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Crowdfunding: Not as simple as it looks

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“Far from the madding crowd’s ignoble strife, their sober wishes never learned to stray.”
— Thomas Gray, “Elegy Written in a Country Churchyard” (1751)

In October, the Securities and Exchange Commission promulgated draft rules to implement “crowdfunding” in securities sales.

Release 33-9470’s length (almost 600 pages) suggests that the simple idea contained in the 2012 JOBS Act — that ordinary middle-class “Joe” should be able to purchase valuable shares of start-up companies, just like big boys do — is not so simple.

Before turning the “madding crowd” loose in the emerging companies market, we should understand the history of the proposed rule and its fundamentally flawed underpinnings.

Brief history

The JOBS Act added Section 4(a)(6) to the 1933 Securities Act, exempting from registration securities issued by companies (up to $1 million annually) where purchasers lacked both sophistication and “accredited” status (a definition capturing wealthy investors).

Investors with annual income or net worth less than $100,000 could purchase the greater of $2,000 or 5 percent of annual income or net worth; those above $100,000, up to 10 percent (not exceeding an annual aggregate of $100,000).

Transactions would be effected online through either an existing broker or a “funding portal,” which would list company information.

Our Joe, applying the “wisdom of the crowds,” could evaluate an investment. Money would not be accepted until a minimum amount was raised. The portal would provide investor education, require investors to exhibit understanding of risk and illiquidity, perform background checks on company principals to eliminate fraudsters, and include information about the offering.

The statute requires companies to file with the SEC, and to post on the portal, information, including: identification of officers, directors and 20-percent shareholders; business description; financial condition; certain financial information (for offerings above $500,000, audited financials); use of proceeds; offering deadline; price; capital structure; and method for pricing the securities.

More restrictions: no public advertising of the offering (compared to Rule 506(c), the new SEC rule permitting public advertising provided investors are accredited); advertising must direct the investor to the portal; companies file SEC annual reports and send annual financials to investors; shares cannot be transferred (for one year) except to accredited investors or family members, unless registered; and exemption is not available to foreign corporations, ’34 Act registrants and investment companies.

How can the SEC still protect the public? The release reflects a frantic effort to balance the statute with realities of investor protection, and then contains a couple hundred questions for the public to answer relating to whether the SEC actually achieved the right balance. The 90-day comment period expires in January.

Philosophical underpinnings

The JOBS Act was designed to jump start the economy. Small business drives employment: Finance small companies and they hire more people.

And how do you protect people from fraud and risk of investing in such enterprises? “The wisdom of the crowd.”

All five SEC commissioners voted in favor of the release. Their statements noted the overwhelming bipartisan support of Congress, the goal of the act to cure “chronic unemployment,” the anti-fraud policing role of the portal, and provisions making “bad actors” ineligible to use the exemption.

There were clear undertones of social policy: The portals were the mechanism to “democratize” access to capital investment. The portals were to provide an electronic platform by which all investors could discuss investments, an open chat room.

As Commissioner Michael S. Piwowar stated: “All investors — not just the so-called accredited investor — will have the opportunity to invest in entrepreneurs and their ideas at an earlier stage than ever before. The concept of the wisdom of the crowd, which has proven to be useful in other areas, will now be unleashed to allocate capital to more productive uses.”

Although the commissioners did note that there was risk of fraud, particularly against the elderly and “affinity groups,” and although they invited investor advocates to comment, the commissioners proposed their rule, with incredibly detailed subparts, as their best shot at meeting the statutory mandate.

Those who might doubt that so esoteric an idea such as “wisdom of the crowd” is actually underlining SEC efforts should look at the very first paragraph of the release. It anticipates that investors may “share information about the project, cause, idea or business with each other and use the information to decide whether or not to fund the campaign based on the collective ‘wisdom of the crowd.’”

Critique

Will crowdfunding result in more start-up companies? The release’s 100-plus page economic analysis identifies current sources of start-up funding and the likely impact of crowdfunding on capital formation, noting that crowdfunding may cannibalize other sources, rather than materially increase the monetary pool.

Will crowdfunding increase employment? Accept the SEC’s assumption that crowdfunding will be undertaken by early stage companies (the “S” in JOBS Act stands for “Start-ups”). There may be an initial uptick in employment, but it will not be massive; it is not like we are funding major highways or manufacturing high-volume goods. Early-stage companies well may not be huge employers.

How permanent will these jobs be? The SEC, in its economic analysis, notes a 2010 study that only 68 percent of new high-tech businesses survived four years, let alone thrived. In another study of more than 2,000 companies receiving at least $1 million in venture funding from 2004 through 2010, almost three-quarters of the companies “failed.”

If, as a matter of policy, you wanted to pour investment into businesses that will drive permanent employment, are these the companies we should be financing? Are we diverting investment from sounder markets into weaker markets?

Whether people are or are not investing in the most job-productive industries, statistically most of those companies will fail. What will be the impact of massive failure on the investment market?

As I write this in mid-November, I see a copy of this week’s Wall Street Journal with a front-page headline: “Stocks Regain Broad Appeal — mom-and-pop investors are back.” If we are attempting to democratize the capital markets, how do we do that by allowing our “Joe” to make investments in companies with a 70-percent failure rate?

Putting aside the negative impact on personal wealth and economic spending, will an unintended consequence be the further retrenchment of Joe from the capital markets? Perhaps from all investments, even in mature companies?

What will be the impact of increased fraudulent offerings? It seems unquestionable but that there will be fraudulent crowdfunding offerings.

The SEC notes that NASAA (the organization of state securities administrators) has formed a national task force to police anticipated crowdfunding fraud. Joe absorbed Enron, and absorbed Madoff, and each debacle drove Joe out of the market for a while. How many times can Joe be defrauded before he simply gives up?

But let us further assume that investors will fund emerging companies that will reduce chronic unemployment and that the levels of failure and fraud will be tolerable. Is it correct that the wisdom of the crowd will help inform investors?

Let us assume that the portals can mechanically facilitate the exchange of information, which the statute suggests will occur.

Let us start by measuring the size of the crowd. Under the proposed regulatory scheme, only those persons who have established an investment account with a portal will be allowed to post. Let us also discount that registered “ringers” post positive reactions to an investment, directed to unsophisticated Joe. Will there be enough real participants posting their “wisdom” on the portal so that a robust sample will be obtained? Will the posters provide the diversity of viewpoint thought to be necessary to make the crowd “wise”?

Crowds have wisdom when there is a discernible, quantifiable answer. The classic original iteration of the concept involved a large number of people guessing the weight of a dead animal. Few guesses were close, but the median was within 1 percent of the animal's actual weight.

If experienced venture capitalists cannot figure out which company is going to be successful based on much greater information, is it logical to believe that the crowd median here will have better wisdom?

I don't have a nuanced appreciation of how "the wisdom of the crowd" works, let alone more complex modeling applied to it. I wonder whether Congress got this idea right and whether the SEC properly embraced it. Certainly, there is no discussion of the concept of crowd wisdom in the vast release; it is simply accepted, on page 1, as an underlying truth.

Concluding question

Is it really an exercise in democracy to offer to unsophisticated investors a collection of investments in emerging companies? What are we sharing in a democratic fashion? A 70-percent failure rate?

The marketplace will embrace, and fully test, crowdfunding rules as ultimately adopted. Crowdfunding is indeed coming. This is not a trial balloon; this is mandated by statute. But it will not be as easy as it sounds, and I fear that its philosophical underpinnings are overdrawn.

The answers ultimately will be brought to us courtesy of the madding crowd.
