the reputation of those seeking crowdfunding. However, this is likely to be exacarbated in case the project does not reach the funding threshold and is withdrawn without positive assessment from the crowd.

### A testbed for ideas?

Crowdfunding campaigns usually need to raise the full amount asked for in order to obtain financing. It can be argued that the crowd makes up a panel of judges regarding whether the idea proposed is sustainable, hence the successful crowdfunding campaign is a strong indicator that the market will adopt the idea. Although little is known on this aspect of crowdfunding, some studies point to that there is this effect of ‘wisdom of the crowd’ from crowdfunding and that indeed venture capital firms and business angels are interested in using this mechanism as a testbed for the projects they consider backing (Colombo and Shafi, 2017, Brown et al., 2017).

On the other hand, it is still not known if there is a strong correlation between what the crowd perceives as valuable investment proposals and what the market eventually accepts. As mentioned, the competences of the crowd can be questioned, and the investment behavior is often not rational.

## Concluding remarks – a regional innovation policy assessment

As a conclusion, the above-mentioned problem areas make up a double agenda. First, it asks if regional policy actors are over-entutiastic about crowdfunding. Second, the problem areas pointed to make up a research agenda calling for answers to a number of questions that in combination could shed more light on how we should normatively perceive crowdfunding.

More generally, it can be discussed to which extent there is a rationale for policy, or at least a regulation, or if bottom-up driven, private initiatives should be given room for unfolding opportunities for groups at the financial markets who are otherwise marginalised and rationed (Estrin et al., 2018). Generally, we know rather little on the demand and effects of crowdfunding (Brown et al., 2017). In this way it could be discussed whether crowdfunding is as a way of ‘democratising’ the funding flows of new products and business models, or if it rather implies a de-coupling of finance and competences, as was also pointed out as a problem area. The former effect is a natural consequence of a large user involvement in not only innovation inputs and problem-solving, but also in the financing part of it. The latter effect stems from the fact that potentially ‘ordinary’ business angels with business experience and competences are crowded-out and are less interested in firms who in the early funding rounds raised funding through crowd-funding. This argument can, though, be reversed as some research point to that successful crowdfunding alleviates barriers to external second round financing sources (Brown et al., 2017). Additionally, other non-financial benefits such as product valuation and network effects may compensate for the loss of the direct engagement that business angels often have.

Investments are made on the basis of criteria that are not necessarily rational from a business development perspective, e.g. herding and because of an appealing pitch and video or generally human capital signals through the internet (Piva and Rossi-Lamastra, 2018), and by individuals who do not have the background for making a proper due diligence and assessment of the potentials of the proposal. Even compared to ordinary stock market investments where a bank underwrite the market introduction process and set an initial price, crowdfunding investors are worse off regarding available information and secondary market trading that ensure rapid incorporation of information and expectations into the prices. Equity crowdfunding investors do not generally have much information and even not changes in prices as these are fixed during the campaign. Generally, this will lead to mis-allocation of capital and many unviable businesses and entrepreneurs are funded. This is in itself problematic. A further problem is that crowdfunding can make up an obstacle for further funding rounds due to complications in the ownership/control as well as IP rights. Moreover, the mis-allocation of capital is particular problematic if some of the funding put into crowdfunding is crowding out financial capital for funding through other mediation between savings and investments such as banks.

Generally, this is an area that policy-wise has primary interest on a nation state level of aggregation. Policy measures include a broad array. A Danish report (Erhvervsministeriet, 2014) list that it could be considered to make use of crowdfunding attached to existing policy schemes[[5]](#footnote-5); to provide guidance to all involved actors regarding the regulations and requirements; to extend existing loan guarantee schemes to lending crowdfunding platforms; to educate local, public business advisors; to monitor market development and be prepared and agile in adjusting regulation; to seek international collaboration (EU) on common regulations that balance investor protection and good framework conditions for crowdfunding platforms. Some of these instruments can be used at a regional scale.

In conclusion, regional innovation policies have sought to alleviate regional funding gaps. It is, though, highly questioned if equity crowdfunding is an expedient way forward. The above-mentioned problem areas make up a research agenda that should be embarked on and resolved before potentials of new funding mechanisms are stimulated by way of regional policies.

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1. Cumming and Johan (2017, p.366) note that ‘….crowdfunding research started later than it perhaps should have, while crowdfunding is now one of the most active and fastest-growing research areas in entrepreneurial ﬁnance.’ [↑](#footnote-ref-1)
2. Additionally, by far the majority of studies are from a US-context, see e.g. Dushnitsky et al. (2016) for an exeption. [↑](#footnote-ref-2)
3. <http://www.vf.dk/~/media/files/analyser/andre%20analyser/det%20danske%20crowdfundingmarked%20i%202016.pdf> [↑](#footnote-ref-3)
4. However, previous research studies large markets such as the U.S., Australia, U.K., Italy, possibly affecting the extent to which there is an investment ‘home bias’. [↑](#footnote-ref-4)
5. An example includes the crowdfunding associated with the Danish policy schemes Market Maturation Fund (Erhvervsministeriet, 2014). [↑](#footnote-ref-5)