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Crowdfunding

To question the merits of crowdfunding seems a surefire means of being awarded an OC – Order of Curmudgeon –. Millions of person hours have been devoted to introduce it to the world and more than a few forests consumed by its advocates. There is clearly some steak, ten million dollars of prepaid Pebble watches being an excellent case in point. One case in point, however, does not reshape a society. In this Capital Markets note our thrust is to discern over the years to come whether the highly audible sizzle is to be matched by stake in the founders' and then funders' stomachs.

A little historical perspective seems warranted. Few now question that society's realization of ubiquitous computing has reshaped industries in the last two decades. Even fewer question that one of society's core functions, the allocation of savings, will or should be exempted, particularly post 2008. Those saying that there is sizzle and steak in the deployment of hardware and software for the internet and mobile phones which improves the allocation of capital in society are surely on the right side of history. We will get products that otherwise would not have seen the light of day, as Kick Starter so clearly demonstrated by being the means of financing the Pebble Watch when existing sources of funds choose not to invest. The watch was bought by 68,000 customers.

Nor is there doubt that opportunity for improvement exists, some would say abounds, in the capital market processes in respect of funding new entrants, themselves a fount of new processes, products and services. The creator of AngelList estimates that 20% of the 700 new weekly listings requesting funds merit consideration. Given

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that an active angel group in Canada looks at twenty opportunities a year and under the current rules invest in two or three, proponents of equity crowdfunding are again on the right side of history in arguing for more sources of capital. Equity crowdfunding advocates seek to implement their realization that it is technically well within our means to deploy the technologies underpinning crowdfunding and allow entrepreneurs to offer shares rather than products in exchange. We have decided on the latter. The issue is whether we should do so for the former.

To gain insight into a response to the issue, let's look at some probable impacts of the deployment of equity crowd sourcing on founders, funders and beyond, to the functioning of two core tasks of our society, allocation of capital and economic fraud.

Founders

Knowing that there is increased availability of funding would bring joy to the heart of any founder, at least initially. A key promise of equity crowdfunding is that anyone in the world can chip in a thousand or two: so raising a million takes less than a thousand people. Even if the idea is beyond the pale of most of us, funds are more likely to be made available through crowdfunding than currently used approaches because of the world-wide reach of crowdfunding platforms.

Many a founder's joy would be quickly tempered by the realization that crowdfunding undermines the old complaint that "investors don't get it." There is really no more hiding behind that reasoning. More reflective founders would also realize, as did Tracy Clark, founder of the Bridgeheads chain of coffee shops, that lack of funds is not the only challenge to be met. She mused publicly that maintaining the Bridgehead culture could be imperiled were too much capital be too readily available. Availability brings home to founders the other half of the capital raising equation: the responsibility to use other people's money to create wealth, not destroy funders' wealth and their own as well.

Adding to the founders' burden will be that dispersed crowdfunders cannot easily have a lunch or a coffee and come to a conclusion about the founder's trust worthiness and capability by use of a face-to-face meeting. How will funders make the judgment call about the founders' capacity to position and reposition the business over the years required to attain positive stable revenues? Look for someone who has already made the assessment? Seek third party validations? Some founders will surely seek a competitive advantage by providing third party validations as part and parcel of their offering to funders.

Another burden for founders will be to assure themselves that the funders' incentives are well aligned with those of the founders. How will funders get a return of their capital and a return on capital is central to minimizing misalignment. Founders will learn to think this through clearly. Their starting point will be to estimate what the business model and projections show the firm can afford. Equity may simply be too expensive for many. So getting the right kind of money in the right quantities from the right kind of people for their business will remain a critical part of every founder's preparations for the money chase. Expect to see the rise of investment banking functions to support equity crowdfunding in various platforms and possible as a classic fee for service investment banking organizations.

Use of crowdfunding, whether in exchange for equity or for goods such as a Pebble Watch, brings with it burdens new and old: but one great advantage is generated. Achievement of the old dictum “fail early fail often” on the road to success, becomes much easier, particularly for products. For many products, proof of market is built in to the process far earlier than the old “build it and they will come” model encrusted as it is with gate keepers. For founders, one of the pleasantest possibilities inherent in crowdfunding is that niche ideas will be economically feasible to a far greater extent than today. In turn this will allow more entrepreneurs to succeed. No small improvement given the failure rates for new firms.

Lastly, founders are bound to observe that if what they want is capital, they can offer goods or even services on a pre-paid basis and get it -- shades of Michel Dell in his dorm thirty years ago. The anticipated insight for founders will be to reason that the barrier to equity crowdfunding as a source of funds is that issuing shares or warrants falls under securities legislation. And it does for just one reason -- it is the form used not the fact that consideration is offered. We are left to speculate why the Michael Dells of the world would not simply offer two computers, one of which could be sold by the funder. Pebble allowed multiple purchases. It is only a small step to raise funds by offering to pay those providing cash a finance contract, for example a royalty on future sales, instead of a prepaid product contract. No corporate securities are issued: cash is obtained.

Funders

Assessment of the impact of crowdfunding amongst those supplying funds starts with the identification of distinct groupings. Two are useful; individuals supplying their own funds – angels - and organizations using other people’s money - firms. The evidence thus far is that crowdfunding models are not having much impact on firms. However, it is clear that if a founder gets prepaid orders as did Pebble, then those offering order financing are in the front line of change. The same would be true for banks offering lines of credit based on receivables and factoring firms that fund receivables.

Platforms supportive of crowdfunding and capable of doing so for equity crowdfunding have already had an impact on individual angels and angel groups during the past decade. AngelList, Gust, and other existing organizations link funders and founders. In their absence, each party spent many hours seeking the other. The overt function of these platforms is to ease the introduction process, a prerequisite for crowdfunding, equity or not. In reality it is introduction of a standard format and facilitation of the mechanics of due diligence that has had a noticeable impact on angel groups. Gust requires funders to use a standard format so angels and angel groups can quickly determine their level of interest. Ottawa’s Capital Angel Network requires all those wishing to present to use the Gust Format to describe the investment opportunity. It is not used by the Capital Angel Network to source deals, even though it clearly could be in those cases where the funder permits open access to their application form. {The funder can limit access to a specific angel group.}

Introduction services are also provided and augmented by a myriad of accelerators and other bricks and mortar enterprises: they also provide third party verification of founders' performance in a known setting. Were securities commissions to permit issuance of securities as envisioned by equity crowdfunding proponents, then for competitive reasons platforms will seek to distinguish themselves by incorporation of third party verifications of the business model and the people. One organization, Crowd Check appears designed to offer employment type background checks on founders. Expect wise founders to use it on funders.

The task of organizing angels to act in concert has been likened to herding cats. Despite the evidence that groups make better decisions, many an angel prefers to act alone. The advent of platforms coupled with founders willing to allow angels widespread access could lead to the emergence of angels investing on their own-lone angels - and then leading the fund raising efforts to raise the balance from the crowd. In full blown operation such lone angels would perform the investment banking function of preparing the founder to seek funds. Because of the time consuming nature of these tasks, expect angel focused investment banks to arise.

Funders may embrace equity crowdfunding because it facilitates a portfolio approach to their angel investing budget. Locally sourced deals, particularly outside Silicon Valley and Boston, tend to be of a kind; medical devices, enterprise software, etc. Crowdfunding permits diversification across geography and allocation of the same total budget amongst more opportunities. Angels may even "invest" in product crowdfunding as well and thus satisfy the other dimension of angel investing, being a part of a success story. Wearing a Pebble communicates that clearly.

On the negative side of the same coin, angels could well find that by facilitating the entry of more angels equity crowdfunding will depress returns to their capital. Founders may need to sell a smaller portion of their shares to raise a given amount of funds: it will cost angels more to play. Opposition by angels has been reported and their concern may be well based: funders need founders for whom they are the handmaidens in the ultimate scheme of things.

As seen from the top of the hill: society's perspective

The prospect of crowdfunding offers a solution to one of the longstanding structural problems in the capital markets of developed and developing economies: channeling rivulets of funds to those with prospects but without financial track records. In the plaintive words of one such entrepreneur, "I only need a $100,000. I don't know what to do with a $1,000,000." Implicit in the remark is recognition of the founder's responsibility to use other peoples' money to create wealth, a recognition that is not universal amongst those seeking funds. For society to reap the benefits of rivulet funding there would have to be an widespread ethos of wealth creation, of the obligation to put back into society. Fortunately that would not be difficult to introduce. The littlest angels – crowdfunders – would soon learn the meaning of Mark Twain's observation: I am more concerned with the return of my capital than the return on my capital. Before writing their cheque they would be satisfied about both.

A plethora of rivulets would lead to new products being made available for niche markets. Some would become markets of substantial size, many would remain so small that $100,000 does it or overdid it, and many would grow slowly allowing the founder to fund growth thereafter on their own: other peoples' money would not be required. Over time society would find itself enriched by an increased diversity of products and services, a decrease of a one size for many mindset.

Coupled with a mindset of an economic order quantity of near one, would be the knowledge and proof that crowdfunding provided access to funding closely tied to merit those who had paid for product in advance, and those investors who could accurately foresee who would pay. Writ large society is more likely to believe that merit-based funding is preferable to who-you-know based funding – a rolodex-based funding model – populated by tollgaters.

Utopia in the capital markets is less plausible than in most other segments of society. Indeed most would regard the conjunction of utopia and capital markets as the ultimate oxymoron, surpassing even the much maligned oft cited exemplar, military intelligence. Widespread fear of fraud abounds in discussions about crowdfunding, in particular amongst securities commissions who command societies securities toll gates. For a well constructed presentation of the issues the Ontario Securities Commission December 2012 Consultation Staff Paper on Exempt Markets deserves a read. The responses are also available on line as of the end of March 2013.

In the absence of utopian behavior by founders issuing securities the question becomes: a) how much fraud will be created by allowing the issuance of securities on a crowdfunding basis; and b) is society prepared to accept the resultant frauds as the price of knowing that it has merit based funding and solved the rivulets of capital problem?

Insight into the first can be obtained from looking at two key facts. Little if any fraud has been reported to date in crowdfunding where the consideration was product. The reason is that these new technologies are being applied in such a way as to support transparency. Incentives are therefore aligned in support of self-policing, one of the most effective social mechanisms known. The second fact is that evidence created by an experiment run by the Canadian Securities Administrators showed that only one percent of Canadians who were attracted by a too good to be true claim present on the web failed to grasp that point.

A response to the second part of the question is to observe that society tolerates terrible individual outcomes in the context of legalized gambling and alcohol consumption. There the percentage of abusers exceeds a reasoned estimate of the rate of fraud in the securities world, under 1%. Society's dilemma is that those manning the securities tollgates and their natural allies are predisposed to function within a prohibition mindset of zero tolerance, their own utopia, regardless of the larger merits to society.

Note the use of the word "predisposed". The overall thrust of the Ontario Securities Commission's staff paper hinted at the presence of a broad societal perspective. This elicited a handful of submissions that provided The Ontario Securities Commission not totally traditional means to introduce equity crowdfunding without being reckless with the public interest.

It remains to be seen how The Ontario Securities Commission will choose to resolve its apparent internal divisions. Will they adopt an *inside out perspective* curbing equity crowdfunding as best they can under the provisions of a restrictive prospective exemption? Will they simply do the classic Canadian thing, wait it out until the USA's Securities and Exchange Commission makes it position known? Or will the Ontario Securities Commission take an *outside in perspective* by weighing the overall benefits to an Ontario desperate for productivity and tax revenue increases and take a creative lead? For example, why not simply allow Ontario's angel investors to notify the Commission that they wish to operate without the protections of the securities legislation. This would permit equity crowdfunding transactions designed to fit the widely varied specific interests of the funders and founders on a transaction by transaction basis? Such an *outside in approach* would ad steak to the equity crowdfunding sizzle, thereby bringing it in balance with sizzle of Kick Starter and Indieagogo crowdfunding.