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# THE CROWD-FUNDING REVOLUTION



**HOW TO RAISE  
VENTURE CAPITAL  
USING SOCIAL MEDIA**



**KEVIN LAWTON AND DAN MAROM**

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# Chapter | 1

## THE RISE OF THE CROWD

*If Facebook were a country, it would be the  
3rd most populated.*  
—TechXav

The Group of Seven (G-7), an international organization established to facilitate economic cooperation, dates back to the member nations' summit meetings circa 1975, but it was officially established in 1985, not that long before the commercialized Internet was born.<sup>1</sup> In the ensuing decades after its establishment, a lot has happened on the global economic scene, including the expansion of the group to become the G-20, representing 20 of the world's major economies. But another important trend, at least as profound, has been growing: the number of Internet users in the world has grown to over 2 billion, out of a total population of 7 billion. If we utilize the number of Internet users as a proxy for sizing the available Earthly "crowd," then we have already in essence implicitly formed the Group of 2 Billion (G-2 Billion). And given the current rate of Internet penetration and population

growth, in just a few years or so, we may have in just three decades transitioned from the G-7 to the G-7 Billion.

This isn't creative hyperbole. Use of the crowds has disrupted or has begun to disrupt an extraordinary number of business and social activities. Until the more recent crowdfunding trend emerged, many uses of the connected crowd were referred to under the more encompassing rubric of "crowdsourcing," a term coined by Jeff Howe in his 2006 *Wired* magazine article "The Rise of Crowdsourcing."<sup>2</sup> Conceptually, crowdsourcing using the connected crowd has been in use for much longer than the term *crowdsourcing* has existed. Perhaps one of the earliest and most high-impact examples is the free software and open source movements that now power many of the world's websites. In fact, free and open source software development has been ongoing since long before the Commercial Internet Age, back when, as your author can attest to, e-mail had to be addressed through an ugly predetermined routing path (the "bang path" for you cadre).

It's hardly surprising that the earliest adopters of what we now think of as crowdsourcing were technology enthusiasts: technology was much harder to use, and enthusiasts were close enough to the technology to be aware of its potentials. Equally as unsurprising were the motivations of the early adopters, which are perhaps better expressed by asking the contrary "Why wouldn't they?" Human nature has always driven people to seek others with common interests and to commune in those areas of interest, as embodied in the proverbial "Birds of a feather, flock together," the essence of which dates back at least to the Greek philosopher Democritus (circa 460 BC).<sup>3</sup> The latent urge has always been there, and the Internet (even prior to its commercialization) has served to merely open up the playing field to a much larger group. Opening up the playing field it did, as the Internet-enabled open source movement built an ever-increasing momentum and entered the mainstream in the late 1990s and early 2000s, coincidental with the general technology initial public



offering (IPO) bubble. It received the most flattering of endorsements any newcomer could hope for by the incumbents, being called a “cancer,” “communism,” “hype,” and all kinds of other terms of validation, especially when emanating from big players who would otherwise not waste their breath. Remember the Ghandi-esque “First they ignore you, then they laugh at you, then they attack you, then you win”? Open source was already in the third phase by then.

Today, Microsoft has a web page dedicated to open source, but at the time it was launched, Microsoft took a very different tone: “We recognize the value of working with others . . . ,”<sup>4</sup> which the company wrote out in a familiar and personalized handwriting style, as if on a chalkboard. Well, we now live in a world in which the power and value in collaboration are much more widely respected.

What’s been interesting about the name-calling, across the social networking spectrum from open source to crowdfunding, is that they all got it wrong. A more apropos term might better have been “community-ism” because that’s what it is—decentralized, self-determined community clusters woven into the tapestry of the greater whole. Communism, by contrast, is when community is centralized, intermediated, and dictated to by a hierarchical bureaucracy. Or in other words, it uses a power structure that often resembles, at least in spirit, the place where an overwhelming percentage of the name-callers come from.

As the web revolutionized the general population’s access to information and to each other, and as it made doing so increasingly easier, opportunity costs dropped. What happened to open source happened similarly to a broader class of crowdsourcing and other forms of accessing the general crowd. Mobile phone penetration exploded, and the phones got smarter including offering access to the web. Innovations in personal computers and their portability continued to accumulate, and personal computers morphed into netbooks, tablets, and other form factors. Mobile data plans, WiFi, Internet terminals at libraries, coffee shops, and airports—and more

recently Internet-enabled TVs that have applications much the same as personal computers—all are part of the wave of increasing connectivity that has fueled the crowd. And there is absolutely no mystery in any of this—the power of the crowd is essentially a mathematical inverse function of opportunity costs (including lack of access). Technology and Internet access have changed everything.

*Wikipedia* is one of the most publicly visible “crown jewel” achievements of crowdsourcing, involving massive and organic orchestration. But behind the scenes, search engines such as Google feed on even more massive and yet implicitly crowdsourced information—the web of intersite references (links) on the Internet. Kiva popularized crowdsourced microlending to entrepreneurs across the globe for the purpose of alleviating poverty. CrowdSPRING and 99designs offer crowdsourced graphic design. Springwise crowdsources business idea spotting. The Google Translator Kit mixes artificial intelligence (AI) and crowdsourced language translation. kaChing and Covestor crowdsource finding investment managers. The pilot Peer To Patent<sup>5</sup> project opens the patent examination process to public participation, and it has been trialed with some successes in the United States, Japan, and Australia. Even in the quant hedge fund industry, there is Algodeal, which allows people to build their own quant strategies on their platform—Algodeal allocates money to the best strategies and lets the algorithm authors share in the profits!<sup>6</sup>

A relatively exhaustive list of crowdsourcing efforts would be an enormous undertaking; a shorter list might be one that itemizes the industries which have not been subject to crowdsourcing. On the long list of the industries that have used crowdsourcing are drug discovery, oil and gas research, search for extraterrestrial life, Mars crater analysis, map and traffic information construction, restaurant and movie ratings, T-shirt design, problem solving, executive recruiting, web usability testing, fashion design, news, and photography. And it was only a matter of time: there is now a *crowd conference*,<sup>7</sup> billed as “the world’s first conference on the future of

distributed work,” and a *crowd consortium*.<sup>8</sup> Many people and organizations now recognize the value of working with others.

## The Dynamic Duo: Social and Physical Technologies

Conceptually, the collective wisdom and power of the crowd dates back to *at least* the days of Plato in ancient Greece, where dialogue was the essence of participative democracy. While a peer-to-peer democracy was effective only in local politics at the time, they didn’t exactly have Internet access either. Unfortunately, even though our avenues of communication have increased, dialogic forms of democracy have actually deteriorated, intermediated by decreasingly less representative forms.<sup>9</sup> So politically, we have scarcely even experimented with the collective wisdom, and we seem to be headed in the opposite direction. And yet technologically, we are in just the beginning of what portends to be a quantum leap forward in the collective wisdom of the human race.

In modern times, it seems almost a bit trite to evoke the Internet as a change agent. But there is some stellar work with fascinating observations that suggests we are in nothing short of a revolution. The book *The Wealth of Networks: How Social Production Transforms Markets and Freedom*,<sup>10</sup> written by Yochai Benkler (professor for entrepreneurial legal studies at Harvard Law School), is one of the most thorough, insightful, and articulate masterpieces related to this field. It should be required reading material for every political figure or policy maker. One of Benkler’s observations captures the essence of growth in our new Internet-based *complexity economics*:

The rise of the networked, computer-mediated communications environment has changed this basic fact. The material requirements for effective information production and communication are now owned by numbers of individuals *several orders of magnitude*

*larger* than the number of owners of the basic means of information production and exchange a mere two decades ago [emphasis mine].

But even beyond indicating changes in scale, Benkler goes further to explain changes to the nature and structure of our economy:

The removal of the physical constraints on effective information production has made human creativity and the economics of information itself the core structuring facts in the new networked information economy. These have quite different characteristics than coal, steel, and manual human labor, which characterized the industrial economy and structured our basic thinking about economic production for the past century.

Enormous changes to the scale, content, and nature of our modern economy are, alone, enough to warrant the characterization of a “quantum leap” amid our otherwise evolutionary socioeconomic path. But Benkler elaborates something much deeper and more profound—that is, that the patterns in our social wiring have been applied to an expanded role, and they have become very central to the modern economy:

We merely need to see that the material conditions of production in the networked information economy have changed in ways that increase the relative salience of social sharing and exchange as a modality of economic production. That is, behaviors and motivation patterns familiar to us from social relations generally continue to cohere in their own patterns. What has changed is that now these patterns of behavior have become effective beyond the domains of building social relations of mutual interest and fulfilling our emotional and psychological needs of companionship and mutual recognition. They have come to play a substantial role as modes of motivating, informing, and organizing productive behavior at the very core of the information economy.

In *The Origin of Wealth*, Eric Beinhocker differentiates two types of technologies: physical and social. As he defines, *physical technologies* (PTs) are “methods and designs for transforming matter, energy, and information from one state into another in pursuit of a goal or goals.”<sup>11</sup> And *social technologies* (STs) are “methods and designs for organizing people in pursuit of a goal or goals.”<sup>12</sup> While the advancements of PTs have and will always be incredibly important, modern advances in STs have been legion and have pervaded many parts of our lives. Facebook, LinkedIn, Twitter, Meetup, Yelp, text messages, cloud computing—these all have strong ST elements, in that they change the way we organize.

Breaking out technologies into these two camps is very useful because it’s then quite intuitive to think about much of our recent cultural changes in this Commercial Internet Age in terms of familiar STs. But at a macro level, STs have enabled a powerful phenomenon, a source of the magical powers of the crowd. In Beinhocker’s words:

Once the evolution of STs reached the stage at which large numbers of people could form cooperative networks and had the means for communicating and storing significant amounts of data, human organizations took on a different character—they became capable of emergent computation. Organizations of people have the ability to process information and solve complex problems that individuals cannot process or solve on their own.

Accessing a crowd is not only a way to access more people—the crowd can be much greater than the sum of its parts.

If you were to ask inventors just how radical their inventions are, if they’re honest, they’ll likely tell you their inventions are actually incremental improvements over, or aggregations of, other inventions. That’s mostly been the state of affairs in the history of inventions, as it has for most human achievements, poetically articulated by a statement attributed to Isaac Newton: “If I have seen farther it

is because I stand on the shoulders of giants.” Given the nature of incremental advancement and the sheer number of potential inventors, it explains why there is quite often parallel “spontaneous inventions” of similar design. And it certainly does not bode well for the efficacy of an intellectual property system in an age of social networking, especially one of patents. But what is truly exciting in this regard is that the natural and perhaps exponential multiplier effect of inventive incrementalism takes on a whole new exponent when the entire crowd is given access. Beinhocker recognizes this almost fractal effect, observing, “One of the most remarkable things about human Physical Technology is how each new invention creates both the possibility of, and the need for, more inventions.”<sup>13</sup> One could easily contend that Beinhocker’s observation would apply in spades to social technologies.

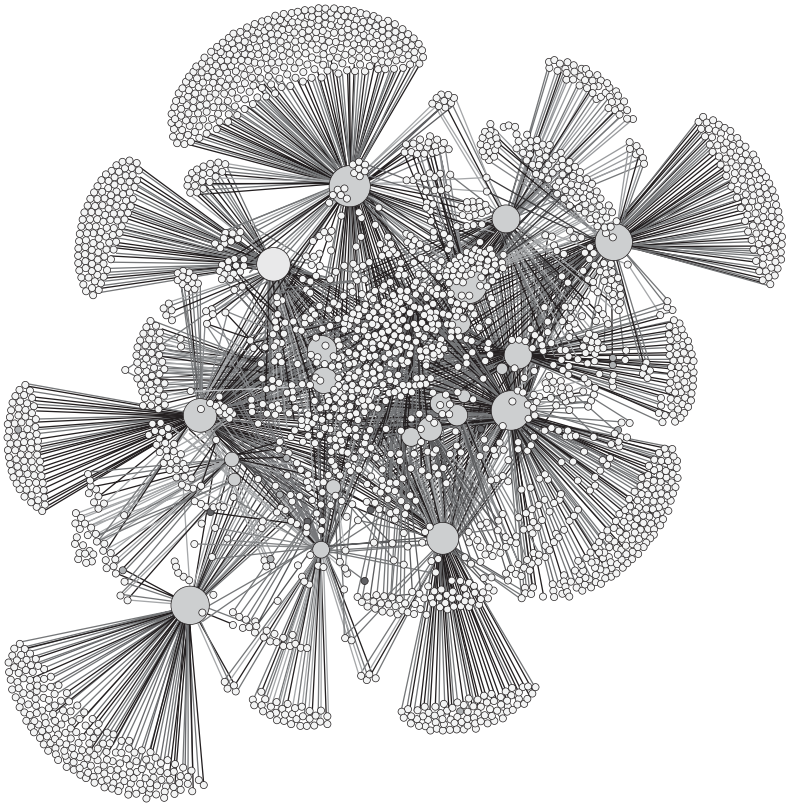
## **Affinity Groups**

It would be an untenable proposition with any sizable crowd to communicate actively in an every-person-to-every-person fashion. Information flow would quickly overwhelm the participants, wreaking communications havoc and likely subtracting value instead of adding it. While obviously for mostly one-way communications, a large number of people can potentially receive information from a given source (the hub-and-spoke pattern), as soon as there is a material amount of two-way communications, that relationship breaks down rapidly. For a small number of people, of course, a tight every-to-every pattern of communication may suffice.

What’s incredible about networked crowds is that they form structural patterns, which arbitrate a living balance between the various participants’ needs to actively communicate and connect to other parties. They can be hierarchical or even fractal patterns, each level providing a nexus to the next. But there’s nothing saying the structure has to be optimal. It only has to be functional. When

it's not reasonably functional, any one member would be inclined to unplug from his or her current part of the overall pattern and presumably plug into a more suitable place. Thus the structure of a crowd tends to be in a dynamic state of continuous rebalancing.

To help visualize the awesome complexity and beauty of an interconnected crowd, look at Figure 1.1, which is a fantastic graphic that was created by Chris Ward from his research studies on social networking and prediction markets at the University of Utah's School of Business.<sup>14</sup> The figure depicts a social network graph from a project on trader behavior in an online prediction market. A picture is worth a thousand interconnected words.



**Figure 1.1** A Social Network Graph from a Project on Trader Behavior in an Online Prediction Market

Source: Chris Ward, <http://www.spurstream.com/blog/>, accessed in 2010.

One of the most important components in the structure of a networked crowd is formed by an *affinity group*, which can be loosely defined as a group of people with similar interests or motivations. They are in part responsible for various pieces of information getting traction by and exposure to the larger crowd and also for maintaining the higher collective intelligence of the crowd (as opposed to central command structures that tend to dumb people down). The role of affinity groups was very elegantly articulated by Benkler in *The Wealth of Networks*:

Filtering, accreditation, synthesis, and salience are created through a system of peer review by information affinity groups, topical or interest based. These groups filter the observations and opinions of an enormous range of people, and transmit those that pass local peer review to broader groups and ultimately to the polity more broadly, without recourse to market-based points of control over the information flow. Intense interest and engagement by small groups that share common concerns, rather than lowest-common-denominator interest in wide groups that are largely alienated from each other, is what draws attention to statements and makes them more visible.

Affinity groups can be durable and static in constitution. But they can also be characterized more as dynamical systems, reformulating in real time.

When the right balance of adaptability, credibility, and other mechanisms are combined, affinity groups represent the soul of scalability and efficacy of utilizing crowds. And this is not limited to the day-to-day activities we usually think of as befitting of crowdsourcing. Another such area of promise, for example, is in their application to humanitarian operations, especially during times of crises. Jonathan Gosier, in his blog post “Crowdsourcing and Chaos Theory,”<sup>15</sup> discusses issues and directions in using the crowd



for humanitarian operations, with the aim of enhancing decision making with dynamic inputs from the crowd. As he points out, a number of humanitarian groups operate like football teams, with prescribed plans of action. However, this type of planning often breaks down:

I'm of the belief that humanitarian operations reflect dynamical systems. Political variables, organization structure, the people selected to run programs—these are variables that, from the outset, affect everything that organization will try to do because they aren't "constant." They change over time in reaction to things changing around them. Most organizations try to contain "the butterfly effect" by favoring deterministic methodologies.

As is Gosier's point, crowdsourcing isn't really crowdsourcing without using the crowd, and one needs to use the crowd in a very dynamic system. Thus, he proposes using inputs from the crowd to buffer against dynamic change.

Although he doesn't propose any specific solutions, he touches on one of the most critical aspects of the power (and future) of crowdsourcing—notably, how the crowd collectively validates information (for better or worse), calling this phenomena "folksonomic triage," derived from *folksonomy* ("people defined") and *triage* ("condition-based decisions"). One of the problems with such folksonomic triage is that herding occurs around small early bits of information, which can have very negative effects if the information is incorrect or fraudulent.

This is where, I believe, we are only in the beginnings of our potentials in understanding and properly using affinity groups to rapidly identify, assess, and otherwise influence crowdsourced decision making. Affinity groups can be thought of as amplifiers, so tomorrow's crowdsourcing mechanisms can help amplify accuracy and truth by offering mechanisms to assess credibility, timeliness,

and possession of what's called *local information* (information that is held by only a few), and they can facilitate these assessments in near or actual real time across an arbitrary set of participants for a given event or outcome.

It's important to note that a person who otherwise serves as an excellent affinity group member for one group (or crisis event) may well not have the proper local information to act as an amplifier for a similar group (or event) if the local information requirements are different. This difference can be simply a change in physical location, but it can relate to almost anything else including political affiliation, time zone, language, and culture. It is my belief that discovering an effective means to facilitate rapid affinity group assessment is the province of tomorrow's crown achievement in realizing the power of crowdsourcing, and it will likely be a differentiator in the winning crowdsourcing (and specifically crowdfunding) platforms.

## Participation and the New Prosumer Class

David Johnson, then a visiting professor at the New York Law School, wrote in his piece about virtual companies: "The marketplace speaks the language of price. Traditional companies speak the language of obedience. Peer production speaks the language of love."<sup>16</sup> It's a grave mistake to think in terms of a clear producer-consumer divide. This is an age of a substantially more engaged crowd, both in terms of defining what they consume and how they consume it. These are sentiments echoed by the words of Joanna Shields, vice president and managing director for Facebook Europe, Middle East, and Africa (EMEA): "The most important word in the Internet world today is not *search*. It's *share*."<sup>17</sup>

Besides contributing to *Wikipedia* and open source, we as a collective do web mashups ("a web page or application that uses and combines data, presentation, or functionality from two or more

sources to create new services”<sup>18</sup>), remix YouTube videos, review restaurants, share our photos for others to incorporate into their web posting, post our favorite news items to the likes of Digg and Slashdot, rate and comment on those same news items, share links prolifically, create blog posts and send tweets, create our own game mazes, answer questions on Quora, review books on Amazon.com, and of course use our phones to cast votes for *American Idol* contestants. Whether we participate by creating a mini-opus page on *Wikipedia* or simply push the “Like” button on Facebook, we are nearly all pro-sumers now (a blend of the words *producers* and *consumers*).

Along with the evolution of the pro-sumers came the *pro-ams*—“amateurs who work to professional standards,”<sup>19</sup> as the authors of the book *The Pro-Am Revolution* described them. These are essentially a new and third class of people—those with talents and knowledge on a par with or sometimes exceeding the professional class but who appear more as the pro-sumer class. Many quality bloggers fit this category, as do many photographers and independent filmmakers. This trend isn’t at all surprising. Given enough people with valuable talents and knowledge, all that was necessary to enable them to express themselves was a lowering of the opportunity costs of doing so. And the development of increasingly easy to use and more powerful Internet and social networking tools enabled precisely that.

## **The Response to the Loss of Social Capital**

In the book *Bowling Alone: The Collapse and Revival of American Community*,<sup>20</sup> Robert Putnam describes how we have become “increasingly disconnected from family, friends, neighbors, and our democratic structures,” and he warns that “our stock of social capital—the very fabric of our connections with each other, has plummeted, impoverishing our lives and communities.” In this

context, it becomes clearer that the rise of the crowd is not purely a response to new opportunities. It is, in many ways, a revival of our social needs to interact and be part of something larger—our intrinsic hunger for a sense of community.

For whatever suburbanization, the television, the change in women's roles, and even access to computers did to diminish social capital, there is a corresponding promise in the utilization of the crowd to revive forms of community, such as when it is used as an effective means of facilitating local activities: "America has civically reinvented itself before—approximately 100 years ago at the turn of the last century." It's critical to comprehend the magnitude of the societal imbalance that has occurred in that duration of time in order to contemplate the natural counterforce that is looking for an outlet. And then one must realize that social networking, crowdsourcing, and crowdfunding are smack in the middle of that outlet. This isn't a fad, it's not a bubble, and it's not a mania. This is our culture.

## The New Crowd-employment Paradigm

The question "Where do you work?" embodies an until-now very entrenched employment paradigm, one in which we are generally associated with a single company. But along with the diffusion of the consumer-producer and professional-amateur boundaries comes a similar effect on the employer-employee relationship. Or as Benkler states: "The emergence of radically decentralized, non-market production provides a new outlet for the attenuation of the constrained and constraining roles of employees and consumers."<sup>21</sup>

As opportunities increase for us to avail ourselves to exposure as pro-sumers and pro-ams, and as crowdsourcing and crowdfunding give us opportunities for employment in a style that is closer to contract work, it is increasingly possible for us to survive financially as *crowd-ployees* (people who gain their income largely from

crowdsourced activities). Writers, for example, can write and sell e-books, but they can work in their downtimes as editors for other writers' books, facilitated through a crowdsourced editing site that uses reputation-based referrals. The same writers may even recycle some of their income into investments in independent films, perhaps participating in the writing or editing of the scripts. In this model, it's not even clear what an employer is. The flip side of this equation for companies is that they can tap the crowd to perform an increasing number of their tasks and, even more important, to make an increasing number of their *decisions*. Certainly, smaller agile companies will be created that use the crowds more extensively, right from the beginning. This will and is changing the nature of the employer-employee paradigm and the way we work now and in the future. But it will also make for some thorny intellectual property (IP) entanglement issues—another reason to contemplate a refactoring of the IP system we have in place today.

## **The Crowd-poration**

From the point of view of open source development, it's easy to understand how living, dynamic groups can thrive, even while spanning the globe and encountering a certain amount of churn in the body of developers. There isn't necessarily a sense of a geographic epicenter, or in corporate terms, a headquarters. Neither is there generally a "board of directors" that periodically convenes, takes notes, and makes big decisions. Rather, decisions are made continually, and the power structure is codified not by contractual documents but by whatever dynamic forms are in use. But open source is just one example of a growing class of virtual organizations that organize mostly or completely via social and other forms of networking. Unfortunately, this model has not really been available to profit-seeking organizations who organize in a similar fashion. Traditionally, an organization is generally forced to fit into the

physical-centric corporate structure, with all its paperwork filings, meetings, and physical address requirements.

At least that was the case until June 6, 2008, in the state of Vermont, in the United States. Pioneered by David Johnson (then a visiting professor at the New York Law School) and others, Vermont passed laws that allow companies to form and operate entirely online. As the associated wiki<sup>22</sup> states: “There is no need for paper-based filings, in person (or even synchronous) annual meetings, or a physical address for the company. . . . In other words, you can create a wiki for profit!” That solicited some interesting news titles, including “Vermont Wants to Be the ‘Delaware of the Net,’”<sup>23</sup> a nod to Delaware for being the go-to state for incorporation in the United States for many physical companies due to Delaware’s corporation-friendly laws, fees, and taxation.

That could make Vermont, at least in the United States, a designation for crowdsourcing and perhaps crowdfunding. It will be interesting to see where this leads.

# THE CROWD-FUNDING REVOLUTION

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