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Will crowdfunding help start up the economy?

BY ANDREW SHENG THINK ASIAN

It is now the buzzword for raising funds for start-ups

THE New Year has started with such gloom and doom in financial markets, that everyone thinks that start-ups may be the future of jobs and growth.

But we all agree that small and medium enterprises (SMEs) which are the major providers of jobs in any economy, are also typically long on passion and short of cash and funding.

Conventional stock markets raise funds for large corporations and it takes a long track record in earnings and reputation before SMEs can find the sponsors and the funding to list in the stock markets.

Crowdfunding is now the buzzword for raising funds for start-ups, but until recently, it was illegal under the law to raise equity (in the form of tradable securities) from the public (beyond a small limited number of partners) unless approved by the securities regulators.

That process is not only costly but complicated for SMEs to manage.

Crowdfunding became popular in the US when website platforms started to raise money for charities (and for political donations) in small amounts from the public.

The definition of rich enough is defined as someone with an annual income of US$200,000 (US$300,000 including spouse income) and whose net worth (excluding primary residence) including spouse is more than US$1mil.

In Hong Kong, the broad definition of a professional investor is one with net assets of over HK$8mil. With crowd-funding, however, the door is now wide open to anyone to invest in these start-ups. So how can the SEC protect investors? The protection is again two-fold.

The first is telling investors how to judge how much they can risk investing in these assets. The second is to ensure that the crowdfunding platforms are actually run by broker-dealers or funding portals regulated by the SEC or the Financial Industry Regulatory Authority.

Like the definition of accredited investors (www.sec.gov), each crowdfunding investor should learn how much they can afford to invest during any 12-month period. The investor is subject to both an income and wealth test.

If the income or net worth is less than US$100,000 (excluding primary residence), then they can invest within one year up to US$2,000 in the crowdfunding security or 5% of the lesser of annual income or net worth. If the annual income or net worth is more than US$100,000, then the investor can invest up to 10% of annual income or net worth, whichever is lesser, but not to exceed US$100,000. Since the crowd-funding portal or broker dealers are regulated, the chances of fraud are reduced but are not zero.

The US Securities and Exchange Commission (SEC) has this week approved with effect from May 16, 2016, that companies may use crowdfunding to offer and sell securities to the investing public. This revolutionises the access of SMEs to funding and also investors being able to take equity in start-ups.

Traditionally, start-ups get their equity from family and friends.

With the arrival of the Internet, some enterprising start-ups try to access capital from strangers from the crowd, whilst other platforms look to become the "start-up exchange" to help SMEs crowd-fund their activities.

The risks of investing in such unregulated platforms are two-fold – the possibility of investing in fraudulent companies and also being cheated by the platform. Unregulated P2P platforms in China are now shutting down and losing investor trust because quite a few are scams.

To protect the public, the SEC generally bans companies and private funds from offering or selling securities unless the transaction has been registered with the SEC or an exemption from registration is made. Exemptions are only made to certain securities, such as hedge and venture funds with higher risks, if the investor is an "accredited investor".

This means that if the investor is rich and experienced enough, he or she would be allowed to buy these exempt funds or securities, because the principle of "caveat emptor" or "buyer beware" fully applies.

Policymakers throughout Asia pay a lot of lip service on the need to help nurture SMEs, but the record is so far uneven.

Throwing money at the problem is not the right answer.

The reason is that there is terrible shortage of skills, not just in the market place, but even less at the official and bureaucratic levels, of understanding the real difficulties that start-ups face.

Cutting back the barriers to SME success needs a concerted effort from different agencies, departments and regulatory hurdles, but also mobilising skills from academia, business associations and civil societies.

If we don't get the energies of our youth in start-ups, are we surprised that they are channeling their energies in the street or fighting for different causes?

Crowdfunding is not the be-all and end-all of helping SMEs, but the SEC guidelines are a good start.

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Companies or start-ups cannot access crowd-funding directly from the public but must use the regulated portals or broker-dealers. Furthermore, to safeguard themselves, crowdfunding investors are advised to understand the high risks involved and to do their homework thoroughly in researching and understanding what they are buying or investing in.

The investors need to understand fully their speculative risks, illiquidity, cancellation restrictions, difficulties of valuation, limited disclosure and information, fraud, lack of professional advice, and most of all, that they are betting not on assets, but on individuals or teams.

Young start-ups often make many mistakes, technical, legal and basic management of people and talent. Thus, risks in these assets could be very high and the chances of success are not great. But some start-ups do make it big.

The good news is that once SEC takes the lead in clarifying the rules for crowd-funding, other regulatory agencies in Asia will be able to adapt these rules to help create the local eco-system for crowdfunding.

Last year, the Malaysian Securities Commission published guidelines to facilitate equity crowdfunding. The Hong Kong Securities Commission has also consulted on the subject in 2014, but has yet to introduce specific laws or regulations applicable for crowd-funding.

The real issue about start-ups is actually finding the right expertise to coach them on how to make their ideas and ventures more commercial, professional and fundable. This is highly intensive work, which is currently not taught in universities, but mostly learnt on the job.