Preparing for the chaos of equity crowdfunding

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Equity crowdfunding is not yet legal, but when it is, expect a period of "chaos" before those involved learn how to make the most of its benefits and minimize its risks, say University of Toronto researchers.

"There's no question that there will be fraud and that some investors will lose money, but that's true in every market. This is a new market and we suspect there will be a steep learning curve for all participants – entrepreneurs, investors, crowdfunding platforms, and regulators," says Ajay Agrawal, an associate professor of strategic management at the University of Toronto's Rotman School of Management who has written a paper on the topic with two other Rotman researchers.

The paper, to be included as a chapter in an upcoming volume published by the Boston-based National Bureau of Economic Research, is aimed at U.S. policy-makers as they continue to consider regulations that will govern equity crowdfunding.

While mainstream media news stories have often painted equity crowdfunding as either a panacea for struggling business start-ups, or a dangerous financial threat, the paper seeks to lay out a reasoned framework to assess its potential risks and benefits.

"Our objective was to put some structure around this innovation in financial markets," says Agrawal, who wrote the paper with Christian Catalini, a Rotman PhD student, and Avi Goldfarb, a professor of marketing. "It's not often that we get a chance to speculate on the advent of a new market. It's exciting."

There are already more than 200 non-equity crowdfunding platforms, which allow people to financially contribute, often in small amounts, to another individual or group's project via the internet, either as a donation or in return for a reward. Projects range from disaster relief to technological Inventions to artistic works.

But U.S. regulators have moved cautiously on allowing the mechanism to be used to raise business capital, currently limited to only accredited Investors. The Obama administration's Jumpstart Our Business Startups (JOBS) Act In 2012 paved the way for equity crowdfunding but is still awaiting regulations to be set by the Securities and Exchange Commission (SEC) to open the market to anyone.

Despite regulators' best efforts, equity crowdfunding will experience inevitable growing pains, says the Rotman paper, and many of these may be solved by the market itself, through innovation.

Setting mechanisms that would make entrepreneurs face costs for fraud, incompetence, and creating unrealistic expectations; and making it easier for funders to learn about entrepreneurs and companies that interest them will also help mitigate potential risks, it says.

Nevertheless, "a fool and their money are quickly parted in any setting," says Agrawal. "It feels like we are being far more protective of people making mistakes buying small amounts of equity through crowdfunding than we are of people making mistakes buying other goods and services on the internet that are sometimes fraudulent, of lower-quality, or overpriced."

More information: www.nber.org/papers/w19133

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