An Introduction to Crowdfunding

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Markets for crowdfunding have experienced rapid development and significant growth in recent years. While they were barely known to a broader audience until recently, they have now developed into a multi-billion dollar industry worldwide, including various types of financing and securities markets. The key feature of crowdfunding markets is that they lack any form of traditional financial intermediation. This is characterised by a financial institution such as a bank that is responsible for screening and monitoring and has the right incentives in place to act in the capital providers' interest by having, for example, sufficient skin in the game through a substantial portion of a loan on its books.

In crowdfunding markets, by contrast, individuals directly finance other individuals or companies, without an intermediary. Suppliers of crowdfunding services regularly describe themselves as platforms that do not undertake a genuine risk assessment or take any risk in the project to be funded.

This raises the important question of why individuals or companies prefer to be directly financed by other individuals rather than using traditional financial services. One reason, the more benign one, would be that they dislike traditional financial institutions, including their transactions costs, and would rather receive financing directly from sympathetic individuals. A less benign reason could be adverse selection, i.e., crowdfunding markets may only serve those in need of financing who have been rejected by traditional financial services and are now desperately seeking a lender of last resort. In the latter case, the expected default rates in crowdfunding markets would be significantly higher than those for companies with traditional financial service providers.

The substantial growth of crowdfunding markets is significantly driven by the public availability and verifiability of information for the screening process of those individuals or companies seeking external financing. To put things into perspective, an industry report states: "Global crowdfunding experienced accelerated growth in 2014, expanding by 167 percent to reach USD 16.2 billion raised, up from USD 6.1 billion in 2013. In 2015, the industry is set to more than double once again, on its way to raising USD 34.4 billion." (crowdsourcing.org 2015).

The significant availability and growing pool of capital from crowdfunding has attracted lively political and regulatory interest. On the one hand, policy-makers see crowdfunding as a promising opportunity to provide a financing source, particularly for small and medium-sized enterprises, many of which would otherwise suffer from financing restrictions. In the United States, this interest has led to strong bipartisan support for the creation of the "Jumpstart Our Business Startups (JOBS) Act", signed by President Obama on April 5, 2012, which legalised crowdfunding by authorising SEC-approved[2] portals for companies enabling them to seek funding from anyone. Crowdfunding could thus have the potential to fundamentally change the investment and financing process, as well as to provide greater transparency. On the other hand, regulators are concerned about the potential threats to investor protection in the absence of a regulated financial intermediator in charge of the screening and monitoring process. The Consumer Financial Protection Bureau (CFPB) states, that crowdfunding markets "could have significant implications for consumers seeking alternative sources of credit" particularly in the form of online lending in peer-to-peer transactions (USGAO 2011, 56). One major concern that has been stated by numerous regulators and academics is that investors could be taken advantage of by unscrupulous lenders.

The academic literature on this topic has analysed the market for crowdfunding with growing interest. However, despite the growing importance of crowdfunding markets and their perception as markets of the

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[2] SEC = United States Securities and Exchange Commission.

future, our understanding of their functioning is still limited. Clearly, they differ from traditional markets, specifically due to the lack of a formal intermediary. Important questions include: How does the lack of financial intermediaries affect market outcomes? Which incentives on the part of the agents involved merit specific attention? Which externalities have to be considered? How does the interplay between sophisticated and unsophisticated investors, as well as the demand and supply side, evolve? Which type of regulation is needed, and how does the existing regulatory framework in different countries take into account the specific characteristics of these markets?

Answers to these questions provide an important step towards a better understanding of the functioning of crowdfunding markets. The papers in the current CESifo DICE Report 2/2016 deal with various aspects of crowdfunding and provide answers to some of the questions above. These papers are briefly summarised here and put into perspective in terms of the general context.

In their paper entitled "Understanding the Strategies of Crowdfunding Platforms" Paul Belleflamme, Nessrine Omrani, and Martin Peitz view crowdfunding platforms (CFP) as two-sided platforms for coordinating the supply of (funders) and demand (fundraisers) for capital. While positive external effects can be expected to exist between the magnitude of these two groups in both directions, the authors argue that these external effects are more complex, giving rise to the existence of CFPs ("why"). In particular, the cross-group external effects of more fundraisers on funders may not always be positive, particularly in cases where a larger number of projects on a platform a) reduces the likelihood of these projects being funded and thus of proving successful or b) increases the level of information asymmetry. Furthermore, the within-group external effects of fundraisers may turn negative, as an increase in the number of fundraisers could reduce the likelihood of each single fundraiser receiving funding. CFPs thus have to define strategies to capture the value they create for their users ("how"). This can take the form of price strategies, i.e. by charging only fundraisers, or non-price strategies, i.e., by making fundraisers use "All-or-Nothing" offers to induce them to set realistic funding targets, or by bringing in sophisticated funders to take over the role of information verification, similar to that of a bank in a regular lending transaction.

In her paper entitled "Securities Crowdfunding and Investor Protection" Joan MacLeod Heminway addresses the concern of fraud in crowdfunding markets and the resulting response of protective regulation. She begins by defining crowdfunding "as a method for financing businesses or projects that involves soliciting and securing funding from a broad, disaggregated mass of potential funders, typically through the internet." The author subsequently argues that different types of regulation are needed for different types of crowdfunding (donative, presale, reward, securities, and investment crowdfunding). Focusing on crowdfunding securities, Heminway argues that the regulation of crowdfunding follows the regulation of securities in the form of "mandatory disclosure, liability for fraud, misstatements, or omissions, or substantive regulation as investor protection tools" and points to the various sets of rules and their priorities in various countries.

Lars Hornuf and Matthias Schmitt, in their paper "Success and Failure in Equity Crowdfunding", concentrate on equity crowdfunding as a relatively new phenomenon among the various types of crowdfunding, with a particular focus on Germany and the United Kingdom. They find that the failure rates for crowdfunded ventures in Germany do not exceed those of startups in general, suggesting that these ventures cannot be regarded as classical lemons. They also highlight certain forms of staging whereby investors can retain control over the use of funds. Furthermore, the authors argue that venture capitalists and angel financiers use the outcome of crowdfunding processes as a valuable signal for their own investment decisions. Overall, exits have not been overly promising to date, which suggests that the returns for a well-diversified investor would be negative to date in Germany. While this evidence stands in contrast to that of positive returns in the United Kingdom, it casts some doubt over the long-term growth and viability of these markets in Europe.

In their paper "A Case of Regulatory Evolution – A Review of the UK Financial Conduct Authority's (FCA) Approach to Crowdfunding" Robert Wardrop and Tania Ziegler describe the regulatory treatment of crowdfunding in the United Kingdom, Europe's market leader. The FCA differentiates between four types of crowdfunding activities, including loan-based and investment-based crowdfunding, and three types of investors, including sophisticated and ordinary investors, and allows platforms to provide their services only to certain types of investors. The authors conclude from current feedback from industry participants that the existing regulation is working effectively.

Finally, and related to Wardrop and Ziegler, Armin Schwienbacher's paper "Crowdfunding and the 'Alternativfinanzierungsgesetz' in Austria" focuses on the specific regulation of crowdfunding in Austria that was implemented in 2015, describing the various facets of this regulation and its application to crowdfunding ventures in Austria. He points out that national regulation may soon reach its limits as platforms become pan-European or even more international, calling for even broader regulation. Similarly, opportunities for regulatory arbitrage may arise and lead to the same need for international harmonisation.

References

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