CROWDFUNDING: ECONOMICS OR POLITICS?

Crowdfunding Event
Centre for Innovation Law and Policy

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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 PROSECTUSES

- 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 → P makes investors no better off

    2. Small firms → P makes investors better off

- Conclusion → 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 → IDENTIFY CAPITAL MARKET "GAPS"

→ benefit of exemptions likely to be greatest where gaps exist

→ aim exemptions at those gaps

PROPOSITION → IF THERE IS ANY GAP, IT IS HIGH-TECH START-UPS

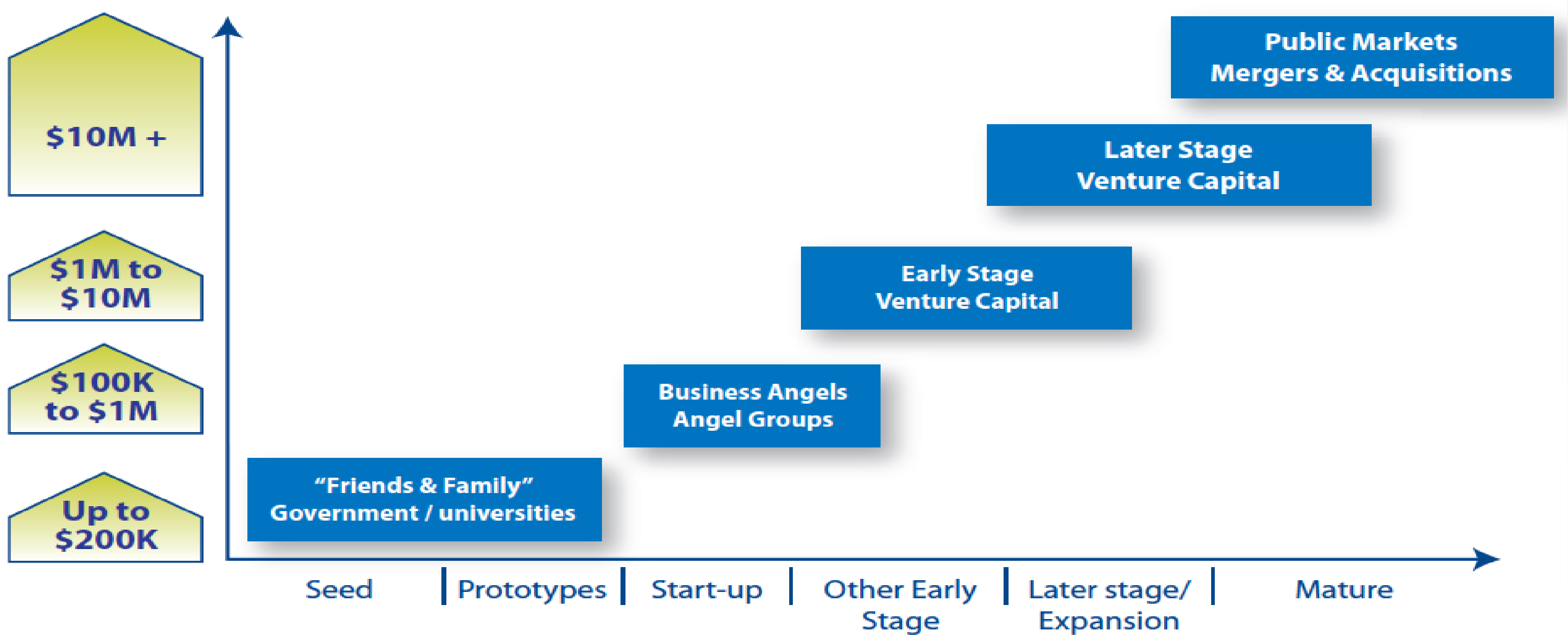
WHY HIGH-TECH? → ECONOMIC PAYOFF

- 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



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