Financial Economists Roundtable

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Statement on

Crowdfunding

Larry Harris*
Executive Director
University of Southern California
Los Angeles, CA 90089-1422
(323) 244-1154
LHarris@USC.edu

The Financial Economist Roundtable (FER) is a group of senior financial economists who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The Roundtable focuses on microeconomic issues in investments, corporate finance, and financial institutions and markets, both in the U.S. and internationally. Its major objective is to create a forum for intellectual interaction that promotes in-depth analyses of current policy issues in order to raise the level of public and private policy debate and improve the quality of policy decisions.

FER was founded in 1993 and meets annually. Members attending a FER meeting discuss specific policy issues on which statements may be adopted. When a statement is issued, it reflects a consensus among at least two-thirds of the attending members and is signed by all the members supporting it. The statements are intended to increase the awareness and understanding of public policy makers, the financial economics profession, the communications media, and the general public. FER statements are distributed to relevant policy makers and the media. This statement is the outcome of the FER's discussion at its annual meeting, which took place on July 18-20, 2015 in Vancouver.

The statement observes that crowdfunding offers a limited but significant opportunity to match small investors with startup companies, thus partly democratizing the world of finance. The Financial Economists Roundtable believes that limited and well thought out regulation can help to protect small investors in this market without significantly reducing expected returns. The key to the successful development of a healthy crowdfunding market will be the development of market solutions to the information asymmetries that characterize capital formation both large and small.

For additional information, contact:

Jay R. Ritter University of Florida (352) 846-2837 jay.ritter@warrington.ufl.edu	Jennifer Conrad University of North Carolina (919) 962-3132 Jennifer_Conrad@kenan-flagler.unc.edu
Jonathan Karpoff University of Washington (206) 685-4954 karpoff@uw.edu	Craig Lewis Vanderbilt Univesity 615-322-2626 Craig.Lewis@owen.vanderbilt.edu

Crowdfunding

Statement of the Financial Economics Roundtable

I. Introduction

Crowdfunding enables a large number of investors to each invest a small amount of money in a firm or project. The term typically refers to money raised online, and the venture usually is in an early stage of its life-cycle.[1] Many people view crowdfunding as a way of "democratizing" finance by permitting ordinary individuals to invest in early-stage companies. Outside of the U.S., crowdfunding has been used for years, although this funding has most frequently involved debt-like securities such as those used in peer-to-peer lending.[2]

Proponents of crowdfunding cite several potential benefits. Most obviously, crowdfunding can provide capital to a niche of deserving companies that are too small for venture capitalists and banks to finance profitably. This niche has grown since the 2008 Global Financial Crisis as banks became reluctant to lend to many small- and medium-size enterprises.[3] Crowdfunded firms also can benefit from advice given by their investors, which helps them to improve products and services. Proponents also suggest that crowdfunding can harness advances

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[1] The SEC provides a short description of crowdfunding at https://www.sec.gov/rules/proposed/2013/33-9470.pdf, page 6.

[2] The University of Cambridge report *Moving Mainstream* (2015) and *UK Alternative Finance Industry Report* (2014) document a rapid growth, albeit from a small base, of the European alternative finance market. The U.K. has been the leader in this area, with peer-to-peer business lending and peer-to-peer consumer lending comprising 74% of the total alternative market in that country. Excluding the U.K., in decreasing order of importance, the most important categories have been: peer-to-peer consumer lending, peer-to-peer business lending, rewards-based crowdfunding, and equity crowdfunding.

[3] See, e.g., 'Treasure Hunt', in the *Economist* (June 27, 2015), for a description of the recent credit environment for small and medium-sized enterprises in Europe. For an analysis of small business in the U.S., see "The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game" by Mills and McCarthy (2014).

in information technology, computing power, and big data, which can reduce the cost of capital for young and underserved firms, open up new pools of capital, and expand investment opportunities for small investors, especially in new industries. In addition, they argue that intermediaries have already emerged to mitigate some of the potential problems associated with crowdfunding, and that this form of financing can and will improve if given the opportunity.

Critics of crowdfunding point to potential problems. Adverse selection in this market may be severe; entities seeking crowdfunding may be those that tried but could not obtain traditional capital from more experienced market participants such as banks, angel investors, and venture capitalists. Rather than providing new capital to worthy projects that otherwise would not receive capital, crowdfunding instead may simply facilitate investment in poor quality and even fraudulent projects.

Another concern is that the "wisdom of the crowd" premise, which underlies crowdfunding, may fail. Individuals who invest $1,000 have less incentive to investigate and evaluate a company than do venture capitalists who invest millions. This collective action problem could be so severe that the crowdfunding market fails to grow into a meaningful source of private finance.

The Financial Economists Roundtable, a group of distinguished senior financial economists, met in Vancouver, British Columbia in July 2015 to discuss crowdfunding and to offer suggestions regarding the development and regulation of the industry. We believe that crowdfunding is unlikely to become the primary way that young firms raise capital, as several factors will limit its appeal to many suppliers and demanders of capital. Nonetheless, market solutions developed by private-sector financial intermediaries may at least partially offset these limiting factors and facilitate growth in the crowdfunding market. For example, crowdfunding portals can provide some investor protection by tracking issuers' previous ventures, much as eBay provides information on buyers' and sellers' performance in prior transactions. In addition, while some regulatory requirements can aid in the formation of a healthy crowdfunding market, we believe that the nascent crowdfunding market is most likely to succeed with a light-handed regulatory regime, just as small companies benefit from lighter regulatory burdens.[4]

II. Current Issues in the Crowdfunding Market

As intermediaries, crowdfunding portals have strong incentives to develop creative and cost-effective ways to allow investors to fund young companies with a high likelihood of success. Examples exist in the peer-to-peer lending space: Firms such as LendingClub, founded in 2006, have been using big data to connect borrowers and lenders. LendingClub takes a small fee in return for, among other things, evaluating the credit risk of the borrower.

Equivalent services in equity markets are harder to provide. Large-scale equity financing is inherently difficult to monitor. Unlike individual borrowers, young companies rarely have extensive track records that investors can use to accurately forecast future performance. Legal action against firms for problems associated with equity financing also is more difficult than for problems associated with debt financing. And successful firms may redirect firm cash flows to the founders through a variety of opaque mechanisms, significantly reducing the upside payoff to equity investors.

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[4] In reflection of these potential benefits, and despite these potential concerns, the U.S. Congress enacted the Jumpstart Our Business Startups (JOBS) Act of 2012 to facilitate crowdfunding. The JOBS Act provides some exemptions from Securities and Exchange Commission (SEC) regulations to enable entrepreneurs to obtain funding from "the crowd," not just the roughly eight million "accredited" investors who traditionally have provided private investment. From a regulatory perspective, crowdfunding can be viewed as an extension to the current exemption from registration under Rule 504 of Regulation D of the Securities Act since it shares a number of features with Rule 504. For example, both the SEC's proposed Crowdfunding rule and Rule 504 of Regulation D permit issuers to sell up to $1,000,000 of restricted securities within a 12 -month period provided they do not generally solicit. The main differences are that crowdfunding portals allow issuers to engage in an extremely limited form of on-line solicitation and that investors are expected to adhere to relatively modest investment limits.

Many start-up companies need more than just capital. Venture capitalists frequently supply advice along with their capital, and many entrepreneurs, especially those in the technology and biotech industries, prefer to receive "professional" finance from venture capitalists. This preference limits the supply of high-quality companies with large upside potential to crowdfunding investors.

Finally, although proponents of crowdfunding suggest that young companies face difficulty raising capital, little evidence exists to suggest that historical rates of return on capital are excessively high for small businesses, whether publicly traded or not, as one might expect to see if they could not obtain capital.[5] Given the relatively low returns earned on young publicly traded small firms in Europe and the U.S. in the last few decades, we expect that the average return earned by crowdfunding investors will be low. Any significant adverse selection problems in this market also will have a negative impact on returns. Low returns will limit the growth in funds committed over time—although the possibility of even a single extreme positive payoff will attract some crowdfunding investors despite low average returns.

III. Future Developments in the Crowdfunding Market

Crowdfunding can serve both small investors who seek to participate in young companies as well as young companies that seek financial capital. To thrive as a new source of finance, the crowdfunding industry must develop practices that help balance the efficiencies of an open market with the need to protect small investors from fraud and mismanagement. We believe the following practices would facilitate the growth of this new market.

[5] See Moskowitz and Vissing-Jorgensen's "The Returns to Entrepreneurial Investment: A Private Equity Premium Puzzle?" in the 2002 *American Economic Review* for private businesses in the U.S., and Ritter, Signori, and Vismara's "Economies of Scope and IPO Activity in Europe" in the 2014 *Handbook of Research on IPOs*, edited by Mario Levis and Silvio Vismara, for profitability and stock market returns on small company IPOs in Europe.

1. Crowdfunding platforms must develop and adopt disclosure standards that make identifying and tracking issuers easy. Such standards may include unique identifiers for both individuals and companies that seek finance. They should require that issuers provide full legal names and brief biographical sketches of all principals.[6]
2. The industry should develop simple procedures to track ownership claims and record gains and losses. Such tracking facilitates the flow of information about the risks and returns to crowdfunding investments and helps investors identify promoters' prior performance. With such facilities, a platform with a successful track record may build reputational capital that attracts better issuers and, in turn, allows it to screen out lower quality issuers.
3. Crowdfunding platforms also may develop facilities that help investors exchange their claims in crowdfunded firms. The ability to easily transfer ownership would improve the liquidity of crowdfunded investments and attract more investors.
4. The crowdfunding industry (or its regulators) should consider creating investor suitability standards that restrict who can invest and the amounts invested. Protections for small investors could include, as the S.E.C. has proposed, limits on the amount invested, the fraction of the investor's wealth that can be invested, or the total funds raised.[7] Such limitations will reduce the frequency of small investors losing everything. Another mechanism that could protect small investors would be to only allow them to participate in deals that also attract accredited investors. As an example, small investors could be allowed to participate in a financing round only if accredited investors also take up some

[6] For example, if the Gainesville Drone Company, founded by James Chen, is seeking funding, potential investors may have difficulty identifying information about the founder. But if James Kuo-chiang Chen is listed as the founder, search engines are more likely to identify information about him without it being hidden among twenty other people with the name James Chen.
[7] See the SEC's proposed Crowdfunding release, Federal Register, Vol. 78, No. 214, November 5, 2013, Proposed Rules, 66,428 – 66,602.

pre-specified portion of the financing. The rationale for such a requirement is that small investors could piggyback on accredited investors' due diligence in vetting the issuing company.

In summary, crowdfunding offers a limited but significant opportunity to match small investors with startup companies, thus partly democratizing the world of finance. Limited and well thought out regulation can help to protect small investors in this market without significantly reducing expected returns, but the key to the successful development of a healthy crowdfunding market will be the development of market solutions to the information asymmetries that characterize capital formation both large and small.

FER Members Signing the Statement, "Crowdfunding"

Edward I. Altman
New York University

Marshall Blume
University of Pennsylvania

Arnoud Boot
University of Amsterdam

Jennifer Conrad
University of North Carolina

Elroy Dimson
London Business School

Darrell Duffie
Stanford University

Franklin R. Edwards
Columbia University

Charles A. E. Goodhart
London School of Economics

Marty Gruber
New York University

Richard J. Herring
University of Pennsylvania

Ravi Jagannathan
Northwestern University

Jay R. Ritter
University of Florida

Kose John
New York University

Edward Kane
Boston College

Jon Karpoff
University of Washington

George G. Kaufman
Loyola University

Jan Pieter Krahnen
Johan Goethe University

Larry Harris
University of Southern California

Robert Litan
Brookings Institution

Dennis E. Logue
Ledyard National Bank

Deborah J Lucas
MIT

Robert McDonald
Northwestern University

Olivia Mitchel
University of Pennsylvania

Mareen O'Hara
Cornell University

Stephen Penman
Columbia University

Rafael Repullo
CEMFI

Stephen Schaefer
London Business School

Cathy Schrand
University of Pennsylvania

Kenneth E. Scott
Stanford Law School

Lemma Senbet
University of Maryland

Erik Sirri
Babson College

Chester S. Spatt
Carnegie Mellon University

Robert Stambaugh
University of Pennsylvania

Takeo Hoshi
University of California, San Diego

Laura Starks
University of Texas, Austin

Ingo Walter
New York University

Ingrid Werner
Ohio State University

James A. Wilcox
University of California, Berkeley