Equity Crowdfunding for Independent Film and The JOBS Act: Sizing the Market Potential of Title III

Charlotte Wells

The Leonard N. Stern School of Business
Glucksman Institute for Research in Securities Markets
Faculty Advisor: Alexander Ljungqvist
April 1, 2016

I. INTRODUCTION

The $1.97 billion crowdfunded by film and performing arts projects in 2014 (as reported by Massolution) suggests that crowdfunding – the so-called “sleeping giant” of independent film financing – may be waking from its slumber, at least on a global scale. At present, crowdfunding for film in the United States is primarily sought through donation or reward-based campaigns, but as new SEC regulation comes into effect in 2016, equity crowdfunding could unveil a new and significant source of capital for producers. In an industry known for exceedingly complex accounting and profit sharing mechanisms, however, concerns about mandatory reporting, inexperienced investors, and the already bleak probability of a return on low-budget productions have engendered a cautious skepticism regarding its potential.

The purpose of this paper is to size the market opportunity for equity crowdfunding under this new regulation, not by deriving the secret sauce for extra-ordinary profits, but by taking a sober and pragmatic position in considering what type of film might seek out crowdfunding of this nature, why such projects might attract small-scale, non-accredited investors, and under what circumstances they might maximize their probability of delivering a return.

To this end, I will begin with a review of the legislation in question and industry trends, narrowing the scope of the discussion to movies of a determined scale and budget. I will proceed with an historical analysis of box office performance with a view to evaluating profitability of viable movies from an investor perspective. Given the results, I will review the underlying economics of the equity crowdfunding model as it relates to independent film to better understand the dynamics and incentives of key stakeholders. I will conclude by drawing together these various strands to consider the broader impact of equity crowdfunding on this leery and oftentimes capricious industry.

II. REGULATION

The Jumpstart Our Business Startups Act, more commonly designated The JOBS Act, was signed into law in 2012. An amalgamation of other bills, its purpose was to increase capital access to smaller companies, previously restricted by the SEC regulations and high compliance costs associated with public offerings.[1] Most significantly, The JOBS Act has legalized soliciting and raising investment online through public security offerings via registered intermediaries; in short, it has opened the doors for legalized, equity crowdfunding.

The JOBS Act was comprised of seven titles, whose rules have been arduously finalized and rolled out over the past four years. Title II first lifted the ban on "general solicitation" for security offerings to *accredited* investors (individuals or organizations with assets or income exceeding stated thresholds) and Title IV, also known as Regulation A+, subsequently expanded its reach to *non-accredited* investors.[2] Regulation A+, however, is constructed such that companies must choose between adhering to Blue Sky Laws (State securities laws) with fewer reporting requirements (Tier 1 - $20 million cap) and bypassing Blue Sky Laws, but providing frequent reports and audited financial statements (Tier 2 - $50 million cap).[3] The inherent compromise and compliance in both tiers remains prohibitive for companies seeking smaller investments from non-accredited investors. Title III – the last to be implemented – promises an alternative.

On October 30, 2015 the SEC adopted the final rules for Title III – Regulation Crowdfunding. The rules allow U.S. businesses to engage in securities-based crowdfunding

[1] PwC estimates that the average IPO costs a company $3.7 million, in addition to an underwriter fee of 5-7% of gross proceeds. "Considering an IPO?" (2012).
[2] "Accredited Investor" is defined in full in Regulation D, Rule 501: http://www.ecfr.gov/cgi-bin/retrieveECFR?gp=&SID=8edfd12967d69c024485029d968ee737&r=SECTION&n=17y3.0.1.1.12.0.46.176.
[3] "SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital" (2015).

offerings of up to $1 million in a twelve-month period. Investors, in the same time frame, can invest up to $100,000 in aggregate across all offerings, with further restrictions based on their net worth and annual income.[4] Title III also mandates that companies make offerings exclusively through a single accredited broker-dealer or funding portal (an SEC entity created for this purpose) and file annual reports to both the SEC and investors. The rules become active on May 16, 2016.

The nomenclature “equity crowdfunding” has become a catch-all term in the media for all securities-based crowdfunding models. While the sale of equity and debt instruments is permissible under The JOBS Act – and indeed, both have been used in the realm of film financing under comparable legislation in Europe – I will focus on the “equity model” for the purposes of this paper, based on profit or revenue sharing. Furthermore, unless otherwise stated, the remainder of this discussion, including all numbers and statistics, relate specifically to the United States.

III. INDEPENDENT FILM FINANCING AND INDUSTRY TRENDS

Independent films, which account for around a quarter of domestic box office, are categorized as films not produced by one of the six major studios.[5] More specifically, independent film financing is so-called when the funds are secured not solely from a distributor and in order to pay for the costs of physical production.[6] While financing outside of the studio

[4] Investors with a net worth of *less than* $100,000 can invest an aggregate total across all offerings of either $2,000 or 5 % of the lesser of their annual income or net worth. Investors with a net worth of *more than* $100,000 can invest 10% of the lesser of their annual income or net worth.

[5] The six major MPAA member studios (and owners) are: Walt Disney Studios Motion Pictures (The Walt Disney Company), Paramount Pictures Corporation (Viacom), Sony Pictures Entertainment, Inc. (Sony), Twentieth Century Fox Film Corporation (21st Century Fox, spun off from News Corp. in 2013), Universal City Studios LLC (Comcast), and Warner Bros. Entertainment Inc. (Time Warner).

[6] Ulin (2013): 113.

system is challenging, sometimes impossibly so, success ideally rewards producers and creative stakeholders with more autonomy in their decision making and the possibility of more upside in their share of profits.

Although the financing structure of independent films varies by project, production funds are usually secured through a combination of the following: local tax incentives based on the shooting location (as high as 30% in NY State, for example); foreign presales (when foreign distributors buy advance distribution rights by territory); downstream-ancillary revenue advances (DVDs, merchandise); negative pickups (a distribution guarantee which serves as collateral to another line of credit); and third party funding (gap financing from banks, often against unsold foreign territories, direct bank credit lines, private equity, and angel investors.)[7]

Foreign presales used to be a sizable portion of this pie, but their share has been slimming. Presales are contingent upon attaching specific cast members to a project; actors with bankable international appeal. Because surprisingly few meet this criteria, a large pool of productions competes for the same talent. Agents and managers are cognizant of this and a catch-22 has emerged. Foreign distributors want talent contractually attached prior to making financial commitments and agents want financing secured before confirming their clients. The market has moved to correct for this through an increase in all-equity financed productions and the emergence of new industry players with deep pockets who are willing to take risks on lesser known talent and/or less obviously commercial content.[8]

Projects financed through just equity can also be more favorable for investors. The downside of equity contributions in a segmented financing structure incorporating elements above is that the equity is often sought in the latter stages of financing. Thus, when profits are

[7] Ulin (2013): 102-118.
[8] Brown (2015b): 16.

distributed, more senior contributions delay equity's recoupment and diminish its eventual return. 100% equity financed projects lessen investors' risk by both eliminating the costs of debt and reducing the number of parties who can lay claim to profit. Generally speaking, in an all-equity financed film, the film's distributor will take a 50% share of profits and the remaining 50% will be divided evenly between talent and investors.

There are three stakeholders to consider in sizing the market potential of Title III; filmmakers, investors, and funding portals. I will review each of these parties' interests in **Section V**, but as I proceed now to consider the viability of certain types of film under this new regulation, I will take an investor-centric position with a view that the long term success of Title III or any new financing model lies in its ability to satisfy demand.

IV. THE PROFITABILITY OF MOVIES VIABLE UNDER TITLE III

Title III's $1 million annual ceiling is very low in the context of feature filmmaking and immediately orientates the discussion in the domain of low-budget productions. This gives rise to two scenarios in which financing is sought via Regulation Crowdfunding:

A) Films whose budgets fall into the million and sub-million-dollar range and whose financing is secured wholly via Title III fundraising; or

B) Films whose budgets exceed $1 million and for which equity crowdfunding constitutes only a portion of the budget.

If $1 million were a small fraction of the overall budget, producers would likely reduce costs or seek another form of financing to bridge the gap, steering clear of the burden of Title III's SEC reporting. I will thus constrain scenario B's budget to $5 million. To better understand the potential impact of Title III on the low-budget independent film industry, it is necessary to examine under what circumstances such films are profitable and how they generate a return for investors.

The Motion Picture Association of America (MPAA) estimated that between 2010 and 2014 1,385 "Non-member" (i.e. independent) films were in production with budgets under $1 million. My initial data haul from OpusData, sister company of popular box office reporting site The Numbers, yielded just 50 titles with budgets in this range and a further 75 titles with budgets between $1 and $5 million, released between 2011 and 2015. There were an additional 595 titles with no known budget.[9] By filtering out most movies distributed by studios and supplementing/correcting data through web searches, including reviewing interviews with filmmakers in trade publications, I was able to improve the data, which I sorted into sets. Set A, films with budgets ≤ $1 million, now consists of 116 titles with estimated budgets and a further 296 titles with no confirmed budget, but which most likely fall into the sub-million dollar range.[10] Set B, films with budgets between $1 and 5 million, comprises a total of 163 titles. **Table I** contains a statistical summary of the worldwide box office revenue in data sets A and B.

Table I: Worldwide Box Office (2011-2015)

***Budget** ≤ $1 million* (Set A)		*$1 million < **Budget** ≤ $5 million* (Set B)	
Titles (Count)	412	Titles (Count)	163
Domestic/Intl (%)	62/38	Domestic/Intl (%)	60/40
Min	525	Min	1,776
Max	101,758,489	Max	202,053,386
Mean	1,300,516	Mean	13,241,182
Median	32,044	Median	1,217,307
Standard Deviation	7,057,646	Standard Deviation	29,970,622

[9] Data retrieved on February 17, 2016 from opusdata.com. The data was narrowed the data by production country [United States], genre [excl. Documentary, Comedy/Performance], and release data [2011-2015].
[10] For example, no known or high profile cast members attached, or a frequency of the term "micro-budget" in interviews or reviews.

In both sets, the distribution of box office revenue is skewed heavily to the right, with means ($1.3 million and $13.2 million) far exceeding the medians ($32,044 and $1.2 million). **Exhibits I** and **II** below illustrate the data in histograms, plotted on a logarithmic scale on the x-axis to better approximate a normal pattern of distribution for ease of inference. The second y-axis indicates the cumulative proportion or frequency of a given dollar gross, providing some sense of probability based on the historical data. It is notable that films in the "horror" and "thriller/suspense" genres comprise the top six grossing movies in Set A and top eight in Set B, constituting a prodigious 35.4% and 41.5% of the total worldwide box office revenues in their respective sets.

<u>Exhibit I: Log(worldwide box office, budget ≤ $1 million)</u>

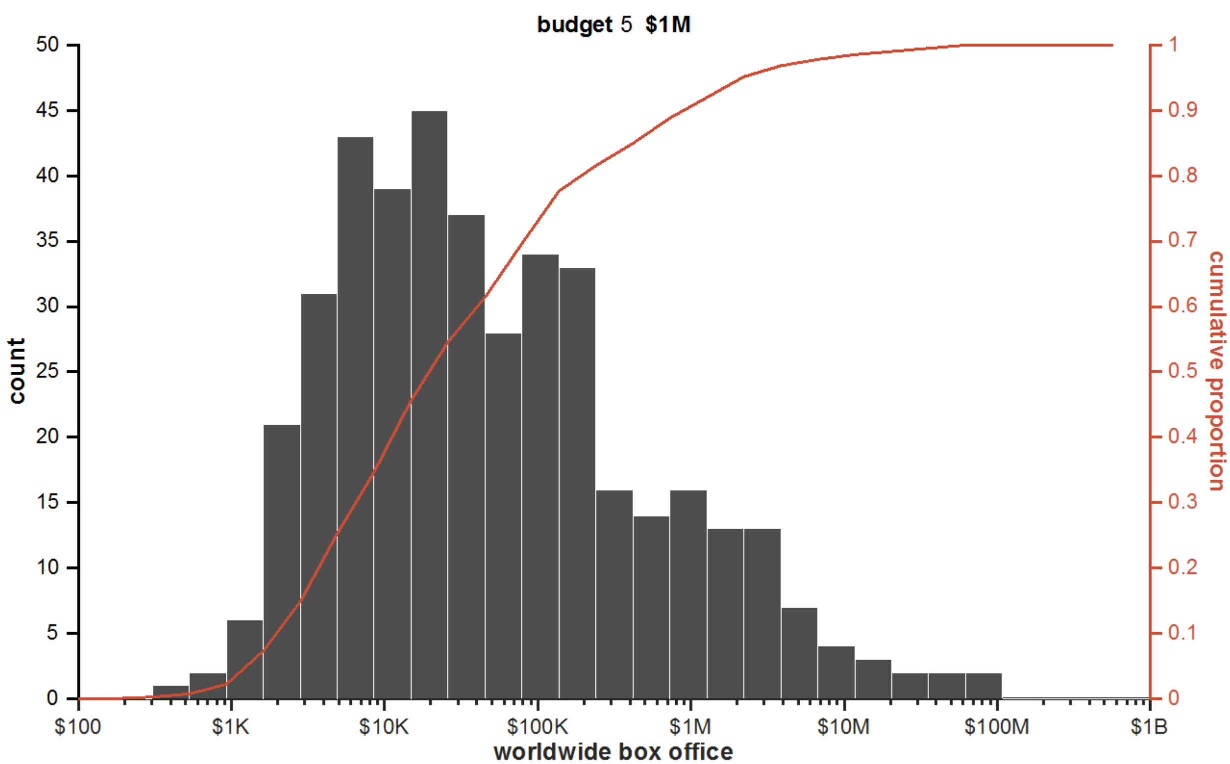
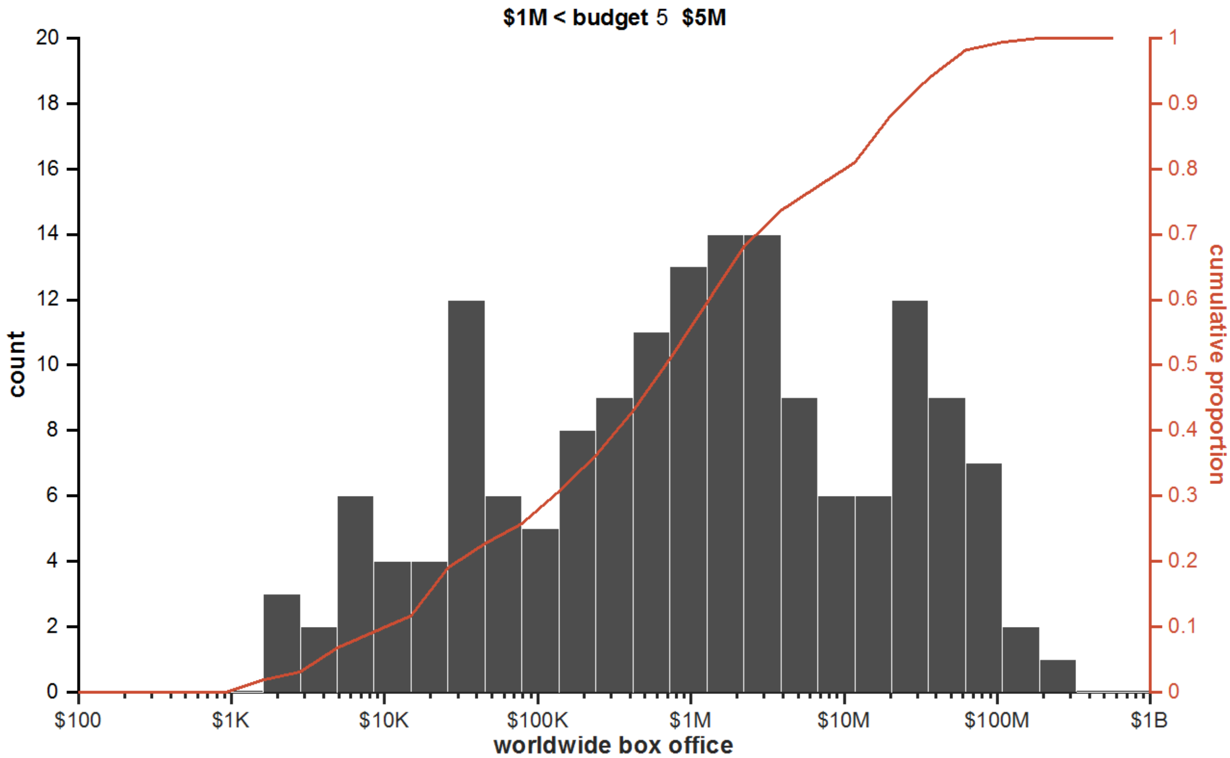


Exhibit II: Log(worldwide box office, $1 million < budget ≤ $5 million)



To evaluate the relevance of this data with a view to determining these films' viability for equity crowdfunding, profit rather than revenue must be considered, as should the broader context of how investors, specifically, make a return on independent film investments.

When producers, marketers, or financial analysts project a film's financial performance, all revenue streams (DVD/Bluray, Video On Demand, TV rights, merchandise, etc.) and costs (prints and advertising, distributions fees) are modeled as a function of box office and budget. In the industry, this model is designated the movie's "Ultimate" and is actualized post-release. **Tables II** and **III** illustrate simplified "Ultimates" for two hypothetical films with budgets of $1 million and $5 million, using domestic/international proportions derived from the data sets described in **Table I**. The median and mean values of box office gross from Sets A and B are highlighted in the first row.

Table II: Ultimate (budget = $1 million)

Production Budget	*$1,000,000*						
Gross Box Office	**$32,044**	**$1,296,241**	**$1,300,516**	**$2,293,349**	**$5,000,000**	**$20,000,000**	**$100,000,000**
Domestic Segment	62%	62%	62%	62%	62%	62%	62%
Foreign Segment	38%	38%	38%	38%	38%	38%	38%
Revenues							
Worldwide							
Film Rental (45%)	$14,420	$583,308	$585,232	$1,032,007	$2,250,000	$9,000,000	$45,000,000
VOD/Home Video (55%)	$17,624	$712,932	$715,284	$1,261,342	$2,750,000	$11,000,000	$55,000,000
Television (40%)	$12,818	$518,496	$520,206	$917,340	$2,000,000	$8,000,000	$40,000,000
Ancillary (2%)	$641	$25,925	$26,010	$45,867	$100,000	$400,000	$2,000,000
GROSS RECEIPTS	**$45,502**	**$1,840,662**	**$1,846,733**	**$3,256,556**	**$7,100,000**	**$28,400,000**	**$142,000,000**
Expenses							
Prints and Advertising	$45,502	$1,300,000	$1,300,000	$1,300,000	$1,300,000	$1,300,000	$1,300,000
Non-theatrical Distribution Fees	$10,879	$440,074	$441,525	$778,592	$1,697,500	$6,790,000	$33,950,000
Residuals	$2,487	$100,588	$100,920	$177,964	$388,000	$1,552,000	$7,760,000
TOTAL EXPENSES	**$58,868**	**$1,840,662**	**$1,842,445**	**$2,256,556**	**$3,385,500**	**$9,642,000**	**$43,010,000**
Minimum Guarantee	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
NET	**$(1,013,366)**	**$(1,000,00)**	**$(995,713)**	**$(0)**	**$2,714,500**	**$17,758,000**	**$97,990,000**
Back End Profit	**$-**	**$-**	**$-**	**$-**	**$2,714,500**	**$17,758,000**	**$97,990,000**
Distributor (50%)	$-	$-	$-	$-	$1,357,250	$8,879,000	$48,995,000
Talent (25%)	$-	$-	$-	$-	$678,625	$4,439,500	$24,497,500
Production Company / Investors (25%)	$-	$-	$-	$-	$678,625	$4,439,500	$24,497,500

Table III: Ultimate (budget = $5 million)

Production Budget	*$5,000,000*						
Gross Box Office	**$1,217,307**	**$6,481,205**	**$11,466,746**	**$13,241,182**	**$20,000,000**	**$50,000,000**	**$100,000,000**
Domestic Segment	62%	62%	62%	62%	62%	62%	62%
Foreign Segment	38%	38%	38%	38%	38%	38%	38%
Revenues							
Worldwide							
Film Rental (45%)	$547,788	$2,916,542	$5,160,036	$5,958,532	$9,000,000	$22,500,000	$45,000,000
VOD/Home Video (55%)	$669,519	$3,564,662	$6,306,711	$7,282,650	$11,000,000	$27,500,000	$55,000,000
Television (40%)	$486,923	$2,592,482	$4,586,699	$5,296,473	$8,000,000	$20,000,000	$40,000,000
Ancillary (2%)	$24,346	$129,624	$229,335	$264,824	$400,000	$1,000,000	$2,000,000
GROSS RECEIPTS	**$1,728,576**	**$9,203,310**	**$16,282,780**	**$18,802,478**	**$28,400,000**	**$71,000,000**	**$142,000,000**
Expenses							
Prints and Advertising	$1,728,576	$6,500,000	$6,500,000	$6,500,000	$6,500,000	$6,500,000	$6,500,000
Non-theatrical Distribution Fees	$413,276	$2,200,369	$3,892,960	$4,495,381	$6,790,000	$16,975,000	$33,950,000
Residuals	$94,463	$502,941	$889,820	$1,027,516	$1,552,000	$3,880,000	$7,760,000
TOTAL EXPENSES	**$2,236,315**	**$9,203,310**	**$11,282,780**	**$12,022,897**	**$14,842,000**	**$27,355,000**	**$48,210,000**
Minimum Guarantee	$5,000,000	$5,000,000	$5,000,000	$5,000,000	$5,000,000	$5,000,000	$5,000,000
NET	**$(5,507,739)**	**$(5,000,000)**	**$-**	**$1,779,581**	**$8,558,000**	**$38,645,000**	**$88,790,000**
Back End Profit	**$-**	**$-**	**$-**	**$1,779,581**	**$8,558,000**	**$38,645,000**	**$88,790,000**
Distributor (50%)	$-	$-	$-	$889,791	$4,279,000	$19,322,500	$44,395,000
Talent (25%)	$-	$-	$-	$444,895	$2,139,500	$9,661,250	$22,197,500
Production Company / Investors (25%)	$-	$-	$-	$444,895	$2,139,500	$9,661,250	$22,197,500

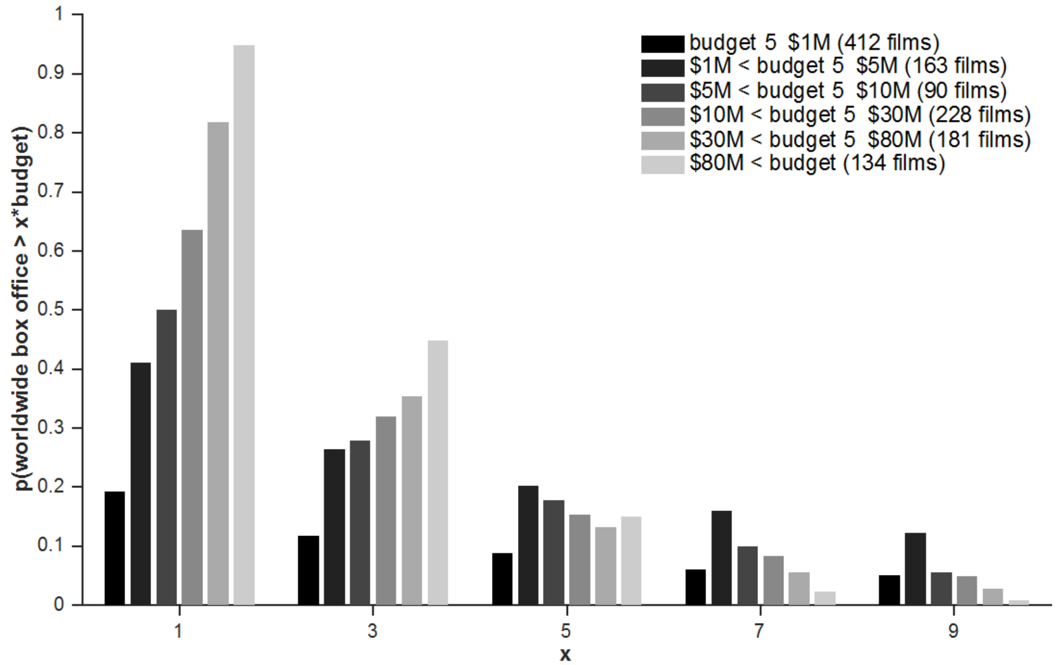
Tables II and **III** make the following assumptions: revenues are a function of gross worldwide box office (as per the percentages in the first column). “Prints and Advertising” expenses are a minimum of gross receipts or a multiple of 1.3 times the production budget; “Non-theatrical distribution fees” are 35% of the sum of non-theatrical revenue (all revenue excluding “Film Rental”); “Residuals” are 8% of non-theatrical revenue. I set the “Minimum Guarantee”, that is the amount paid upfront by the distributor to the production company, equal to the budget (by far the largest assumption with the greatest uncertainty). The resulting profit is split between the distributor, talent, and the production company/investors at a ratio of 50:25:25.[11]

The movies break even for the distributor at $2.3 million and $11.4 million respectively (on a $1 million and a $5 million production budget). Based on the descriptive data plotted in the histograms above, the probability of movies in these budget ranges reaching a breakeven gross at the box office (the point at which investors would earn a return beyond the principal) is 7.8% and 22.7%.

When the box office grosses are plotted against exact budgets rather than in broadly specified sets as above, the odds improve somewhat. **Exhibit III** charts the probability that a film will gross a multiple (x) of its budget at the worldwide box office. For those titles under $1 million dollars without a known budget, I assumed one of approximately $550,000 (the average of the known budgets in Set A).

[11] These estimates are derived from a combination of an ultimate template provided by Gary Faber, Adjunct Associate Professor of Marketing, and an actual ultimate model employed for a distributed independent film.

Exhibit III: Probability (Frequency) of Box Office Exceeding Multiple (x) .



On the one hand, this chart is intuitive. Movies with bigger budgets are more likely to attain lower multiples (major distributors, increased resources, marketing spend, etc.), and movies with lowers budgets more likely to attain higher multiples (a $5 million movie needs box office of just $45 million to attain a multiple of nine, compared $720 million for an $80 million movie). Yet, the divergence across the low budget ranges (the first three bars) is intriguing and relevant. A movie in the $1-5 million range is more than twice as likely to reach a multiple of nine, compared to movies with budgets under $1 million or between $5 and $10 million, yielding a higher expected value for investors in absolute terms regardless of the relative difference in box office.

To summarize thus far: Investors are better positioned to make a return on movies financed wholly by equity; under Title III's restrictions, the budget for such a film would be capped at $1 million. However, movies in the $1-5 million range, for which equity would be only a partial contributor, are more likely to produce outliers and extra-ordinary returns. In both cases, the probability of any positive return remains low. However, it is possible for equity investors to recoup some or all of their principal and even to earn a return before a movie ever screens in a theater.

In a series of white papers for Slated, Colin Brown proposes that presales advances and tax incentives could, under the right circumstances, be considered a film's salvage value.[12] I capped the budget of a Title III equity financed film at $1 million (and not $1.4 million to account for tax incentives) because tax incentives are issued in the form of a rebate up to 18 months after shooting and thus a loan would be required to bridge the gap. By limiting the budget to $1 million, investors could indeed be guaranteed up to 30% back before any other transaction occurred, lowering the breakeven threshold for subsequent performance (i.e. sale to a distributor).

The selling of rights to domestic or foreign distributors post-completion is a transaction often facilitated by film markets at major festivals. In the ultimate models above I assumed a purchase price equal to the budget whereby an investor in an all-equity financed film would retrieve the principal upfront via the minimum guarantee. Of course, selling these rights for a given value is also uncertain and unlike box office (for which the data is noisy, but at least public), the "behind closed doors" and often piecemeal nature of the transactions (in the case of foreign distribution) makes analyzing outcomes very difficult. For films with budgets under a million dollars, film festival statistics offer a glimpse of insight.

Between 2010 and 2014, 19,679 feature films were submitted to Sundance, around half of

[12] Brown (2015c): 16.

which were U.S. entries. Cultural Weekly estimated that these films had an average budget of $750,000.[13] Of those that were eventually accepted, 300 received distribution deals, equivalent to around 1.5%. Independent films can secure distribution at other festivals and out with the festival circuit, but these numbers give some sense of how few, low-budget independent films make it into theaters at all.

There are alternatives to theatrical distribution – self-distribution models leveraging Video On Demand (VOD), such as Vimeo On Demand and VHX, and demand-based theater platforms like Tugg, which have excelled for some niche and social-impact documentaries, but the reality remains that low budget narrative films made for under five million dollars offer very little chance of delivering a return. Moreover, movies within the $1-5 million range are more likely to be backed by established producers and those with an attractive overall package (director, cast, intellectual property) are more likely to secure funding using traditional means. This gives rises to the potential for adverse selection among projects seeking equity crowdfunding and thus I will proceed to an economic analysis of the crowdfunding model to better understand the types of films not just viable, but likely to seek out this new source of capital and the incentives for participation of each of the three key stakeholders.

V. ECONOMICS OF THE EQUITY CROWDFUNDING MODEL FOR FILM

Agrawal, Catalini, and Goldfarb's (2013) oft-cited paper remains the broadest survey of the basic economic concepts that underlie crowdfunding. Having established risk and uncertainty in the previous section, I will apply some of these economic constructs to the equity crowdfunding model as it relates to independent film.

[13] Leipzig (2015).

The entertainment-based crowdfunding model engages three players: content producers (supply), investors (demand), and crowdfunding portals (CFPs – a catch-all term for facilitating platforms, either reward based sites like Kickstarter or SEC accredited broker-dealers and funding portals like IndieCrowdFunder). The incentives and interests of these parties may differ, conflict, and change over the course of a production's lifecycle. As Title III equity crowdfunding for film has yet to be realized in the U.S., examples from Europe and comparisons with the more established and tested reward-based models will prove instructive.

V.1 Supply: Content Producers

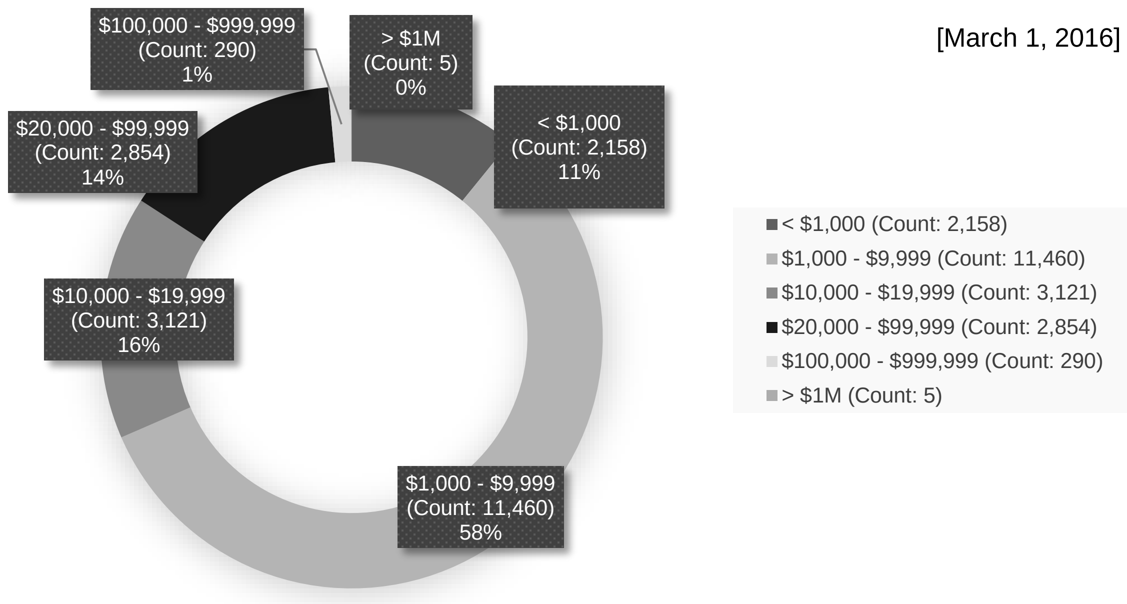
Outside of Hollywood's studio system, the independent film industry accounts for around 80% of theatrical releases in the United States each year. In 2014, that equated to 481 of the 707 films that earned domestic box office.[14] However, film festival submission statistics belie a much bigger industry in terms of production, as previously discussed. In that same year, Sundance Film Festival, the biggest domestically, received 4,057 feature-length submissions, with an estimated combined investment of $3.04 billion.[15] Just 119 films were accepted and of those, 75 received a distribution deal. Approximately half of Sundance submissions originate in the U.S., implying a production volume (most in the sub-million-dollar range) that exceeds the number of films with domestic theatrical distribution (which includes foreign titles) by a multiple of four.

Of course, not all films produced within this range have sought crowdfunding. Kickstarter, the largest reward-based CFP in the U.S. by total capital raised, was launched in 2009 and has

[14] "MPAA Theatrical Market Statistics 2014" (2015). This number includes both films produced in the U.S. and those produced internationally.
[15] 4,057 includes both narrative and documentary, U.S. and international films. Just under 50% were U.S. entries. Leipzig (2015).

since seen $325.56 million pledged to ‘Film and Video’ across its global platform.[16] Yet, just 1% of the campaigns which successfully reached their target sought more that $100,000.

Exhibit IV: Kickstarter Successfully Funded Film and TV Projects to Date



Incentives and Disincentives

Beyond those who may have previously solicited funds through donation or perk-based campaigns are producers seeking to bypass the burden, costs, and demands of preselling for production funds and for whom the cost of debt significantly increases the overall budget. The first equity crowdfunded film in the United Kingdom, *Salty*, is scheduled to go into production in the coming months. Simon West (director of *Tomb Raider*, *Expendables 2*) noted the cost of borrowing as the deciding factor in turning to “the crowd”, citing rates as high as 30%.[17]

[16] "Kickstarter Stats — Kickstarter" (2016)
[17] "Hollywood Turns To U.K. Equity Crowd-Funding" (2015).

Thus a major incentive of crowdfunding for content producers (and the goal of the JOBS Act more broadly) is the lower cost of capital and potential elimination of the need for and cost of debt. Other incentives for crowdfunding vary by campaign type and scale. At its best, a successful crowdfunding campaign builds audience and awareness by accessing and leveraging communities invested in the content or creators. In this sense, crowdfunding truly can represent the "democratization of funding" – the mantra on which Indiegogo was founded. For the most prominent and lucrative campaigns – feature adaptation of cult TV series *Veronica Mars* ($5.7M, Kickstarter) and sequel of cult comedy *Super Troopers* ($4.5M, Indiegogo), the crowdfunding call to action galvanized fans and served as a marketing boost for producers, proving demand to distributors and other financial stakeholders.

Disincentives, on the other hand, include the costs and expertise associated with mandatory reporting to the SEC (in an industry that traditionally eschews financial transparency) and managing a large, fragmented (in number and locale), and potentially green investor base.

V.2 Demand: Investors

The definition of a non-accredited investor can best be derived from that of its opposite; a company with assets in excess of $5 million, or an individual with assets in excess of $1 million or else an individual income (for at least each of the past two years) of more than $200,000. Non-accredited investors span everyone else, with limitations not on worth, but on investing power. The novelty of Title III crowdfunding lies in its potential to reach this new class of investor by providing investment opportunity.

Incentives and Disincentives

Investor incentives in the equity crowdfunding model for film can be divided into three non-mutually-exclusive categories – financial, status-based, and philanthropic. The former is self-explanatory, although **Section IV** implies that either investors are highly risk seeking, not performing adequate due diligence on their exposure, or gain disproportionate value from other intangible benefits.[18] In 2012, the Finish-German Nazi lunar comedy, *Iron Sky*, secured $1 million of its $10 million budget via equity crowdfunding from 280 investors across Europe. Two years later, it had returned just 10% of the investment after poor box office results.[19] This disappointment did not, however, preclude the production team from crowdfunding a further $250,000 in “War Bonds” (a 2-year bond with a yield of 4-8%) and $640,000 via Indiegogo for development and post production funds for the sequel. The market’s indifference to past performance in this case hints at other investor incentives.

“Status-based” incentives include the cachet acquired through early adoption as well as community affiliation, often fan-driven. In the aforementioned *Salty*, the British Simon West film nearing principal photography, one of the investors – new to film investing – described a “sense of ownership” of the film and that his fears about risk were allayed by the team’s “track record”.[20] It would seem that in reality this investor placed the most value on his “status” and involvement, as Simon West’s last two films, *Stolen* and *Wild Card*, earned $2.1 million and $6 million at the box office on budgets of $30 million and $35 million respectively. This lowering of the barriers of entry to film investment can also leave investors vulnerable, unaware of steps to take in performing effective due diligence.

---

[18] In Europe, there is an additional, significant financial incentive in the form of tax relief of up to 50% of the amount invested.
[19] Goldstein (2014).
[20] Flint (2015).

“Philanthropic” contributors might first be assumed as just family or friends and indeed these contributions are important – they have been shown to account for a disproportionate volume of initial funding for projects, which can signal its credibility and worth to other investors.[21] However, philanthropic investments can also come from those unknown to the filmmaker; those moved by a social cause or a niche community or interest and whose willingness to contribute could potentially be increased by the mere possibility of upside, however slight. Agrawal, Catalini, and Goldfarb (2013) consider philanthropic contributions to be significant and this significance may well increase as Title III comes into effect.

Disincentives from an investor’s point of view, beyond the project risk, are the risks associated with backing creators ranging from inept to fraudulent.

V.3 Facilitators: Funding Portals

On January 29, 2016 the SEC and FINRA (Financial Industry Regulatory Authority) began accepting Funding Portal New Member Applications from companies seeking to take advantage of the new ‘Funding Portal’ entity formalized in Title III. Funding Portals obviate the high compliance costs of Broker-Dealers so long as they comply with SEC mandates which dictate that, among other things, they not: “provide investment advice or make recommendations; solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; hold, manage, possess, or otherwise handle investor funds or securities”.[22] Thus far, just two entertainment focused entrants have announced their initial registration: The Rudimental and IndieCrowdFunder. Via a holding page on its website, donation-based crowdfunding frontrunner Indiegogo has signaled a move into equity offerings with further

[21] Agrawal, Catalini, and Goldfarb (2014): 31.
[22] *Title III - Final Rules* (2015): 273

updates to come.[23] The incentives for funding portals are straightforward – as with reward based CFPs, equity funding portals will charge around 5% of funds raised for the service they provide: facilitating the matching of creators and investors.

V.4 Market Failure: Adverse Selection and Moral Hazard

Individuals of high net worth with a serious interest in film investing are highly sought after by independent producers. In spite of this, in the past year, demand has exceeded supply, at least supply that is "investment grade" – a team with a highly verifiable track record and a project with as many indicators of success as possible (known talent, underlying intellectual property, etc.)[24] Thus arises the potential for adverse selection on crowdfunding platforms, whereby less desirable projects seek investment, while the most desirable projects continue to rely on traditional forms of financing like presales. Another key form of market failure in the crowdfunding space is moral hazard.

Equity crowdfunding implicitly requires investors to predict demand for a given film and such predictions must be made primarily based on information provided by content creators.[25] IndieCrowdFunder, noted above, currently hosts *Joining the Race* a PG-13 comedy about a man in a mid-life crisis rediscovering his joie de vivre at a NASCAR experience week. The site offers reward-based crowdfunding and, for accredited investors, the opportunity to register their interest in an equity offering. The page cites three comparable films to indicate possible box office performance including *Talladega Nights: The Ballad of Ricky Bobby*, co-written by and starring Will Ferrell, which grossed almost $163 million at the global box office on a budget of

[23] "Equity Crowdfunding - Indiegogo" (2016).
[24] Brown (2015a): 2.
[25] Agrawal, Catalini, and Goldfarb (2014): 6.

$72.5 million, and *City Slickers*, a 1991 western starring Billy Crystal, which grossed almost $180 million on a budget of $26 million. For investors new to the film industry, this box office potential may appear promising, but the reality is that unless *Joining the Race* stars Will Ferrell or an actor of equivalent stature, which it does not, these numbers are misleading.

Mechanisms designed to limit market failure include accountability provisions, most prominently, the SEC legislation itself, in addition to the rules set out by individual funding portals. The initial SEC legislation also includes language that enforces a "provision point mechanism" whereby funding is only received when the full amount sought has been reached or surpassed.[26] Other important elements include reputation signaling through "quality signals" (a history of producing and selling films, acclaim verified by awards, a significant social media following, etc.), "feedback systems" (mandatory reporting, staged financing as in the case of *Iron Sky 2*), and "trustworthy intermediaries" (the readiness of crowdfunding platforms like Indiegogo, with an established brand and infrastructure, to register as funding portals).

VI. CONCLUSION

Sizing the market for Regulation Crowdfunding requires identifying the likely profiles of individual stakeholders. From the supply side, low-budget independent films produced for under $5 million appear the most probable candidates. For investors seeking outliers, films in the $1-5 million range hold more promise than those produced for less, but investors must balance a potentially diminished recoupment position detailed in individual contracts with this increased probability, taking into account that films in the upper echelons of this range may be more likely to rely on traditional sources of financing. Moreover, some of investors' financial risk can be

[26] Agrawal, Catalini, and Goldfarb (2014): 30.

mitigated by leveraging tax incentives after the fact (i.e. not incorporating them into the production budget), recouping up to 30% of the principal before any other sale or transaction occurs.

Content creators must weigh the burden of SEC reporting and investor management with access to cheaper capital and reduced debt. Non-accredited investors will gain access to new investment opportunities, but must be wary of information asymmetries and conduct proper due diligence on prospective productions.

Industry skepticism regarding the impact of equity crowdfunding appears founded and it remains to be seen whether the non-accredited investor class will expand beyond those who currently participate in non-equity crowdfunding, given the low prospects of a financial return. Other investor incentives, especially those that are philanthropic, may thus prove essential to determining equity crowdfunding's long-term success. Given mainstream Hollywood's ongoing lack of diversity on screen and off and its propensity for blockbuster franchises, it would seem that one area in which equity crowdfunding could excel is in supporting underrepresented talent and finding audiences (and investors) committed to content and creators overlooked as "not commercially viable" by traditional funding sources, even those in the independent sector. As the independent distribution industry grows, it could also play an increasingly significant role by diminishing reliance on theatrical distribution and providing lower-cost and more efficient access to target audiences.

Another possibility for equity crowdfunding could be the development of micro-budget slates (a concept Lionsgate was undertaking in 2012 and which the NYU Production Lab has begun to embark on within an academic framework), whereby the funds are raised to finance, for example, five films produced for $200,000, in an attempt to diversify some of the risk.

Equity Crowdfunding under Title III will come into effect in May and in the months and years that follow empirical studies will emerge. For now, like much else in the industry, its potential remains uncertain, yet it is an undeniably exciting proposition. It is important to soberly manage the expectations of financial return in low-budget filmmaking, but creative and shrewd use of equity crowdfunding could generate social gains beyond those with a dollar value through increased opportunity and representation for filmmakers and investors.

REFERENCES

Agrawal, A., Catalini, C., and Goldfarb, A. 2014. "Some Simple Economics Of Crowdfunding". *Innovation Policy And The Economy* 14 (1): 63-97. doi:10.1086/674021.

Ahlers, G.K.C., Cumming, D., Günther, C., and Schweizer, D. 2015. "Signaling In Equity Crowdfunding". *Entrepreneurship Theory And Practice* 39 (4): 955-980. doi:10.1111/etap.12157.

Belleflamme, P., Omrani, N., and Peitz, M. "The Economics Of Crowdfunding Platforms". *SSRN Electronic Journal*. doi:10.2139/ssrn.2585611.

Brown, C. 2015a. "Filmed Entertainment as an Attractive Asset Class". *Slated*. http://info.slated.com/filmonomics/filmed-entertainment-as-an-asset-class/

Brown, C. 2015b. "Key Considerations in Film Finance". *Slated.* http://info.slated.com/filmonomics/key-considerations-in-film-finance/

Brown, C. 2015c. "The Benefits of Film Investing". *Slated.* http://info.slated.com/filmonomics/benefits-of-film-investing/

———. 2012. *Considering An IPO? The Costs Of Going And Being Public May Surprise You*. Ebook. 1st ed. PwC. http://www.pwc.com/us/en/deals/publications/cost-of-ipo-september-2012.html.

———. 2016. "Equity Crowdfunding - Indiegogo". *Indiegogo*. https://learn.indiegogo.com/equity-crowdfunding/.

Flint, K. 2015. "Con Air Director Takes Salty Path To A Crowdfunding Record". *The Guardian*. http://www.theguardian.com/film/2015/apr/14/simon-west-salty-crowdfunding-con-air-tomb-raider.

Goldstein, G. 2014. "Berlin: Crowdfunding Catches On With European Filmmakers". *Variety*. http://variety.com/2014/film/markets-festivals/berlin-crowdfunding-catches-on-with-european-filmmakers-1201086015/.

———. 2015. "Hollywood Turns To U.K. Equity Crowd-Funding". *Bloomberg.Com*. http://www.bloomberg.com/news/videos/2015-03-19/hollywood-turns-to-u-k-equity-crowd-funding.

———. 2012. *Jumpstart Our Business Startups (JOBS) Act*. Securities and Exchange Commission.

"Kickstarter Stats — Kickstarter". 2016. *Kickstarter.com*. https://www.kickstarter.com/help/stats.

Knight, T. B. and Leo, H. and Ohmer, A. 1012, "A Very Quiet Revolution: A Primer on Securities Crowdfunding and Title III of the Jobs Act." *Michigan Journal of Private Equity & Venture Capital Law*, 2:1:135-54.

Leipzig, A. 2014. "Sundance Infographic 2014: Are Indies The "8th Studio"? - Cultural Weekly". *Cultural Weekly*. http://www.culturalweekly.com/sundance-infographic-2014/.

———. 2015. *SEC Adopts Rules To Facilitate Smaller Companies' Access To Capital*. Securities and Exchange Commission. https://www.sec.gov/news/pressrelease/2015-49.html.

———. 2015. *Title III – Final Rules*. Securities and Exchange Commission. http://www.sec.gov/rules/final/2015/33-9974.pdf

———. 2015. *Theatrical Market Statistics 2014*. Ebook. 1st ed. MPAA. http://www.mpaa.org/wp-content/uploads/2015/03/MPAA-Theatrical-Market-Statistics-2014.pdf.

Ulin, J. 2013. *The Business Of Media Distribution. Monetizing Film, TV And Video Content In An Online World. 2Nd, Rev. Ed*. Oxford: Focal Press.