CROWDFUNDING: ECONOMICS OR POLITICS?

Crowdfunding Event
Centre for Innovation Law and Policy

Professor Jeff MacIntosh
Toronto Stock Exchange Professor of Capital Markets
Faculty of Law, University of Toronto

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WHY PROSPECTUSES?

- Divergence between what buyers think they’re getting and what they’re actually getting
- Buyers taken advantage of by sellers
- Capital not allocated efficiently
- Traditional rationale for P → *equalizes information, exposes risks*
PROBLEM: NO ONE ACTUALLY READS PROSPECTUSES

- Even analysts and buy-side investors read no more than about 4 pages
  - Does this mean the P is useless?
Investor Returns Before/After Introduction of P Requirement

- Results
  1. Big firms $\rightarrow$ P makes investors no better off
  2. Small firms $\rightarrow$ P makes investors better off

- Conclusion $\rightarrow$ P good idea for small firms
LONG-RUN RETURNS TO IPOs

- Institutional Purchasers Buying Big Firms → “normal” returns
- Retail Purchasers buying Small Firms → IPOs severely underperform market
- Conclusion? → Shows limits of prospectus in small retail-driven IPOs
  → “Impressario” Theory: these IPOs sold more on razzle-dazzle than risk/return
- Implication for Exemptions? → We should be cautious about extending them
IF PROSPECTUS WORKS, WHY?

1. discipline of process
2. signal of quality
ARE EXEMPTIONS THAT IMPOSE PROCESS AND/OR CREATE A QUALITY SIGNAL A SUBSTITUTE FOR INVESTOR SOPHISTICATION?

- Scaled-back Process/signal (OM)
- Intermediated Offering (e.g. JOBS Act)
- Civil/Criminal/Administrative Liabilities (OM)
ALTERNATIVE APPROACHES THAT LIMIT RISK

- Maximum investment size
  - One size fits all
  - Geared to income/net worth (JOBS Act)
- Maximum amount raised (JOBS Act)
- Restrictions on resale
- Restrictions on advertising (JOBS Act)
HOW DO WE KNOW WHEN WE HAVE THE RIGHT EXEMPTIONS?

THE COST/BENEFIT APPROACH
1. Sophistication → P not cost justified
2. Securities inherently safe → same
3. Other regulatory scheme in place (e.g. amalgamation) → “buyers” already protected
4. Pre-existing relationship → buyers have info about trustworthiness and/or quality of investment → P not cost justified
CROWDFUNDING SHOULD BE JUDGED BY THE SAME METRIC

Q: Does extension of exemptions meet cost/benefit test?
WHAT COSTS? WHAT BENEFITS?

- **Benefit** → more firms funded, more jobs, more economic activity

- **Cost** → misallocation of capital
  - Systematic divergence between expected return and actual return

- **Cause**: Misrepresentation (fraudulent, negligent, innocent)

- **Cause**: Absence of proper vetting
  - Investor failure to understand risks/returns
  - Investee failure to understand risks/returns
  - Investee lack of skill
ULTIMATE MEASURE OF COST/BENEFIT TRADE-OFF: NET PRESENT VALUE

Problem → don’t have data on all amounts invested

Worse Problem → returns data impossible to collect at reasonable cost
TWO TYPES OF STUDIES

1. Longitudinal (over time) → Number of complaints to regulators per dollar invested
   - Observe what happens when rules change
   - Control for economic variables

1. Cross-sectional → compare different jurisdictions with different exemptive regimes
   - Number of complaints per dollar invested
   - Control for economic variables
The Best Cross-Sectional Data ➔ Intra-Country

- Canada is the only developed economy in the world in which you can do this
- Provincially-based securities regulation ➔ laboratory for testing different models
- National Commission will remove this laboratory
AN ALTERNATIVE APPROACH TO VETTING EXEMPTIONS \rightarrow IDENTIFY CAPITAL MARKET “GAPS”

\rightarrow benefit of exemptions likely to be greatest where gaps exist
\rightarrow aim exemptions at those gaps
PROPOSITION ➔ IF THERE IS ANY GAP, IT IS HIGH-TECH START-UPS
WHY HIGH-TECH? ➔ ECONOMIC PAYOFF

- Economic multiplier ➔ social return to tech businesses much greater than private return
- KBI ➔ Canada’s future is not low tech low value-added, but high-tech high value added
- Export economy ➔ in future will be heavily dependent on tech sector (Ontario Premier’s Council, 1989)
- Jenkins Report (2012) ➔ labour productivity ➔ innovative business ➔ tech start-ups
WHY HIGH TECH?  → SOURCES OF FUNDING

- Non-tech → entrepreneur, FF, banks, angels
- Tech → government/universities, entrepreneur, FF, angels, VCs, IPOs
  - “Valley of Death”
  - High information asymmetry
Figure 7.1  Funding Chain by Stage of Development and Size of Investment

- Public Markets
- Mergers & Acquisitions
- Later Stage Venture Capital
- Early Stage Venture Capital
- Business Angels Angel Groups
- “Friends & Family” Government / universities

Source: The Panel.
WILL CROWDFUNDING PLAY A USEFUL ROLE IN FUNDING HIGH-TECH START-UPS?

- Probably not
- Problem → extreme information asymmetry
- Tough for angels/VCs to make intelligent choices
- Likelihood of misallocation of capital is high
- Existing exemptions accommodate knowledgeable investors (angels/VCs)
MY INITIAL TAKE:
CROWDFUNDING IS MORE POLITICS THAN ECONOMICS