The Promise and Perils of Crowdfunding

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Crowdfunding -- raising many small contributions of capital from individual funders via the internet -- is a burgeoning phenomenon. We focus on two forms of crowdfunding that are especially fit for financing innovative start-ups, ‘reward’ crowdfunding and ‘equity’ crowdfunding. In the former, individuals contribute money in exchange for a reward - generally a new product, in the case of technology companies; in the latter, crowdfunders get an equity interest in the funded venture. We first contrast these two forms in terms of the risk crowdfunders bear, the motivations that may lead them to invest, and the potential for irrational herding behaviour. The comparison allows us to highlight the promise of reward crowdfunding and the perils of equity crowdfunding from the standpoint of the investing crowd. A comparison between retail investing at the IPO stage and equity crowdfunding further expose the riskiness of the latter, given the absence of most of the institutional mechanisms that have developed in decades to protect investors in the former, including securities regulations. After describing the legal regime (proposed or in place) in two sample jurisdictions, the US with its tradition for high-cost, high-protection securities laws that will have to be tweaked to make equity crowdfunding viable, and the UK, which has early on provided for a nimble set of rules for the same, we conclude with some tentative thoughts on the merits of introducing a lighter regime for equity crowdfunding and what its features could be.

Professor John Armour is the Hogan Lovells Professor of Law and Finance at Oxford University, and a Fellow of the European Corporate Governance Institute. He was previously a member of the Faculty of Law and the interdisciplinary Centre for Business Research at the University of Cambridge, and has held visiting posts at various institutions including the University of Chicago, Columbia Law School, the University of Frankfurt, the Max Planck Institute in Hamburg, and the University of Pennsylvania Law School. Armour has published widely in the fields of company law, financial regulation, and corporate insolvency. His main research interest lies in the integration of legal and economic analysis, with particular emphasis on the impact on the real economy of changes in company law, corporate insolvency law and financial regulation. He serves as an Executive Editor of the Journal for Corporate Law Studies and the Journal of Law, Finance and Accounting, and has been involved in policy-related projects commissioned by the UK’s Department of Trade and Industry (now BIS), Financial Services Authority (now FCA) and Insolvency Service, the Commonwealth Secretariat, and the World Bank. He currently serves as a member of the European Commission’s Informal Company Law Expert Group.

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