

The Promise and Perils of Crowdfunding: Between Corporate Finance and Consumer Contracts

Law Working Paper N° 366/2017

September 2017

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ECGI Working Paper Series in Law

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Abstract

'Crowdfunding'—raising capital through large numbers of small contributions—is a burgeoning phenomenon, spurred by the internet's capacity to reduce communication costs. Its still-evolving status is reflected in diversity of contracting practices: for example, 'equity' crowdfunders invest in shares, whereas 'reward' crowdfunders get advance units of product. These practices occupy a hinterland between existing regimes of securities regulation and consumer contract law, with no consistency of treatment. Thus consumer protection law in the UK (but not the US) imposes mandatory terms that impede risk-sharing in reward crowdfunding, whereas US (but not UK) securities law mandates expensive disclosures that hinder equity crowdfunding. This article offers a normative roadmap for the regulation of crowdfunding. We suggest that while crowdfunding poses real risks for funders, neither the classical regulatory techniques of securities or consumer law provide an effective response. At the same time, a review of rapidly-developing mechanisms in crowdfunding markets suggests they offer the potential to provide meaningful protection for funders. In light of this, a permissive regulatory approach—with a credible threat of intervention should the market fail to protect consumers—is justified.

Keywords: crowdfunding, start-up finance, securities law, distance selling

JEL Classifications: K12, K22, G34

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Abstract

‘Crowdfunding’—raising capital through large numbers of small contributions—is a burgeoning phenomenon, spurred by the internet’s capacity to reduce communication costs. Its still-evolving status is reflected in diversity of contracting practices: for example, ‘equity’ crowdfunders invest in shares, whereas ‘reward’ crowdfunders get advance units of product. These practices occupy a hinterland between existing regimes of securities regulation and consumer contract law, with no consistency of treatment. Thus consumer protection law in the UK (but not the US) imposes mandatory terms that impede risk-sharing in reward crowdfunding, whereas US (but not UK) securities law mandates expensive disclosures that hinder equity crowdfunding. This article offers a normative roadmap for the regulation of crowdfunding. We suggest that while crowdfunding poses real risks for funders, neither the classical regulatory techniques of securities or consumer law provide an effective response. At the same time, a review of rapidly-developing mechanisms in crowdfunding markets suggests they offer the potential to provide meaningful protection for funders. In light of this, a permissive regulatory approach—with a credible threat of intervention should the market fail to protect consumers—is justified.

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The final version of this paper is forthcoming in the Modern Law Review. The present version is the one submitted to it in November 2016.

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Introduction

Start-up firms are good for the economy. They are disproportionately associated with innovation—as measured by patent applications and R&D spend—and job creation.¹ However, such firms—with untried products, and often untested founders—frequently find it difficult to obtain finance.² This difficulty has arguably been exacerbated by constriction in bank lending since the financial crisis.³ These considerations combine to make the possibility of a ‘funding gap’ for start-up firms a significant concern for policymakers.⁴

In the last few years, a new source of finance for start-ups, known as ‘crowdfunding’ (‘CF’), has become widely available. As the name implies, this involves raising capital from a large number of individuals, each of whom typically contributes a small sum. The internet has lowered the costs of raising funds in this way, by facilitating the dissemination of information about small projects. Use of CF has grown exponentially. Industry statistics estimate a total of \$34 billion was raised worldwide using crowdfunding in 2015, having grown thirteen-fold over

¹ See eg BH Hall, ‘Innovation and Productivity’, NBER Working Paper No 17178 (2011); L Kogan et al, ‘Technological Innovation, Resource Allocation, and Growth’, NBER Working Paper No 17769 (2012); National Audit Office, BIS and HM Treasury, *Report by the Comptroller and Auditor General: Improving Access to Finance for Small and Medium-Sized Enterprises*, HC 734, November 2013, 13; BIS, ‘SMEs: The Key Enablers of Business Success and the Economic Rationale for Government Intervention’, BIS Analysis Paper No 2, December 2013.

² See BIS, ‘SME Access to External Finance’, BIS Economics Paper No 16, January 2012; A Freeman, *Challenging Myths About the Funding of Small Businesses: Finance for Growth* (London: Demos, 2013); National Audit Office et al, above n 1, 13-15; British Business Bank, ‘Analysis of the UK Smaller Business Growth Loans Market’, Research Report, March 2015; cf R Brown and S Lee, *Funding Issues Confronting High Growth SMEs in the UK* (Edinburgh: ICAS, 2014).

³ See eg I McCafferty, ‘UK Business Finance Since the Crisis—Moving to a New Normal?’, speech given at Bloomberg, London, 20 October 2015.

⁴ For details of recent policy initiatives, see BIS and HM Treasury, ‘2010 to 2015 Government Policy: Business Enterprise’, Policy Paper, May 2015, available at <https://www.gov.uk/government/publications/2010-to-2015-government-policy-business-enterprise>.

just three years.⁵ This is just over a sixth of the amount raised worldwide through initial public offerings ('IPOs') on equity markets in the same year.⁶

While the availability of CF is clearly good news for entrepreneurs, its merits for those providing the funding are deserving of close scrutiny. Because funders typically invest only small sums in projects, CF may appeal to 'retail' (that is, consumer) funders. The problem is that consumers have limited capacity to assess the prospects of a business, and are prone to making investment decisions subject to biases and herd behaviour. In addition to losses to investors, this can cause finance to be misallocated to inferior business projects. These risks raise important questions for regulators.

In this article, we sketch out a normative roadmap for the regulation of CF in relation to business start-ups. This is a highly salient enquiry. In the UK, the Financial Conduct Authority ('FCA') has recently announced its third review of CF regulation in as many years.⁷ In the US, SEC regulations for retail CF came into force in May 2016 pursuant to the JOBS Act of 2012;⁸ their operation is being carefully studied. Meanwhile, the European Commission is actively seeking to promote CF as part of the Capital Markets Union action plan.⁹

⁵ Massolution, *Crowdfunding Industry 2015 Report* (2016).

⁶ EY, *EY Global IPO Trends 2015 4Q*, 4 (2016).

⁷ FCA, *Call for Input to the Post-Implementation Review of the FCA's Crowdfunding Rules*, July 2016. See also FCA, *The FCA's Regulatory Approach to Crowdfunding over the Internet, and the Promotion of Non-Readily Realisable Securities by Other Media*, PS14/4 (2014).

⁸ Securities and Exchange Commission, 'Crowdfunding: Final Rule' (2015) 80 *Federal Register* 71388 (17 CFR Parts 200, 226, 232, 239, 240, 249, 269 and 274).

⁹ See European Commission, *Action Plan on Building a Capital Markets Union*, COM(2015) 468 final, 30 September 2015, 7; European Commission, *Crowdfunding in the EU Capital Markets Union*, SWD(2016) 154 final, 3 May 2016.

We begin by considering the use of CF and the characteristics of typical CF contracts. One type of CF contract—the ‘reward’ model, in which investors are rewarded with units of product—offers both firms and investors the promise of reducing uncertainty by generating new information about consumer demand. By using reward CF, founders capture synergies between their product and capital markets. Rather than raise capital and aggregate information about likely success as a by-product (through the price mechanism), they tap the product market, thus directly testing demand, and raise capital as a by-product.

In contrast, with ‘equity’ CF, where investors buy shares, their valuations are based on estimates of others’ future consumption of the product, about which they have no special expertise. There is consequently a real peril that retail investors will simply ‘herd’ into investments that early adopters have previously found attractive, which can lead to misallocation of capital.

We then review the regulation of CF in the UK (which largely reflects the implementation of EU law) and the US. Because CF is a novel practice, regulatory policy has tended, to some degree, to take the form of the application of existing frameworks designed with other contexts in mind. This has led to inconsistent, and in places misconceived, regulatory treatment.

Reward CF binds together a start-up firm’s financial and product markets. The involvement of the product market means that the practice is probably subject, in the UK, to the regime established by EU consumer protection rules, mandating amongst other things that consumers have an option to cancel the transaction and reclaim their money. This, we argue, fails to take account of funders’ dual function as product consumers *and financiers*, in the latter aspect of which they bear risk associated with the product’s completion. In contrast, few mandatory terms are imposed on consumer contracts in the US. This gives parties greater

freedom to design reward CF arrangements. While reward CF is virtually non-existent in the UK, it has flourished in the US.

Equity CF involves issuing securities to investors, and for that reason is formally within the domain of ‘securities regulation’. A central plank of securities regulation is mandatory disclosure, the compliance costs of which are often prohibitive for small firms. Despite the lowering of these costs through a special regime for equity CF, introduced in May 2016, it appears that they are still high enough to stymie the development of equity CF in the US. The primary function of securities disclosure is not so much to inform retail investors directly—who do not actually read the information—but to facilitate the operation of securities markets populated by sophisticated buyers, such as institutional investors, whose aggregate knowledge, translating into bids (and asks), informs securities prices. Equity CF markets tend to operate without such sophisticated players, and so we argue that mandating disclosure is a waste of resources. In contrast, equity CF has flourished in the UK by virtue of a complete exemption under the Prospectus Directive from mandatory disclosure for small issuers.

The structure of the problems of CF are common to many consumer finance transactions. Funders do not read disclosures, and are prone to make investment decisions on the basis of herding and biased judgments. However, evidence-based regulatory solutions in consumer finance tend to be context-specific, and poorly-crafted intervention can as easily make things worse as better. At this early stage of the market’s development, we consequently advocate a permissive regulatory regime. This allows the promise of reward CF to be fulfilled, and offers the opportunity for the development of market solutions in respect of equity CF. In the penultimate section, we review the range of market mechanisms that have been deployed in the UK and other jurisdictions to overcome the contracting problems inherent in equity CF. We argue that these hold out promise, and that a permissive regulatory approach—with a credible threat of intervention should the market fail to protect consumers—is justified. At the

outset, it should be emphasised that as the CF industry is in its infancy, our analysis and conclusions must be regarded as preliminary.

Crowdfunding for start-ups

Challenges of start-up financing

Most business start-ups fail, so funding a start-up is a risky endeavour. There is no market for the firm's product—indeed, in most cases there is not even (yet) a product—and so profitability forecasts are at best guesstimates of likely production costs and market size. These factors greatly intensify the core problems of any business financing arrangement—namely, uncertainty, information asymmetry, and the risk of opportunism.¹⁰ Most founders begin by investing their savings, making use of personal credit facilities, and tapping family and friends for funds.¹¹ For founders who have exhausted such 'personal' finance, raising outside finance is a considerable challenge. Start-ups generally do not generate steady cash flows to pay interest and—beyond re-mortgaging the founder's family home—lack liquid assets to offer as security.¹² This makes them unattractive candidates for corporate debt financing, which constrains the most obvious source of funds for most small businesses, namely bank lending.¹³

¹⁰ See generally RJ Gilson, 'Locating Innovation: The Endogeneity of Technology, Organizational Structure, and Financial Contracting' (2010) 110 *Columbia Law Review* 885, 901.

¹¹ See eg AM Robb and DT Robinson, 'The Capital Structure Decisions of New Firms' (2014) 27 *Review of Financial Studies* 153.

¹² On home remortgage finance, see MC Schmalz, DA Sraer and D Thesmar, 'Housing Collateral and Entrepreneurship', NBER Working Paper 19680 (2013).

¹³ AN Berger and GF Udell, 'The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle' (1998) 22 *Journal of Banking & Finance* 613; RE Carpenter and BC Petersen, 'Capital Market Imperfections, High-Tech Investment and New Equity Financing' (2002) 112 *Economic*

Another well-known source of finance for start-ups is from venture capitalists ('VCs') and 'business angels', whose investment model is designed to accommodate the particular challenges of start-up financing.¹⁴ These investors manage the high risk of failure by diversifying their investments across a portfolio, and being very selective in which firms they invest, using specialist expertise to assess the quality of the entrepreneurial team and their proposed product. They take control rights—often disproportionate to their investment—and use these to enhance the quality of decision-making and mitigate the potential for opportunism by the entrepreneur.¹⁵ However, such expertise is in short supply, and the investment model requires geographic proximity for the investor to be able to participate actively in decision-making.¹⁶ Consequently, venture capitalists tend to be based in areas where there are large 'clusters' of new firms, typically near a source of technological innovation such as a university.¹⁷ But for an entrepreneur not living in, or willing to relocate to, the vicinity of a venture capitalist, this source of finance is unlikely to be available.

Journal F54; P Aghion, S Bond, A Klemm and I Martinescu, 'Technology and Financial Structure: Are Innovative Firms Different?' (2004) 2 *Journal of the European Economic Association* 277.

¹⁴ See generally PA Gompers and J Lerner, *The Venture Capital Cycle* (Cambridge, MA: MIT Press, 1999); J Armour and L Enriques, 'Financing Disruption', working paper, Oxford University (2016). Business angels are wealthy individuals with prior entrepreneurial experience who now invest in other projects: see eg S Prowse, 'Angel Investors and the Market for Angel Investments' (1998) 22 *Journal of Banking and Finance* 785.

¹⁵ WA Sahlman, 'The Structure and Governance of Venture Capital Organizations' (1990) 27 *Journal of Financial Economics* 473; SN Kaplan and P Strömberg, 'Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts' (2003) 70 *Review of Financial Studies* 281.

¹⁶ J Lerner, 'Venture Capitalists and the Oversight of Private Firms' (1995) 50 *J Fin* 301; MA Zook, 'Grounded Capital: Venture Financing and the Geography of the Internet Industry, 1994-2000' (2002) 2 *Journal of Economic Geography* 151.

¹⁷ See RL Florida and M Kenney, 'Venture Capital, High Technology and Regional Development' (1988) 22 *Regional Studies* 33; A Saxenian, *Regional Advantage: Culture and Competition in Silicon Valley and Route 128* (Cambridge, MA: Harvard UP, 1994); R Martin, P Sunley and D Turner, 'Taking Risks in Regions: The

No such geographic proximity is necessary for equity fundraising through stock markets. Unlike venture capitalists, stock market investors are generally passive, and many do not have any specialist expertise in selecting investments. Rather than making assessments themselves, they rely on securities regulation and the reputation of underwriters to weed out ‘lemons’, and the market’s ability to aggregate information to ensure the price at which securities are offered is appropriate.¹⁸ However, raising capital by making a public offer involves significant fixed costs associated with securities law compliance and underwriting. For example, respondents to the European Commission’s recent consultation on the Prospectus Directive estimated the cost of producing an IPO prospectus on a range averaging between just under €1m (minimum) to just over €2.3m (maximum).¹⁹ This puts capital-raising from regulated markets far beyond the reach of start-ups.

Against this background of apparent funding constraints for start-ups, crowdfunding offers the promise of meeting some part of entrepreneurs’ unmet demand for outside finance.

Types of crowdfunding contract

Crowdfunding is the aggregation of many individuals’ small direct investments in a project. There is of course nothing new about this in principle.²⁰ What is different today, however, is

Geographical Anatomy of Europe’s Emerging Venture Capital Market’ (2002) 2 *Journal of Economic Geography* 121.

¹⁸ See generally, J Armour et al, *Principles of Financial Regulation* (Oxford: OUP, 2016), Chs 5-6.

¹⁹ European Commission, *Published Results: Consultation on the Review of the Prospectus Directive*, available at <http://ec.europa.eu/eusurvey/publication/prospectus-directive-2015?language=en>. See also European Commission, *Consultation Document: Review of the Prospectus Directive*, February 2015 (2015), 4-6.

²⁰ See eg V Kuppaswamy and BL Bayus, ‘Crowdfunding Creative Ideas: The Dynamics of Project Backers in Kickstarter’, UNC Kenan-Flagler Research Paper 2013-15 (2015), 2 (‘Mozart and Beethoven financed concerts and new music compositions with money from interested patrons, [and] that the Statue of Liberty was funded by small donations from the American and French people’).

the scale of activity, which is driven by the use of technology to lower communication costs. Where in the past geography would have placed a significant constraint on the success of this kind of fundraising,²¹ the internet means that a great deal of information can be conveyed to potential funders nationally and internationally.²²

Because CF aggregates large numbers of individual investments, it encompasses multiple investment contracts written in parallel between the individual investors and the entrepreneur. These contracts are typically on terms offered to the investors by the entrepreneur with the assistance of a ‘platform’, a web-based service that establishes a marketplace of CF offerings.²³ CF came to prominence initially as a technique for raising funds for charitable or public-interest projects, for which funders (donors) were promised no returns other than the satisfaction of knowing the project would be pursued. Significant amounts of money continue to be raised as such ‘donation’ CF, but it is outside our current focus on funding for business start-ups.

Two types of CF contract are particularly significant for funding business start-ups: ‘reward’ CF and ‘equity’ CF (also known as ‘crowdinvesting’).²⁴ Reward CF involves the promise of some type of valuable non-financial return on investment. With a start-up, the most

²¹ See eg J Franks, C Mayer and S Rossi, ‘Ownership: Evolution and Regulation’ (2009) 22 *Review of Financial Studies* 4009, 4041-44 (geographic proximity traditionally important for private investors in UK firms).

²² A Agrawal, C Catalini and A Goldfarb, ‘Crowdfunding: Geography, Social Networks, and the Timing of Investment Decisions’ (2015) 24 *Journal of Economics Management & Strategy* 253.

²³ The same contract will be offered to all investors in a particular offer, and so we describe and analyse here the properties of the ‘contract’ in the singular.

²⁴ On the terminology, see eg Massolution, *Crowdfunding Industry Report 2014* (2015), 40-45; D Cumming and L Hornuf (eds), *The Economics of Crowdfunding: Startups, Portals and Investor Behavior* (London: Palgrave Macmillan, forthcoming 2017).

common reward promised consists of one or more units of the firm’s proposed product.²⁵ Reward CF thus combines access to the product and the capital markets. In contrast, with equity CF, investors buy shares in start-up businesses via a CF platform. Table 1 sets out the amounts of funds raised using these two forms of CF for each year since 2012. As a comparator, Table 1 also shows funds invested in the form of seed and early-stage venture capital finance during the same period. As can be seen, the use of both types of CF has grown rapidly. In relation to the UK, equity CF has grown particularly strongly, to outstrip all UK seed and early-stage VC investment. However, reward CF has grown far less rapidly in the UK, well behind its global trend.

Table 1: Aggregate funds invested (£m) by financial contract type, 2012-2015

Year	Total CF		Reward CF		Equity CF		Seed/Early stage VC	
	Global	UK	Global	UK	Global	UK	Global	UK
2012	2,070	267	300	4	91	4	19,500	219
2013	4,677	666	557	21	304	28	22,100	142
2014	12,421	1,740	1,020	26	854	84	39,400	108
2015	26,377	3,200	2,055	42	1,969	245	56,500	225

Notes: Data for Global CF activity are from Massolution *Crowdfunding Industry Reports*; Data for UK CF activity are from Cambridge University Centre for Alternative Finance/NESTA *UK Alternative Finance Industry Reports*. UK equity CF data exclude real estate investments. Data for UK VC finance are from BVCA, *Reports on Investment Activity*; Data for Global VC finance are estimated from KPMG, *Venture Pulse*.

A third form of CF used for business is ‘loan’ CF (also known as ‘crowdlending’ or ‘peer-to-business lending’). As the name suggests, this involves (retail) funders advancing credit to businesses, usually with the aid of credit scores produced by the platform. It too has grown very rapidly as a form of small business finance, in large part because of the contraction

²⁵ In some cases, ‘rewards’ may be rather more ephemeral (eg ‘a signed thank you from the founder’), meaning that the funding arrangement is essentially donative. We take the distinguishing feature of ‘reward’ from ‘donative’ CF to be the presence of a valuable reward.

of ordinary bank lending—for which it is a close substitute—since the financial crisis.²⁶ As discussed, however, debt financing is unsuitable for firms without hard assets,²⁷ which is borne out by the fact that loan CF tends to be sought by established small businesses, as opposed to start-ups.²⁸ We consequently do not focus on loan CF in this article.

Crowdfunders’ motivations may include an element of ‘intrinsic’ benefit, whereby participation in funding is itself a component of the return. Most obviously, in donation CF, funders derive their returns through the satisfaction of knowing that a cause they value has been furthered. There may also be intrinsic benefits to funding even in commercial contexts. For example, a reward CF funder’s satisfaction from the product might be enhanced by having had the opportunity to contribute to its development.²⁹ Even equity CF investors may possibly enjoy intrinsic benefits—perhaps the satisfaction of being part of a community of investors who interact with an entrepreneur,³⁰ or excitement at the opportunity to identify ‘the next Google’ ahead of their peers.³¹ That said, a quasi-experiment with Dutch funders found that intrinsic benefits played little part in funders’ decisions regarding either type of CF.³²

²⁶ See eg McCafferty, above n 3.

²⁷ See above n 13.

²⁸ See TL Mach, CM Carter, and CR Slattery, ‘Peer-to-Peer Lending to Small Businesses’, Working Paper, Federal Reserve (2014), (describing pattern of borrowing from Lending Club, a leading US loan crowdfunding platform) That said, the common practice using the founder’s personal credit for seed finance (see above nn 11-12 and text thereto) is also replicated in loan crowdfunding.

²⁹ P Belleflamme, T Lambert and A Schwienbacher, ‘Crowdfunding: Tapping the Right Crowd’ (2014) 29 *Journal of Business Venturing* 585, 588-89.

³⁰ *Ibid*, 591.

³¹ A Schwartz, ‘The Nonfinancial Returns of Crowdfunding’ (2015) 34 *Review of Banking and Financial Law* 565, 575-76.

³² M Cholakova and B Clarysse, ‘Does the Possibility to Make Equity Investments in Crowdfunding Projects Crowd Out Reward-Based Investments?’ (2015) 39 *Entrepreneurship Theory and Practice* 1.

The perils of equity crowdfunding

While equity CF holds out promise for entrepreneurs as a source of financing, it appears highly perilous for investors. Like venture capitalists, equity crowdfunders invest in nascent businesses, with all the associated uncertainty. But unlike a venture capitalist, retail CF investors lack specialist expertise about the prospects of the business projects they back, which leaves them more exposed to poor selection. Nor, continuing the comparison, do they take control rights, because the costs of doing so outweigh the benefits, given CF investors' lack of expertise and high coordination costs. This lack of control leaves them more exposed than a VC to agency costs—that is, opportunistic conduct by the entrepreneur after an investment is made. That said, because they do not need to exert resources in exercising control, equity CF investors are able—at least in theory—to diversify their investment over a wider portfolio of firms than would a VC. Indeed, equity CF's passive, uninformed and widely diversified investment pattern sounds more like that of traditional retail investors in public equity markets than of VCs investing in start-ups.

Yet if we pursue this alternate comparison, equity CF investors also look far more exposed than those investing in public equity markets. In public equity markets, a bevy of mechanisms combine to protect retail investors by weeding out poor-quality firms at the outset and ensuring that the price swiftly reflects all available information—that is, it is 'informationally efficient'.³³ In particular, secondary market trading acts to aggregate investors' assessments of the price relevance of publicly available information into the market price extremely rapidly. This makes the market price the best available estimate of the

³³ See generally R Gilson and R Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 *Virginia Law Review* 549; BG Malkiel, 'The Efficient Market Hypothesis and its Critics' (2003) 17 *Journal of Economic Perspectives* 59; Armour et al, above n 18, Ch 5.

securities' value, based on publicly available information. Mandatory disclosure obligations for public companies ensure that the set of publicly available information supports informed pricing.³⁴

However, there is usually no secondary market for equity CF investments. This means that equity CF investors lack liquidity: once they have invested, they are unable to exit unless and until the founders sell the business. More fundamentally, it means that the price at which investors buy in is determined solely by the primary market—whereby firms sell newly-issued securities to investors. Of course, stock exchanges also have primary markets. An initial public offering ('IPO') on a public equity market is preceded by a 'bookbuilding' process, in which an investment bank will set the initial price based on informed investors' estimates of the likely value of the securities. The investment bank's reputation and contacts serve to convince the informed investors to take the process seriously, and to add further credibility it undertakes to underwrite any shortfall.

Equity CF offerings are far more basic: the issuer typically offers the securities directly to retail investors, without any bookbuilding process or similar mechanism.³⁵ Platforms provide access to information about the company's (self-produced) valuation, its business plan, the target amount, and the percentage of equity it represents based on the valuation; in addition to that, information is provided about how much funding the crowd has already committed, and how many investors have already committed to funding. The offer is generally made

³⁴ See R Kraakman et al, *The Anatomy of Corporate Law*, 3rd ed (Oxford: OUP, forthcoming 2016), Ch 9.

³⁵ Loan crowdfunding platforms do use auction mechanisms: see J Franks, N Serrano-Velarde and O Sussman, 'Marketplace Lending, Information Efficiency, and Liquidity', working paper (2016).

contingent on enough commitments being made to meet the issuer's self-declared funding target.

Theory suggests that, rather than serving to aggregate information, the sequential arrival of investors is likely to engender herding.³⁶ In an ordinary secondary market, investors assess their own valuation of the security against that reflected in the market price, which adjusts depending on demand. In the CF setting, where a secondary market does not exist or is highly illiquid, the price does not change in response to demand. Investors therefore draw inferences about the accuracy of the price from the level of observed demand.

Herding in CF can be illustrated with the following simple model.³⁷ Assume that there are n persons who consider an opportunity on a CF platform. Each person i does so in sequence, for $i = i_1$ to i_n , with earlier investment decisions made known to subsequent arrivals. Some proportion Φ of the persons (such that $0 < \Phi < 1$) have incomplete pieces of information about the quality of the opportunity. Assume that the investors can determine whether a piece of information is positive or negative with respect to the opportunity's prospects, but because they are not experts, they cannot tell how strong the signal is. Assume further that the probability of any piece of information being positive or negative is equal (that is, 0.5), and that investors do not invest unless they are aware of some positive information, and of more positive than negative information.

It follows that when i_1 considers the investment, she will only invest if she has positive information. If i_1 invests, then i_2 can subsequently infer from i_1 's investment that i_1 had positive information, and this increases the probability that i_2 will invest. Clearly, i_2 will invest if she has positive information of her own. But even if she has no information of her own, she can

³⁶ See AV Banerjee, 'A Simple Model of Herd Behavior' (1992) 107 *Quarterly Journal of Economics* 797.

³⁷ This is a simplification of Banerjee's model, *ibid*.

still infer the existence of i_1 's positive information from the latter's actions, and so will now invest. Conversely, if i_2 has negative information, she will not invest: her negative information will 'cancel out' the positive information she infers from i_1 's investment.

Now consider what happens when i_3 arrives. If both i_1 and i_2 invested, then i_3 will now invest regardless of her own information. This is because i_3 now makes the inference that at least i_1 , and possibly also i_2 , had positive information. If i_3 has no information, or has positive information, then the analysis is the same as for i_2 . However, i_3 will now invest even if she has negative information. In this case she will infer that there are $1 + \Phi$ positive pieces of information, as she can infer with certainty that i_1 had positive information, and the probability that i_2 had positive information, conditional on having invested, is Φ .³⁸ Consequently the positive information i_3 infers exceeds the negative information she has. The effect is *a fortiori* for subsequent investors, who will now all make the same decision: the actions of the first two have triggered an 'information cascade'. This result turns on the fact that subsequent arrivals are unable to distinguish, amongst prior investors, between those who invested on the basis of positive information and those who invested simply on the basis of inferences, with no information of their own.³⁹

Herding is borne out in CF practice. It is well-known that 'momentum' is crucial to the success of CF projects:⁴⁰ if a significant number of funders can be contracted quickly, then

³⁸ The probability that i_2 has *no* information is $(1 - \Phi)$, and the probability she has *any* information is Φ . By investing, i_2 reveals that she does not have negative information. Thus, if she does have information, it must be positive—so the probability she has *positive* information is the same as the probability she has *any* information.

³⁹ As we shall see in our discussion of market mechanisms (below, text to nn 133-139), this effect can be reduced by mechanisms that reveal more information about the characteristics of early investors.

⁴⁰ As a leading UK equity crowdfunding platform bluntly puts it in its online guidance for founders: '[i]f you can create early momentum and interest your pitch has a much greater chance of success so lining up investors before

others will also join. Conversely, a project that does not attract initial support is likely to languish. This predicts a ‘bimodal’ distribution of funding: that projects should typically either get high levels of support, or very little. This prediction is consistent with casual empiricism. Table 2 presents data from projects offered for investment on Crowdcube.com, a UK-based equity CF portal, in January 2015 and October 2016. For a total of 43 projects offered, the average level of funding received was 42 per cent of the founders’ target. However, this masks a bimodal distribution: 26 per cent of offers received more than three-quarters of their target, 63 per cent received one quarter or less of their target, but only 12 per cent received between one-quarter and three-quarters of their target. These results, which complement those reported in other studies,⁴¹ are consistent with theoretical predictions of herding.

Table 2: Level of funding, relative to target, for Crowdcube projects

Date	Jan 2015		Oct 2016		Mean	
	No	%	No	%	No	%
All offers	28	100	15	100	43	100
Funded to $\geq 75\%$ of target	7	25	4	27	11	26
Funded to $> 25\%$ but $< 75\%$ of target	2	7	3	20	5	12
Funded to $\leq 25\%$ of target	19	68	8	53	27	63
Mean proportion funded		37		49		42

Notes: data are taken from investment opportunities available on Crowdcube.com on 23 January 2015 and 5 October 2016 respectively. Because of rounding percentages do not sum exactly to 100 in all cases.

Where herding occurs, funders as a group behave as if they attach great significance to the information possessed by early arrivals and little or no significance to that possessed by

you go live is imperative’. See Crowdcube, ‘Entrepreneur's Guide to the Crowdcube Crowdfunding Process’, <https://www.crowdcube.com/pg/the-crowdcube-crowdfunding-process-1371>.

⁴¹ See eg S Vismara, ‘Information Cascades Among Investors in Equity Crowdfunding’, Working Paper, University of Bergamo (2015).

later arrivals, even if—as we assumed in the foregoing analysis—the information is all of equal quality. This means that the quality of decision-making will be lower than a process that makes use of all the information available to the group. Herding consequently results in a misallocation of resources—overinvestment in projects for which the prospects look weak and underinvestment in projects for which the prospects look strong—which will consequently reduce returns to investors.

In reality, there is likely to be a bias towards overinvestment, for two reasons. First, it is commonly the case that all that is reported is the number of persons who previously invested, and not the number who considered the opportunity and declined to invest. Here, all that subsequent investors can do is to draw inferences based on the amount of time for which an offer has remained open. If it has been open for a while and has received no investment, then people considering it will assume that the number of persons who have passed it over is ‘large’ and so there will be unlikely to be any investment at this stage. Second, and more perniciously, empirical studies report that initial investors are disproportionately likely to be friends and family of the founders, whose assessment of the project’s merits are likely to be strongly biased in favour.⁴² If herding follows, this will consequently bias the collective decision. Given the foregoing perils, equity CF is probably the riskiest (non-leveraged) investment class a retail investor can access.

The promise of reward crowdfunding

The other CF contract that is popular with start-ups is so-called ‘reward’ CF. This involves raising finance from a firm’s (prospective) consumers, who are promised early shipment of

⁴² Agrawal et al, above n 22; E Mollick, ‘The Dynamics of Crowdfunding: An Exploratory Study’ (2014) 29 *Journal of Business Venturing* 1; MG Colombo, C Franzoni and C Rossi-Lamastra, ‘Internal Social Capital and the Attraction of Early Contributions in Crowdfunding’ (2015) 39 *Entrepreneurship Theory and Practice* 75.

units of the product in return for their funding. Like equity CF, the firm contracts with the funders directly, and there is no subsequent trading of claims between funders in a secondary market. However, the fact that the funding technique melds together the capital and product markets means that the interaction between funders is quite different.

Reward CF is similar to pre-purchase of a product, save that the entrepreneur typically makes fewer representations regarding the quality of the product, or even its prospects of delivery, than would an established manufacturer. A prominent example of such risk-sharing is found in the *Terms of Use* offered by Kickstarter, a leading reward CF platform. They provide that the delivery date is an, ‘estimate ... not a guarantee to fulfil by that date. The schedule may change as the creator works on the project’.⁴³ As regards non-delivery, the same terms provide that a creator who is unable to fulfil rewards may alternatively ‘me[e]t their obligations to backers’ if they:⁴⁴

‘post an update that explains what work has been done, how funds were used, and what prevents them from finishing the project as planned; work diligently and in good faith to bring the project to the best possible conclusion in a timeframe that’s communicated to backers; ... demonstrate that they’ve used funds appropriately and made every reasonable effort to complete the project as promised; ... [have] been honest, and ... made no material misrepresentations in their communication to backers; and ... offer to return any remaining funds to backers who have not received their reward (in

⁴³ Kickstarter, *Terms of Use*, clause 5 (<https://www.kickstarter.com/terms-of-use>). The *Terms of Use* clearly appear to be intended to govern not only relations between users and the Kickstarter platform, but also between users and each other.

⁴⁴ Ibid, clause 4. Entrepreneurs, not the portal itself, are solely responsible for the fulfilment of their reward obligations: ibid, clause 6.

proportion to the amounts pledged), or else explain how those funds will be used to complete the project in some alternate form’.

This clearly establishes a different risk allocation from that normally found in a contract for the sale of goods, which is specific to the circumstances of experimental development of a product on behalf of a group of enthusiasts. This risk-sharing is accepted by the funders because of the innovative nature of the product.⁴⁵ Funders are people who have a strong preference for the product offered, and because it is innovative, are unable to satisfy that preference elsewhere. For the funders, their preference for the product is so strong that it is worth paying even for a less-than-certain prospect of getting it.

Of course, such risk-sharing leaves funders exposed to agency costs, but these are mitigated by the introduction of a requirement of good faith in performance by the founder, along with an obligation to demonstrate why any outcome has resulted other than delivery.⁴⁶ These echo contractual mechanisms commonly used in agreements between sophisticated parties relating to the joint production of technological innovation.⁴⁷ An early study of reward CF suggests that non-delivery is in fact rare for projects using reward CF: less than five per

⁴⁵ As explained in Kickstarter’s FAQ: ‘[B]ackers must understand that Kickstarter is not a store. When you back a project, you’re helping to create something new — not ordering something that already exists. There’s a chance something could happen that prevents the creator from being able to finish the project as promised’. (FAQ: ‘What is a creator obligated to do once their project is funded?’, available at <https://www.kickstarter.com/help/faq/kickstarter+basics?ref=footer>).

⁴⁶ Text to n 44. Similarly, the terms of use of another leading reward CF platform, Indiegogo, appear to create mutual obligations of good faith regarding resolution of non-delivery: ‘If a Campaign Owner is unable to perform on any promise and/or commitment to Contributors, the Campaign Owner will work with the Contributors to reach a mutually satisfactory resolution, which may include the issuance of a refund of Contributions by the Campaign Owner’ (Indiegogo Inc, *Terms of Use*, available at <https://www.indiegogo.com/about/terms>).

⁴⁷ See eg RJ Gilson, CF Sabel and RE Scott, ‘Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice and Doctrine’ (2010) 110 *Columbia Law Review* 1377, 1424-31.

cent of founders failed to deliver, although over 75 per cent were late as compared with their initial delivery estimate.⁴⁸

The key distinction of reward CF from equity CF is the nature of the funder's payoff. With equity CF, the value of the payoff depends on how successful the business is in general, which, in turn, depends on many factors that a typical retail investor is unlikely to be able to assess. In contrast, the payoff in reward CF is a unit of the product. The value of this depends on the strength of the funder's preference for the product. This is something known only to the funder, and in respect of which the funder is expert. Where preferences and payoffs are different among people, the possibility of herding is greatly reduced.⁴⁹ In the present context, the inference that can be drawn from earlier funders' support depends on *their* preference for the product, which will not generalise in the same way as expectations of financial returns.

Moreover, a decision to fund *reveals* previously private information about the funder's preference for the product. By making the funding call conditional on a sufficient amount of finance being raised, the entrepreneur can use a reward CF round as a way of determining whether or not there is sufficient demand for the product.⁵⁰ Thus the entrepreneur gets a 'forward' picture of the putative product market *and* raises funding at the same time.

Of course, a decision to fund reflects not only the funder's preference for the product, but also their assessment of the likelihood that it will be delivered. This injects some noise, and

⁴⁸ Mollick, above n 42, 11-12.

⁴⁹ See eg S Bikhchandani, D Hirshleifer, and I Welch, 'Learning from the Behavior of Others: Conformity, Fads, and Informational Cascades' (1998) 12 *Journal of Economic Perspectives* 151, 161.

⁵⁰ See A Agrawal, C Catalini and A Goldfarb, 'Some Simple Economics of Crowdfunding' (2014) 14 *Innovation Policy and the Economy* 63, 68.

possibility of herding, into the process.⁵¹ Nevertheless, the synergy between product and capital markets that reward CF entails makes it a much more informative funding technique than equity CF. It also makes it much more difficult to conclude that funders are getting a poor return: the natural inference from funding is that funders want the product so much they are prepared to take the risk of non-delivery.

Regulating Crowdfunding in the UK and US

Having described the features of the two types of CF contract for start-up firms, we now consider how they are regulated. In so doing, we focus on the UK and the US. The UK's regulation of equity CF is of relevance not just for the domestic market, but potentially also as a model for other jurisdictions, especially within the EU. This is because much of the content of UK securities law is derived from EU legislation,⁵² and more than half of all the equity CF platforms operating in the EU are based in the UK.⁵³ And the US, home to the world's largest venture capital investment community and securities markets, has long been acknowledged to be a leader in the provision of finance for innovation.

These two countries have taken very different approaches to the regulation of CF. The UK, making use of an exemption to EU securities laws permitting a 'small offering exemption', imposes no disclosure obligations on equity CF. On the other hand, the US applies burdensome disclosure regulations to equity CF—albeit watered down for small firms—as it does to all

⁵¹ There is some evidence of herding in studies of reward CF: see Kuppaswamy and Bayus, above n 20, 11, 35; Colombo et al, above n 42, 84.

⁵² While the UK's membership of the EU now looks foreshortened, most of the relevant EU law rules have been enacted as part of UK domestic law, or look likely to be so enacted as part of the process of exiting. We therefore expect them to remain relevant for at least the foreseeable future.

⁵³ ESMA, *Investment-Based Crowdfunding: Insights from Regulators in the EU*, ESMA/2015/856 Ann 1 (2015), 2.

issues of securities to the public. Yet when we turn to reward CF, a battery of consumer protection laws—mainly derived from the EU *acquis*—are applicable in the UK, whereas there is no equivalent in the US.

Equity CF

The UK has implemented in full an optional exemption under the EU’s Prospectus Directive for securities offerings amounting to than €5 million by a single firm in a 12-month period.⁵⁴ This facilitates CF offerings by exempting relevant issuers from the obligation to prepare a prospectus—a very significant saving in compliance costs.⁵⁵

Nevertheless, portals offering equity CF in the UK must be authorised by the FCA, because they carry out financial promotions and arrange deals in investments.⁵⁶ This requirement is grounded in EU law: under the Markets in Financial Instruments Directive (‘MiFID’), all firms engaged in the business of receiving and transmitting orders relating to financial instruments must be authorised by the national competent authority,⁵⁷ and equity CF

⁵⁴ Financial Services and Markets Act 2000 (‘FSMA’), s 85(5)(a), Sch 11A, para 9; Prospectus Directive 2003/71/EC [2003] OJ L 345/64 (as amended) (the ‘Prospectus Directive’), Art 1(2)(h). The exemption is permissive, thus granting member states discretion to regulate smaller offerings.

⁵⁵ See above, text to n 19.

⁵⁶ FSMA ss 19, 21; Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/554, Art 25.

⁵⁷ Markets in Financial Instruments Directive (‘MiFID’) 2004/39/EC [2004] OJ L145/1, Art 5(1) (requirement for authorisation), Art 4(1)(2) and Annex I, Section A (‘investment services and activities’). From 1 January 2018, Markets in Financial Instruments Directive (recast) (‘MiFID II’) 2014/65/EU [2014] OJ L 173/349, Arts 5(1), 4(1)(2) and Annex I, Section A. See also ESMA, ‘Opinion: Investment-based Crowdfunding’, ESMA/2014/1378, 18 December 2014, at [48].

offerings, provided they are in principle transferable, fall within the definition of ‘financial instruments’.⁵⁸

The FCA introduced specific consumer protection rules for equity CF platforms in 2014, regularising what had until then been an *ad hoc* approach to authorisation.⁵⁹ Pursuant to the MiFID regime, these rules subject authorised CF platforms to conduct of business obligations. There is a general obligation to ensure that financial promotions offered on the platform are ‘fair, clear and not misleading’,⁶⁰ and a requirement that the platform (or the investor’s financial adviser) assess whether CF securities are appropriate for an investor client, by determining whether the investor has the ‘necessary knowledge and experience to understand the risks involved’.⁶¹ In practice, this is met by requiring investors to answer a simple automated test about the characteristics of equity CF investments, for which guidance is provided.

In addition, the FCA introduced restrictions on the extent to which individuals may invest in equity CF. Equity CF securities may only be offered to sophisticated investors or to

⁵⁸ MiFID, Annex I, Section C (‘financial instruments’ includes ‘transferable securities’, in turn defined in Art 4(1)(18)); see similarly MiFID II, Annex I Section C and Art 4(1)(44). While in some member states, CF platforms have avoided this obligation by marketing only non-transferable securities (see ESMA, above n 57, at [45]), the UK implementation as ‘financial promotions’ (above n 56) also encompasses these.

⁵⁹ See FCA, *The FCA’s Regulatory Approach*, above n 7.

⁶⁰ FCA, *Conduct of Business Sourcebook* (‘COBS’) 4.2.1R. This implements MiFID, Art 19(2) (MiFID II, Art 24(3)).

⁶¹ COBS 4.7.7(3), 4.7.8(2), 10.2. The ‘appropriateness’ obligation implements MiFID, Art 19(5) (MiFID II, Art 25(3)).

retail investors who certify that they have not invested, and will not invest, more than 10 per cent of their net assets in non-readily realisable securities.⁶²

The starting point for equity CF in the US was, in contrast to the UK, a securities regulation regime that until recently had no exemption for small offers. Title II of the JOBS Act of 2012 removed obstacles to the setup of equity CF platforms provided access was limited to accredited investors (high net worth individuals).⁶³ Under Title III of the JOBS Act,⁶⁴ Congress inaugurated a small offering regime for firms raising no more than \$1 million over a 12-month period,⁶⁵ and directed the SEC to pass associated rules. The SEC did not adopt its final ‘Regulation Crowdfunding’ (‘Regulation CF’) until October 2015, which came into force in May 2016.⁶⁶

In some respects, the conditions for issuing under Regulation CF echo the regulatory treatment of equity CF in the UK. In particular, equity CF transactions must be conducted through an intermediary registered with the SEC, either as a broker or a new type of regulated entity called a ‘funding portal’, which must take steps to ensure investors understand the risks involved.⁶⁷ Intermediaries must have a reasonable basis for believing that issuers on their

⁶² COBS 4.7.7(2), 4.7.9-4.7.10.

⁶³ Individuals are ‘accredited investors’ if they have net worth (excluding their home) exceeding \$1m, or annual income exceeding \$200,000 (or \$300,000 jointly with their spouse): SEC Regulation D, Rule 501 (17 CFR § 230.501). Such persons are presumed to be able to afford access to financial advice.

⁶⁴ Jumpstart Our Business Startups Act, Pub L. No. 112–106, 126 Stat. 306 (2012) (the ‘JOBS Act’). Title III of the JOBS Act may also be cited as the ‘Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012’ or the ‘CROWDFUND Act’.

⁶⁵ Securities Act of 1933 § 4(a)(6).

⁶⁶ See above n 8.

⁶⁷ *Ibid* §§ 4(a)(6)(C), 4A(a). As of the time of writing, 17 funding portals had registered with the SEC. See <https://www.finra.org/about/funding-portals-we-regulate>.

platform are in compliance with relevant regulations, and must deny access to issuers they believe may present potential for fraud.⁶⁸ To avoid conflicts of interest, intermediaries are prohibited from taking any financial interest in issuers using their services.⁶⁹

There are also quantitative restrictions on the exposure of retail investors, although—in contrast to the UK rules—these restrict the amount that may be invested *per issuer*,⁷⁰ as opposed to in the asset class as a whole. In order to prevent evasion of the foregoing restrictions, securities issued in a CF transaction may not be transferred by a purchaser within a year, although they are freely transferable thereafter.⁷¹

Where US regulatory environment for equity CF differs most significantly from the UK is as regards mandatory disclosure. US equity CF issuers must file an extensive list of disclosures with the SEC, and also make them available to potential investors via the CF platform.⁷² They must also provide a complete set of financial statements, prepared under US GAAP, for the previous two years or the period since formation, whichever is shorter, and

⁶⁸ Ibid § 4A(a)(5). The intermediary is entitled to rely on representations from the issuer, absent knowledge or indications to the contrary.

⁶⁹ Ibid § 4A(a)(11) (also applicable to directors, officers and partners of the intermediary).

⁷⁰ Ibid § 4(a)(6)(B). For an investor whose annual income and net worth are both below \$100,000, the maximum that may be invested in a single issuer is \$2,000 or 5% of annual income or net worth, whichever is greater. If either the investor's annual income or net worth exceeds \$100,000, a limit of 10% of annual income or net worth, whichever is greater, but not to exceed \$100,000, applies.

⁷¹ Ibid § 4(a)(3). See also SEC, above n 8, 71475. There are exceptions for resales to the issuer or to accredited investors.

⁷² Ibid § 4A(b)(1)(A)-(H). These include information on directors, officers and principal shareholders; the issuer's business and business plan; the purpose and use of proceeds of the offering; the price of the securities or the method of its determination; the target offering amount and the deadline to reach it; the ownership and capital structure of the issuer; and any risk factors related to the offering. SEC rules additionally mandate disclosure of fees paid by the issuer to the intermediary; material risk factors affecting the issuer's business; the material terms of its debt; and certain related-party transactions (ibid § 4A(b)(1)(I), 17 CFR § 227.201).

provide a narrative discussion of its historical results, liquidity and capital resources.⁷³ The degree of required external scrutiny of the financial statements increases with the size of the offering: the smallest issues (up to \$100,000) need only be certified by the issuer's CEO, whereas larger issues (above \$500,000) must be fully audited.⁷⁴ Having completed an equity CF issue, there is then an ongoing obligation to file annual reports with the SEC.⁷⁵

Crowdfunding investors may bring actions against issuers for material misstatements or omissions in the offering documents.⁷⁶ Depending on the circumstances, CF intermediaries may also be treated as 'issuers' for the purposes of liability.⁷⁷ Intermediaries consequently conduct due diligence on potential issuers before deciding whether to allow them to list their securities for sale on their platform.

The SEC's own estimates of compliance costs suggest that Regulation CF may not be appealing for issuers seeking to raise smaller amounts. The agency estimated that the fixed costs for required filings would be \$6,460 and that intermediaries would charge between five and 15 per cent of the amount raised, which means that fees for a \$100,000 offering may be as high as 21.5 per cent of the capital raised.⁷⁸ This contrasts unfavourably with the costs of an equity CF offer in the UK or a reward CF offer in the US, where platform and payment service

⁷³ Securities Act of 1933 § 4A(b)(1)(D).

⁷⁴ Ibid. Issues of between \$100,000 to \$500,000 must be reviewed by an independent public accountant.

⁷⁵ Ibid § 4A(b)(4).

⁷⁶ Section 4A(c) of the Securities Act.

⁷⁷ The SEC has pointedly declined to exclude CF intermediaries from the definition of 'issuers': see SEC, above n 8, 71477-71479.

⁷⁸ See SEC, 'Proposed Rules: Crowdfunding' (2013) 78 *Federal Register* 66436, 66521.

provider fees are in the region of eight to ten per cent of the funds raised.⁷⁹ These additional costs will make US equity CF offerings less attractive to founders.⁸⁰ In the first three months of Regulation CF's operation, 82 equity CF campaigns were launched under it, raising a total a total of \$7.2 million.⁸¹ This looks very modest when it is borne in mind that approximately \$300 million was raised in US reward CF every quarter of the previous year.⁸²

To summarise, the contrast between the regulation of equity CF in the UK and US turns on the application of mandatory disclosure. The more onerous US rules make equity CF issues more costly in that country, and the equity CF sector appears accordingly stunted. However—as we shall see—when we turn to reward CF, this jurisdictional pattern of regulatory intensity and market success is reversed.

Reward CF

Reward CF contracts are (conditional) undertakings to transfer title to future goods, or to provide future services.⁸³ As such, although they involve the funder bearing part of the risk of

⁷⁹ See eg Crowdcube, 'Crowdcube Fees', available at <https://www.crowdcube.com/pg/crowdcubefees-34>; Kickstarter, 'FAQ: What are the fees?', available at <https://www.kickstarter.com/help/faq/kickstarter+basics?ref=footer>.

⁸⁰ For example, in the case described in the text, the equity actually contributed to the issuer's operations would only be \$78,540 and it would need to increase in value by \$21,460 (27.3%) before it would even reach investors' *break-even* valuation of \$100,000. Because fees are a fixed cost, they consume a smaller fraction of larger offerings: for a \$1 million offering, anticipated costs would be between 8.5-18.5% of the offering.

⁸¹ Crowdfund Capital Advisers, 'What is the data showing us about Regulation Crowdfunding?', *Entrepreneur The Arts Blog*, 30 August, 2016 (<http://blog.entrepreneurhearts.com/2016/08/30/what-is-the-data-showing-us-about-regulation-crowdfunding/>).

⁸² Globally \$2,055m was raised by way of reward CF during 2015, or \$514m per quarter (above, Table 1). The US accounts for around 60% of global CF activity (Massolution, above n 24, 58).

⁸³ See eg UK platform Crowdfunder, <http://www.crowdfunder.co.uk/rewards-page> (distinguishing reward from donative CF: 'pre-sell your product ... [e]veryone wants something for their money').

business failure, they are neither cash-settled nor do they involve the purchaser receiving a return that varies with the profitability of the business. Consequently they are not classified as ‘financial instruments’ or ‘securities’.⁸⁴ As a result, reward CF is not regulated as a public offer by the FCA in the UK or as a securities offering by the SEC in the US.⁸⁵ Rather, offerings of this type are subject to general contract law and consumer protection obligations, because entrepreneurs raising funds are doing so in the course of their business, whereas reward backers are typically acting as individuals outside the course of their business.

Contract law is a matter for state law in the US, although all states have adopted the Uniform Commercial Code, which governs sales contracts. This provides standard remedies for late delivery and delivery of goods not matching their description or fitness for purpose.⁸⁶ However, parties may waive such protections by express contractual provision.⁸⁷

States typically also have consumer protection laws, albeit rather more timid in their scope and less coherent in their organisation than the regime established in the EU. For example, New York, which is the governing law for Kickstarter’s *Terms of Use*,⁸⁸ has general provisions requiring agreements governing consumer transactions to be written in ‘plain language’ and not in very small print,⁸⁹ which appear to be readily met by Kickstarter’s terms.

⁸⁴ For the EU, see MiFID, Art 4(1)(17) and Annex I, Part C (defining ‘financial instruments’) (see similarly MiFID II, Art 4(1)(15) and Annex I, Part C); for the US, see Securities Act of 1933 § 2(a)(1) (defining ‘security’) and *United Housing Foundation, Inc v Forman* 421 US 837 (1975), 852-53 (‘[W]hen a purchaser is motivated by a desire to use or consume the item purchased ... the securities laws do not apply’).

⁸⁵ FCA, *Call for Input*, above n 7, 6 n 2.

⁸⁶ UCC §§ 2-313, 2-314, 2-601.

⁸⁷ *Ibid*, §§ 2-303, 2-316, 2-317.

⁸⁸ Kickstarter, *Terms of Use*, above n 43, clause 17.

⁸⁹ NY General Obligations Law § 5-702; NY Civil Practice Law and Rules § 4544.

Many states also have general provisions prohibiting ‘deceptive acts or practices’ in consumer transactions.⁹⁰ These provisions may be invoked to protect citizens of the state in question who entered into reward CF transactions under the laws of other states. For example, in *State of Washington v Altius Management LLC*,⁹¹ the Attorney General of Washington State successfully obtained a default judgment under Washington’s equivalent general prohibition⁹² against a firm and its owner that had failed to deliver rewards (or even communicate) over a period of several years since running a successful funding campaign on Kickstarter. Kickstarter’s *Terms of Use* at the time stipulated that founders of commercial projects were required to offer a refund if they were unable to fulfil rewards,⁹³ and the judge reasoned that failure to do so violated the statute. However, Kickstarter subsequently modified its terms, as discussed above,⁹⁴ to make clear that non-delivery would not be a breach provided the founder can account for how the money has been spent in pursuit of the project. The resulting position appears to be that misrepresentation or, *a fortiori*, fraud, may violate such statutes, but that delivery failures, whether explained by reference to technological impossibility or even in the presence of a pattern of timely and open communications with funders and best-effort, but fruitless attempts to deliver on the promises, will not.

⁹⁰ NY General Business Law § 349.

⁹¹ King County Superior Court, Washington State, 22 July 2015.

⁹² Revised Code of Washington § 19.86.020 (prohibiting ‘unfair or deceptive acts or practices in the conduct of any trade or commerce’). The Attorney General represented Washington State citizens who had backed the defendant’s Kickstarter campaign.

⁹³ Kickstarter, *Terms of Use* October 2012 (applicable to projects launched before 18 October 2014), available at <https://www.kickstarter.com/terms-of-use/oct2012?country=US> (‘Project Creators are required to fulfil all rewards of successful fundraising campaigns or refund any Backer whose reward they do not or cannot fulfil’).

⁹⁴ See above, text to nn 43-45.

Matters are very different in the UK (and indeed the EU more generally), where several mandatory rules of consumer contract law may be applicable to reward CF agreements. First, founders offering their products as rewards are likely to find that funders will enjoy non-waivable rights to a refund after delivery of goods or commencement of a service if they are unhappy with the quality of what they receive. The most extensive such entitlement is the unconditional ‘right to cancel’ under the Consumer Contracts (Information, Cancellation and Additional Charges) Regulations 2013 (the ‘CCRs’),⁹⁵ which implement the EU’s Consumer Rights Directive.⁹⁶ The CCRs grant consumers purchasing under a distance sales contract an unconditional right to cancel within 14 days of receipt of the goods, whereupon the supplier must reimburse the amount paid by the consumer.⁹⁷ A ‘sales contract’ is defined as ‘a contract under which a trader ... agrees to transfer the ownership of goods to a consumer and the consumer pays or agrees to pay the price’, including any contract that has both goods and services as its object’,⁹⁸ which would seem apt to cover many cases of reward CF. Although financial services contracts, defined as ‘services of a banking, credit, insurance, personal pension, investment or payment nature,’ are excluded from the CCRs,⁹⁹ a typical reward CF

⁹⁵ SI 2013/3134. The CCRs replaced the earlier Consumer Protection (Distance Selling) Regulations 2000, SI 2000/2334.

⁹⁶ 2011/83/EC [2011] OJ L304/64. This replaced Directive 97/7/EC on the protection of consumers in respect of distance contracts and directive 85/577/EC to protect consumers in respect of contracts negotiated away from business premises.

⁹⁷ CCRs, above n 95, rr 4-6 and Part 3. This right to cancel is subject to an exclusion for ‘goods that are made to the consumer’s specifications or are clearly personalised’ (ibid, reg 28(1)(b)), which might exempt some, but by no means all, instances of reward CF. There is also an exclusion for goods and services for which ‘the price is dependent on fluctuations in the financial market which cannot be controlled by the trader’ (ibid, reg 28(1)(a)), which does not on its face extend to reward CF.

⁹⁸ CCRs, above n 95, r 5.

⁹⁹ Ibid, r 6.

arrangement would not fall within the scope of this exclusion.¹⁰⁰ There may also be similar, albeit more circumscribed, mandatory cancellation rights available for longer periods under the Consumer Rights Act 2015,¹⁰¹ or the Unfair Trading Regulations 2008 (the ‘UTRs’).¹⁰²

Second, the UTRs make it a criminal offence of strict liability, punishable by up to two years’ imprisonment, for sellers to make misleading statements or to omit material information in relation to consumer contracts.¹⁰³ The consequence of this is likely to be to increase the cost of producing materials describing reward CF offers so as to avoid potential criminal liability.

Third, the Consumer Rights Act, which implements the Unfair Contract Terms Directive,¹⁰⁴ provides for substantive control of ‘fairness’ of non-core terms in contracts between businesses and consumers. While specification of the main subject-matter and the price are excluded from such scrutiny,¹⁰⁵ terms purporting to exclude liability for non-delivery

¹⁰⁰ While parties might in theory seek to engage the exemption by structuring reward CF arrangements as loans from the funder to the founder, which the latter then repays in kind, it is doubtful whether a court would accept such a label as denying the transaction the status of a ‘sales contract’, and the consumer the associated protection (see generally *Snook v London and West Riding Investments Ltd* [1967] 2 QQB 786, 802; *Street v Mountford* [1985] AC 809, 826-827; *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148, 160-163; *Bankway Properties Ltd v Pensfold-Dunsford* [2001] EWCA Civ 528, [2001] 1 WLR 1369 at [42]-[44]; *Autoclenz Ltd v Belcher* [2011] UKSC 41, [2011] IRLR 820 at [23]-[29]).

¹⁰¹ Sections 3, 9 and 20 (consumer contracts ‘for a trader to supply goods’, including not only ‘sales’ but also contracts for ‘transfer of goods’, confer on consumers the right to reject goods and receive refund within 30 days of receipt if goods not of satisfactory quality given their marketing).

¹⁰² SI 2008/1277 (implementing the EU’s Unfair Commercial Practices Directive 2005/29/EC [2005] OJ L149/22), Part 4A rr 27A, 27E, 27J-27K (contracts for sale or supply of goods or services by trader to consumer, giving consumer right to unwind contract and receive refund within 90 days of receipt of goods or commencement of service, if funder relied on seller’s misleading statement about product, plus damages for reasonably foreseeable consequential loss).

¹⁰³ UTRs, regs 5-6, 9-10, 13.

¹⁰⁴ Council Directive 93/13/EEC [1993] OJ L95/29.

¹⁰⁵ Consumer Rights Act 2015 s 64(1).

or late delivery are not. Attempts by an entrepreneur to make a funder bear the risk of outright non-delivery might well be seen as creating an unfair ‘imbalance’ in the contract—the consumer having paid the ‘price’ but the entrepreneur purporting to be relieved of the obligation to deliver.¹⁰⁶ However, late delivery, given the context, is more likely to be something it would be reasonable to provide for as a contingency.¹⁰⁷

The net effect of these provisions, and especially the right to cancel under the CCRs, is to upset the risk-sharing in reward CF described above:¹⁰⁸ the entrepreneur now bears all the risk that the product does not turn out satisfactorily. This is likely to make reward CF considerably less appealing in the UK than the US for an entrepreneur considering funding options. This variation in treatment appears consistent with data on the use of reward CF, which, as we saw in Table 1, is under-used in the UK relative to the global norm.

It is worth noting that the UK data on reward CF reported in Table 1 capture only activity on UK platforms.¹⁰⁹ US-based platforms such as Kickstarter accept funding (and projects) from most countries in the world, so UK funders or founders wishing to pursue reward CF might do so via use a US platform instead. While the relevant terms of use will contain jurisdiction and choice of law clauses in favour of a US state—New York, for example, in the case of Kickstarter¹¹⁰—this seems unlikely to escape the consumer safeguards built into the

¹⁰⁶ See *ibid* Sch 2, para 7 (terms permitting trader to retain sums paid by consumer where trader dissolves the contract are presumptively unfair).

¹⁰⁷ See *ibid* Sch 2, para 13 (terms permitting trader to alter characteristics of goods *without a valid reason* presumptively invalid) (emphasis added).

¹⁰⁸ See above, text to nn 43-45.

¹⁰⁹ See Nesta and Cambridge Centre for Alternative Finance, *Pushing Boundaries: The 2015 UK Alternative Finance Industry Report* (2016), 10.

¹¹⁰ See Kickstarter, *Terms of Use*, above n 43, clause 17.

EU's private international law framework. Where a trader 'directs [commercial] activities' to a consumer's country of residence, mandatory consumer protection rules of that jurisdiction's law will apply regardless of choice of law,¹¹¹ and the consumer is guaranteed the option to sue in the jurisdiction of her domicile, regardless of choice of forum.¹¹² According to the CJEU's case law, firms can 'direct commercial activities' to consumers in a particular country through a website, provided that the setup of the website contemplates transactions with consumers in that country (for example, by referencing it expressly).¹¹³ Where the parties are both domiciled in the EU, this would put a brake on UK founders evading the domestic consumer protection regime by seeking to raise reward CF on a US platform.¹¹⁴

To conclude this section, we briefly review the main points of contrast. The UK's consumer protection framework makes it difficult to establish a risk-sharing agreement for reward CF, whereas the rules applicable in the US do not. In contrast, the mandatory disclosure obligations imposed by US securities law make it very expensive to launch equity CF campaigns there, whereas the exemption for small offers in the UK does not. The differences in regulation appear to matter on the ground, being aligned with relatively greater use of reward CF in the US, and equity CF in the UK. Yet can the very different treatment—within both the

¹¹¹ Regulation (EC) No 593/2008 on the Law Applicable to Contractual Relations (Rome I) [2008] OJ L177/6, Art 6.

¹¹² Regulation (EU) No 1215/2012 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters (recast) [2012] OJ L351/1, Arts 6(1), 17, 18.

¹¹³ See Cases C-585/08 and C-144/09, *Pammer and Hotel Alpenhof GesmbH* ECLI:EU:C:2010:740; See also Case C-190/11, *Mühlleitner* ECLI:EU:C:2012:542.

¹¹⁴ However, difficulties with recognition and enforcement of judgments likely undermine the efficacy of such protection as regards founders based outside the EU. Consistently with this, we understand it is reasonably common for US founders to raise funds on Kickstarter from EU backers.

UK and the US—of these functionally quite similar activities be justified? In the next section, we address CF regulation from a normative perspective.

How Should Crowdfunding be Regulated?

As we have seen, CF sits in territory at the intersection of securities markets and consumer protection law. While these two fields pursue similar general regulatory goals—protecting the interests of less-informed parties—they do so by very different routes. As a novel practice, CF has found itself regulated by these existing bodies of rules. This treats CF as if it were analogous to longer-established—and better-understood—activities. However, these results are the product of inertia, rather than considered reflection. It is desirable to approach the regulation of a new practice such as CF from a *functional* perspective. This entails asking, first, what the practice seeks to achieve; and second, how regulation can improve it.¹¹⁵ The juxtaposition of securities and consumer law across the practice of CF permits us to evaluate the comparative efficacy of the regulatory tools used in these two domains.

A common, and basic, problem in both reward and equity contexts is that retail funders lack information about the risks of the enterprise, which affects the expected enjoyment of the product or financial return, respectively. If funders lack sufficient information, however, nothing forces them to support a project. Consequently we might expect founders to have strong incentives to disclose sufficient information to satisfy funders' demand. Of course, for this to be credible, it is necessary to have in place mechanisms to prohibit fraud and misrepresentation. Such mechanisms are present respectively in criminal and general contract law.

¹¹⁵ For our application of this approach in other contexts, see R Kraakman et al, above n 34, Ch 1; J Armour et al, above n 18, Ch 3.

However, the problems run deeper than a simple asymmetry of information. First, in many cases, the founder will not have the relevant information themselves. This means that funding such a project involves an element of risk-sharing. Second, as we saw, the sequential arrival of funders makes the funding decision prone to information cascades, which can lead to the making of collective funding decisions on the basis of a limited subset of information available. Third, funders are liable to be subject to behavioural biases, which amongst other things may lead them not to appreciate that they lack appropriate information to make a decision.

Reviewing the functioning of the markets yields a clear initial implication: the problems of market failure are greater in relation to equity than reward CF. The information funders need to make a decision about an equity investment is greater than a purchase decision; the reward CF process actually *reveals* new information about consumer demand for the product; and herding problems are less in relation to reward than equity CF. This implies that—contrary to the pattern in the UK—greater regulatory intervention is likely to be justified in relation to equity CF than reward CF. We now turn to consider particular regulatory strategies.

Is Mandatory Disclosure Useful?

As we have seen, the biggest difference between US and UK regulation of equity CF concerns mandatory disclosure. This prompts an assessment of its appropriateness in the CF context. Although mandatory disclosure has a long history in relation to securities and consumer laws generally, its utility is greatly compromised by the fact, established very clearly by behavioural research, that most individuals simply do not read disclosures.¹¹⁶ Whether because the

¹¹⁶ O Ben-Shahar and CE Schneider, *More Than You Wanted to Know* (Princeton, NJ: Princeton UP, 2014), 68-9. See also O Bar-Gill, *Seduction by Contract: Law, Economics and Psychology in Consumer Markets* (Oxford: OUP, 2012), Ch 1.

necessary investment of time is not justified by the amount at stake, or because the individual is subject to a decisional bias, the implication is the same: mandating disclosure of information directly to individuals is, largely speaking, a regulatory failure. It is costly to do—which costs are typically passed on to customers—but generally makes no difference to outcomes.¹¹⁷

In the context of securities regulation, commentators have moved toward viewing mandatory disclosure as a means of enhancing the efficiency of securities *markets*.¹¹⁸ This is achieved through the activity of institutional investors, whose asset managers do read and analyse disclosures and trade on the basis of this information.¹¹⁹ On this view, the rationale for mandating disclosure is that such information is a public good in the secondary market: left to their own devices, firms would be chary of possibly giving away competitive advantages, and so disclose less than is socially useful.¹²⁰ Mandating disclosure enables the market to price securities more accurately—that is, on the basis of a larger set of information. More accurate pricing in turn has important benefits. First, it facilitates the deployment of capital to its highest valued uses. This is most obviously the case as regards initial offers, where investors allocate capital to new projects, but is also the case for secondary markets. If managers have

¹¹⁷ See eg F Marotta-Wurgler, ‘Does Contract Disclosure Matter?’ (2012) 168 *Journal of Institutional and Theoretical Economics* 94 (consumer contracts generally); Armour et al, above n 18, 256-61.

¹¹⁸ See eg MB Fox, LR Glosten and GV Rauterberg, ‘The New Stock Market: Sense and Nonsense’ (2015) 65 *Duke Law Journal* 191, 221-25; Armour et al, above n 18, 160-67.

¹¹⁹ See eg Z Goshen and G Parchomovsky, ‘The Essential Role of Securities Regulation’ (2006) 55 *Duke Law Journal* 711.

¹²⁰ See JC Coffee, Jr, ‘Market Failure and the Economic Case for a Mandatory Disclosure System’ (1984) 70 *Virginia Law Review* 717; MB Fox, ‘Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment’ (1999) 85 *Virginia Law Review* 1335, 1355-6. For empirical results supporting this view, see M Greenstone, P Oyer, and A Vissing-Jorgensen, ‘Mandated Disclosure, Stock Returns and the 1964 Securities Acts Amendments’ (2006) 121 *QJE* 399; A Ferrell, ‘Mandated Disclosure and Stock Returns: Evidence from the Over-the-Counter Market’ (2007) 36 *Journal of Legal Studies* 213.

incentives—plausibly through linking their pay to the stock price—to maximise the share price, then more accurate price movement will encourage managers to allocate the firm’s resources toward their highest-valued uses.¹²¹ Second, more accurate stock pricing stimulates liquidity in the market, by ensuring that investors who need to buy and sell can do so at a price that best reflects the value of the security.¹²²

However, there is typically no secondary market for equity CF—indeed, secondary trading is prohibited in the US for the first year.¹²³ This means that rationales based on market efficiency must be based on the operation of the primary market. As we have seen, however, all the evidence suggests that retail investors generally do not read disclosures provided to them in the context of primary markets. Consequently, we cannot expect mandatory disclosures to result in improved outcomes. An instructive case study is Laibson et al’s experiment on the impact of ‘summary prospectuses’ on retail investor decision-making as regards investment choices in mutual funds.¹²⁴ In this context, investors choose to buy shares directly from the mutual fund, and so their decision is analogous to funders selecting equity CF pitches. The authors reported that summary prospectuses—which were intended to make the information

¹²¹ J Dow and G Gorton, ‘Stock Market Efficiency and Economic Efficiency: Is There a Connection?’ (1997) 52 *Journal of Finance* 1087; AR Admati and P Pfleiderer, ‘Forcing Firms to Talk: Financial Disclosure Regulation and Externalities’ (2000) 13 *Review of Financial Studies* 479; JN Gordon, ‘The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices’ (2007) 59 *Stanford Law Review* 1465.

¹²² M Kahan, ‘Securities Laws and the Social Costs of “Inaccurate” Stock Prices’ (1992) 41 *Duke Law Journal* 977, 1017-21.

¹²³ See above n 71.

¹²⁴ J Beshears, JJ Choi, D Laibson and BC Madrian, ‘How Does Simplified Disclosure Affect Individuals’ Mutual Fund Choices?’ in DA Wise (ed), *Explorations in the Economics of Aging* (Chicago: University of Chicago Press, 2011), 75.

easier for retail investors to digest—brought no measurable improvement in substantive choices.¹²⁵

So mandatory disclosure is unlikely to produce any meaningful benefits in the context of CF. Moreover, as we have seen, it is costly to undertake. This implies that mandatory disclosure is *worse* than useless in this context.¹²⁶ The basis of the US approach to regulating equity CF therefore appears misconceived.

Consumer Protection Beyond Disclosure?

Plausibly, it makes more sense to view the regulatory challenges for retail CF as being a species of consumer protection. From an economic perspective, the fundamental problem to which consumer protection regulation responds is that, whether owing to lack of information-processing capability or decisional biases, consumers make predictable errors in their decision-making. Recent regulatory policy in consumer finance has emphasised that disclosure is not a solution to these problems, and that more interventionist measures are sometimes justified.¹²⁷ Potential interventions range from—at the least interventionist—the imposition of default rules beneficial to the consumer’s position, through the imposition of mandatory rules to—at the most interventionist—outright prohibition of certain types of transaction. It is a simple insight that the more interventionist the regulatory technique, the greater the harm done if it is mis-specified. Inappropriately restricting a valuable practice can be just as harmful as failing to

¹²⁵ The substantive choices in both cases reflected an excessive focus on past returns and insufficient attention to fees, which would impair the investors’ returns.

¹²⁶ This is consistent with Ben-Shahar and Schneider’s evaluation of the policy in other primary market contexts. See above n 116.

¹²⁷ See generally FCA, ‘Applying Behavioural Economics at the Financial Conduct Authority’, Occasional Paper No 1 (2013); J Niemann, ‘Behavioural Economics and the CFPB’, *Consumer Financial Protection Bureau Journal*, 22 September 2015.

restrict an exploitative practice. The rapidly-growing body of experimental literature relating to consumer protection policy indicates, however, that successful regulatory interventions are often highly context-specific. Considerable information must be gathered before an appropriate intervention can be designed.

Viewed from a consumer protection perspective, four features of CF offers are particularly salient. First, these are obviously highly risky contracts for consumers. There is a high likelihood that consumers will mistakenly be optimistic about the prospects of a particular firm, and consequently overinvest. Yet this is not in itself problematic. Provided consumers can be restrained from risking resources they cannot afford to lose, and are encouraged to diversify, this tracks investment risk generally. In this regard, limitations on the amount that retail investors may stake in equity CF seem a particularly worthwhile policy.

Second, CF funding may be socially valuable. This is most obvious with reward CF, where successful funding generates valuable information regarding the market for the firm's products. This implies that restricting the provision of reward CF is misguided. Even for equity CF, however, there may be valuable projects which, without this source of finance, would not get funded. The geographic restrictions on VC finance, the costs of public capital markets, and the asset restrictions on access to debt finance mean that these financing sources may not be available.¹²⁸ Moreover, reward CF may be unsuitable for larger capital calls—beyond a certain scale, it may cannibalise the 'regular' market for the firm's product.¹²⁹ In addition, entrepreneurs may prefer to avoid VC finance in order to retain greater control over their

¹²⁸ See above, text to nn 16-17.

¹²⁹ Belleflamme et al, above n 29.

firm.¹³⁰ Given these constraints on alternative funding sources, there is no reason to think that seeking equity CF should be construed as any adverse signal of a firm's quality.¹³¹ Indeed, there may be valuable projects which, without optimistic financiers, may never get funded.¹³² This implies that the arguments for permitting equity CF outweighs that for prohibition.

Third, there appears to be little risk that consumers' mistakes will be systematically exploited. A concern underpinning many consumer protection laws is that of 'imbalance' between the parties. A business firm usually enjoys economies of scale in designing the terms of a transaction, leading to advertising and standard terms designed to make the product appealing to consumers' biases. Market competition encourages firms to seek to take advantage of these errors as a way of selling more product. Quite apart from the unfairness of this dynamic, the prospect of such exploitation deters consumers from participating in markets, and the resources invested by firms in developing and marketing products that are not actually desired by consumers are wasted. However, in the context of CF, an entrepreneur is unlikely to be able to devote significant time to the design of a financing contract, and so is unlikely to be able to use this to exploit consumers effectively. More plausibly, the portal may be able to capture economies of scale in the design of CF contracts. This implies that the focus of

¹³⁰ See eg DM Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors' (2008) 61 *Vanderbilt Law Review* 1405, 1431-33. Angels' investing styles vary significantly: while the overall picture is one of less formal arrangements than in the case of VCs, still some angels adopt the same protective measures that are common in VC investment contracts: *ibid*, 1420-25. On VCs, see JM Fried and M Ganor, 'Agency Costs of Venture Capitalist Control in Startups' (2006) 81 *NYU Law Review* 967.

¹³¹ Cf MB Dorff, 'The Siren Call of Equity Crowdfunding' (2015) 39 *Journal of Corporation Law* 493, 496-97. For similar concerns with regard to pre-crowdfunding direct internet offerings in the 1990s see SJ Choi, 'Gatekeepers and the Internet: Rethinking the Regulation of Small Business Capital Formation' (1998) 2 *Journal of Small and Emerging Business Law* 27, 38-39.

¹³² R Nanda and M Rhodes-Kropf, 'Financing Risk and Innovation' (2016) *Management Science* (advance publication).

regulatory engagement should be vis-à-vis the portal rather than as between the entrepreneur and the funder. This is a component of equity CF regulation in both the UK and the US. However, UK consumer protection legislation—inappropriately in our view—fastens on the contract between entrepreneurs and reward CF funders.

Fourth, whilst it may well be possible to design a more nuanced intervention that protects CF funders without restricting the practice itself, too little is currently known about how CF works for regulators to be able to select a policy instrument appropriately. There is consequently a risk of unnecessary restrictions being imposed. The way in which the UK's consumer protection regime imposes a mandatory cancellation option into reward CF contracts appears to be a case in point. While intended to promote the interests of consumers, this provision seems entirely inappropriate for a context in which consumers undertake to share production risks with producers. Its consequence, it appears, is to restrict the raising of reward CF in the UK.

In the presence of a new practice such as CF, there may be much for regulators to gain from undertaking to review the marketplace regularly but to postpone decisions about intervention. Repeat players in the market, such as portals, have incentives to introduce safeguards that increase investment returns, to the extent that this stimulates demand for offerings. Such incentives can be further sharpened by the implicit threat of regulatory intervention. Market-designed safeguards can consequently substitute for—or at the very least inform—regulatory intervention. As an example of this, we explore in the next section mechanisms introduced by portals in order to reduce the risk of investment in equity CF, where funders are most exposed and existing regulatory strategies (in the form of disclosure) seem ineffective.

Market-based safeguards for equity CF

Where equity CF is permitted, market participants have experimented with mechanisms to reduce the risk that bad projects are funded and that investors become prey to fraudulent or opportunistic behaviour on the part of fundraisers. We divide these mechanisms into three categories: first, those that try to leverage more effectively the *collective* wisdom of the crowd, by reducing the possibility of inappropriate herding. Second, we consider the adaptation of contractual protection devices used by VCs and, to a lesser degree, angel investors. And third, we look at attempts to make equity CF make more use of customized versions of investor protection mechanisms used in traditional IPO markets.

Leveraging the wisdom of crowds

We have seen how the sequential arrival of investors in CF campaigns is prone to herding.¹³³ This is driven by subsequent investors' inability to distinguish between prior investors who have positive information and those who have simply followed the herd. One way to mitigate this is to reveal more granular information about the attributes of (prior) investors. This makes it easier for non-expert investors to identify which of the already-committed investors are making investments on the basis of their own analysis of information, and which are simply drawing inferences from prior investors' decisions.

A simple mechanism along these lines, commonly used in practice, is to let potential funders know not only the aggregate amount of funding pledged by prior investors, but also the individual distribution. The intuition is that the more a single investor pledges, the more

¹³³ Above, text to nn 36-39.

careful her due diligence will have been.¹³⁴ Even more nuanced inferences can be drawn if details of early investors' other interactions on the platform are made known to subsequent investors. This allows subsequent investors to draw inferences about the nature and quality of prior investors' expertise. For example, Appbackr, a US platform specialising in smart phone apps, makes available via user profiles information about investors' other on-platform investments and whether they have themselves launched an app. Kim and Viswanathan report that apps for which early backers have greater numbers of prior investments in the platform—signalling expertise in investing in the sector—or have themselves launched an app on the platform—signalling expertise in app development—are more likely to be successful both in raising subsequent funding and, ultimately, as business ventures.¹³⁵

Another—surprisingly powerful—tool is to facilitate what might be called 'crowd due diligence',¹³⁶ through permitting would-be investors to pose questions to those seeking funding, the answers to which are then available to other potential investors. These Q&A fora can reveal useful information not only about the merits of the project, but also the attitude of

¹³⁴ A study of German equity CF platforms finds that, where such information is made available, large investments by a single investor are positively correlated with the number of subsequent investments later the same day: L Hornuf and A Schwienbacher, 'Funding Dynamics in Crowdfunding', Working Paper (2015), 18.

¹³⁵ K Kim and S Viswanathan, 'The "Experts" in the Crowd: The Role of "Expert" Investors in a Crowdfunding Market', working paper, City University of Hong Kong / University of Maryland (2016). Interestingly, the effect of early backers having development expertise is most significant for apps seeking funding at the pre-launch stage, where technical viability may not yet be clear, whereas the effect of their investment expertise is most significant at the post-launch stage. See also Vismara, above n 41 (study of UK equity CF platform Crowdcube: presence of early investors who consent to making their other investment choices public increases take-up of offers with subsequent investors).

¹³⁶ See Agrawal et al, above n 50, 83-85.

the entrepreneur and the expertise of the investors asking the questions.¹³⁷ Expert investors' presence on such web fora helps less sophisticated investors to make more informed choices.

A more radical step to limit the risk of herding would be to allow access only to funders who can be expected to conduct some form of due diligence themselves before investing. A mild way of screening for this is to impose a minimum investment amount per individual—as, for example, the German platform Innvestment has done.¹³⁸ More drastic, and somewhat counter to the very idea of CF, is the solution of limiting access to the platform only to expert investors. For example, AngelMD is a US investment platform which allows medical professionals to invest in medical start-ups.¹³⁹ One might also imagine two-stage CF campaigns, in which in the first phase, only experts or experienced investors may invest, followed by the retail crowd once the experts have had the chance to signal.

Replicating sophisticated contractual protection

Crowdfunders invest in companies that are at a similarly early stage of development to firms that raise VC or angel finance. But unlike VCs and angels, crowdfunders are unable to bargain for protection or to be meaningfully involved in the business so as to monitor the entrepreneur. However, equity CF platforms may play a role here. To start with, they may (and usually do) screen offerings themselves, much like individual members of angel investor pools do for the

¹³⁷ An example of such Q&As section for a specific pitch can be found at <http://tinyurl.com/l85nxxl>.

¹³⁸ The minimum thresholds vary between €500 and €25,000: see L Hornuf and A Schwiendbacher, 'Should Securities Regulation Promote Crowdfunding?', working paper, SSRN (2015), 29-30.

¹³⁹ See https://www.angelmd.co/investor_faqs. The platform was established prior to the advent of retail equity CF in the US in May 2016, and so investors must also be 'accredited'—that is, wealthy (see above n 63). Accredited investors without medical qualifications may also join on an invitation-only basis.

entire pool.¹⁴⁰ That said, there is no evidence that platform screening is as reliable as an angel investor's, because platforms' incentives to do so are much weaker. They receive a fee if the pitch is successful, but do not usually have any financial stake in the fundraising company's success,¹⁴¹ and indeed are prohibited from doing so in the U.S.¹⁴²

Because potential CF investors may be sceptical about a platform's ability or incentives to screen projects effectively, especially before the platform has established a reputation on the market, an alternative is to co-opt angel investors with an established track record to do the screening. For example, the UK platform SyndicateRoom, 'only list[s] companies that are already backed by professional "business angels", who are investing their own money and thus have taken an active role in evaluating the strength of the deal'.¹⁴³ It then offers its members 'the "same share class and same price per share" if they decide to invest alongside these professionals'.¹⁴⁴

Another technique is to seek to deploy the kinds of contractual governance mechanisms used by VCs and angel investors. Generally, CF deals do not employ such mechanisms, because of the high coordination costs faced by investors.¹⁴⁵ The desire to reduce coordination costs can leave funders exposed to entrepreneur opportunism: some CF deals provide funders with securities that lack voting rights and are subordinated to entrepreneurs'

¹⁴⁰ P Belleflamme, N Omrani and M Peitz, 'The Economics of Crowdfunding Platforms' (2015) 33 *Information Economics and Policy* 11, 18.

¹⁴¹ Ibid, 17.

¹⁴² Above n 68.

¹⁴³ <https://www.syndicateroom.com/about-us/about-syndicateroom.aspx>.

¹⁴⁴ Ibid.

¹⁴⁵ See above, text to n 15.

equity claims, in sharp contrast with VCs' practice of taking outside control rights and liquidation preference.¹⁴⁶ Some platforms, however, consciously market themselves as protecting crowdfunders by acting as their nominee in negotiating—and making use of—the typical contractual rights VCs reserve for themselves. For example, UK equity CF platform Seedrs makes a point of signing investment agreements in their capacity as crowdfunders' nominee. Such agreements grant investors pre-emption rights, tag-along rights, and negative control (veto rights) regarding important issues, 'such as the winding-up of the company, changing the business of the company, issuing preference shares, transferring assets out of the company, making certain loans, or increasing director salaries beyond an agreed level'.¹⁴⁷ These rights are exercised by the platform on investors' behalf.¹⁴⁸

Similarly to angel investor syndicates, some continental European platforms, such as MyMicroInvest and Innvestment,¹⁴⁹ use a special purpose vehicle to hold shares in the crowdfunded companies, while investors receive certificates in the vehicle. Others, like Seedrs, use a nominee structure, by which the platform has title over the funded companies shares and investors have beneficial ownership.¹⁵⁰ In either case, coordination costs are reduced by having someone in charge of exercising funders' rights collectively.¹⁵¹

¹⁴⁶ See L Hornuf and A Schwienbacher, 'Crowdinvesting – Angel Investing for the Masses', in H Landström (ed), *Handbook of Research on Venture Capital: Volume 3—Business Angels* (Cheltenham: Edward Elgar, forthcoming).

¹⁴⁷ See <http://learn.seedrs.com/protecting-small-investors-in-equity-crowdfunding-rounds/>.

¹⁴⁸ Ibid.

¹⁴⁹ See <https://www.mymicroinvest.com/en/about/transaction> and <https://www.innvestment.de/investors/vertrag.html>.

¹⁵⁰ See <http://learn.seedrs.com/it-isnt-nominal-why-a-nominee-structure-is-vital-in-equity-crowdfunding/>.

¹⁵¹ Of course, this itself introduces a further layer of potential agency costs.

Adapting IPO market institutions

As argued in section 2.3, equity CF investors' position is not unlike that of retail investors in an IPO, but with the additional risks stemming from the unavailability of the market (and legal) institutions that have developed through the decades to protect the latter. This provokes consideration of the extent to which such institutions could be adapted to the equity CF context.

Gatekeepers and disclosure. IPO markets have long relied on gatekeepers to reduce the risk that investors are ripped off: underwriters, audit firms, lawyers, analysts, and the stock exchange lend their reputations to the issuer and, each in their own way, vouch for its quality.¹⁵² This means that, having agreed to assist in the IPO, gatekeepers have incentives to ensure that the issuer's quality is no lower than the public perceives it to be.¹⁵³ Could gatekeepers play a role similar in equity CF offers?

The obvious candidate would be CF platforms. In the long run, platforms' business model is only viable to the extent that investors trust that the fundraisers using them are reliable. Clearly, platforms cannot tolerate a record of fraud, fundraisers' opportunistic behaviour, or even poor business projects. Some form of screening is therefore to be expected. In fact, most platforms positively market themselves as undertaking some 'due diligence' on the fundraisers and their pitch—that is, investigating the veracity of claims made.¹⁵⁴

¹⁵² See generally Armour et al, above n 18, 118-125.

¹⁵³ See eg SJ Choi and AC Pritchard, *Securities Regulation: Cases and Analysis*, 3rd ed (New York: Foundation Press, 2012), 702.

¹⁵⁴ For instance, Crowdcube asserts: 'Before a pitch goes live we verify every material factual claim made on the pitch page by obtaining evidence from credible sources. We ensure any subjective statements/opinions expressed by the business are clearly identified as such. We also investigate the legal structure of the business to ensure it offers investors a fair deal, and disclose any material differences to our standard articles of association or other legal documentation relating to the pitch. We carry out checks on the business and its directors to detect any

One may wonder whether platform-mandated disclosures may serve investors as well as mandatory disclosures do in the IPO context. Generally speaking, an optimistic view would be that platforms will require disclosure of all essential items for potential investors, and possibly learn from the interactions between potential investors and issuers that occur on their websites to fine-tune required disclosures by including items that such interactions reveal to be valuable to investors.

Given the competition in the CF platforms market, however, a sceptic may take the view that platforms will impose less disclosure than investors would want, so as not to lose fundraising entrepreneurs to less demanding rivals. But loose standards will hurt the platform's reputation vis-à-vis investors: pleasing entrepreneurs from this perspective is definitely not in the *long-term* interest of the platform. Once again, with the industry in its infancy and hype about CF, there is a serious risk that some of the current players in the market are there to make a quick buck and run.

As hinted before, Q&A interactions between the crowd and the entrepreneur may unearth essential information. But investors should have a preference for platforms already requiring issuers to provide such information. In addition to relying on Q&A sections to supplement disclosure on a case-by-case basis, platforms can save potential investors' time by coming up with standardized questions for entrepreneurs that they may be required to answer should a given number of platform users find them of relevance.¹⁵⁵ It would be then easy to

adverse data that has the potential to negatively affect the crowd. We review the financial forecasts of the business to ensure they are a fair and reasonable reflection of the business as it currently stands, and that their forecasts are backed by reasonable thinking and assumptions.' See Crowdcube, FAQs (available at <https://www.crowdcube.com/faqs/investing-in-equity/what-due-diligence-does-crowdcube-do-before-pitches-go-live-on-the-site>). Other platforms, such as Seedrs and SyndicateRoom, make similar claims.

¹⁵⁵ S Hanks, G Romano and E Tonelli, 'Madness of Crowds or Regulatory Preconception?: The Weak Foundation of Financial Crowdfunding Regulation in the US and Italy' (2014) 11 *European Company Law* 243, 257.

incorporate the regularly popular questions among the standard required disclosures, possibly on an industry by industry basis.

Pricing. The second principal tool of investor protection is the pricing mechanism itself. Section 2.3 briefly contrasted the bookbuilding process in the IPO market with fundraisers' home-made pricing on CF portals. This is another area where market innovation is generating tools to protect investors, in this case by lowering the risk of unrealistic valuations of fundraisers' businesses.

Various platforms have devised arrangements aimed at improving the largely predominant home-made take-it-or-leave-it pricing model. Innovestment, a German CF platform, at one time used a multi-stage auction system to determine the offering price,¹⁵⁶ but later abandoned it, due to investors' dissatisfaction with its complexity.¹⁵⁷

UK equity CF platform Crowdcube offers a 'price review' mechanism which relies on the bargaining power of investors willing to buy a relatively large stake in the company. An investor willing to invest at least £5,000 but at a lower price per share than the existing pitch may provide her own valuation of the business and declare how much she would invest at the proposed lower price. Such a counteroffer is then put to the entrepreneur, and, if accepted, will apply to all previous and future investors.¹⁵⁸

¹⁵⁶ See Hornuf and Schwenbacher, above n 134, 7, for a description of the auction process.

¹⁵⁷ Some investors did not understand how the process worked, and others did not like being left with no shares when bidding too low: Phone conversation with Christine Friedrich, Managing Director of Innovestment GmbH (March 10, 2015).

¹⁵⁸ See <https://www.crowdcube.com/faqs/investing-in-equity/what-is-the-alternative-offer-tool>. Belgian platform MyMicroInvest has a similar mechanism, under which the CF offer is at the same terms as any agreed by the entrepreneur with professional investors before the CF offering is closed: see <https://www.mymicroinvest.com/en/faq>.

To our knowledge, in only one case—German platform Bergfürst—has there been a serious attempt to establish a secondary market in CF shares offered on a platform. Although Bergfürst has been active since 2012, it has only managed to have two companies traded on its market, suggesting that this is not a viable model for most equity-crowdfunded firms.¹⁵⁹ The reasons for that appear to be two-fold. Firstly, equity CF offerings are often too small, and buyers too few, for a liquid market to develop. Secondly, many EU regulations, such as the Market Abuse Regulation, now apply to both regulated markets and multilateral trading facilities, so that accepting to have one’s shares listed on one of these (which seems to be a condition, however insufficient, to ensure liquidity) entails significant compliance costs.

Conclusion

Crowdfunding by start-up firms is big news. The practice has grown astonishingly rapidly in the past few years, but there are big regional differences in the way in which it is being used. Equity CF, where funders buy minority shares in the business, has grown much more rapidly in the UK than the US. In contrast, the geographic pattern for reward CF, where funders are promised units of the firm’s future product, has been the reverse of this: far more rapid growth in the US than the UK.

It seems hard to resist the conclusion that regulation has played a role in this pattern of development. In the US, equity CF for retail investors has until very recently been prohibited. Reforms introduced in May 2016 under the JOBS Act, although they seek to facilitate this form of fundraising, still impose onerous disclosure obligations on firms. In contrast, the UK regime,

¹⁵⁹ See <https://de.bergfuerst.com/investitionsmoeglichkeiten>, under ‘Handelsplatz’ (the remaining investments available for trade on the secondary market are debt securities).

while placing restrictions on the amount individual investors can stake in the asset class, imposes no mandatory disclosure obligations on firms.

Turning to reward CF, the pattern of regulatory burdens is reversed. The UK's consumer protection laws—derived from the EU *acquis*—appear prone to upset risk-sharing arrangements in reward CF. Most notably, consumers enjoy non-waivable rights to cancel distance selling contracts after receipt of the goods, meaning that reward funders do not bear any risk that rewards will not meet with their expectations. In contrast, US consumer protection laws focus on policing fraud, misrepresentation, and breaches of agreed undertakings.

While both forms of CF involve decisions being made by funders with very incomplete information, the interaction between funders yields effects that point in different directions. The promise of reward CF is that by committing funding, backers reveal their preferences regarding the proposed product, and a successful funding campaign thus generates *new* positive information about the viability of the project. In this respect, reward CF harnesses the ‘wisdom of the crowd’. In contrast, the peril of equity CF is that funders making investment decisions in sequence are likely to ‘herd’ after early participants, such that the collective decision actually gets made on the basis of *less* information than the investors may have possessed at the beginning. This comparison of the functioning of the two funding markets suggests that regulatory scrutiny of equity CF should be comparatively more intensive than for reward CF: the opposite of the UK's current approach.

The inconsistencies in the treatment of CF stem from the application of pre-existing rules devised for different, albeit on their face formally similar phenomena, coupled with lawmakers' inertia. A functional approach to regulating CF, focusing on the extent to which particular interventions improve outcomes, highlights the inappropriateness of many of the current tools employed by regulators. There is no basis for assuming that retail funders will

read the product of mandatory disclosures, and in the absence of a secondary market or any bookbuilding process to aggregate information from sophisticated investors, the expense of the regime seems unjustified. Similarly, while there may be a case for more nuanced interventions designed to protect consumers' interests, there is insufficient evidence at this early stage of the market's development to know what such measures should look like, and inappropriate mandatory rules can easily do more harm than good. That said, one measure that clearly does appear useful is restricting the extent of retail investors' overall exposure to CF, as has been done in the UK and, less efficaciously, in the US.

CF platforms have incentives to implement measures to protect funders; these incentives are enhanced by the implicit threat of greater regulatory intervention. A review of the marketplace reveals a great deal of activity in this respect, with experimentation across a diversity of approaches. We argue that for the present, regulators are well advised to stand back and observe which of these experiments succeeds, and why.

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