Can We All Participate in The Next Unicorn?

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The full article may be accessed here.

Central Issue of the Paper

Unicorns is a term used to describe private venture-capital backed startup firms valued at over $1 billion. Stanford (2015) reports that 2015 may well be remembered as the year of the unicorn.

The results from unicorn investing are of relevance in light of the new rules regarding crowdfunding. One can look at the experience from the 2015 unicorns and infer what may happen for investors who are early stage investors under the new rules. On October 30, 2015, the Securities and Exchange Commission (SEC) approved rules that allow all investors to invest and receive equity stakes in startup businesses via crowdfunding. For the very first time, private company issuers are able to solicit investments in their securities using public advertising, and permit investment by both accredited and non-accredited investors.

The possibility of non-accredited investors participating in equity-based crowdfunding began with the passage of the 2012 Jumpstart Our Business Startups Act (JOBS Act). This latest SEC rule change under the Title III portion of the JOBS Act opens the way for private startup companies to raise money from a wide range of investors in return for equity or other securities.

With the passage of the Title III portion of the JOBS Act, this paper tries to address a very critical question: can non-accredited investors find and invest in the next unicorn?

Approach Employed by Paper

By examining the performance of the 144 unicorns listed in The Wall Street Journal (WSJ), they show why non-accredited investors will be interested in investing in startup firms. They examine unicorn investors to determine who has been the most successful in picking unicorns and from those results they infer how non-accredited investors might fare as they invest in startups. The new rules have only recently seen implementation, so only time will tell whether investors can indeed find the next unicorns. In addition, they examine what might be the best strategies for non-accredited investors to use equity crowdfunding and how equity crowdfunding may be tweaked to create a better investing environment.

Equity crowdfunding and its success will be measured based on the returns investors receive from their investments. The United Kingdom (UK) has had a longer history then the US with equity crowdfunding that started with the crowdfunding site, Crowdcube in 2011. Similar to changes sought by the JOBS Act of 2012, equity crowdfunding in the UK was started to grow the funding of small and medium sized enterprises. AltFi Data [2015], a data aggregator of equity crowdfunding, published a report on equity crowdfunding from 2011 through June 30, 2015 using the five most significant online platforms based on origination volume. These include Crowdcube, Seedrs, SyndicateRoom, CrowdBnk and Venture Funders. There were 431 investment crowdfunding rounds from 367 companies. The UK report indicates that crowdfunding has revolutionized the funding of small and medium sized enterprises involving both professional and small retail investors. It is reported that 62% of crowd funding investors describe themselves as retail investors with no previous investment experience.

Findings of the Paper

The paper showed the reward for early stage investing is the potential for large returns, but one of the problems of early stage investing is the potential for fraud because the non-accredited investors lack experience. Other issues associated with equity crowdfunding are the lack of liquidity and the risk. To reduce the exposure to risk, the SEC is limiting the amount of funding a non-accredited investor can deploy, but there is still the illiquidity issue.

Since non-accredited crowdfunding has not yet started in the US, it is too early to tell how popular equity crowdfunding will be with non-accredited investors and whether fraud will be an issue. Examining the UK experience, equity crowdfunding is growing and it appears it will change how small companies will capitalize themselves. Since non-accredited investors don't have experience investing in private companies, US equity crowdfunding platforms should follow the lead of UK platforms and allow non-accredited investors to co-invest with accredited investors. Given that one of the goals of the JOBS Act is to create job growth, the US may want to consider giving a tax break to investors that invest in startups similar to the UK. Another example would be the Shanghai market where Jie, Areddy, and Areddy [2016] report that to spur investment firms to take more risk on early stage tech startups, the Shanghai market is offering subsidies of up to 30% to 60% of financial losses incurred by investors. As mentioned, time will tell all, but for now it seems to be off to a good start.