Protecting the Future of Equity Crowdfunding

Equity crowdfunding has the potential to help entrepreneurs around the world finance innovation and growth, but in many cases, powerful regulators are standing in the way says guest blogger Mary Fox

Equity crowdfunding (sometimes referred to as securities-based crowdfunding) is a form of alternative entrepreneurial finance where individuals utilize online platforms to invest relatively small amounts of money in a startup company in exchange for equity shares.

Risks associated with this form of investment make lawmakers and regulators nervous, but supporters of equity crowdfunding point out that platforms have put their own measures into place to protect investors and entrepreneurs from unnecessary risks such as those associated with fraud and information distribution. Access to capital is a major issue for entrepreneurs around the world and if equity crowdfunding has the ability to ameliorate this challenge in any way, then it's an issue for the entire global economy — not just those in the inner circles of the investment world.

Different regulatory approaches

The FCA (Financial Conduct Authority) and lawmakers in the United Kingdom have a taken a sort of "sit back and wait" approach to regulation, implementing moderate rules (i.e. setting investment limits per investor and requiring strong communication between entrepreneurs and investors) but relying heavily on platforms and entrepreneurs to play a significant role in protecting investors. The FCA has indicated that they will adjust these regulations as necessary.

By contrast, the SEC (Securities and Exchange Commission) and lawmakers in the United States have leaned toward the "big brother" approach, allowing only "accredited investors" (individuals with a net worth above $1 million, not including the home they live in) to engage in equity crowdfunding. To give you a bit of background, in 2012, President Obama signed the "Jumpstart our Business Startups Act" (JOBS Act) which made it easier for entrepreneurs to raise capital. Title II of the JOBS Act enabled companies to raise up to $1 million from "accredited investors" and therefore enabled a *form* of equity crowdfunding. If we're honest, it's not really funding by the *"crowd"* as much as it is funding by the *"wealthy crowd*".

The JOBS Act also included Title III, the CROWDFUNDING Act, which will eventually enable average Americans to purchase equity in startups via equity crowdfunding platforms. Sounds pretty great for entrepreneurs, a bit risky for investors and maybe a bit threatening for venture capitalists. But the SEC has not yet implemented Title III and has indicated that implementation is not expected before early 2016.

What's the hold-up? Many individuals have pointed fingers at the SEC for not speeding up the process, while others are pointing toward congress for rushing a law that should have been better thought out. The only thing we know for certain is that Title III is not going to be implemented anytime soon — and this is a problem for entrepreneurs.

Investors vs Entrepreneurs?

Access to capital is a profound challenge for ambitious entrepreneurs hoping to scale their companies. While we are seeing an increase in angel investments and venture capital, these investments often rely on the right connections, a strong reputation, or impressive traction in their market. Even then, these forms of finance focus on larger dollar amounts, creating a gap in funding for individuals who need less than $1 million. Crowdfunding platforms like Kickstarter or Indiegogo have bridged the gap to some degree, but these campaigns are donation-based and tend to generate small amounts of seed capital. Further, and perhaps most importantly, women find it difficult to acquire much needed capital, and equity crowdfunding has the potential to bridge the gap.

Critics point out that regulators can't help entrepreneurs at the risk of investor welfare. The same argument could be made in reverse — we can't protect some unknown investor at the risk of running many (most?) entrepreneurs out of business due to lack of access to capital.

Besides, at least to some degree, investors are being protected by platforms which have a vested interest in ensuring that each investor understands the inherent risks associated with investing in a startup. On many platforms in the UK, investors must pass a quiz before investing. This quiz includes questions relating to the liquidity of their investment (i.e., investors' funds will be tied up in this investment until the company sells or goes public), the likeliness of a return on their investment (i.e., startups regularly fail and investors will likely lose their money), and the importance of diversifying their portfolio. The hope is that these questions will deter investors from making a risky investment with funds they are unable to lose. Even so, more research is necessary to understand which measures are most effective at preventing uninformed investors from risking money they cannot afford to lose.

Widening Participation

Regulators need to understand more about this form of entrepreneurial finance, the risks associated and the types of individuals who are most vulnerable. Research needs to be conducted on the demographics of investors, successful entrepreneurs and industries. Further, more research is needed to determine which preventative measures are most useful for preventing fraud. It must be said that there is an impressive, rapidly growing body of research on this topic.

However, with time comes an increase in equity crowdfunding campaigns and therefore more data that can be used to determine optimal policy. Perhaps if armed with more research, the SEC, and regulators in other countries throughout the globe, will feel more confident in following the U.K.'s footsteps in enabling ordinary citizens to participate on equity crowdfunding platforms.

Mary Fox is the Co-Founder and Managing Director of Olivemonday, an e-commerce startup in Kansas City, Missouri. Mary earned her MSc in Management Organisations and Governance from LSE in 2014. Her dissertation, supervised by Professor Saul Estrin, analysed the impact of premature Equity Crowdfunding regulation in the United States and United Kingdom. Prior to her postgraduate studies, Mary served as a Special Assistant in the Foreign Policy department at the Brookings Institution.

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