

Comment on Key Provisions of the Proposed Crowdfunding Prospectus Exemption

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These comments are prepared with the aim of applying our research to the Ontario Securities Commission's proposed crowdfunding prospectus exemptions. We are encouraged by the progress in creating guidelines for crowdfunding, and we believe the general structure of the guidelines should enable equity-based crowdfunding to succeed in Ontario. Our research papers, "Some Simple Economics of Crowdfunding" and "Crowdfunding: Geography, Social Networks, and the Timing of Investment Decisions," examine many issues related to the motivations of entrepreneurs and funders on crowdfunding platforms. Below we highlight three areas in which our research informs suggested changes to the proposed crowdfunding prospectus exemptions: (i) A false sense of risk spreading, (ii) Enabling lead investors, and (iii) Experimentation and competition between platforms.

I. False Sense of Risk Spreading and Reduction

We believe two aspects of the exemption might lead investors to perceive crowdfunding investments as safer than they actually are:

1. *"An investor is not permitted to invest more than \$2,500 in a single investment, or more than \$10,000 in total under the exemption in a calendar year" (OSC 2014).*
2. *"There is a \$1.5 million limit on the aggregate amount that can be raised under the exemption by the issuer group in a specified time period" (OSC 2014).*

These two restrictions aim to reduce the downside risk from the failure of a single venture. We worry that the first provision, intended to encourage diversification, may lead to a false

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sense of security from an investor's perspective. Early-stage financing is very risky, and the chance of losing all the invested money given four investments remains extremely high. In order to assist funders, diversification rules may be implemented that mirror that of the Crowdfund Act (S.2190), where funders may not invest more than 10% of their annual income or net worth and are capped at \$100,000 for any single investment opportunity (Agrawal, Catalini, and Goldfarb 2013, pp.26-27). Such provisions may be more suitable to match the risk trade-offs for different funders.

With a cap per investor in place, the benefit of limiting the total amount raised is restricted. It constrains the potential of crowdfunding platforms to fund truly innovative but capital intensive projects without reducing the risk to individual investors. While a large failure would increase media attention, it would not substantially change the risk to individual investors. One possible middle ground is to have funding tied to the achievement of measureable milestones, which should be outlined in a business plan (Agrawal, Catalini, and Goldfarb 2013, pp.18-20).

II. Enable Lead Investors

Lead investors play an integral role within crowdfunding. In our paper *"Crowdfunding: Geography, Social Networks, and the Timing of Investment Decisions,"* we uncover that concentrated involvement from these funders at the early stages of funding influences the success of crowdfunding campaigns (Agrawal, Catalini, and Goldfarb 2014, pp. 3-5). The crowdfunding exemption under "Distribution Details - Types of securities," states: *"All of the securities offered in a crowdfunding distribution must have the same price, terms and conditions"* (OSC 2014). Our research suggests the contrary. Free riding does exist within these platforms, and proper mechanisms are required to assist in muting its effect. Having different prices may enable the firms to reward first movers and mute the collective action problem. This may provide a solution to coordination failure (Agrawal, Catalini, and Goldfarb 2013, pp.31). Early funders generate a valuable signal for later ones through accumulated capital (Agrawal, Catalini, and Goldfarb 2013, pp.31), and incentivizing information revealing by individuals with access to offline information about the entrepreneurs (and a motivation to perform due

diligence) may lead to more effective markets. An example of such a market design feature is “syndicates and backers” on the San Francisco-based platform AngelList, which enables the lead investor to charge subsequent investors a carry on future returns.

III. Experimentation and Competition Between Platforms

While it is projected that more than one platform initially will arise, the potential monopolization of the industry will depend upon the cost of participating in numerous platforms and whether specialized features increase value to users. At this early stage in the evolution of the market for crowdfunded equity capital, it is difficult to predict whether the market will converge on a single platform. Regulation should provide platforms with the flexibility to experiment with a wide range of features, services, and business models (Agrawal, Catalini, and Goldfarb 2014, p. 1). Regulators, platform operators, investors, and issuers all will learn a great deal through competition in this market. While many platforms may fail, it is only through diversity that the most effective market structure will arise. This point is not specific to any particular aspect of the proposed guidelines. We include it as a reminder of the continued uncertainty about the best business models in crowdfunding and the need to support experimentation in the industry’s primary stage.

References

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