Why Crowdfunding Will Happen

The genie is out of the bottle

Bob Vinson, Managing Partner
October, 2013

The very notion that the private securities market might return to the pre-1933 environment of wild speculation by completely unsophisticated small investors scares the SEC to death. After all, that's what caused the great crash of '29 wasn't it? That's why Congress, in its wisdom, promulgated the Securities Act of 1933 strictly regulating the issuing of private securities and the Securities Exchange Act of 1934 regulating securities transactions. However, given the dismal world financial environment after 2008 and stung by the US loss of its AAA debt rating Congress and the Administration started to rethink some of the provisions of these Acts. One of the results has been the passage of the JOBS (Jumpstart Our Business Startups Act). The intention of this Act, according to Congress, is "…to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies." And so we have entered the struggle to balance investor protection and facile capital formation.

The US JOBS bill and securities trading

For smaller companies, those the JOBS Bill terms "emerging companies" (under $1 billion in revenue), the most common method of raising capital has been to issue and privately sell equities making use of the exemption from registration provided by Regulation D, section 506, of the Securities Act of 1933. However, this exemption came with several restrictions:

1. Issuers were not allowed to broadly advertise the availability of their equities (no mass solicitation)
2. May sell only to institutional investors, accredited investors, and a limited number of non-accredited investors (limited primary market)
3. Purchasers were restricted from reselling the equities for a period of time (no immediate secondary market)

In 2011, the Obama administration, prodded by the then severe recession starting in 2008, recognized that these regulations had a restrictive effect on the formation of financial capital, especially in the arena of emerging businesses. At the time, unemployment in the US was reaching 10% in some areas and remained high despite signs of recovery. The White House initially proposed a mix of infrastructure redevelopment, education and training assistance, tax relief and incentives for small businesses. After several evolutions one of the actions taken by Congress to address unemployment based on the belief that small businesses are the largest contributors to new job creation became the Jumpstart Our Business Startups (JOBS) Act signed into law in 2012. The Act amended previous legislation such as

Sarbanes-Oxley, the Securities Act of 1933, the Securities Exchange act of 1934 and others. For securities placement agents and traders the most impactful portions of the Act are Title II – Relief from ban on general solicitation and Title III – Crowdfunding.

The bill instructed SEC to promulgate regulations allowing general solicitation for Reg D, rule 506 issues, by far the most common exemption used by private equity issuers. The changes to Rule 506 came in the form of the issuing of Rule 506(c) allowing general solicitation and advertising for a private placement offering (increased scope of primary market) providing that only accredited investors may purchase. However, the new rule placed the burden of determining whether buyers are actually accredited investors on the issuer.

Title III of the Bill called for establishment within 270 days of regulations governing the creation and operation of crowdfunding portals and the conditions of exemption from registration for issuers using them. While the term "crowfunding" has come to mean any offer made via the world-wide web in return for financial support, in Title III, Congress narrowly defines it as "…transactions involving the offer or sale of securities by an issuer…conducted through a broker or funding portal…" Unfortunately, Title III limits issues under this exemption to a maximum of $1 million in any rolling 12-month period.

Disintermediation in investment banking

The regulatory enforcement imposed on the securities markets in the US as a reaction to the Great Depression and previous and subsequent bad acting by issuers and their agents has contributed hugely to the creation of a massive intermediary, specifically the investment banking industry. While it is entirely possible for securities issuers to manage the marketing and sales of their own issues, due in large part to regulatory and legal requirements it is perceived to be safer and probably is more economical for the issuers to pay large fees to investment bankers to do the job, especially in the case of private issues where the issuers are smaller companies with limited reach and limited resources and small risk tolerance.

We can see similar creations in other industries. In the accounting industry, the proliferation of public accounting firms and independent Certified Public Accountants has a lot to do with regulatory enforcement by the US Internal Revenue Service.

There are several deleterious effects of intermediation in any industry:

- Increased transaction costs – Intermediary compensation adds cost to each transaction.
- Agency issues – The intermediaries acting as agents for the principal have their own interests and agendas in the transaction
- Increased execution time – The longer chain produced by including intermediaries increases time required to negotiate, make decisions, and to execute transactions
- Reduced flexibility – Most intermediaries constrain their capabilities and strictly define their transaction processes in order to limit their costs.
- Information unbalance – The operation of a free market demands that both participants in a transaction have the same level of information regarding the transaction, the so-called mutually informed transaction. The insertion of a third party tends to make information sharing more complex and to incent information hoarding to produce negotiation advantage.
- Loss of customer relationship control – End-use customers (investors in the private equity world) become the customers of the intermediary rather than of the producer (issuer).
- Limited prospect base – Traditionally, due to the difficulty of performing due diligence, intermediaries sourced and completed transactions utilizing established and trusted personal relationships with producers and with purchasers. Consequently, the producer's potential customer base is limited by the relationships, prospecting ability, and reach of the intermediary.

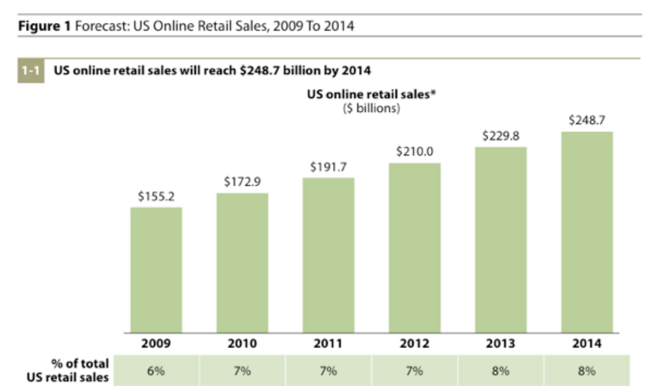
Eliminating these burdens would be beneficial to issuers across the board. Replacing the current deal structure of issuer-investment banker-purchaser with an issuer-portal-purchaser model would remove much of the burden of intermediation. Issuers and buyers would be directly linked through a neutral matching system, the “funding portal” as envisioned by the JOBS Act.

The SEC has announced intention to foment regulation that would specify that to qualify as a funding portal, an entity must not:

- provide investment advice or make recommendations; solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;
- compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
- hold, manage, possess, or otherwise handle investor funds or securities; or
- engage in any other activities the SEC determines to prohibit in its crowdfunding rulemaking.

If the SEC in fact rules thus then funding portals will have to adhere to a fixed fee for service revenue structure and services offered will be limited primarily to listing and matching service much as those in the real estate sales industry. The results will be generally reduced transaction costs by eliminating broker success fees and elimination of agency issues introduced by intermediation since the portals will not be allowed to participate in deal structuring nor negotiation. Because of these benefits small issuers will tend to leave investment bankers and migrate to the funding portals.

Also, because of these benefits there will be some pressure from larger issuers to eliminate, or at least increase the $1 million cap.



Source: Forrester Research

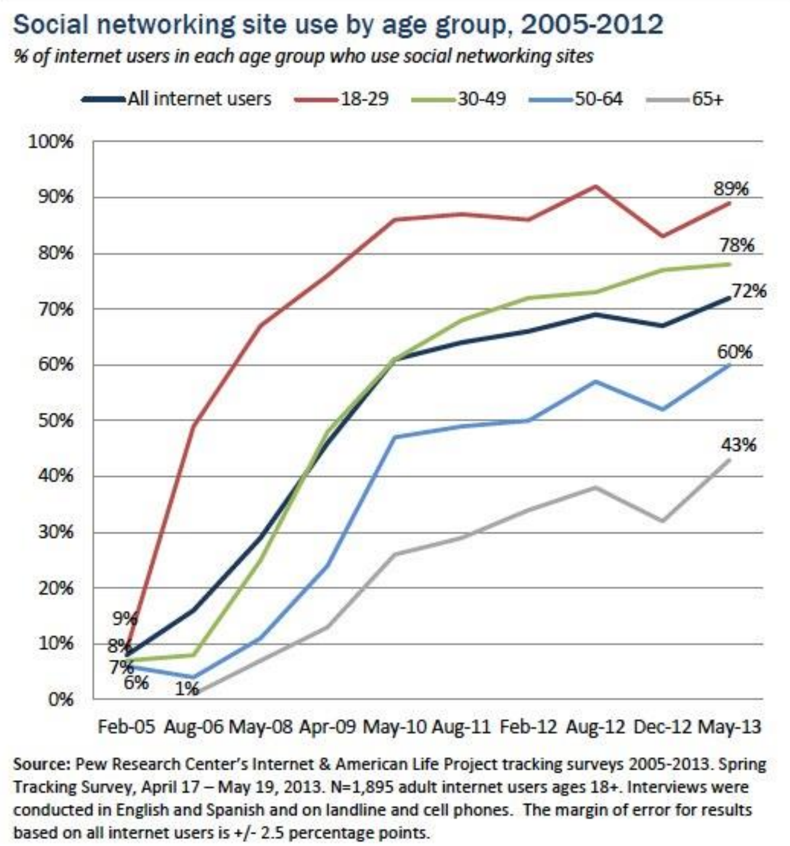
Such disintermediation, driven by free internet trading, has already occurred in the retail and public securities trading industries. According to Forrester Research, approximately 8% of retail sales occur through the internet, bypassing the brick and mortar purveyors. That may not seem like a lot, but remember it was zero in the early ‘90’s. So in a little more than 20 years the internet share of retail sales has climbed from nothing to $230 billion. In addition, the presence of retailers on the internet significantly influences purchases in the brick and mortar world. A recent survey by Accenture indicates that 65% of U.S. shoppers will browse online to identify and price purchases and then buy in store over the holidays.

Another, and closer, example of disintermediation is that of public equity investing. Organizations such as Charles Schwab, ScottTrade, ETrade, MerrillEdge and the like have established themselves as direct to purchasers sources for public company securities and other financial instruments, bypassing, in some cases their own, in the field retail investment representatives.

Influence of the web social ecosystem

One of the necessary conditions for a successful investment transaction is mutual trust not only between the buyer and seller, but among the buyer, seller, and intermediary if any.

Traditionally issuing and acquiring companies consistently have gone to bankers with whom they have had ongoing relationships, mostly personal, between the bank's executives and the issuer's executives.



This is the proverbial "good ol' boys" network. A recent paper analyzing the characteristics of relationships between firms and their investment banks ("The Changing Nature of Investment Banking Relationships", Shane A. Corwin and Mike Stegemoller, April, 2013) found that, while the nature of these relationships were changing in that "…firms have increased the number and decreased the exclusivity of their IB relationships…", across all types of transactions, still banks that participate in a given transaction for a given firm also participate in a following transaction with the same firm within a three-year period more that 65% of the time. This indicates the importance of personal trusted relationships in such transactions.

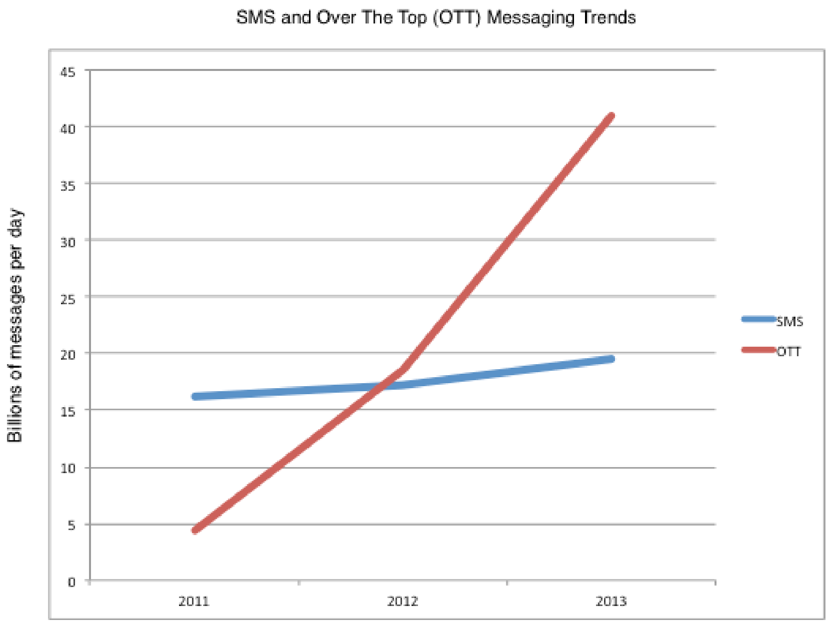
In the past, people could only establish such relationships through face-to-face interaction. However, the emergence of social networks (Facebook, Twitter, MySpace, etc.) has created among certain age groups, the ability to establish trusted relationships through the internet without face-to-face contact. A study by the Pew Research Center's Internet and American Life Project predicts social networking site usage increasing by May of 2013 to 89% of internet users between 18-29, to 78% for internet users between 30-49, and to 72% for all internet users (see above). Another critical part of this online relationship formation is instant information exchange (text messaging especially).

Instant information through texting, and other instant messaging means provide immediate situational awareness and the ability to carry out complex transactions among the members of the online community, whether those transactions are social or commercial. According to Informa, instant messaging and OTT (messaging provided by separate applications) has grown in the last

- *Reported by CTIA in December 2009, the 286 million US mobile subscribers sent 152.7 billion text messages per month, for an average of 534 messages per subscriber per month*
- *Pew Research Center found in May 2010 that 72% of U.S. adult cellphone users send and receive text messages*

couple of years to nearly 20 billion instant messages sent and over 40 billion OTT messages sent (see below).

Such users trust transactional partners such as Amazon, Charles Schwab, eBay, Quicken, and many others despite not meeting any of them face to face. This group has come to depend on online feeds to provide them with instant information both social: "Where are my friends?", "What are they doing?", "Can I join them?"; and commercial: "What products are available?", "What is the price?", "How soon can I get them?".



Source: Informa, May 2013 (https://commerce.informatm.com/reports/main/voip-ip-messaging-revised.html)

To complete the picture, these social networkers have accepted a broad array of advisors, teachers, and mentors through the medium of electronic delivery: online universities (University of Phoenix, Kaplan, DeVry), a myriad of online continuing professional education and professional certification programs,

Using a combination of technologies this group has created and come to expect a connected community of trusted friends, providers, and advisors which has a global reach and can provide monumental volumes of information just for the asking. When they become the current crop of investors, investment bankers, and corporate financial managers, they will expect the same facility in their financial environment.

Selection of regulatory venue

Once private securities trading exists on the world-wide web it immediately has a global reach. The fact that private securities transactions can be performed through the web gives that market the ability to headquarter anywhere in the world. As we saw after the passage of Sarbanes-Oxley, financial transactions tend to migrate toward the venue which offers more flexibility, less regulation, and less cost. After SOX, US initial public offerings dropped significantly while the number of US companies coming out in foreign markets increased, at least partly in response to increased regulatory restrictions. Private security trading will tend to do the same and will tend to congregate in the regulatory venue that offers the least restrictions. If the US SEC insists on limiting the online private trading organizations' markets and offer limits then portals will tend to settle in other, less restrictive, regulatory venues while depending on the universality of the internet to reach American investors.

However, current SEC regulations require broker-dealer operations physically located within the United States to register and the SEC also generally compels registration by foreign broker-dealers that induce or attempt to induce trades by any person in the United States (except foreign persons temporarily present here).

Paragraph (a)(1) of Rule 15a-6 exempts from broker-dealer registration any foreign broker-dealer to the extent that it effects transactions in securities with or for persons “that have not been solicited by the foreign broker-dealer.”

So, despite some easing of restrictions from the JOBS bill, immediate efforts to globalize US private securities offerings still will be thwarted by the current remaining regulatory authority. However, the globalization of financial activity will continue to press US regulators to relax restraints on private sector capital formation. In its 2012 report “THE LIBERALIZATION AND MANAGEMENT OF CAPITAL FLOWS: AN INSTITUTIONAL VIEW”, the International Monetary Fund noted a gradual increase in the openness of capital flows among both member and developing countries. “In recent decades, there has been a gradual trend toward liberalization of capital flows, both inward and outward, among member countries.” While liberalization of cross-border capital flows (including private equity investments) declined significantly in the face of the 2008-2012 global recession, the general trend has been a definite loosening of what the Fund calls “capital flow management measures” (regulation of capital markets by each country). This trend will resume and continue as world economies rebound.

Addressing information asymmetry

One of the major issues the Securities and Exchange Commission regulatory discipline aimed to address at inception was that of information asymmetry in securities transactions. When the SEC was created in 1933 it was particularly difficult for investors wanting to purchase securities to discover any information regarding the securities or the companies behind them. Such information as was available typically came from the issuer itself and might or might not be accurate or complete and might in some cases be outright fraudulent. It’s well accepted by economists that transactional information asymmetry, the case in which one participant in the transaction holds most of the cards, can lead to severe misappropriation of resources.

To address these concerns in regard to publicly traded companies in the US, the SEC requires all public companies to follow a strict public reporting regimen. Each publicly traded domestic company is required to file with the SEC periodic reports disclosing financial, organizational, executive compensation, and ownership and change of ownership data. These reports, the 10Q, 10K, 8K, etc., are available to potential investors through the SEC’s Electronic Data Gathering, Analysis and Retrieval (EDGAR) system giving them a fairly complete picture of the reporting company’s situation.

Unfortunately this is not the case for privately-held companies whose issues are exempt from SEC filing. Under various exemptions smaller issuers are not required to register with the SEC nor make public such information. However, commonly such issuers must provide prior to a securities transaction, a document (usually a private placement memo or PPM) containing such information to prospective purchasers. In general, although they don’t report to the SEC, private issuers are subject to the same standards of full disclosure and to the same civil and criminal penalties in the case of bad acting as public issuers.

The primary emphasis of investor protection within the securities trading market is the principal of “full disclosure”. According to the SEC:

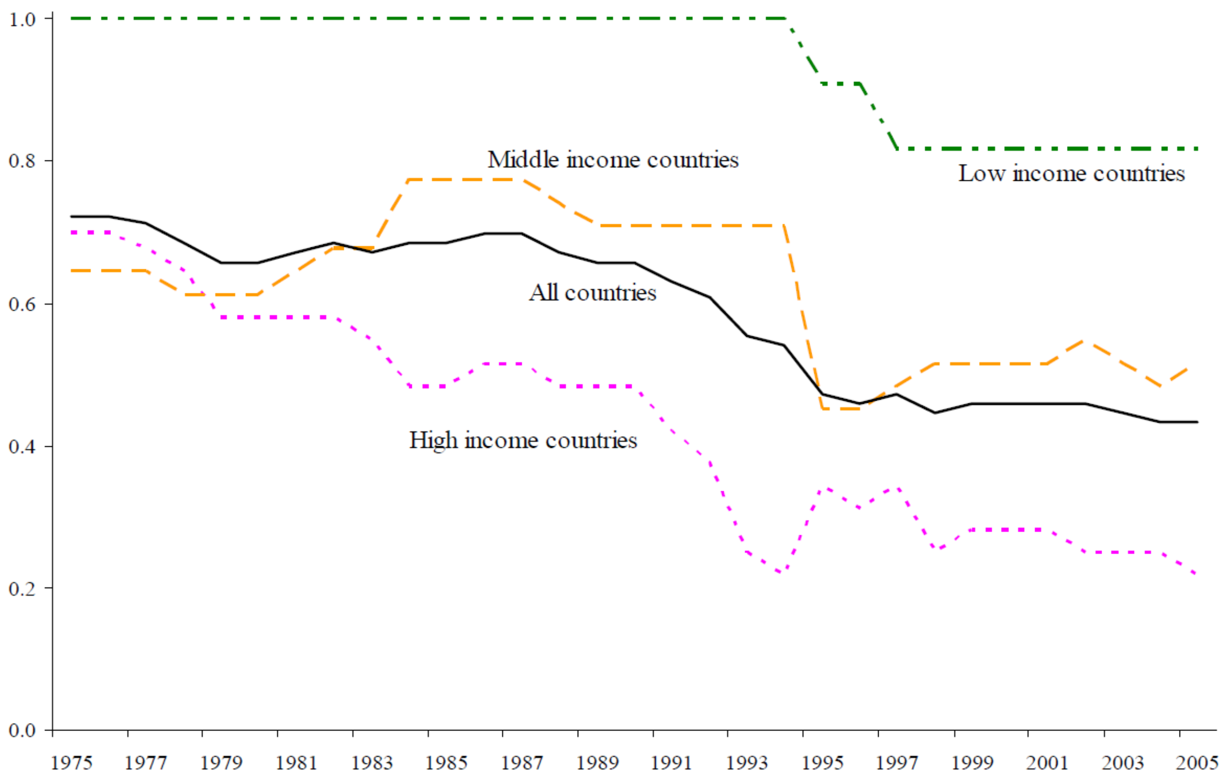
> *“The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it.”*

The bottom line is that there should be a similar level of due diligence information available to investors whether the offering company is public or private. Lack of this information should be taken by investors as a glaring red flag and investors should avoid such transactions as a matter of personal preservation.

Additionally, as we saw above, more and more personal and corporate information is becoming available through the working of the global social networks established through the internet.
Finally, post facto penalties for non-disclosure or fraud in securities transactions in the US are the same whether the issuer is a public company or not. These penalties are intended to deter withholding or falsification of information regarding securities issues.

Financial globalization

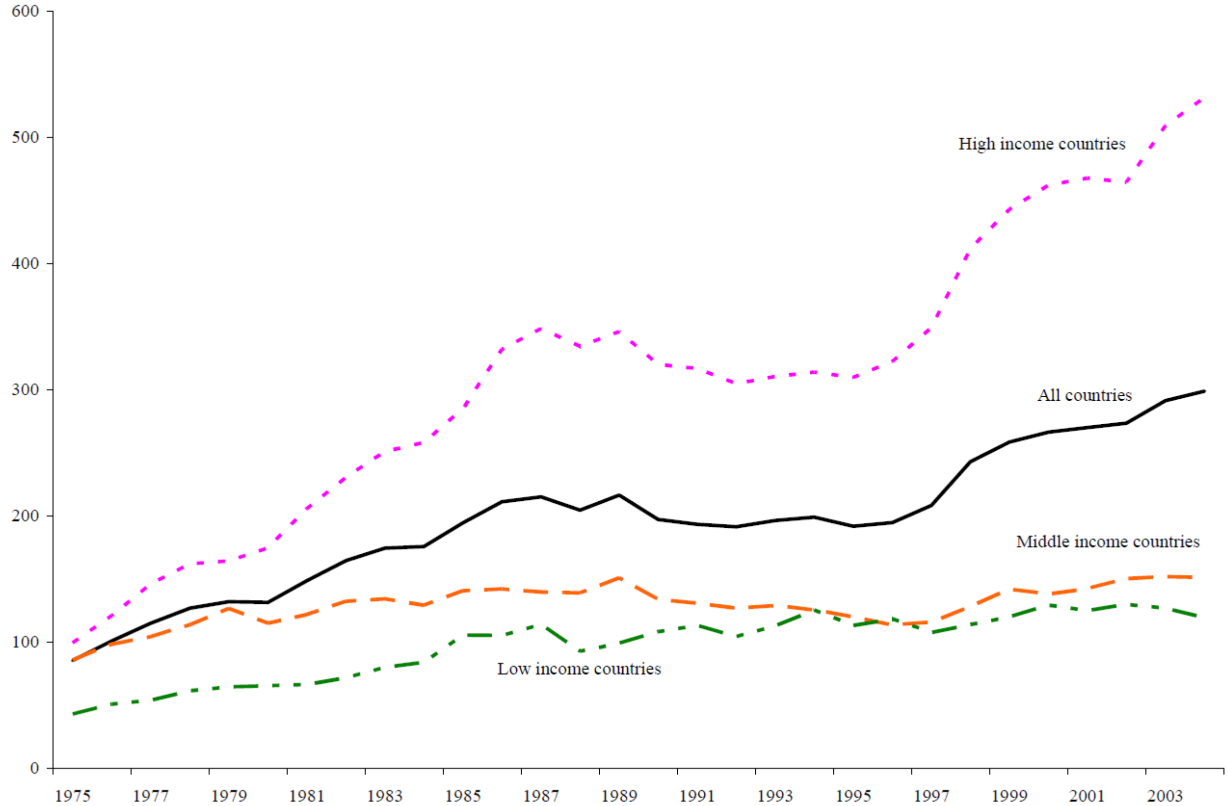
Capital Controls by Financial Openness and Income Group, 1975-2005



Source: Reaping the Benefits of Financial Globalization, International Monetary Fund, 2007. (note: The metric used here is the IMF Capital Controls Index, a lower index indicates more relaxed control)

The final trend bearing on the inevitability of global crowdfunding is that of the general liberalization of each country's financial regulatory system. Based on the IMF's binary capital controls indicator, an index measuring relative openness of a country's capital control regime, the above graphs show a definite trend toward more open flows of capital among countries, especially among high income countries such as the US and countries in the EU.
This general increase in *de jure* openness has helped to increase capital flows among countries as measured by external assets and liabilities as a percent of GDP (below).

Gross External Assets and Liabilities by Income Group, 1975–2004
(In percent of GDP)



Source: Reaping the Benefits of Financial Globalization, International Monetary Fund, 2007.

What are the benefits of financial globalization? According to the IMF staff (Globalization: A Brief Overview, 2008):

> *"There is substantial evidence, from countries of different sizes and different regions, that as countries "globalize" their citizens benefit, in the form of access to a wider variety of goods and services, lower prices, more and better-paying jobs, improved health, and higher overall living standards."*

In the future, the prospect of capturing these benefits nationally and individually will continue to put downward pressure on each individual county's regulatory restrictions on direct foreign financial trading. Such artifices as the American Depository Receipt will tend to fade away in favor of direct trading.

Once again the world-wide reach of the internet and the electronic social ecosystem will encourage trade globalization including financial transactions. Investors who are used to buying goods online internationally will not be long satisfied with being restricted to strictly domestic financial transactions.

Bottom line

So many and powerful domestic and global forces are lined up to push for the free and direct trade of corporate securities world-wide. The internet is the most rational forum for this to occur given its global reach and the facile presentation and information capabilities of existing internet technology.

Globalization of finance – Studies pointed out by the International Monetary Fund indicate that world-wide countries are relaxing their capital exchange controls regimens. There are significant differences among the various country income classes but all are in general decline long-term. At least partly because of this decline, external assets and liabilities ownerships for each of the income groups increased significantly over this period. The primary drive for both of these trends is the perception that such financial openness boosts living standards. Certainly open and universal crowd-funding can be a major contributor.

Transaction cost reduction – By eliminating intermediaries in the transaction process, issuers and investors eliminate intermediaries' fees. Even though crowdfunding portals interject fees into the process, these costs will be quite a bit lower than those charged by investment bankers. In fact, under full, free direct investment, it will be possible for issuers to solicit and consummate transactions on their own without portal intervention. In either case issuers will tend to eliminate agency costs arising from differing objectives between themselves and the bankers in either case.

Influence of online social communities – There is little doubt that the internet-based social ecosystem is here to stay. One of its effects is to build among potentially geographically separated individuals, communities of trust. Future investors, those that are used to purchasing goods online and trusting these vendors, will want the same facility and community of trust when they begin investing in securities. In fact, these communities exist in the public investing world. Future investors will begin to press for this convenience and freedom in the private securities arena.

Time saving – Both by eliminating intermediaries and allowing direct transaction negotiation, securities crowdfunding will save time for the issuer and for the investor. In an age in which the claims on a business person's time multiply significantly each year, this can be a powerful influence.

Abundance of public information – The ultimate argument for maintenance or increase in regulatory control of capital markets in the US has always been the protection of the investor. By that regulators mean to force information symmetry in securities transactions. In the past this has taken the form of regulations providing for rescission, civil penalties, and in some cases, criminal penalties in cases where there was not full disclosure by the issuer or even there was outright purposeful fraud.

Global reach of electronic trading – Because internet-based transactions have a global reach, those countries that insist on maintaining a restrictive capital control regime will see capital transactions start to migrate to other countries having less rigorous controls. There was some evidence of this effect in the US following the imposition of Sarbanes-Oxley. Many initial public offerings (IPO's) that normally would have taken place in the US markets instead migrated to the AIM market in London, the Scandinavian exchanges, the Canadian exchange, and others.

For these reasons: financial globalization, growing presence of internet-based communities, more general availability full disclosure information, availability of significant transaction time and cost reductions, general economic benefits of relaxed capital regulation, there is and will continue to be pressure on national regulators in all countries to allow unrestricted securities trading online.