Crowdfunding

Catalyzing growth, investment and access to capital

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Access to capital and investment is an integral part of translating innovative ideas into sustainable businesses that drive job creation and growth. For a significant number of entrepreneurs, however, traditional banking and venture capital mechanisms are unable and/or unwilling to provide them with the capital required to turn their ideas into reality. As a result, small and medium-sized businesses (SMEs) and the entrepreneurs that drive them are increasingly seeking out non-traditional sources of financing, such as innovative crowdfunding organizations like Kickstarter and IndieGoGo. Perhaps soon, equity crowdfunding platforms will become the primary means of growing ideas into businesses through a democratized model of finance. In doing so, crowdfunding builds on the evolving processes of web-enabled engagement and participation that have disintermediated numerous industries that were previously thought impenetrable.

Through its role as a conduit for donations, loans and investment, crowdfunding is poised to play a significant role in financing SMEs. Equity crowdfunding, in particular, offers significant potential to open up a new funding source for entrepreneurs, and a new avenue for investment for investors. In so doing, this nascent platform will help facilitate job creation and innovation by ensuring that good ideas don't die on the kitchen tables of would-be entrepreneurs. As this report argues, however, jurisdictions seeking to capitalize on this new avenue must develop balanced regulatory frameworks that protect investors without stifling the elements of long-tail participation and engagement that make this medium a potential game-changer.

Introduction

In an increasingly competitive global race for job creation, catalyzing the growth and success of homegrown entrepreneurs is priority one. Yet, as a 2013 survey of entrepreneurs from across G20 countries shows, access to funding for new ventures continues to be perceived as a struggle and ongoing impediment to start-up creation (Ernst & Young 2013).[1] In Canada, small and medium-sized enterprises (SMEs) identify insufficient access to capital as the primary impediment to investment in the drivers of growth — technology, management capacity, and research and development (R&D). More importantly, financing for higher risk, young and innovative firms is perhaps the hardest and most expensive to come by in Canada (Seens 2013). A 2010 survey of Ontario start-ups across both the for-profit and not-for-profit sectors found that over 70 percent believed access to financing was a major obstacle to startup or expansion (Malholtra, Laird and Spence 2010). Consequently, nearly three-quarters of all start-ups and over fifty percent of SMEs rely on personal savings, placing significant limits on their ability to invest effectively in growth (SME Financing Data Initiative 2009).

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Paradoxically, these research-intensive and growth-oriented firms struggle to access the capital necessary to finance their ongoing activities, despite the fact that they are the key drivers to ongoing job growth, insofar as they comprise a segment of the high-growth, high-impact firms that provide the bulk of total job creation. It is therefore essential — for both economic growth and the employment opportunities that accompany it — to ensure that such ventures can access the capital required for ongoing growth and investment.

Among the avenues poised to have a significant impact on this financing gap is the concept of crowdfunding. The aforementioned study of G20 entrepreneurs found that nearly 50 percent of them think "improved access to funding through new innovative platforms will have the greatest impact on accelerating entrepreneurship" (Ernst & Young 2013). Interestingly, this belief in the potential of crowdfunding is significantly higher among female entrepreneurs, indicating a potentially significant means of addressing the considerable under-representation of women in entrepreneurship. As Caranci and Preston (2012) note, "Canadian women are underrepresented among the self-employed and business owners, with little improvement over the past decade."

Crowdfunding — a relatively new form of financing — sees individuals donate, lend or invest into a specific project or nascent enterprise. Through the aggregation of small contributions, entrepreneurs are able to fulfill financing needs, from the low thousands into the millions of dollars. The donation model is premised on an exchange of financial assets from the donor for a token, non-monetary asset, usually a copy of the end unit. The lending model of crowdfunding is a for-profit transaction with lending rates established through auction-type mechanisms, whereas the equity model operates on an assumption of financial again. While both the donation and lending models are popular in the United States, in Canada only the donation model has so far gained traction. In Europe and the United Kingdom, the equity investment model has taken on a more prominent role.

Across the global crowdfunding sphere, there are over 500 platforms that enable these three types of aggregated fundraising, with over US$2.7 billion having been raised globally in 2012 and a projected US$5.1 billion in 2013 (Massolution 2013). The US alone hosts an estimated 308 such platforms. Carl Esposti, CEO of Massolution and author of an annual

[1] According to a 2013 Ernst & Young survey of more than 1,500 entrepreneurs from across G20 countries, 73 percent say access to funding remains very or somewhat difficult.

crowdfunding industry report, addresses the industry's size by noting that "there is an immense desire to want to support the aspirations of entrepreneurs and people who are pursuing causes" (Hamilton 2013). Crowdfunding takes its roots from the concept of crowdsourcing, popularized by Jeff Howe (2009), author of Crowdsourcing: Why the Power of the Crowd Is Driving the Future of Business. In it, Howe (2009, 14) writes "Crowdsourcing turns on the assumption that we are all creators… [it] uses technology to foster unprecedented levels of collaboration and meaningful exchanges between people and builds on Toffler's belief that people want to participate in the products and services that are meaningful to them, not just passively consume them." While the utility of the concept was most powerfully expressed in the design and development of open source projects such as Linux and Wikipedia, crowdsourcing projects have become increasingly commonplace in all areas of business, government and society, including the structures and processes of investment and lending.

The Donor Model

On the leading edge of this wave are crowdfunding platforms such as Kickstarter and IndieGoGo, which operate on a donor model. Describing itself as "the world's largest funding platform for creative projects," Kickstarter has helped entrepreneurs and creative individuals to raise over US$500 million from over 4.5 million individuals on the site. These contributions come with no expectation of ownership or financial return. As the organization notes, "backers are supporting projects to help them come to life, not to profit financially." Kickstarter operates on an "all or nothing basis": project funds are only disbursed if the funding target is hit.[2] Supporters of successfully funded and completed projects can, in some cases, benefit by receiving a copy of the final project output. An analysis of both successful and failed Kickstarter proposals finds that the most effective requests for support range from US$5,000 to US$50,000, while the most common pledges are, in decreasing order, $25, $50 and $100. Such small pledges can, however, add up to significant totals. In January 2012 the Elevation Dock, a unique iPhone dock, became Kickstarter's first US$1 million project, despite an initial ask of US$75,000. In just 60 days, the project attracted over 12,500 backers, raising US$1,464,706. In April 2012, the Pebble, a wristwatch that connects with a smartphone wirelessly to alert the user of incoming calls and messages, raised over US$10 million from 68,829 backers. It did so after having struck out in attempts to raise the funds through traditional venture capital and angel investor channels.

These new communities of lender/donors and entrepreneurs represent an iterative or horizontal adaptation of popular online lending platforms such as Kiva.org. Founded in 2005, Kiva and its network of field partners connect individual lenders to vetted entrepreneurs anywhere in the world. The platform initially launched in April 2005 with seven loans totalling US$3,500. Through mid-2013, Kiva has facilitated over 582,000 loans for an aggregate of US$450 million in lending, with nearly one million lenders helping to enable this financing.

Kiva.org founder Matt Flannerty notes that Kiva users represent a risk-tolerant source of funds: "Individual Internet users lending small amounts at a time have a greater appetite for risk than commercial institutions or wealthy individuals using microfinance as part of their retirement account" (Flannerty 2007). Freed from the constraints of monthly return targets, this new pool of lenders allows the focus on outcomes, in this case lending to developing world borrowers, to be the priority.

The lesson here is clear — a new model for financing is available to entrepreneurs, one that disintermediates traditional financing channels and goes straight to the end-user and the broader community of project stakeholders.

[2] By way of comparison, Indiegogo allows creators to receive pledges on an ongoing basis which may, in some cases, lessen the crowd-based legitimacy that many investors seek.

The Lending Model

The intrinsic benefit of enabling an entrepreneur aside, both Kickstarter and Kiva are premised on a rather altruistic relationship between the supply and demand for capital. In contrast, peer-to-peer lending sites such as Prosper and LendingClub facilitate a more traditional relationship between those seeking and supplying capital, structured within the framework of crowdfunding. Prosper was the first peer-to-peer lending marketplace in the United States and has grown to host over 1.6 million members and over US$500 million in funded loans. Prosper enables loan requests between US$2,000 and US$35,000, which are filled by individuals who lend as little as $25 per loan. In contrast to Kiva's interest-free model, Prosper allows lenders to set the terms for their loans, ensuring a return on their loan, albeit one that allows borrowers better terms than are available through traditional financial service channels. Lending Club, now the largest peer-to-peer lender in the US, with over US$2 billion in loans made since 2007, recently landed a US$125 million investment from Google.

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The Canadian landscape for peer-to-peer lending is far less dynamic. In 2007, a Toronto-based start-up called CommunityLend announced its intention to replicate the success of American peer-to-peer lending north of the border, raising several million dollars in venture capital funding to do so. Regulatory issues, however, delayed the platform launch until February 2010, and then in only limited form.

Statistics on Kiva

Total amount lent through Kiva: $450,382,425
Kiva Users: 1,447,615
Kiva Users who have funded a loan: 954,525
Borrowers funded through Kiva: 1,077,044
Number of loans made through Kiva: 582,149
Kiva Field Partners: 204
Countries where Kiva Field Partners are located: 69
Repayment rate: 99.00%
Average loan size: $407.94
Average loans made per Kiva lender: 9.70

Source: Kiva.org, July 2013

In late 2009, a ruling by the Ontario Securities Commission (OSC) approved the launch of CommunityLend, but limited participation to accredited investors with a net worth over CAN$1 million or an annual income exceeding CAN$200,000. Clearly, this ruling limited the pool of potential lenders and is understood to be one of the primary factors underlying the CommunityLend's decision, in February 2012, to suspend its operations. At the time of the site's closure, the delinquency rate on loans was zero percent.

The experience of Canadian regulatory impediments notwithstanding, the potential value of this peer-to-peer channel to both ends of the lending equation is clear. Massolution (2013) estimates that the lending portion of the global crowdfunding industry grew to US$1.2 billion in 2012 and will double in 2013. As a result, borrowers benefit from more attractive interest rates, while lenders have access to a new asset pool with which to diversify their investments. And given that over 80 percent of Lending Club borrowers report using their loans to consolidate debt or pay off their credit cards, the disruptive effect such lending can have on traditional financing channels is significant, hence Google's investment.

The Equity Model

In spring 2012, US President Barack Obama signed the US Jumpstart Our Business Startups Act (the JOBS Act) into law. The Act ushered in a wave of optimism related to the ability of small business and entrepreneurs to raise much-needed financial capital. While small companies have conventionally struggled to raise capital from traditional venture capital and private equity firms, the JOBS Act offers an alternative route more akin to popular crowdfunding sites such as Kickstarter, enabling entrepreneurs to solicit small contributions from thousands of online participants. The Act allows investors of any kind to purchase equity in start-ups and small businesses, termed “emerging growth companies,” with revenue under US$1 billion. As it stands, the JOBS Act proposes that mainstream individual investors will be able to invest up to an annual ceiling of US$2,000 to US$100,000, depending on their income. For entrepreneurial applicants, the Act portends a simplified listing process that will avoid the onerous Sarbanes-Oxley regulations mandated for typical initial public offerings. As President Obama remarked at the signing of the JOBS Act,

> For start-ups and small businesses, this bill is a potential game changer. Right now, you can only turn to a limited group of investors — including banks and wealthy individuals — to get funding. Laws that are nearly eight decades old make it impossible for others to invest. But a lot has changed in 80 years, and it’s time our laws did as well. Because of this bill, start-ups and small business will now have access to a big, new pool of potential investors — namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in.

In so doing, the JOBS Act, and equity crowdfunding more broadly, seeks to address the significant lack of capital facing early-stage companies that are too small for traditional venture capital channels, yet beyond the self-financing capacity of entrepreneurs. This “valley of death” sees one half of small entrepreneurial firms die within their first two years of existence (Cressy 2006). In the United States, companies that fall in this demographic have attracted only six percent of total venture capital funds, despite their significant need (White House 2012). In Canada, Sustainable Development Technology Canada (2013) highlights a similar and equally significant pre-commercialization funding gap that far outstrips existing venture capital and angel capacity supply.

Within the equity realm, two different target participants exist. The JOBS Act seeks to engage small investors, akin to those who participate in Kickstarter or Kiva projects. Operating on a similar theory — albeit at a different buy-in level — are platforms that seek to engage accredited investors with a defined level of wealth and income. For example, the OSC defines an accredited investor as having over CAN$1 million in assets or a historical annual income over CAN$200,000. The Australian Small Scale Offerings Board (ASSOB) has operated an equity crowdfunding platform focused on this participant segment since 2005. Projects can seek upwards of A$2 million from no more than 20 retail investors, and an additional A$3 million from what it terms “sophisticated” investors, defined on the basis of net assets over A$2.5 million. As of mid-2013, the site has raised over A$133 million from over 2000 investors. The average investment size is over A$38,000, with aggregate fundraising efforts averaging A$500,000 per company. The largest fundraising total was A$3.5 million. The MaRS Social Venture Exchange (SVX) project recently launched in Ontario operates on a similar accredited investor basis (see Case Study 1: Equity Crowdfunding in Canada).

The main argument for limiting participation to larger investors is that their investment knowledge acts as a strong barrier to fraud. However, by relegating a far larger number of potential investors to the sidelines, accredited investor models fail to leverage the potential to garner much greater aggregate inputs of capital for new ventures.

Finally, established equity crowdfunding platforms in Australia and the United Kingdom (see Case Study 2: Equity Crowdfunding in the UK) highlight the role that such investment mechanisms can play in channelling financing to sectors of the economy that are often ignored by venture capital and angel groups. For example, while a breakdown of ASSOB-funded projects shows a strong appetite for information and communication technology (ICT)-related projects (+25 percent), less traditionally funded areas such as health and beauty (10 percent), food and beverage (8 percent), and mining and oil (8 percent) have all received significant shares of investment (Alchemy 2012).

Overall, equity crowdfunding holds significant potential as a means of aggregating the contributions of small investors into meaningful financing opportunities for entrepreneurs. However, this opportunity and its impact on economic growth and employment can only be fully exploited if a regulatory framework is developed to ensure that investors are protected, that the potential for fraud is mitigated.

Opportunities and Challenges

Crowdfunding through equity, lending, or donations has emerged as an alternative means of addressing the significant financing gap faced by SMEs and entrepreneurs by injecting capital from a large pool of previously unengaged participants. Differences exist between the three models, however, notably in their application to a broader pool of SMEs looking for financing.

The Kickstarter-type donation model, made famous by successes such as Pebble, has shown an ability to raise significant amounts of capital for specific projects. The pool of participants, however, is necessarily limited by the lack of financial return available through this form of crowdfunding. To be sure, the success of such platforms highlights the relatively large pool of funders who participate because they believe in the ideas that entrepreneurs are pursuing and want to support them for altruistic reasons. Moreover, the all-or-nothing model unique to this form of crowdfunding provides a means of legitimization and donor protection that places the onus on fundraisers to provide transparent, verifiable and credible business plans. However, insofar as policy-makers seek to find a sustainable and ongoing source of SME funding, the donation model faces significant limitations, given that the bulk of funded projects fall in the $5–$50,000 range, too small for the broader pool of start-ups seeking growth funding.

This question of size befalls the lending model as well. Moreover, the lending model is similarly limited by the necessary processes of determining appropriate interest rate returns, a task beyond the capacities of most casual participants. The general usage of lending platforms for debt consolidation also limits the likely growth of the industry, insofar as this may hold less appeal for participants seeking to gain a more altruistic return.

The equity crowdfunding model holds far more policy relevance. By combining profit-driven motives with an ability to draw on the desire of participants to fund local projects, start-up entrepreneurs or mature SMEs, the formal equity investment model could provide a significant injection of funding into cash-starved small firms. As Crowdfund Capital Advisors (CCA) has suggested, if Americans invested just one percent of their savings via crowdfunding, over US$300 billion would be made available to US SMEs (Best, Neiss and Jones 2012). In Canada, with an average annual savings rate just shy of CAN$10,000, a similar allocation (however optimistic) would bring over CAN$2 billion into the crowdfunding market. The potential impact of such inflows on the availability of financing for start-ups and small business is immense. Moreover, in contrast to the dramatic decline in capital seen in the wake of the most recent global financial crisis, the funding that flows through crowdfunding platforms is expected to be more long-term and stable.

The benefits of these new models of investment, however, are more than just financial. As the European Crowdfunding Network (ECN) notes (2012), “for SMEs and entrepreneurs, not only can crowdfunding provide start-up capital, it espouses several non-financial benefits: validation of product features, market segmentation, price and demand, pre-sales and customer feedback as well as word-of-mouth marketing and a stable, committed shareholding structure."

To realize these benefits, policy-makers, investors and entrepreneurs must work together to resolve the challenges that accompany this new form of equity investment. Sites like Kickstarter operate on a donation or reward basis, and thus convey zero unanticipated risk to the contributor, which makes the site therefore exempt from US securities law. But crowdfunded equity platforms require regulatory approval. In the US, concerns over investor protection — notably, protecting against the potential for fraud — have held up Securities and Exchange Commission (SEC) approval of key elements of the US JOBS Act. A year following President Obama's remarks, small investors are still waiting for their chance to participate in this reformed market for entrepreneurial investment, as are dozens of start-up crowdfunding firms that have set up operations in the hopes of positioning themselves in the potentially lucrative role of funding portal or intermediary (Cortese 2013). The same is true in Ontario, where regulatory consultation is highly focused on the risk of fraud and investor protection.

The US JOBS Act, in particular, is not without its critics. Steven Rattner (2013), former adviser to President Obama, has noted that it represents the "greatest loosening of securities regulation in modern history." He goes on to call the plan "pure folly," noting that playing the lottery would guarantee an individual investor better odds than direct investment in start-ups (ibid.).

Although these risks cannot be swept aside entirely, they are not nearly as dire as Rattner suggests. Given proposed limits on investor exposure in the US, "pure folly" represents a significant exaggeration of the risks. JOBS Act investors with a net worth of less than US$100,000 will be able to invest US$2,000 or five percent of their net worth, whereas investors with a net worth of more than $100,000 will be limited to 10 percent of their assets. As the Kauffman State of Entrepreneurship address notes, "Financial innovation has acquired a bad name over the past few years, but the presumption at the SEC should be that any financial innovation carries both risks and rewards and that real world experimentation is the best way to test a new innovation" (Kauffman Foundation 2013). Moreover, the empirical evidence from jurisdictions that have implemented forms of equity crowdfunding highlight a very low rate of investor fraud. In Australia, for example, which has a seven-year head start on crowdfunded investment through the ASSOB, no cases of fraud have been discovered. The same is true in nascent investment models in the UK (Invest Crowdfund Canada 2012).

Policy-makers can address concerns related to the potential for fraud by implementing the following regulatory steps:

- A ceiling on per deal investment by individual investors, as well as, for a trial period, a maximum annual contribution through equity crowdfunding platforms.
- A maximum of two annual share issuances by applicant companies to ensure valuations remain transparent and accurate.
- The development of a standardized template for annual corporate reporting for crowdfunded companies to ensure ongoing transparency and shareholder education.
- The development of a revocable licence for equity crowdfunding platforms, judged on the basis of approval standards for applicant companies, as a means of ensuring only legitimate companies are allowed to list.

A second concern relates to an investor's ability to exit the market. As noted in the Seedrs case study below, such low volume equities create a long-term asset class with limited opportunities for exit. While this is part and parcel of any new investment class, regulators must ensure that this fact is well understood and communicated across platforms, particularly because low liquidity will impact the finances of less "sophisticated"/non-accredited investors more acutely. Moreover, as the equity platform operated by the ASSOB highlights, it is possible to establish secondary markets for these low-volume securities, albeit one with infrequent transactions.

Ultimately, with a properly implemented framework for investor protection, and a set of incentives for platform operators that ensures only legitimate and valid proposals move forward to the investment stage, the risks present in equity crowdfunding can be mitigated without adversely overregulating a new source of financing for start-ups and entrepreneurs.

Case Study 1: Equity Crowdfunding in Canada

While the introduction of the US JOBS Act serves as the bellwether for American thinking on the topic, under existing security laws in Canada, it is currently illegal for a company to sell equity through a crowdfunding-type mechanism. In late 2012, however, the OSC opened a consultation on the topic, with the aim of considering exemptions to current securities regulation that would allow the legalization of crowdfunding in Ontario (OSC 2012). In June 2013, the OSC approved a limited term exemption to MaRS, a Toronto-based not-for-profit, for the establishment a crowdfunding platform for accredited investors. While not the fully public platform that advocates have sought, the MaRS SVX will allow investors to crowdfund investments that show a “demonstrable social and/or environmental impact and less than $25 million in revenues” (Sellers and Oliver 2013). While certainly a move in the right direction, limited participation to accredited investors once again puts significant limits on the pool of potential participants and thus the ability to scale the platform to an efficient size. Across the country, the Saskatchewan Financial and Consumer Affairs Authority (FCAA) released a concept proposal on July 9, 2013 that would see equity crowdfunding for start-ups legalized. Under the prairie province’s plan, equity issuers will be able to raise no more than CAN$100,000 twice a year. Investors will be limited to investing no more than CAN$1,000 per deal; however, there is no ceiling on the aggregate amount an investor can make over the course of a year (FCAA 2013). At the time of writing, similar consultations have been launched in British Columbia, Alberta and Quebec.

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These consultations and pilots come as pan-Canadian support for this alternative financing mechanism grows. Chief among supporters is the Canadian Advanced Technology Alliance (CATA). In an open letter to federal Minister of Industry Christian Paradis, CATA notes that “There is every reason to suggest that frustrated Canadian entrepreneurs will see the advantages offered by the crowdfunding provisions for raising capital when those provisions are implemented in the United States, and they will take their best ideas to the US to develop and commercialize” (2012). As CATA President John Reid adds, “Innovation is declining in Canada; we need to change more rapidly to become a more intelligent nation. Crowdfunding investing can help make that transformation happen” (ibid.). Owing to the rejection of a proposed national securities regulator by the Supreme Court of Canada in 2011, CATA is focusing its lobbying efforts on a province-by-province approach to amendments in securities legislation. As in the US, opposition to the introduction of equity crowdfunding does exist. The OSC notes that through its consultation process, “almost all” of the 26 comments received on the proposed exemption to securities regulation were opposed to crowdfunding on the basis of a lack of data. This opposition notwithstanding, the OSC has committed to further study crowdfunding, having

> "The Canadian innovation and economic ecosystem is at risk of falling behind."

acknowledged that it represents a potentially effective means of delivering capital to SMEs (OSC 2013).

The introduction of equity crowdfunding in Canada would build on domestic crowdfunding efforts akin to Kickstarter established by groups such as the Toronto-based Centre for Social Innovation. The organization's nascent Catalyst platform has funded seven projects so far, including a CAN$25,000 social media project backed by 95 individuals. Like Kickstarter, no financial returns are permitted via Catalyst, although intrinsic and non-monetary returns are available depending on the project. According to the National Crowdfunding Association of Canada (NCFA), 62 active and beta platforms currently operate across the country. Moreover, in June 2013, Kickstarter announced the development of a Canadian platform.

In their response to the OSC consultation, the NCAF notes that crowdfunded equity is a necessary means of addressing the financing shortfall that many SMEs face. In particular, they point to the financing gap that exists between the traditional "bootstrapping" early stage processes and mid-stage venture capital and angel investment. Moreover, they note that while incubator and accelerator centres are a means of filling this gap, these mechanisms tend to be focused on niche industries, particularly ICT. Not adopting a permissive environment with respect to equity crowdfunding runs the risk, according to the NCAF, of seeing "Canada [lose] its Canadian-funded ideas and best entrepreneurs to countries with more supportive funding environments and access to capital (e.g., United States) that are keen to commercialize on Canadian start-up ventures" (NCFA 2013).

This notion that the Canadian innovation and economic ecosystem is at risk of falling behind is supported by data about the jurisdictions that have been the most aggressive in establishing regulatory regimes to enable crowdfunding. While Canada is in line with its European peers vis-à-vis the number of crowdfunding platforms established (2012 data), it lags significantly behind the US. Moreover, when it comes to equity crowdfunding, European countries such as Germany, Spain and Italy have each established national regulations that permit this form of equity investment (ECN 2012).[3]

To date, the experience across these jurisdictions makes it clear that the current period represents a learning process. No single model of regulation has emerged, nor is there consensus on how best to protect the interests of investors. This uncertainty, however, cannot be used as an excuse to avoid moving forward with experimentation in the field. Given the funding challenges that exist for Canadian start-ups and SMEs, and given the economic and employment implications that accompany underperformance in firm creation, it is imperative that policy-makers open all appropriate avenues for firm growth. Equity crowdfunding, if framed with appropriate limits on investor exposure and appropriate requirements regarding firm disclosures, is part of the solution.

Case Study 2: The UK's Light-handed Approach to Equity Crowdfunding

While North American jurisdictions struggle to create the regulatory frameworks to catalyze a new form of small business investments while ensuring adequate investor protection, in the UK, the Financial Conduct Authority (FCA) and its predecessor, the Financial Services Authority (FSA), have employed a far more light-handed approach to this new model of funding. This approach has enabled crowdfunded equity platforms like Seedrs.com to flourish, but it has

[3] For German equity crowdfunding see: www.seedmatch.de; For Spain: www.bihoop.com; For Italy: www.crowdfundme.it.

also prompted industry upstarts to approach the government about developing a regulatory model to ensure that “rogues” are kept out.

This principles-based approach has allowed Seedrs.com to succeed. Built on a belief in the necessary democratization of equity investment, Seedrs co-founder and CEO Jeff Lynn notes that “[W]e need to get investment out of the hands of the so-called elite and into the hands of the masses. That’s what we’re trying to do” (Lynn 2012). Established in 2009, the platform has funded 28 deals for over £1.3 million as of July 2013. Lynn notes that this equity crowdfunding approach helps address a significant gap in the marketplace for start-ups and SMEs seeking finance. Notably, it provides a source of funding for companies whose valuations and business models are too small or low-growth for traditional venture capital, and are at too early a stage for traditional angel investors. Moreover, while the venture capital/angel space has long concentrated on ICT, funded projects from Seedrs run the gamut from digital to food processing to traditional manufacturing. For example, Seedrs projects include an artisanal, raw-milk blue cheese company and a specialty baked goods manufacturer. The application of this model across the economy subsequently provides a potentially significant impetus for SME growth.

In so doing, Seedrs draws inspiration from a process of disintermediation in the nineteenth-century financial services sector, a time when only the rich could deposit cash in banks. The establishment of the Bank of America by Italian émigré Amadeo Giannini turned this model on its head, allowing anyone with cash to deposit their savings and/or to seek a loan (Clark 2013). Seedrs seeks to do the same in the field of investment by allowing non-elite investors to back companies with small investments. The average investment made by Seedrs investors is £750, with a median figure of £100. The small size of individual investments notwithstanding, the company has faced opposition from both government regulators and industry stakeholders relating to the risks inherent in the model. While the FCA granted Seedrs regulatory approval, it simultaneously noted that platforms like it should be “be targeted at sophisticated investors who know how to value a start-up business, understand the risks involved and that investors could lose all of their money” (ibid Clark). Lynn notes that Seedrs, while built for public consumption, does include a sorting mechanism in the form of a quiz on start-up investments. If a would-be investor fails the quiz, they cannot invest. In addition to these investor-oriented standards, Seedrs vets listing applications to ensure listings are legitimate and credible. According to Lynn, only 25 percent of applications are approved.

The structure of the Seedrs investment platform provides an additional form of investor protection, and thus a means of increasing investor confidence. Notably, individual investors do not hold shares in the companies they invest in; rather, they purchase shares via Seedrs, who acts as a “syndicate lead.” In so doing, Seedrs positions itself to enforce minority shareholder rights and to act on voting matters, thus solving the collective action problem that a dispersed ownership base would create. This certainly raises some questions about how this “syndicate lead” engages and receives comment and feedback from its pool of investors; however, it does go a long way towards protecting individual shareholders from the possibility of fraud. Lynn believes this structure makes the platform more attractive to both investors and share issuers, noting “The company’s management only needs to come to us for one consent when they want to do something, and on the flip side, investors are protected by us from the things management may try to do to minority shareholders” (Wilson 2013). An additional benefit for share issuers, and by extension an additional risk for investors, is the lack of liquidity in this market. As Lynn notes, this lack of liquidity or secondary markets makes for a long-term asset class that provides price stability and minimizes speculative movements.

All considered, Seedrs provides a unique example of the tangible economic benefits that equity crowdfunding can provide to an economy and its entrepreneurs, as well as lessons on how the regulatory environment can enable rather than suffocate this new, alternative financing channel. As the SEC in the US and jurisdictions across Canada study how they might enable this new form of participatory investment, Seedrs and its shareholder aggregating mechanism offer a template that mitigates some of the risk inherent in this new field.

To be sure, it doesn't negate all risk — but no equity investment comes risk-free. The challenge for regulators is to find a balance between the economic imperatives that dictate a need for more SME-oriented capital and adequate protection for investors.

Conclusion and Recommendations

When economist Dr. Mohammad Yunus started experimenting with lending to impoverished Bangladeshi women in the late 1970s, few believed that a revolution in finance was underway; however, his identification of a major gap in the architecture of financial services, in particular the supply of basic financial services to the poor, jumpstarted the development of the microfinance industry that within three decades would serve over 150 million users. In so doing, lending rates have decreased, savings and employment have increased, and poverty is increasingly an escapable plight.

Crowdfunding, particularly equity crowdfunding, portends a similarly impactful future. Just as micro-finance seeks to address the needs of the "unbanked" and underserved communities in developing countries, crowdfunding seeks to address the long-tail entrepreneurs and small business owners whose needs are currently underserviced by traditional financing models, by tapping the long-tail of potential lenders and investors who increasingly seek to both "do good" by their investments, and play a more active role in the investment selection process. As noted, the potential pool of funding from these sources could provide billion-dollar inputs into the operations and growth of SMEs. And given broad consensus related to the "valley of death" that afflicts many SMEs and condemns a great many to failure, this new source of capital could unleash significant long-term employment and economic gains.

Enabling this potential, and thus ensuring that good ideas don't die on the kitchen tables of financially handcuffed entrepreneurs, will require a properly implemented set of market guidelines that balance the risk inherent within the start-up and SME sectors with the overall potential to create jobs and catalyze economic growth. Jurisdictions across Canada should act now to design effective regulations for this investment mechanism, and should include these four important factors:

- A ceiling on per deal investment by individual investors, as well as, for a trial period, a maximum annual contribution through equity crowdfunding platforms.
- A maximum of two annual share issuances by applicant companies to ensure valuations remain transparent and accurate.
- The development of a standardized template for annual corporate reporting for crowdfunded companies to ensure ongoing transparency and shareholder education.
- The development of a revocable licence for equity crowdfunding platforms, judged on the basis of approval standards for applicant companies, as a means of ensuring only legitimate companies are allowed to list.

While such recommendations cannot shield investors from all risk, they provide a bulwark against fraud and the possibility of financial impropriety. Ultimately, policy-makers need to understand the potential of this largely untapped pool of long-tail capital and its potentially transformative impact on the jurisdictions who are best able to unleash it.

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